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Real Estate Monitor

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Mortgage Securities:
The Buying Begins

By John Tax

When it comes to restarting the market for mortgage securities, the famous quote by Winston Churchill is appropriate. As World War II began to turn in the favor of the Allies, Churchill said, "This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning." In the case of financial markets, the end of the beginning comes as banks are finding buyers for their underwater mortgages. Most notably, Black Rock. Inc., which has developed a reputation as an expert manager of depressed mortgage loans, has agreed to buy a large portfolio of distressed subprime mortgages, estimated to amount to $15 billion, from UBS AG of Switzerland for 75 cents on the dollar. This gives some hope that the mortgage market might be beginning to recover. An article in the *Financial Times* (May 12, 2008) notes that in previous financial crises, such asset purchases have signaled a possible turning point. This was so in the 1990s S&L loan crisis when bidders began to acquire the assets of the failed institutions.

On the other hand, while some banks appear desperate to eliminate bad loans from their balance sheets and are offering sizable discounts to possible purchasers, there are buyer fears of buying distressed assets too soon and catching a "falling knife." Nevertheless, according to the article, more than 80 funds in the past 10 months have been raising money to buy bad mortgages at a discount. Some finance houses have invested in mortgage servicing groups, which

collect mortgage payments in order to gain expertise in evaluating home loans.

Valuing Distressed Loans

Because of the obvious uncertainty in predicting the full extent of price declines in U.S. home prices, valuing distressed mortgage assets is a very difficult process. In particular, buyers of mortgage debt often cannot make a reasonable determination of future losses because of the lack of historical data for declines as serious as the one that we are in the midst of. In some cases, loan-to-value ratios for subprime mortgages are as high as 100% (i.e., no equity investment by the homebuyers) or even worse, the debt is more than the current value of the property because of the existence of unreported "piggyback" loans at the time the home was bought or declines in the value of the property.

The valuation problem becomes worse with more complex instruments for which no buyers may be available, particularly if these fall under "fair value" accounting rules that require securities to be "marked to market," which in some extreme cases places very low values on an asset or portfolio of assets. As a result, while many buyers are interested in acquiring the distressed assets, there can be a huge gap between bids and offers.

Caution Advised

Little-noticed and artfully drafted terms that govern the rights and remedies of holders of different tranches of collateralized debt obligations (CDOs) have resulted in disputes and litigation between holders. Defined default triggers such as downgrades in the ratings of assets backing bonds may set off contractual provisions creating conflicts between the different tranches, enabling some holders to seize control of assets, income streams, and/or control rights and remedies. Accordingly, in evaluating distressed debt, it is essential to carefully analyze the nature and structure of the loans; the impact of agreements governing rights and remedies between and among borrowers, lenders, lending syndicates, and members of the syndicates; as well as applicable regulatory schemes.

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General Motors Building:
Final Act?

By Anthony La Malfa

Just as the sale of the Pebble Beach Golf Club to Japanese interests in 1998 marked the high point of that real estate boom, so the sale of New York's General Motors Building by Harry Macklowe may signal the same for the current real estate market. Macklowe sold the GM building plus three other New York office buildings to a group led by Mortimer B. Zuckerman, Chairman of the Board of Directors of Boston Properties Inc. Other members of the group included Goldman Sachs and investors from the nations of Qatar and Kuwait.

Macklowe originally bought the GM Building for $1.4 billion, but further increased the debt to about $1.9 billion. The current sale price is $3.95 billion for the entire group of buildings, with the price for the GM Building itself reported as $2.9 billion, the most ever paid for a U.S. office building. Macklowe was noted for saying that no buyer had ever made money operating the GM Building, but only by selling it for a higher price. One reason is that many of its floors are leased by long-term tenants paying below-market rents. (The asking rate is estimated to be about $200 per square foot at the present time.) That means the owner of the building can realize a profit only by selling the building at a higher price.

Excessive Leverage

While Macklowe and his family will remain important property owners in New York City, the story of the GM Building once again is one of excessive financial leverage. After buying the building in 2003, Macklowe doubled his holdings in Manhattan office towers by buying seven office buildings from Equity Office Properties ("Equity") for $7 billion. The purchase was financed with short-term loans, with the intent of replacing them with longer term financing.

Macklowe borrowed $5.8 billion from Deutsche bank and $1.2 billion from Fortress Investment Group (a global alternative asset manager) and thus needed to use only $50 million in cash to close the Equity purchase. Inability to refinance the loans led to the seven office buildings being put up for sale several months ago, but buyers were hard to find. Macklowe may have valued the properties on expected higher rentals in the not-too-distant future while potential buyers viewed current rent levels as likely to continue for some time. After the loans came due, the GM Building was put up for sale as well.

Complex Financing

Complicating the sale of the former Equity properties was the complexity of their original financing. Deutsche Bank had to obtain the approval from as many as 20 smaller investors who bought portions of the Macklowe debt when the

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building was acquired. At least one of the investors, Vornado Realty Trust ("Vornado"), initially had balked on extending the debt when Macklowe was unable to make payments. The reason might have been that Vornado, a cash-rich REIT, was itself interested in acquiring the properties by paying off the other smaller lenders.

Fortress Investment Group, holding a mezzanine position in the financing that was personally guaranteed by Macklowe, also was seeking some benefit from the sale. Both lenders might have been in a position to block a sale unless their terms were met. For their part, the remaining lenders might have been willing to take a role in financing a major acquisition because this might give them access to information that would not be made public and that could be used to their advantage.

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Distressed Property:
Chronology of a Defaulted Loan

By Dan DiTieri

As uncertainty about the economy continues, lenders and investors are well-advised to review the warning signals of a distressed property so that preventive action can be taken. These warning signals frequently appear in some variation of the following pattern:

- Deferred maintenance
- Over-financing
- Rising vacancies and declining rent receipts
- Tax delinquencies
- Default in debt service payments

Deferred Maintenance

The failure to keep an income property in sound operating condition often is the earliest sign of trouble. The best protection is to have the property inspected at regular intervals by a person trained to spot signs of deterioration (e.g., leaky ceilings on a top floor showing defective roof, cracks in bearing walls, rusted metal, etc.). In addition, periodic operating statements from the owner should be scrutinized to identify (and verify, if necessary) repair and maintenance expenses.

Over-Financed Property

An over-financed property is one lacking a "cushion" to protect the lender, i.e., little or no cash remains for the owner after operating expenses and debt service have been paid. In this situation, even a small increase in expenses or decrease in rentals will mean negative cash flow and the risk of default. A property may be over-financed when the loan is made (often reflecting poor underwriting) or may become over-financed as a result of a declining spread between expense and income. Periodic balance sheets listing all debt, together with operating statements, often will signal a potential problem. Calls to the first mortgagee by a junior lender inquiring if debt service is current is a tip-off that payments may be late on junior loans. Another sign not to be overlooked is payment of debt service by checks drawn on unknown or distant banking institutions.

Rising Vacancies and Declining Income

Any indication from operating statements or otherwise that vacancies are rising or that rental income is not keeping pace with rising expenses is cause for concern. This is likely to be due to causes beyond the owner's control. But rising vacancies may be the result of poor tenant selection or physical deterioration, which in turn may reflect deferred maintenance. Such problems may be curable. And if a squeeze on cash flow is due to temporary factors, a lender may be more willing to work out a forbearance program with the owner if debt service cannot be maintained.

Tax Delinquencies

A major sign of trouble is failure to pay real estate taxes on time, particularly when a substantial penalty can be imposed. A lender should never be in the dark about failure to pay taxes; the mortgage should require copies of receipts from the owner 30 days after the due date. Since property assessments often are too high, a lender should seek to be aware of possible tax overcharges and require owners to apply for reassessments in appropriate cases.

Default in Debt Service Payments

A default in a mortgage payment is usually the end of the line. At this point, a lender that ignored earlier warning signals or that sought unsuccessfully to help the owner solve his problems is faced with the question of workout or foreclosure.

Worst Case Scenario

The "worst case" of a problem loan involves a not-overly scrupulous owner of an income property who comes under extreme cash pressure for any one of a number of reasons. Having only small cash equity in the property, the owner decides the time has come for drastic action. The object is to abandon the prop-

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erty after recouping any remaining equity. This goal is achieved by stalling on mortgage payments for three or four months through a number of devices, including late payments, mistakenly "unsigned" checks, and one or more meetings with the lender that fail to achieve any results. During this period, few or no operating expenses are paid, while the owner accumulates the gross rentals, often enough to reimburse equity, at which point the owner walks away from the property. Prompt action by a lender when signs of distress appear can prevent this scenario from occurring.

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Purchase and Sale:
Contingent Installment Sales

By Robert Klein

Installment sales of real estate—whereby a seller takes back a purchase money mortgage—for all or part of the sales price—become more important in markets such as now when bid-offer spreads widen. Sellers seek to benefit from reportedly low cap rates (high prices) while buyers' offers often are based on more normalized valuations. One way to bridge the gap between the different expectations is the contingent installment sale—an "earnout" arrangement that will increase the ultimate sales price if the seller's expectations are realized. Contingent installment sales encompass three different formats:

- Maximum price upon conditions being met during an indefinite payment period
- Indefinite price and fixed payment period
- Indefinite price and indefinite payment period

In all of these cases, the sale is treated as an installment sale for tax purposes, to be reported pursuant to Code Section 453. However, the seller should analyze the benefits of reporting on the installment sale method because the election not to have the provisions apply must be made on or before the due date, including extensions, for filing the return in which the sale occurs. For example, if the seller has losses available to offset the gain, it may be advisable to elect out of installment sale treatment.

In each case above, the method of taxing the gain differs somewhat, as described below. In the following discussion, it is assumed that any interest on unpaid purchase price is paid separately from the payments of principal. If interest payments were to be included, the calculations would be more complex.

Maximum Price upon Conditions during Indefinite Payment Period

Assume a developer and a landowner are negotiating over a parcel of raw land ready for development. Negotiations are at a standstill because the landowner has set a price that anticipates a short development period and an immediate sale or lease-out. The developer realizes that various contingencies (e.g., rezoning, building approvals and construction delays) as well as market conditions may mean a much longer period before the project is successful. One way to resolve the standoff is to enter into a contingency installment contract that sets a maximum price for the land subject to reduction depending upon (1) the type of development that finally is approved; (2) the time needed to complete the development; and (3) the time to sell or lease the finished space.

When a real estate contract provides for a maximum purchase price subject to reduction, without specifying a fixed period for full payment, the seller can report his gain using the installment method. The maximum price set forth in the contract determines the gross profit percentage. If any conditions then occur during the payment period that reduce the price, the gross profit percentage is reduced for the remaining payment years. If the maximum price is reduced to the point where the seller has already reported more gain than he will ultimately receive, the seller recognizes a loss.

Example: Mrs. Smith owns land with a cost basis of $150,000. She sells the land for a maximum price of $600,000, payable in four annual installments of $150,000. However, the price is to be reduced by specified percentages if certain steps in the development process do not occur on an agreed schedule. In these circumstances, the seller treats the sales price as $600,000 so that the gross profit is $450,000 after deducting the cost basis of $150,000. The gross profit percentage is 75 percent ($450,000 divided by $600,000). Assume that the first three payments are made, totaling $450,000. Mrs. Smith then would have realized $337,500 of income (75 percent of $450,000). If at that time, the price is reduced to the $450,000 already paid, Mrs. Smith's actual gain on the sale will be only $300,000 ($450,000 minus $150,000). She then will be entitled to a capital loss of $37,500.

Indefinite Price and Fixed Payment Period

A contingency installment sale also can be used under an "earnout" arrangement. For example, assume Mr. Jones sells his realty brokerage

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firm for a price equal to 25 percent of the firm's profit for each of the next five years. This type of arrangement frequently is used when a buyer agrees to pay a high price based on the seller's representations as to the future earning power of the business or property. Alternatively, this arrangement can be used when the seller will continue to operate the business or property and the buyer wishes him to have the maximum incentive to use his best efforts.

For tax purposes, when a maximum sales price is not set and the price is to be paid over a fixed period, as in the above example, the seller's cost basis is deemed recovered in equal annual amounts over the payment period. If in any year the payments received by the seller are less than the allocable basis for the year, the difference is not deducted as a loss at that time but rather is carried over to the next year. Alternatively, if the payments in any year are more than the allocable basis for that year, the gain is recognized by the seller.

Example: Assume that Mr. Jones' cost basis for his brokerage firm is $20,000 and he is to receive 25 percent of profits for the next five years. He will be deemed to recover his cost basis at the rate of $4,000 per year. If he receives $3,000 in payments in the first year and $6,000 in the second year, the $1,000 "loss," or non-recovered basis, in the first year is carried over to the second year. Thus the seller will have zero gain in year one and a gain of $1,000 in year two ($6,000 received minus $5,000 in basis).

Indefinite Sales Price and Indefinite Payment Period

Suppose the owner of land containing minerals sells the land for a price equal to a percentage of the market price of the minerals removed each year until the deposit is exhausted. Here, both the sales price and the payment period are indefinite. For tax purposes, the seller recoups his basis in the land in equal annual amounts over a period of 15 years. In years when payments exceed basis, the excess is taxable gain. In years when basis exceeds payments, the excess basis amount is reallocated in equal amounts over the remainder of the 15-year period. If any basis remains at the end of the 15 years, it is carried to future years until all basis has been recovered or until payments cease, in which case a loss is allowed.

In this last type of situation, the IRS will closely scrutinize the transaction to determine whether a sale actually has occurred or whether, in economic effect, payments are in the nature of rent or royalty income. (The tax rules for contingent sales are spelled out by the IRS in Temporary Regulations §15A.453-1(c).)

The above examples cover some of the rules contained in the temporary Treasury Regulations for contingent payment sales and installment sales. Taxpayers should consult with their advisors as to applicability. For example, the installment sale method is generally not applicable to real estate dealer dispositions.

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Leases:

Tenant Strategy for Excess Space

By David Tevlin

A weakening economy means many business tenants may seek to cut costs, including rental expense. Since landlords are very reluctant to reduce rent, tenants must consider other alternatives. Two possibilities are a sublease or assignment of unneeded space and a giveback of space to the landlord.

Sublease or Assignment

In the absence of a provision in the lease, a tenant has the right to assign or sublease without the landlord's consent. It is rare, however, for a lease to be silent on the subject. A landlord often takes the position that no consent will be given to a sublease so long as space is available in the building. But a tenant seeking to sublease can make some good arguments for consent.

First, if the market is awash with empty space, a potential sub-tenant is likely to find space elsewhere rather than in the building in question. The landlord is better off having space occupied by a subtenant who may stay in the building after the prime lease expires. Second, permitting the sublease reduces the risk of a default by the present tenant that would lead to a lawsuit or a bankruptcy filing. In addition, the landlord has the additional security of the subtenant's rent. Giving a tenant a green light to shed excess space could pay off when the tenant considers renewal of its present lease. And landlords known for taking a reasonable approach to tenant requests, both during and after lease negotiations, are bound to have an edge when a tenant must choose between similar buildings.

Other Strategies

If a landlord is adamant about refusing consent to a sublease, the tenant should consider some other approaches, such as:

- *Lease buyout*. This is an expensive approach, but unless the tenant

is in the property management business, it may be better to negotiate a lump-sum payment to the landlord for taking back the unneeded space than to sit with the space.

- *Lease extension*. The tenant can try to negotiate a give-back of the unneeded space in exchange for an extension of the term on the retained space. This may be worth doing even if the tenant must pay the unamortized cost of any tenant improvement allowance provided by the landlord at the beginning of the lease as well as return part of any other concessions given by the landlord.
- *Space swap*. If the landlord owns other property nearby, the tenant may be able to make a downscale move to cheaper or smaller space with only a small penalty. The landlord is more likely to do this if the tenant's existing space is readily marketable.
- *Use options*. If negotiations with the landlord result in a new lease, the tenant should seek to negotiate for a shorter initial term with a series of renewal options. This approach may be more acceptable to the landlord in a weak market because it costs the landlord little at this time.
- *Seek generic space*. If new space is being taken by the tenant as a result of any negotiation with the landlord, the tenant should seek generic space, i.e., space that serves the tenant's needs, but with improvements adaptable to other users so that the space will be readily marketable in the future if it becomes excess again.

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Are Brokers Independent Contractors?

By Alvin Arnold

The National Association of Mortgage Brokers, the primary trade group for brokers, takes the position that a broker works neither for the borrower nor the lender. Imposing a fiduciary duty on the broker would increase the risk that brokers might be sued whenever a loan went bad. State legislatures, however, have taken different views on the issue. Minnesota last year passed a statute that specifies brokers have "an agency relationship" with borrowers. An agent has the obligation to act in the best interest of his or her principal. On the other hand, Colorado has rejected such a standard, having passed bills providing that a broker has only "a duty of good faith and fair dealing."

Duty to Borrower

In California, a 1979 decision by the state supreme court established the rule that mortgage brokers have a fiduciary duty, at least in respect to home mortgages. (Wyatt v. Union Mortgage Co.,598 P. 2d 45). In that case, Wyatt responded to a television advertisement by a broker to seek a second mortgage on his home. The loan officer to whom he was referred gave materially misleading information as to the rate of interest, late payments and size of balloon payments. Subsequently, Wyatt defaulted on the mortgage. When a foreclosure action was begun, Wyatt sought to enjoin the foreclosure and sued for damages. A jury awarded Wyatt $200,000, apportioned between eight corporate and individual defendants, including the broker. The California high court upheld the award, ruling that it was a question for the jury whether the broker had violated the obligation of disclosure and good faith toward Wyatt, who was entitled to rely on the broker's expertise, as reflected in his statements.

Duty to Lender

A 1991 decision by a California appellate court held that a mortgage broker can have an obligation to a lender-client as well. (Barry v. Raskov, 23 Cal. Rptr. 463.) In that case, Barry was approached by a mortgage broker who was seeking to place a second deed of trust loan that was a "very good investment" and was "paying safely." The broker told Barry his investment would be guaranteed "100%" and that he would receive a check each month "without fail." An independent appraiser regularly used by Raskov appraised the property at a high figure. In fact, the property was worth far less than the appraisal and Barry never received any payments on his loan.

Barry sued the broker, alleging fraud and breach of fiduciary duty. A jury awarded Barry damages of $55,000. The California Court of Appeals affirmed, ruling that a mortgage broker is liable to the lender for the fraud or negligence of an independent property appraiser hired by the broker. The broker had a fiduciary duty to the lender that extended to an independent contractor (the appraiser) under the rationale that an employer of an independent contractor is held liable for the contractor's wrongdoing. Otherwise, said the court, mortgage brokers could evade their fiduciary duties simply by allocating the duties to unlicensed independent contractors.

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