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Leveraging a Sale:
Case Study

By John Tax

In a depressed real estate market, sellers must be willing to offer inducements to buyers that in "normal" markets would not be contemplated. Such inducements can be viewed as "leverage" in the broadest meaning of that term, i.e., giving something extra to the buyer just as financial leverage in the form of borrowed funds gives the buyer a higher return than in an all-cash deal. The following shows how a "leveraged sales contract" can provide both buyer and seller exactly what they are looking for and allow the transaction to proceed.

Excess Space for Sale

Consider this example: A retail chain undergoing a consolidation sought to sell well-located retail space for a relatively high asking price, all cash. The sale would include an adjacent parcel of raw land. After several months, the property was still available and came to the attention of an investor with experience in retail operations who believed the recession was coming to an end. She was able to negotiate a contract calling for a price acceptable to the seller but with an unusual degree of leverage that made the contract desirable to her.

Terms of Sale

The essential terms of the contract were these:

Purchase price	$400,000
Cash	$100,000
Purchase money mortgage	$300,000

In addition, the contract of sale had the following provisions:
The down payment was to be $10,000 (10% of the cash price) and in the event the buyer failed to go through with the purchase, her liability would be limited to the down payment (i.e., no personal liability).

Closing of title was to take place eight months from the date of contract, with the buyer to have the right to accelerate the closing on 30 days' notice.

The purchase-money mortgage was to be for 10 years at an interest rate of two percent above the prime rate of XYZ Bank. The mortgage would be standing

(no amortization for the entire term). A release clause in the mortgage would permit the buyer to sell the parcel of vacant land separately from the building upon the payment of $50,000 to the seller in reduction of the mortgage. The mortgage also would be pre-payable at any time without penalty.

The buyer was to have the right to market the property during the eight-month contract period. This included the right to put signs on the property, advertise, and give interested persons the right to inspect the property.

If the buyer found a third party who wished to buy the property, the seller would extend the same purchase-money mortgage terms.

Varieties of Leverage

Each contract condition above represented a different aspect of leverage; together, they added up to a satisfactory risk-reward relationship for the buyer, even in a poor market.

- The first provision, 10% down payment as liquidated damages upon default, gave the buyer control of a $400,000 parcel for $10,000)only 2.5 % of the purchase price.
- The second provision, a delayed closing, gave the buyer eight months during which she could arrange a resale or find a tenant.
- The third condition, purchase money mortgage, created traditional financial leverage, particularly at a time when the prime rate was low and trending lower, since this would reduce the already-low interest rate. In addition, the absence of any amortization reduced debt service payments. Finally, the right to sell the vacant land (then worth $100,000) upon payment of only $50,000 in reduction of the mortgage also created a leverage factor. By selling the land for all cash, the original cash investment of $100,000 would be reduced by half.
- The fourth and fifth provisions gave the buyer the right to market the property during the contract period, together with a right to pass along the benefits of the purchase money mortgage to a new buyer.

Why Seller Agreed

From the seller's point of view, there were several good reasons for agreeing to the terms the buyer wanted:

- The seller had been unable to sell or lease the property for several months.
- The contract price was reasonably close to the original asking price.
- The seller was a professional investor with a record of success.

What Happened

After three months of intense effort, the buyer negotiated a 21-year net lease with a retail chain. The tenant would pay all operating costs, but not the debt service on the purchase money mortgage. As an inducement to the tenant, the initial rent was set relatively low, to step up in stages over the first ten years of the lease:

The figures worked out as follows:
Net rental – $60,000
Mortgage interest –
(8.0% of $300,000). $24,000
Net cash flow – $36,000
Cash-flow return on
$100,000 – 36%

The investor in this example could have used a long-term option rather than a sales contract. Two reasons for preferring the contract approach are: (1) an option expires automatically at the end of its stated term, whereas the purchaser under a sales contract has a right to an adjournment for a reasonable time (unless the contract specifies that "time is of the essence"); and (2) a sales contract signed by the parties lessens the likelihood that disputes may arise later as to the terms of the deal or the intentions of the parties.

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Leases:
Negotiating a Space Reduction

By *David Tevlin*

A tenant with excess space due to weak business conditions and with a lease having years to run may be under pressure to reduce rent payments. Had the tenant been able to obtain a space reduction provision in the lease, it could have provided a solution. Even without this, several alternatives may make a downsizing possible. Four alternatives are (1) lengthening the lease term; (2) buying out the remaining lease term; (3) restructuring the lease; and (4) subleasing the unneeded portion of the space.

Lengthening the Lease Term

In a situation where the tenant is happy with the location but only wants to reduce the amount of leased space, the landlord may agree to reduce the square footage in exchange for an extension of the lease term. In a weak market, the tenant should be able to continue rent at the same level or possibly even reduce it. In a tight market, a higher rent might be necessary. (A tight market also may mean the landlord can lease the excess space at a higher rental.).

Buying Out the Lease

A tenant buyout—a cancellation of the lease—may be possible. This

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means the tenant must be prepared to offer a significant sum to the landlord in exchange. The sum payment will reflect the landlord's unamortized costs in preparing the space plus an amount reflecting the risk the space will remain vacant for a period of time or can only be re-leased at a lower rent. Of course, if rents have increased since the lease began, the landlord may be amenable to terminating the lease for a reasonable fee in anticipation of re-leasing the space at a higher rental,

Restructuring the Lease

During an economic downturn or a period of poor business, a tenant may seek cut the rent obligation by one means or another until conditions improve. If downsizing is not an alternative or is not desired, the tenant can seek to renegotiate the lease so that the current rent is reduced but will be stepped up during future years so that the landlord comes out financially whole by the end of the lease term. At a time when new tenants are hard to find, a landlord may agree to such an arrangement in order to retain the tenant. The revised lease may be more acceptable to the landlord if the tenant agrees to extend the term for one or more years.

Subleasing Excess Space

As a final alternative, a tenant can seek to sublease space no longer necessary for its business. However, even assuming the lease imposes no restriction on the right to sublease, a sublease should be considered only when other alternatives are unavailable. A tenant that subleases becomes a landlord and assumes the responsibilities of that position, including marketing and leasing expenses, brokerage commissions, dealing with tenant improvement (TI) costs and overseeing alterations, negotiating the terms of the sublease, and enforcing the sublease in the event of a default by the subtenant. Finally, the tenant prime remains fully liable for obligations under the prime lease.

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Leases:
Co-Tenancy Provisions

By Wing Leung

The current retail recession is causing retailers in shopping centers and shopping malls to take a close look at their leases to discover if they have co-tenancy provisions permitting them to reduce their rent or even cancel their leases if the anchor tenant that generates traffic for the facility closes its doors. One approach reduces the small-store tenant's minimum rent by a designated percentage until a new anchor begins business. As an alternative, the tenant's rent might be a percentage of sales without regard to any minimum.

In some cases, a tenant may have the right to cancel a lease without penalty if a replacement anchor tenant is not found within a designated time. A co-tenancy clause may permit the retailer to pay perhaps half the total rent for a specified period, for example, one year. If no new anchor is found within that time, the lease can be terminated without payment of a cancellation fee (or a new lease can be negotiated).

Small-Tenant Closes

The right to reduce rent or cancel a lease also may apply if a designated percentage of small-store tenants stop doing business at the center or mall. In such a situation, the shopping center may be willing to negotiate a rent reduction over the balance of the retailer's lease term in exchange for adding several years to the lease. According to one study, the average specialty retailer pays 12 percent of sales for rent so that a reduction of 50 percent of the monthly rent can mean the difference between net profit and loss. In the event a rent cut is granted, the center's owner will insist on a confidentiality clause so that other retailers are unaware of the agreement.

New Leases

A retailer entering into a new lease with a retail center should press for a co-tenancy clause in view of the cautious outlook for the economy. If the center's anchor tenant closes shortly after the lease is signed, the new retailer may not have time to build a following. The best provision for the new tenant is the right to terminate the lease. As a practical matter, the best provision a new tenant is likely to obtain is a rent reduction with the right to terminate if a replacement anchor tenant is not in place within a specified time. The landlord will usually require the tenant prove that gross sales have declined by a specified amount before any relief is obtained.

Exclusive and Radius Clauses

One alternative (or addition) to a co-tenancy clause is an exclusive clause. In the event that the landlord fails to comply, the remedy for the tenant can vary from a rent reduction to the right to terminate the lease. In an exclusive clause, the landlord agrees not to lease other premises in the shopping center (or in a specified area) to another

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tenant for the same purposes as the present lease.

In a radius clause (trade-area limitation), on the other hand, the tenant agrees not to use any other premises within a specified radius of the shopping center for the same purposes as the present lease. Exclusive and radius clauses have been attacked as restraining competition and thus violating the antitrust laws. Courts generally test such lease restrictions against a standard of reasonableness. Under the standard, a restriction is judged reasonable depending on the term (in years) of the restriction, the geographic area affected, and the scope and character of the business activity restricted.

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Capital Gains: Unused Property Sales

By Karl H. Seemer

The U.S. Tax Court ruled that when a couple purchased several parcels of land to build a home and then sold the excess parcels, the realized profit was capital gain rather than ordinary income because the land was not held primarily for sale to customers in the ordinary course of business.

Bruce and Donna Rice bought 14.4 acres of undeveloped property near a preserve. The property was for sale as a unit and could not be subdivided. While they initially planned to keep the entire property, they eventually decided to sell the excess land. Other than sales of their own homes, the Rices had never engaged in the sale of real estate. They hired consultants for zoning, access, water and wastewater service, construction and environmental issues. After deciding to subdivide the property, they hired a consultant to provide a subdivision layout and applied for and received a zoning change to subdivide and develop the property. They divided the property into ten smaller lots, reserving eight lots for homes and two lots for environmental purposes.

Selling Lots

The Rices sold the lots through word of mouth and with a wooden sign at the entrance to the subdivision. They eventually sold one lot in 2000, three lots in 2004 and one lot in each of the next three years. For 2004, the year at issue, the Rices sold one lot for a gain of $89,330 and two lots for a loss. The sales were treated as sales of capital assets. IRS challenged the characterization, contending that the excess lots were held primarily for sale to customers in the ordinary course of business and their sale resulted in ordinary income.

Code Sec. 1221(a) broadly defines a "capital asset" as property held by the taxpayer but subject to a number of exceptions. The exceptions include stock in trade, property of a kind that is properly included in a taxpayer's inventory, and property held primarilyfor sale to customers in the ordinary course of a taxpayer's trade or business. Generally, to determine if property is primarily for sale to customers in the ordinary course of business, the Tax Court examines several factors, including: (1) the taxpayer's purpose in acquiring the property; (2) the purpose for which the property was later held; (3) the taxpayer's everyday business and the relationship of the income from the property to his total income; (4) the frequency, continuity, and substantiality of property sales; (5) the extent of developing and improving the property to increase the sales; (6) the extent to which the taxpayer used advertising, promotion, or other activities to increase sales; (7) the use of a business office for the sale of property; (8) the character and degree of supervision or control the taxpayer exercised over any representative selling the property; and (9) the time and effort the taxpayer habitually devoted to the sales.

Court Ruling

The Tax Court concluded the Rices bought the property as an investment and not as property held for customers in the ordinary course of business. The gain from the sale of the excess lot was entitled to capital gains treatment. The Rices sold the excess lots to dispose of unwanted property. The property was in the school district where they wished to live and was much cheaper than other properties they considered. They did not have the option to buy a smaller portion of the property. They disposed of the excess lots after creating a homeowners association to ensure a certain aesthetic and create a neighborhood.

The court noted that many of the improvements made by the Rices would have been necessary in any case. The court also said the solicitation and advertising efforts were more characteristic of investors than dealers. Other than posting a sign outside the subdivision, they did not advertise or promote the sale of the lots. The lots were sold primarily to friends, friends and relatives, and the number of lots sold was small.

Finally, the court said the Rices had full-time jobs and devoted little time to the sale of the lots. The sales accounted for a small percentage of their income and they retained the

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proceeds rather than buying additional inventory. (Reference: TCM 2009-142.)

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Real Estate Contracts: Words Speak Louder than Actions

By *Alvin Arnold*

While actions may speak louder than words in many circumstances, it is not so when it comes to changing the terms of a written contract, ruled a New York appellate court in the case of *Regal Realty Services*, LLC *v.* 2590 *Frisby* LLC, 2009 WL 1324121 (NYAD 1*st Dep't*).

2590 Frisby LLC entered into a contract in 2007 to sell real property to Regal Realty Services LLC for a price of $3.050 million, with a down payment of $152,500 to be held in escrow by Frisby's attorney. The contract required Regal to obtain a written mortgage commitment in the amount of $2,182,500. If Regal was unable to obtain the mortgage, each party *at that time* had the option to cancel the contract by written notice to the other. In that event, the down payment would be refunded. The contract also provided that its terms could be changed only by written agreement.

Regal's initial mortgage application was to HSBC and was rejected. The contract was not canceled, however, because Frisby suggested that Regal apply to the current mortgagee for financing. This, too, was unsuccessful. Several months later, the parties re-negotiated the terms of the contract, raising the purchase price to $3,075,000 and adding a payment option in the form of a purchase money note and second mortgage. Regal was able to obtain a mortgage commitment from another bank but rejected it because the amount was too small.

In September, Frisby's attorney notified Regal that he was in default of the contract and set a time of the essence closing for a month later. In response, Regal's lawyer wrote back that the contract was terminated and demanding the return of the down payment. At that point, Frisby began this action, seeking to keep the deposit as liquidated damages pursuant to the contract terms. Regal in turn moved for summary judgment, arguing that since both parties worked together to seek a mortgage, this constituted a waiver of the mortgage contingency clause, thus entitling Regal to have his deposit returned.

Court Rulings

With both parties moving for summary judgment, the trial court denied both, finding issues of fact, including whether Frisby, by its actions, extended or waived the mortgage contingency clause. Both parties appealed.

The New York appellate court said "There is a fundamental concept that a written agreement, that is complete, clear and unambiguous on its face must be enforced according to the plain meaning of its terms." Further, said the court, "A contract is unambiguous if the language it uses has a definite and precise meaning, unattended by danger of misconception in the purport of the agreement itself, and concerning which there is no reasonable basis for a difference of opinion." Here, the contract clearly provided that Regal, having been notified of the denial of its financing application, could have canceled the contract or requested an extension. He did neither.

Regal argued that Frisby's assistance in seeking financing with another lender led Regal to believe that Frisby had waived the terms in the contract. Said the court, "This ignores a vital first step in the analysis; before looking in evidence of what was in the parties' minds, a court must give due weight to what was in their contract…. Evidence from outside the four corners of an unambiguous document as the parties' intentions is generally inadmissible to vary the writing. "Furthermore, the contract specifically provided that it could not be changed or terminated without written agreement executed by both parties.

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Mortgages: Tighter Loan Structures

Banks and other financial institutions are facing challenging times as borrowers are unable to meet mortgage payments, or in the case of balloon loans reaching maturity are unable to refinance. In many cases, lenders will have no choice but to re-negotiate loan terms. In doing so, they are likely to insist on structural elements and remedies that were not considered necessary in the boom years just past. Some of these are described below.

Lender-Tenant Agreement

A lender may pay more attention to the legal relationship between it and the tenants at the mortgaged property in the event of a foreclosure. The lender, in order to preserve the income stream, may insist that tenants enter into a non-disturbance agreement providing that if the lender forecloses, the tenant will attorn and recognize the lender as

the successor landlord. Lenders also are likely to insist that tenants agree to pay rent directly to the lender upon request and permit the lender to cure the landlord's defaults in order to prevent a breach of the lease.

Lockboxes and Rental Income

A lender may seek to control a property's rent income from the moment of loan closing or loan extension, using provisions designed to survive the borrower's bankruptcy. The object is to prevent the borrower siphoning off funds for weeks or months before the lender can enforce remedies in the loan documents. In order to control rental income, a lender can establish a lockbox or use a third party trustee to collect rents whether or not the borrower is in default. Rental income then would be used to pay property expenses and debt service before any amounts were given to the borrower. The borrower would be required to prepare requisitions similar to those used for construction loans demonstrating that expenses were within budget.

In arranging this, however, a lender should recognize that a lockbox can create legal issues, the most serious one being whether it gives the lender so much control over the property that it is deemed the "mortgagee in possession." In addition, lockboxes can be complex and time consuming.

Controlling Expenses

A lender is likely to pay more attention than before to the expense side of the property. Particular attention is likely to be paid to real estate taxes, major maintenance and refurbishment costs and leasing commissions that are not routinely paid each month. A lender may require that tax and insurance escrows be established, with money deposited each month before income is distributed to the borrower. However, the lender should agree to pay the same interest rate on escrows as the borrower pays on the mortgage loan.

Of particular importance is the need to have assurance that reserves are created to cover the cost of major future repairs or replacements. Otherwise, when a loan is defaulted, the lender may find that the property requires extensive repairs to put the property back to its initial condition.

Guaranteed Loan

Lenders may require a guarantee of payment by a third party in the event of the borrower's default. A real estate lender normally requires a guarantee to be absolute and unconditional. That is, the guarantee cannot be subject to any right of offset by the guarantor and not affected by any failure of the lender to give notice of default within a specified time. However, the guarantee may cover less than all of the borrower's obligations. Since guarantors are "favored by the law," the guarantee must be explicit as to its coverage.

Secondary Financing

The first mortgage instrument normally bars the borrower from obtaining additional financing without the lender's consent. Such consent should only be given after careful consideration because the existence of secondary financing may mean that the primary lender cannot negotiate a workout or enforce interim remedies or control the bankruptcy without the second lender's cooperation. In many cases, the first mortgage lender is not likely to agree to any secondary financing.

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