

# Real Estate Monitor

**Financing:**

Rating Mezzanine Loans .....1

**Owning Real Estate:**

The Joint Venture.....2

**Wind Farms:**

Not Just Hot Air.....4

**Mortgage Securities:**

What is Happening?.....4

**Form of Ownership:**Partner and Co-Tenant  
Distinguished.....5**Purchase and Sale:**

Flipping the Contract.....6

**Financing:****Rating Mezzanine Loans***By Stuart Eisenberg, CPA*

In the past decade, mezzanine lending has grown from a somewhat arcane form of junior financing to a primary role both in non-securitized lending and particularly in commercial real estate (CRE) collateralized debt obligations (CDOs). Their important role is emphasized in a new report by Moody's Investors Service titled "Moody's Approach to Rating Commercial Real Estate Mezzanine Loans."

**The Role of Mezzanine**

Pre-mezzanine real estate financing consisted primarily of a first mortgage equal to 65 to 75 percent of the property's value and if additional financing was required, by a junior mortgage for an additional 15 or 20 percent. Junior mortgages are not favored by primary lenders because a junior mortgagee is likely to raise legal obstacles to the senior lender's remedies in the event of default. This led to the use of the mezzanine loan that has no claim on the underlying property itself but is secured by a pledge by the borrowers of their equity. For example, if the property is owned by a partnership, the partners can pledge their interests as security for the mezzanine loan. Thus, the mezzanine lender would have no claim against the real estate itself in the event of a default.

**Growth of Mezzanine**

CRE mezzanine debt placed in CRE CDOs increased from just under \$26 million in 2004 to over \$3 billion in 2006. Says Moody's, mezzanine loans now have their own capital market outlook and Moody's rates them in their own right, not viewing them only as an impediment to higher ratings on the senior debt (although they remain so to some degree).

While a mezzanine loan can be long or short term, amortizing or standing and with a floating or fixed rate, most are relatively short term, interest-only

floating rate transactions. A small but growing number, however, are fixed rate debt that matches the term of the senior loan. Most are at the bottom of the debt stack and receive below- investment-grade shadow ratings.

In this respect, mezzanine is akin to B-notes. However, the mezzanine holder lacks any pledge of ownership interest in the property, as noted above. Moody's expects that all of the beneficial ownership interests in the property-owning entity will be pledged as collateral for the mezzanine loan so that any foreclosure of the loan will result in a transfer of all the equity interests, leaving behind no minority interest. Complete control of the property owner is crucial since a pledge of partial ownership interests opens the door to many imponderable legal, structural and credit risks and claims.

### Balloon Maturity

Most real estate loans have balloon maturities (i.e., when the loan matures it has not yet been fully repaid). Moody's prefers both loans to mature at the same time. The balloon date of the senior loan is a natural "break point" when borrowers will be making an all-out effort to "restack" the debt. The major financing sources now prefer "one stop shopping" and "the convenience of refreshing all buckets at once becomes a credit positive." Moody's believes that the inter-creditor agreement (between senior lender and mezzanine lender) probably produces a more favorable result for the mezzanine lender when both loans are originated at the same time.

### Inter-creditor Agreements

The success or failure of a mezzanine loan may depend upon the terms of the inter-creditor agree-

ment with the mortgage lender, since the mezzanine ultimately has only the right to step into the shoes of the borrower in the event of problems. Typical provisions include the following:

- The senior lender must give notice to the mezzanine lender of any default under the senior loan together with the opportunity to cure following expiration of the senior borrower's cure period.
- Amendments to the senior loan documents require the mezzanine lender's consent.
- The mezzanine lender has the right to assign its interest without the senior lender's consent.
- The senior lender will take no action if the borrower defaults under the mezzanine loan (i.e., no cross-default provision in the senior loan documents).
- The senior lender's consent is not needed to enforce the mezzanine lender's rights under the equity pledge.

### Mezzanine Loan Limitations

The mezzanine lender must recognize that a lien does not touch the real estate itself nor does it relate back to the date of the loan. It merely gives the lender the right to step into the borrower's current (and likely troubled) position as it exists at the time of the mezzanine loan foreclosure. By contrast, the real estate mortgage remains the most powerful lender-friendly instrument.

The mezzanine lender's position after foreclosure, says Moody's, "is subject to whatever a borrower in its wisdom or foolishness—or disregard of promises—may have done to the real estate asset." The borrower might even sell the underlying real estate asset from under the mezzanine lender and misapply the

proceeds or give a deed in lieu of foreclosure to the senior lender.

One way for the mezzanine lender to protect its interest is to obtain UCC insurance from one of the major title insurance companies. Such insurance insures the lender's security interest for enforceability, priority, perfection and attachment of the equity collateral. It also insures against fraud and forgery. Also available to the mezzanine lender is a form of title insurance called "mezzanine financing endorsement."

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## Owning Real Estate: The Joint Venture

By Dan DiTieri, CPA

The joint venture, a popular form of ownership of real estate, differs from its close cousin the partnership in one significant respect: Joint venturers join together for a specific project rather than for an ongoing business relationship. The limitation to a single project has the advantage of assuring each joint venturer that any losses will be limited to the funds put up for the specific project. A joint venture, however, is not a legal entity and must take the form of a general or limited partnership (most often) or as a corporation, trust or tenancy-in-common.

Whichever the legal format, the joint venture agreement should specify the precise powers of each joint venturer. Further, the limitation should be made known to third parties so they are aware of any the restrictions on a joint venturer's right to represent the venture. Otherwise, the remaining venturers may be treated as general partners subject to claims made against the joint

venture assets from acts of an individual joint venturer.

### **Tax Status**

Joint ventures are treated as partnerships for income tax purposes. Since they are not taxpaying entities, they act as mere conduits and the income tax consequences of the operations pass through to the joint venturers, giving them the benefit of immediate write-offs of any taxable losses the venture may generate. (Losses, however, may be subject to the passive income rules of the tax code).

### **Key Provisions in Agreement**

A properly drafted purpose clause in the joint venture agreement should describe the proposed venture in some detail. This is particularly important if the venture's legal form is a limited partnership, since limited partners, without the right to participate in management, have no other effective way to restrain the operating partner who might change the venture's scope at a later date.

The joint venture agreement should specify a commencement date and the duration of the venture. Without these specific terms, the agreement can be considered to be "at will," in which case any venturer who acts as a general partner would have the right to terminate the venture at any time. Since under the Uniform Limited Partnership Act (ULPA), a limited partner can withdraw capital on six months' notice unless the partnership agreement provides otherwise, a joint venture in the legal form of a limited partnership should not permit this to be done.

### **Capital Contributions**

The joint venture agreement should specify the contribution of each venturer and the time or (times) of the

contribution. Each venturer is credited with a capital account equal in value to the amount of the contribution. The operating partner, who may be a developer, real estate operator or real estate broker, often contributes services or property rather than cash. If property is being donated, the status of zoning and environmental issues should be determined as well as the feasibility of the intended project.

All co-venturers will be expected to share in any existing liabilities and obligations. However, they should agree to assume only known obligations and require the operating partner to indemnify them against undisclosed obligations.

### **Additional Capital Contributions**

During the life of the venture, it often is necessary to raise additional capital. Who will advance the funds? An obvious answer is that each partner will contribute in proportion to his original capital position. However, since it is often the case that some are "money partners" while others contribute property or expertise, the former may be the only ones in a position to advance the additional capital. Additional cash contributions can be treated either as loans to be repaid before any equity distributions or as additional equity that increases that partner's percentage interest.

### **Distributions**

The joint venture agreement should carefully define "net cash flow," which is the cash that will be available for distribution. Cash flow normally arises either from operations or from a special event such as a loan refinancing. Operating cash flow often is distributed automatically according to an agreed-upon formula. Distributions from a spe-

cial event can either be distributed or be reinvested in the project, with the decision being made by all of the partners or the managing partner.

### **Mortgage Financing**

A real estate venture almost always assumes that a mortgage loan will be obtained. Ideally, a mortgage loan commitment is obtained at the time the joint venture is organized so it is clear how much equity capital will be required. If the money partner is providing funds in the form of a loan in addition to an equity contribution, the venture agreement should carefully distinguish between his role as lender and investor.

### **Voting Powers**

Each joint venturer should be allocated a percentage interest representing his or her cash (or other) contributions to the venture. Management decisions can require a majority vote or some other designated percentage of the total vote.

### **Management of Venture**

Unless otherwise provided in the joint venture agreement, all members of a general partnership (or all the general partners of a limited partnership) have equal rights in managing the venture. In a two-party venture, unanimity may be required. However, it is frequently the case in a multiparty venture that a management committee is established that has the right to make decisions on a majority or other percentage vote.

The right of a venturer to transfer his interest often is subject to conditions. For example, the other venturers may have the right to approve any transfer, subject to reasonable standards. Alternatively, the other venturers may have a right of first

refusal to be triggered by a bona fide offer from a third party to one of the venturers or by the venturer's offer to sell to his interest to the remaining partners or to a third party.

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### Wind Farms: Not Just Hot Air

*by Anthony La Malfa*

The U.S. wind energy industry boosted its capacity to an estimated 11,603 megawatts (mw) in 2006, a 27 percent increase over the prior year. One mw of wind power produces enough electricity to serve 250-300 homes on average each day, so current facilities can serve approximately 2.9 million homes. Says the American Wind Energy Association (AWEA), this clean source of energy displaces as much as 2.3 million tons of carbon dioxide emitted by traditional energy sources. For this reason, the federal government and many states offer tax incentives to increase the use of wind farms.

The Production Tax Credit (PTC) for wind and other renewable energy projects provides a 1.9 percent per kilowatt tax credit for electricity generated over the first 10 years of a project's operation. The credit will expire at the end of 2008 and there is concern that it will not be renewed. Construction costs for wind-powered electric generators are much higher than for fossil fuel plants (cost per megawatt capacity is \$1.5-2 million for wind versus \$700,000 for natural gas), and by one estimate, the extension of the credit from 2006 to 2007 cost the U.S. Treasury \$2.75 billion. That number is likely to mushroom as the industry continues to grow.

### Farmland Benefit

Wind farms can revitalize many rural communities, since a single wind turbine on a wind farm can earn up to \$4,000 annually per megawatt even though only 2 to 5 percent of the land within the wind farm boundary is actually used for turbines and access roads. Wind power plants also can be a valuable source of tax income for local governments and also as a source of employment.

The five states having the most potential for wind energy projects are North Dakota, Texas, Kansas, South Dakota and Montana. However, according to the AWEA, 16 additional states together have the potential to generate 50 or more billions of kilowatt hours. In one case, a 120-square mile wind farm is planned, which would be the largest in the world. More typically, 30 or more acres are required for a project because of the wind's unpredictability.

### Private Investors

The largest investor in wind farms in the United States is the FPL Group, Inc., one of the nation's largest providers of electricity-related services. Wind now represents 12 percent of the FPL Group's diversified energy portfolio, and it is growing along with natural gas and nuclear. The company was responsible for one third of the nation's new construction of wind power installations last year.

A typical large wind project can draw many players. Primarily responsibility lies with the developer, who negotiates with a landowner for the right to "harvest the wind" above the land and place a turbine on a small plat of land, typically less than one acre. According to the AWEA, leasing the right to harvest the wind over a farm can more than double the annual

net income from cultivation or grazing. A developer also must find financing, secure a contract with a utility to buy the electricity produce, purchase the necessary equipment and arrange to have it installed.

### Wind Turbines

Wind turbines come in a variety of sizes, depending upon the use of the electricity to be generated. A large utility-scale turbine might have blades 40 meters long, meaning the diameter of the rotor is over 80 meters—nearly the length of a football field. A turbine is mounted on towers as much as 80 meters tall and can generate 1.8 megawatts of power—enough electricity for 600 homes. Total cost can be more than \$1.5 million.

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### Mortgage Securities: What is Happening?

*By Brian Bader, CPA*

Are we now in a new world of constantly rising values for real estate supported by constantly rising cash flows? Or are optimistic predictions as to future income growth merely a rationalization to justify constantly rising real estate prices (as well as prices for other assets). In a report titled "US CMBS and CRE CDO IQ 2007 Surveillance Review," Moody's Investors Service asks: What is really happening in the market for mortgage securities?

### The Missing Upside

Moody's assessment of property performance normally includes a reasonable allowance for the normal fluctuations in operations (i.e., vacancy rising and falling). Furthermore, mindful that vacant space is

not to be valued at zero, Moody's seldom downgrades an issue unless property performance is meaningfully below initial expectations. This reflects the fact that loans placed in fixed-rate mortgage conduits are initially performing around peak levels, hence the borrower's desire to arrange long-term financing to capitalize on this circumstance. At the same time, the normal expectation is that a property's performance will gradually improve while the loan is gradually amortized, thus creating an upside in quality.

However, says Moody's, in the new world of underwriting, more and more upside is being taken into account up front, sometimes to the point where the in-place DSCR (debt service coverage ratio) is well below the underwritten DSCR. (The DSCR is the ratio of net operating income to annual debt service; thus if NOI is \$10,000 and annual debt service is \$6,000, the DSCR is 1.66. The higher the DSCR, the less likelihood there is of a default.) Thus, if the initial DSCR already anticipates future improvement in performance, future upside is less likely and the risk of future default is increased.

### Upgrades Continue Strong

Notwithstanding the above, during the first quarter of 2007, upgrades continued to outpace downgrades. In 102 securitizations with 1,201 CMBS classes, Moody's made 919 affirmations and confirmations, 251 upgrades and 31 downgrades. For the investment-grade classes, upgrades exceeded downgrades by a wide margin of 229 to 7. For below-investment grade classes, upgrades and downgrades were fairly evenly split (22 to 24). Roughly 76 percent of the classes were unchanged.

### What about the B Players?

The B-piece players who buy the lowest-rated tranches are supposed to "police" the market, throwing out bad loans from the package in a CMBS or CDO. But the policing appears to be becoming less effective because of the many financial options that B players have to otherwise minimize their risk. As one commentator noted, the B players are increasingly hedging their positions or transferring weakening holdings to the CDO market, thus reducing their exposure to loss (and so giving them less inducement to kick out bad loans). Offsetting this to some extent, is increasing scrutiny of the commercial debt markets by the rating agencies. For example, Moody's has announced it will increase its subordination requirements after many years of loosening them.

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### Form of Ownership: Partner and Co-Tenant Distinguished

*By Robert Klein, CPA*

Tenancies-in common (TICs) have become popular as a way for a relatively large group of investors—usually unknown to each other—to exchange individual properties for a TIC interest via a tax-deferred 1031 exchange. Much more common, however, is for two or three friends, or business associates to combine funds to buy a piece of real estate without entering into a formal, written agreement. Are they co-tenants or partners? The guidelines followed by the IRS in deciding the form of

ownership for tax purposes are discussed below.

A Treasury Regulation says that whether an organization will be viewed separate from its owners (e.g., a partnership) for federal tax purposes is a matter of federal law regardless of its characterization under local law (§301.7701-1(a)(1)). The next paragraph of the Regulation states that a separate entity exists for federal tax purposes if co-owners of an apartment building lease space, and in addition, provide services to the occupants either directly or through an agent. But mere co-ownership of property that is maintained, kept in repair, and rented or leased does not constitute a separate entity for federal tax purpose [301.7701-1(a)(2)]. The distinction of whether a partnership exists could be based on the level of services provided.

### Contrasting Examples

In 1975, the IRS concluded that a co-ownership of an apartment building was not a partnership for federal tax purposes. (Revenue Ruling 75-374, 1975-2 C.B. 261.) The co-owners employed an agent to manage the rental units; collect rents, pay expenses attributable to the project, and provide the tenants with customary services in connection with repair and maintenance. Furthermore, the management agent furnished additional services to the tenants; one example was parking, for its own account. The ruling indicated that furnishing customary services in an apartment project will not render co-ownership a partnership. However, furnishing additional services will render the co-ownership a partnership if furnished directly by the co-owners, or through an agent. In the facts of the ruling, the additional services were not furnished by the co-owners, but

by the management company acting on its own behalf.

On the other hand, even if co-owners of property engage in no activity with respect to their property, a partnership apparently will result if they surrender their rights to separately sell their respective shares in the property. For example, assume individuals A, B and C each acquire a one-third interest in a parcel of land. They neither lease the land, nor exploit it by farming, timbering, or mining but merely hold it for future appreciation. They agree the land can be sold upon the vote of two of the three co-tenants, and that no co-tenant has the right to have the land partitioned or to otherwise separately dispose of their interest in the property. On these facts, a partnership apparently results because they have agreed to divide a single profit from the land.

### Planning for Co-Ownership

If two or more persons acquire investment property and wish not to be classified as a partnership for federal tax purposes, each person should take care to establish separate ownership with the right to deal with the undivided interest for his or her own financial benefit. Expenses should be prorated and separately paid if possible. Each co-tenant should separately insure his or her interest.

If property management is delegated to one co-tenant or to an agent, the delegation should be revocable by any co-tenant on short notice (less than one year), and the scope of the delegated authority should be restricted to ministerial duties. Moreover, each co-tenant should retain the right to have the property partitioned, or otherwise be able to dispose of his or her interest in the property. If it is absolutely necessary to inhibit the

co-owners' ability to separately dispose of a share or to require them to follow the will of the majority, first-offer and purchase-option procedures should be adopted.

### Planning for Partnership

Co-owners of investment property might wish to become partners by express intention even though their relationship otherwise might not be deemed a partnership by the IRS. However, this will not be successful if partnership status is sought for a palpable tax avoidance purpose.

For example, if two cash-method taxpayers jointly acquire investment property but conduct no activity with respect to the property and separately reserve the right to take and sell their shares of the property, they are not likely to be considered partners. As co-tenants, each is required to report his share of income and expense with respect to the property. If in order to allocate expenses disproportionately to one co-tenant, they execute a partnership agreement specially allocating the expenses under Code Section 704(b), the IRS may deny partnership status in order to prevent the special allocation.

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### Purchase and Sale: Flipping the Contract

*By Alvin Arnold*

In a strong real estate market, the value of a property can move up sharply upon the announcement of good news. This can be fertile ground for speculators who seek quick gains by trading properties. A popular technique for doing so is the flip contract—that is, entering into a purchase contract with the

seller and then flipping it (assigning the right to buy) to a third party at a higher price. Although on the surface this process seems simple enough, complications could arise that leave the assignor facing an undesirable choice; either closing the purchase contract or walking away with a significant loss.

### Case Study

Assume that Mr. Speculator learns through private sources that a large company is considering the lease of a substantial amount of space in a largely vacant office building. He approaches the owner of the building and negotiates a contract to buy it for \$1 million, \$400,000 cash over an existing \$600,000 first mortgage. Mr. Speculator puts down \$40,000 at contract, agreeing to pay the balance of \$360,000 at a closing in 120 days. The contract has a liquidated damages clause, permitting Mr. Speculator to walk away from the deal upon the loss of the down payment without further liability. The contract permits assignment to a third party.

### Good News

After several weeks, the anticipated good news is announced. Mr. Speculator finds a local syndicate willing to buy the contract, provided that Mr. Speculator is able to obtain second mortgage financing for the \$360,000 cash due at closing. A flip contract (assignment agreement) is entered into between Mr. Speculator and the syndicate. It calls for the syndicate to pay a cash purchase price of \$90,000 to Mr. Speculator simultaneously with the closing of the underlying purchase contract. This amount represents the \$40,000 reimbursement for the down payment plus a \$50,000 profit to Mr. Speculator.

Mr. Speculator is able to obtain from a non-institutional lender a commitment for a discounted second mortgage with a face amount of \$360,000 but to be funded at only \$345,000. Because Mr. Speculator must put up the additional \$15,000 to provide the necessary cash at the closing of the underlying contract, his gross profit is \$35,000 (\$50,000 minus \$15,000 for the mortgage discount).

### Drafting the Flip Contract

In drafting the flip contract under the facts described above, Mr. Speculator and the syndicate should consider a number of issues that fall into two categories: those related to the underlying contract of sale with the property owner and those relating to the flip contract itself. First, the flip contract must have attached to it as an exhibit the original or a true copy of the underlying sales contract, and the assignor must warrant that no changes have been made to the contract and none will be made without the consent of the assignee.

The parties must then specify who will deal with the seller following the assignment. For example, the underlying contract may give the buyer the right to require that any vacant space not be leased (so that the buyer can later negotiate its own leases), provided the buyer agrees to make good any lost rent.

The seller also must be notified of objections to title, any legal violations, or other unfulfilled conditions under the contract. Because the assignee is the true party-in-interest, the right and duty to make decisions on these matters should be the assignee's. However, the

assignor should have the right to step in if the assignee fails to act, to protect the assignor's rights in the event the assignee eventually fails to complete the purchase.

The seller of property normally is not obligated to acknowledge notices from any party other than the assignor unless the seller consented to the assignment. Consequently, the assignor and assignee should agree on a procedure for giving notice; one solution is to have both join in notices to the seller.

The underlying contract may give the buyer the right to terminate the contract under certain conditions (e.g., if the title report contains exceptions not acceptable to the buyer). The flip contract should make clear what will happen if the assignee wishes to exercise the right to terminate the underlying contract and the assignor does not. One solution is to permit the assignee to cancel the flip contract but not the underlying contract. Suppose the seller has the right to cancel if the cost of curing certain violations exceeds a dollar limit and the buyer will not pay the excess. The assignor may insist on having the right to pay in order to keep the flip contract in force.

### Flip Contract Issues

Several negotiating issues arise with regard to the flip contract (assignment agreement) itself. First, if the assignor has certain obligations under the flip contract (e.g., to obtain additional financing, as in the above case study), the consequences should be clear if the obligation cannot be fulfilled. For example, the assignor may be entitled to terminate the flip contract upon

returning any down payment; or may be liable for a liquidated damages payment; or may be liable for actual damages suffered by the assignee (e.g., loss of his bargain).

Second, the flip contract should specify the consequences if the assignee fails to close the underlying contract and the assignor also is unwilling to do so. Normally, the seller of real estate agrees to accept the down payment as liquidated damages. This should be the liability of the assignee. If the seller has the right to any other remedy, the assignor will insist that the assignee be liable for that also. Finally, the assignor should be entitled to all or a portion of his lost profit on the property. Finally, the flip contract should specify the assignor's remedy if the assignee defaults and the assignor decides to close the underlying contract himself.

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