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REAL ESTATE MONITOR

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BDO REAL ESTATE AND HOSPITALITY SERVICES PRACTICE

BDO's Real Estate and Hospitality Services practice consists of multi-disciplined professionals, well-versed in compliance and consulting matters. Our professionals have many years of experience in financial reporting and accounting, tax and auditing issues and are continually updating their knowledge and, therefore, are dedicated to giving timely and accurate advice.

FINANCING: THE PURCHASE MONEY MORTGAGE

By Stuart Eisenberg

THE PURCHASE MONEY MORTGAGE (PMM) CONTINUES TO BE A STAPLE OF REAL ESTATE FINANCING BECAUSE IT CAN SATISFY A VARIETY OF NEEDS FOR BOTH BUYER AND SELLER.

For the buyer, a PMM can be a primary source of financing (eliminating the need to negotiate for a mortgage with a third party) or a secondary source of financing (enabling the buyer to take advantage of an assumable first mortgage on the property). For the seller of real estate with an assumable mortgage with desirable terms, a PMM may enable the seller to obtain a higher selling price. The seller also may view a PMM on sound property to be a desirable investment, providing a higher return than that obtainable if cash proceeds are to be reinvested. Finally, a PMM may have tax advantages to the seller, enabling gain to be recognized only as installment payments are received.

Notwithstanding the possible benefits of a PMM, both parties must negotiate with care. For the seller, the mortgage must impose sufficient restrictions on the buyer to protect the seller against deterioration of the property. For the buyer, the mortgage must not be so restrictive as to interfere with the buyer's

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THE PURCHASE MONEY MORTGAGE

intended use or his ability to deal with changes in economic conditions or the physical state of the property. These considerations are even more important when the PMM (1) as often is the case, is subordinate to an existing mortgage; or (2) will be subordinated to future financing (usually the case when new construction is contemplated).

Before agreeing to take a subordinate position, the seller should be aware of one key fact: any monetary default under the senior debt that is not cured by the new owner must be cured by the seller in order for the latter to protect the junior mortgage. Assuming the seller is satisfied in this respect, the seller must then consider what conditions must be satisfied in order for him/her to agree to taking a subordinate position.

▶INSTITUTIONAL LENDER

The seller should seek to limit subordination only if the senior lender is a bank, insurance company or other institutional lender. Such lenders are likely to be more amenable to a workout plan if a default occurs, rather than seeking a foreclosure that would wipe out the junior debt. Institutional lenders not only are better able to withstand temporary financial setbacks, they also often lack the desire to become owners of property, whereas a private lender may be more likely to take this course.

▶DEBT COVERAGE RATIO

The purchase-money seller may condition subordination only to senior debt that requires a constant annual payment in excess of a designated ratio to net operating income (NOI). For example, the seller may require the debt coverage ratio (DCR) to be no lower than 1:5 to 1. In other words, for every $1.50 of NOI, no more than $1 can be devoted to debt service of the senior debt. This gives the purchase-money seller some assurance that a sufficient cash “cushion” remains after paying debt service on the senior loan to pay the junior loan as well.

▶AMORTIZATION PAYMENTS

A junior purchase-money seller anticipates that his or her security position will improve over time as the senior debt is amortized. However, if the senior lender can grant a moratorium or reduction in amortization payments for several years for one reason or another, the junior lender may be unhappy with the senior lender’s decision. To avoid this, the purchase-money seller should seek to include a covenant in the PMM that all amortization payments be made according to the original terms of the senior loan, unless the purchase-money seller consents to a change.

▶NOTICE OF DEFAULT

An important protection that should be sought by the purchase-money seller is a covenant obligating the buyer (1) to give the seller notice of any default of the senior debt and the opportunity to cure such default; and (2) to exercise the buyer’s best efforts to have such a notice requirement inserted in the senior mortgage instruments. In the event that the new owner is unsuccessful in having the senior lender consent to such obligation, an alternative approach is to obligate the new owner to deliver to the seller (prior to the expiration of the grace period) proof of payment of all monetary obligations. It should be clear that any payments made by the seller to the senior lender will be added to the outstanding balance of the purchase-money loan.

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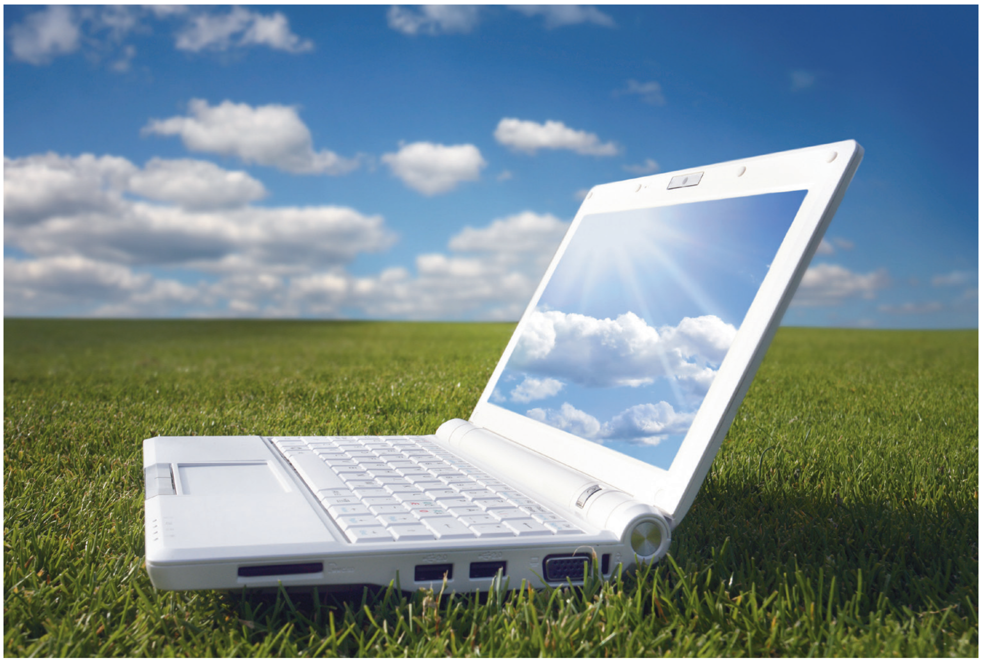
MIGRATING TO THE CLOUD – TIME TO TRADE-IN?



By Wing Leung

BY NOW, YOUR TRAVELS DOWN THE INFORMATION SUPER-HIGHWAY MAY HAVE LEFT YOU WORN AND WEARY AND YOUR EQUIPMENT MAY BE SHOWING ITS AGE.

On occasion, it may have even left you stranded, leading you to be skeptical of the reliability of your formerly trusty system. Maybe your needs have moved on as your organization grows and your equipment is simply not keeping up. Everywhere you turn you see advertisements and endorsements to trade up to the "cloud" that promises accessibility, low cost and low maintenance. Could it be too good to be true?

Cloud computing and storage relocate data and programs to a warehouse of servers and hard drives that are physically located away from the final user's location, but still provide accessibility virtually anywhere there is an Internet connection. Third-party providers claim using the cloud is less costly and less complicated because it has the ability to combine computer resources without the need to build, maintain and store equipment.

Clouds also provide an organization the opportunity to reduce the physical space needed to house the IT staff, equipment and software. Instead of having multiple software licenses across offices, an organization can reduce the number of software licenses it needs if the program is centrally located in the cloud. Whereas a Virtual Private Network (VPN) provides secure data transmission, a VPN does not provide the ability to run software remotely. In terms of disaster recovery, a company may be able to reduce its backup procedures if it can rely on the cloud provider's backups. Cloud providers also claim to be an environmentally friendly alternative to in-house data retention.

With all the positives the cloud offers, it is important to consider the negatives. Accessibility is a double-edged sword. Failures in connectivity will prevent users from performing tasks that are reliant on programs and data located in the cloud. Broadband providers charge based on bandwidth used. Companies that put their data in the hands of third-party cloud providers are susceptible to weaknesses in the provider's internal controls and security from outsiders. Placing data in a public cloud leaves confidential and proprietary data at risk for electronic break-ins. The longevity of the provider should also be of concern. Just over a year ago, Iron Mountain, a data management provider, announced it will exit the cloud storage arena. A company-owned cloud, while still providing accessibility, may not yield cost savings compared to a third-party cloud provider.

Additional considerations:

- What do your users need from your IT system?
- How does the provider secure information? What type of encryption is used?
- Is your data physically safe at the provider? How often and where is data backed up?
- Is logical access safeguarded at the provider?
- What is the experience of the cloud provider?
- Assess findings from the cloud provider's recent SSAE 16 report (on controls placed in operation and tests of operating effectiveness).
- User rights should be limited commensurate with their roles. Property managers should have read-only access to lease agreements.
- Consider client confidentiality for property managers and other service providers. Do your clients permit or prohibit storing their data in the cloud?
- Organizations with multiple platforms should select a cloud provider that services the operating systems used.
- Would a hybrid model versus a public or private model work better in your organization?

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TYPES OF REAL ESTATE OWNERSHIP

By David Tevlin

WHEN BEGINNING A REAL ESTATE VENTURE, THE FIRST DECISION TO MAKE IS WHAT TYPE OF ENTITY WILL OWN THE PROPERTY AND CONDUCT THE ENTERPRISE. THE DECISION IS IMPORTANT BECAUSE OF THE SIGNIFICANT DIFFERENCES BETWEEN THE AVAILABLE OWNERSHIP OPTIONS.

1. **Individual ownership (sole proprietorship).** The simplest and most common form of ownership is ownership by an individual.

2. **Concurrent ownership.** Here, two or more individuals share ownership of real estate by "undivided interests." Each owner owns a designated percentage (an undivided interest in the whole property).

3. **General ownership.** These include three forms of artificial ownership: partnership, corporation, and trust. This is by far the most commonly used option because of its significant tax advantages. The generic form is the general partnership in which all partners essentially have equal liability and equal responsibility.

4. **Limited partnership (limited liability company).** A major evolution of the partnership form has been the invention of the limited partnership. This in essence is a general partnership modified in order to provide "corporate-type" insulation for those partners designated as limited partners. Because it combines the benefits of both the partnership and the corporate forms of ownership, this type has become the standard form for public investment in real estate. More recently, the limited liability company (LLC) has become popular for the same reasons.

5. **Joint venture.** This type takes the form either of a general or limited partnership. The two forms are distinguished in an investment sense. Whereas a general or limited partnership is intended to have a relatively long life and encompass several transactions, the joint venture usually is formed to achieve a specific investment over a limited period of years.

6. **Regular C corporation.** The regular corporation is the standard form of ownership for business operations because it offers the benefits of limited liability and ease of management. It is known as a "C" corporation because the tax rules governing it are contained in Subchapter C of the Internal Revenue Code. This form is less suitable for real estate operations, because the key concern in a real estate context is the avoidance of double tax rather than ease of management or insulation from liability (which can be achieved in other ways).

7. **Subchapter S corporation.** So-called because it is governed by tax rules in Subchapter S of the Internal Revenue Code, this form has a partnership-type feature, namely the elimination of the corporation of a separate taxable entity. Thus the S corporation is to the regular corporation as the limited partnership is to a general partnership. As a result, the S corporation is a much more likely choice for real estate ownership than the regular corporation, although in a number of ways it differs from the standard limited partnership.

8. **Real estate investment trusts.** The REIT is a specialized form utilized for public investment in real estate. It is equivalent to a mutual fund that holds stocks or bonds.

9. **Land trust and personal trust.** These specialized forms of ownership are sometimes used to meet specific needs.

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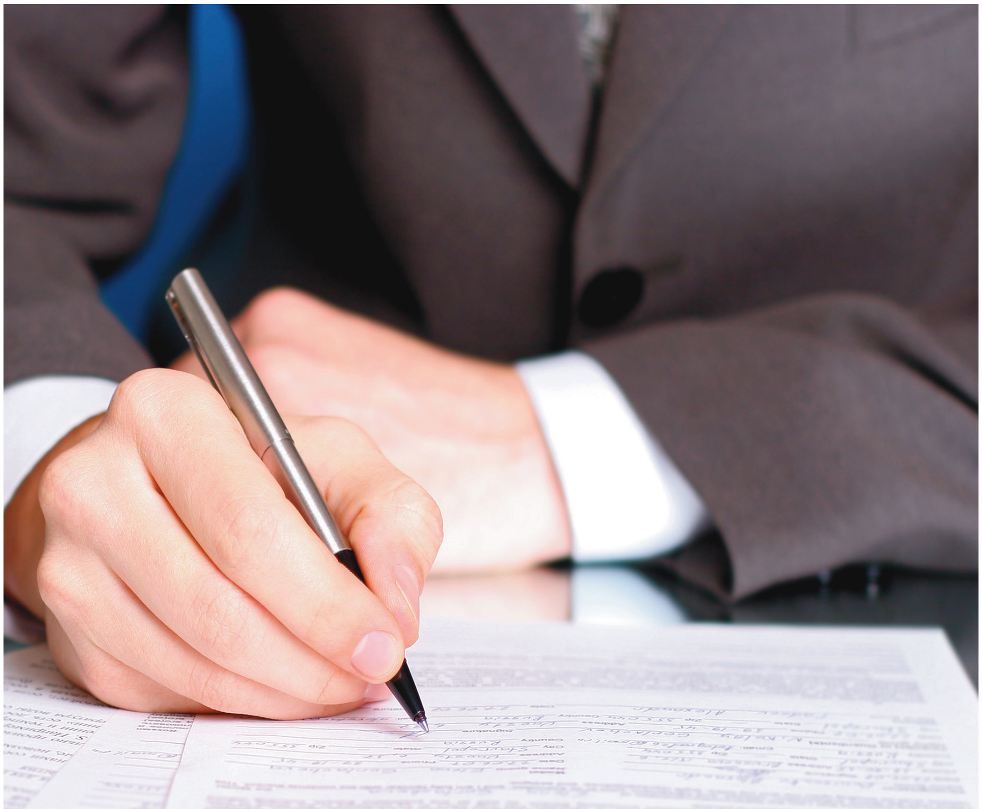
MORTGAGE GUARANTORS GUIDELINES

By Brian Bader



IN A WEAK AND UNCERTAIN ECONOMY, A BUYER SEEKING A MORTGAGE OR AN OWNER SEEKING TO REFINANCE A MATURING LOAN WHO LACKS STRONG FINANCIALS MAY BE REQUIRED TO PROVIDE SOME FORM OF CREDIT ENHANCEMENTS – MOST OFTEN A GUARANTY – TO ASSURE THE BORROWER'S PROMPT PAYMENT OF DEBT SERVICE AND COMPLIANCE WITH OTHER REQUIREMENTS SET FORTH IN THE MORTGAGE.

When a guaranty is given, the guarantor often will be the parent corporation or an officer, director or major shareholder of the corporate borrower, or a high-credit individual partner of a partnership.

While the primary objective of the lender is to have recourse to a third party in the event of a default, the lender also seeks to ensure that the guarantor will be actively involved in the transaction for which funds are being sought. Such guarantors are likely to devote time and effort to the transaction, thereby increasing the chances of success. Furthermore, if problems arise, a guarantor may be willing to provide additional capital in order to prevent a default and avoid the need for the lender to invoke the guaranty. The guarantor, on his or her part, is primarily interested in minimizing any personal exposure. Accordingly, the parties may engage in some strenuous negotiating in order to structure a guaranty that will satisfy both parties. Two of the forms a guaranty can take are described below.

▶GUARANTY OF PAYMENT AND COLLECTION

A guaranty of payment is an absolute obligation to pay the borrower's debt when it becomes due if the borrower fails to do so. The lender need not exhaust his remedies against the borrower or look to any other party before seeking satisfaction from the guarantor. Conversely, a guaranty of collection requires the lender to establish the debt cannot be collected from the borrower before the guaranty can be enforced. Typically, this means the lender must first seek to collect from as many assets of the borrower the lender can reach. (A guaranty generally will be treated as a guaranty of payment, rather than of collection, unless specified in the guaranty itself. However, a cautious lender should insist a guaranty expressly provide that the guaranty is one of payment.)

▶REVOCABLE AND IRREVOCABLE

An irrevocable guaranty cannot be withdrawn by the guarantor until it expires in accordance with its terms (usually when the borrower has paid or otherwise fully performed his obligations). A revocable guaranty can be terminated by the guarantor at some earlier point, usually upon the occurrence or non-occurrence of a certain event. An example would be the lender's failure to satisfy an obligation under the loan agreement (such as to advance funds in a certain amount or on a certain date).

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FINANCING: CARVE-OUT PROVISIONS

By Alvin L. Arnold

TIME WAS WHEN LOAN DOCUMENTS RARELY "CARVED OUT" EXCEPTIONS TO A LENDER'S WILLINGNESS TO WAIVE ANY PERSONAL LIABILITY OF THE BORROWER IN THE EVENT OF A DEFAULT.

This meant the lender could look solely to the property in the event of a default. From the lender's point of view, this appears satisfactory during times when real estate values are rising. But during a period of recession, lenders risk incurring significant losses when properties are foreclosed or taken in lieu of foreclosure. Lenders then also can incur losses because of the failure of the borrower to pay real estate taxes or insurance premiums.

▶PURPOSE OF CARVE-OUTS

Carve-outs in non-recourse loans generally address losses caused by circumstances controlled or permitted by the borrower, as distinguished from losses due to general economic conditions, such as a decline in property values, defaults by tenants or other circumstances beyond the control of the borrower. Of critical importance is whether a breach of a specific carve-out will make the borrower liable for payment of the entire loan or only for losses sustained by the lender as a result of the specific breach.

▶CARVE-OUT RELATING TO WASTE

The concept of "waste" refers to the deliberate or negligent acts or omissions by a person in possession of real estate that reduces the value of the property to the detriment of the mortgage lender, or one holding a future interest in the property. A non-recourse lender may require the loan documents to include a specific carve-out relating to waste. In 1994, the U.S. Court of Appeals for the Second Circuit held that non-payment of real estate taxes constituted waste, entitling the lender to recover distributions made to limited and general partners of a borrower equal in amount to the unpaid real estate taxes. The court ruled such distributions to be fraudulent under the New York State Fraudulent Conveyance Act. The court so ruled even though the loan documents contained no carve-outs. ((Travelers Ins. Company v. 633 Third Associates, 114 F.3d 144 (2d Cir. 1994)).

▶MOST-USED CARVE-OUTS

- Sale or transfer of a significant ownership interests in the borrower without lender approval, the lender being concerned about the experience and integrity of the borrower

- Placing any junior liens or encumbrances against the property. A junior lien that is recourse or that causes the property to be overburdened by debt service will be unacceptable to the non-recourse lender. When operating income dwindles the borrower is more likely to make payments to a recourse junior lien holder than to the prime lender.

- Environmental remediation costs and expenses. The carve-out provision here must enable the lender to recover remediation expenses to the extent that remediation is a reasonable alternative to the lender. If remediation is too expensive or fraught with too many risks and uncertainties, the lender is likely to seek recovery of the entire loan indebtedness from the borrower and other responsible parties.

- Material fraud on the part of the borrower in the loan application or other documents

- Failure to insure or properly apply insurance proceeds or condemnation awards in accordance with the loan documents

- Waste, including unpaid real estate taxes or lack of reasonable care or management

- Failure to discharge mechanics' liens or other liens senior to the prime lender's lien

- The lender should have the right to name the borrower in any action to enforce the mortgage lien or security interest or to pursue any remedy other than obtaining the monetary judgment against the borrower. In some jurisdictions, it is essential that the lender name the borrower in either foreclosure or receivership proceedings even though the loan is made on a non-recourse basis.

- Failure of borrower to enforce obligations under leases so long as the property generates sufficient revenue to enable borrower to do so after payment of debt service and normal operating expenses

- Failure to comply with laws and regulations applicable to property

- Failure to reimburse lender for all costs, including attorney fees, incurred by lender as a result of a breach of any covenant by borrower

- Failure of borrower, guarantor or others to fully pay and satisfy the obligations under any separate guaranty agreement, including indemnity agreements pertaining to hazardous substances and materials.

By Alvin L. Arnold, editor, Real Estate Monitor, New York office of BDO USA. He can be reached at 212-885-8235.

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