Real Estate *advisor*

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Closing the deal with seller financing

Think twice before bailing out
Save your property *and* your tenants

Sec. 1031 exchanges
How to select a qualified intermediary

Ask the Advisor
What type of insurance coverage is needed for new construction projects?

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Closing the deal with seller financing

It's getting to be a tired refrain: The credit market for commercial real estate continues to be tight. But even as the economy begins to show signs of life, the financing needed to close many deals remains elusive, forcing would-be buyers and sellers to seek alternative avenues of funding.

The dearth of options has prompted some motivated sellers to consider offering seller financing, an arrangement previously associated with smaller transactions. Sellers interested in closing larger deals are now seeing the benefits, but they also face many complexities.

Why seller financing?

In seller-financed transactions, the seller generally gives the buyer a secured loan to finance part of the property's purchase price. A seller-financed mortgage loan is secured by a lien on the property; a seller-financed mezzanine loan is secured by a pledge of ownership interests in the purchasing entity.

Sellers might consider this type of arrangement to obtain cash to pay for operations or debt, or to satisfy investor redemption requests. In addition, a seller might choose seller financing to raise capital for other business ventures or to generate liquidity for the overall portfolio.

The seller must determine whether the property is appropriate for this type of arrangement.

In one real-life instance, an owner sought to sell a majority stake in 13 shopping centers to an institutional investor for $890 million. With sales of retail properties down significantly, the seller agreed to provide the buyer with financing for about 20% of the purchase price. The buyer deferred payment of close to $180 million, and the seller obtained a substantial cash infusion.

Seller financing has additional advantages: Among others, it can expand the pool of qualified buyers, foster greater flexibility when negotiating loan terms, and increase the chances of producing an outcome that meets both parties' needs.

What should the seller consider?

Sellers must exercise caution before entering into such transactions. Initially, the seller must ensure that it's qualified to become a lender. It should scrutinize its organizing documents; any joint venture, fund or upper-tier debt agreements; and applicable regulatory requirements to determine if it's allowed to make and hold loans. The seller may need to amend some documents to make it eligible to lend.

Like any lender, the seller must comply with all applicable lending laws, including those related to state licensing, debt collection and securities. Many states — including Arizona, California, Florida and Maryland — impose lending licensing requirements that may affect seller financing arrangements. Further, financial reform legislation enacted in July restricts sellers' ability to extend financing. While the legislation doesn't prohibit sellers from offering financing, it does require them to obtain a mortgage broker's license to finance more than one transaction in a three-year period.

The seller should also assess whether it possesses the necessary capabilities to originate and service loans. Some sellers may need to hire loan servicing agents or invest in establishing their own servicing capabilities.

In addition, the seller must determine whether the property is appropriate for this type of arrangement. A financially robust property will produce optimal results for buyer, seller and any third-party lender; conversely, a property with many vacancies may not generate the returns necessary to allow the buyer to pay off its obligations to the seller and lender, let alone reap a profit.

It's also critical that any current loan on the property grant the seller the right to prepay without incurring a penalty. And the cash proceeds from the sale should be adequate to pay off the existing loan.

Bear in mind that transactions involving third-party lenders (where the buyer borrows from both the seller and an outside lender to meet the purchase price) will likely place the seller in the position of a subordinate lender. However, a seller in these circumstances might be able to command a higher interest rate because of its increased risk.

Finally, once a buyer is found, the seller must conduct thorough due diligence to confirm that the buyer is creditworthy. The seller will need to scrutinize the buyer's financial statements, credit history, tax returns and similar records. It's also a good idea to request banking and business references.

What tax issues come into play?

Seller-financed transactions have several potentially vexing tax implications. If, for example, the seller is a real estate investment trust (REIT), it must determine whether the loan constitutes

Document, document, document

Follow the mainstream lenders' lead when navigating a seller-financed deal, especially if you don't want to reduce the price you can sell or syndicate the loan on the secondary market.

To that end, sellers should obtain:

- The note and mortgage on the property,
- A lender's title insurance policy,
- A guaranty from a creditworthy third party,
- An assignment of any leases and rents,
- Financial covenants and special purpose entity (SPE) restrictions,
- Subordination, nondisturbance and attornment agreements (SNDAs) that address the priority of the rights of tenants and lenders,
- Documents related to escrows for taxes and insurance,
- A deposit control agreement giving the seller a security interest in the property's rents and profits (if applicable), and
- An environmental indemnification clause.

In the case of a seller-financed mezzanine loan, the seller should obtain documentation of mezzanine lender protections, including a pledge of the ownership interests in the buyer's entity.

a "qualifying asset" that generates "qualifying income." A seller-financed loan could jeopardize the seller's status as a REIT under the Internal Revenue Code (IRC) if the loan isn't properly structured.

The IRC's original issue discount rules could also come into play if the loan's redemption price exceeds its issue price. If the rules do come into play, the seller must recognize interest income, and the buyer must recognize interest expense, based on economic accrual.

Additionally, under certain circumstances a seller might be required to pay interest on the deferred capital gains tax liability typically enjoyed under the IRC's installment sale provisions.

Is it right for you?

In uncertain economic times, seller financing may seem like the only viable alternative, but it's not right for every seller and every transaction. Consult your real estate and financial advisors to decide how best to proceed. ■

Think twice before bailing out

Save your property and *your tenants*

The recession has left its mark — not only on Americans' pocketbooks, but also on communities. Once-thriving businesses are squeaking by; others have been boarded up and abandoned. A property owner's financial setback due to loss of tenants can cause a building to fall into disrepair, which may in turn cause existing tenants to leave, leading the owner to lose more money and, in many cases, to lose the property too. How can this vicious cycle be broken?

Turn things around

First work with your lender to get some breathing room. You might renegotiate your interest rates or restrictive loan covenants, for example. Then engage a qualified real estate manager to lead the turnaround effort. Evaluate every aspect of the property. Identify and prioritize problems, brainstorm solutions, and obtain cost estimates. Some issues require a quick fix; others will take time.

For example, a roof leak is a high-priority problem, but it can be relatively simple to address. A tarnished reputation caused by mismanagement and disrepair, on the other hand, can be far more difficult to turn around.

The adage "image is everything" is especially true when a landlord's reputation has gone downhill with its struggling property. The first thing to do is reposition the property with tenants and the brokerage community. Notify the media that the building has been taken over

by new management. Also consider placing a large banner across the building announcing the change.

Keep tenants happy

When tenants leave, their space can often remain vacant for six months or more. Rental loss from vacancies, new tenants' improvements and leasing commissions all point to the same conclusion: Tenant turnover is expensive. When a tenant is finally found, it can take a year or longer to recover losses.

Competitive commercial brokers are always looking for tenants, and dissatisfied tenants are their prime targets. You can decrease the risk of losing tenants by turning your property management company into a service-oriented management team. This means making the team available and listening and responding promptly to tenant feedback. Doing so helps create a loyalty that may outweigh the financial benefits offered by competitors.

Property managers can expand their influence by becoming a "concierge" for their tenants, helping tenants with items that are outside the realm of property management, such as referring cleaning, landscaping, security, delivery, insurance, banking and professional service providers they may need.

Another way to rebuild relationships with existing tenants is to use their products and services and to refer them to your business contacts. Helping tenants grow their businesses not only creates goodwill and provides cash for lease payments, but it also may increase their square footage needs.

Be proactive and survive

Don't let minor problems spiral out of control. With a proactive attitude, an owner who recognizes all possible problems can turn a lemon into lemonade. If you're struggling to rent and maintain one of your properties, work with your real estate and financial advisors on an immediate turnaround strategy. ■

Sec. 1031 exchanges

How to select a qualified intermediary

If you've ever participated in a Section 1031 exchange (also known as a like-kind exchange), you know the critical role that the qualified intermediary (QI) plays. Yet most states don't regulate the QI industry. Investors who fail to use *truly qualified* QIs could regret it.

Why QI selection matters

Under Internal Revenue Code (IRC) Sec. 1031, you can exchange business or investment property for property of a like kind without recognizing any gain or loss until you sell the replacement property. Most such exchanges are deferred exchanges, under which the seller has 45 days to identify a like-kind property and 180 days to invest the sale proceeds in that property.

But the IRC prohibits a taxpayer relinquishing property from gaining actual or constructive receipt of the property's proceeds. So the parties in a deferred exchange rely on a QI — similar to an escrow company — to hold the proceeds until they're transferred to acquire a replacement property.

Unfortunately, QIs aren't required to be bonded or insured or carry a minimum equity capitalization. *Anyone* can start up a QI and start administering Sec. 1031 exchanges.

After several high-profile incidents involving QIs that declared bankruptcy or otherwise were unable to fulfill their contractual obligations, misappropriated client funds, and breached their fiduciary duties, the IRS has warned real estate professionals and investors to exercise caution when selecting QIs. Problems with QIs can end up disqualifying the transaction for the gain deferral.

Factors to weigh

To protect your interests, consider the following criteria before retaining a QI:

Expertise. Make sure your QI has a thorough knowledge of the stringent requirements for Sec. 1031 exchanges and their interplay with other aspects of tax law. The QI should also work on your behalf to help you achieve your wealth management and business objectives. So confirm that the QI can handle all of your exchange needs — some QI firms lack the tax expertise to execute more complex exchange structures. Just one mistake in legal documentation could disqualify a Sec. 1031 exchange.

Control and controls. Research how the QI handles its clients' funds, including what measures it takes to protect funds and ensure liquidity, and whether you'll have any influence on how funds are invested. Find out if the QI commingles or segregates funds. The IRS considers commingled funds to be held as a loan to the QI for tax purposes, and clients are considered general creditors. Segregated funds are also treated as a loan to the QI, but they won't become part of the general asset pool in the event of the QI's bankruptcy.

You may prefer a QI that permits you to decide where the funds are deposited and in which types of accounts. Regardless, insist the QI disclose how it holds funds and earns revenue.

Also inquire about the QI's internal controls and other fraud prevention efforts, such as internal audits and employee screening. Choose a QI that carries sufficient Errors and Omissions (E&O) insurance coverage to protect against loss from human error.

Fee schedule. You should understand the QI's fee schedule from the beginning. It could include transaction fees, hourly exchange consulting fees and interest sharing arrangements.

Look before you leap

When selecting a QI, keep in mind that the size of a QI firm is no guarantee — both regional and national exchange firms have declared bankruptcy. By understanding how a QI works and the investment and tax implications of deferred Sec. 1031 exchanges, you'll be better able to choose wisely. Also, work with your tax advisor to ensure that the deal is structured in such a way that it avoids recognition of gain or loss.

Ask the Advisor

What type of insurance coverage is needed for new construction projects?

Risk management is as integral to a successful project as the construction materials and crew. And the first step is proper insurance coverage. If you're uncertain whether you have enough, ask a qualified professional to help you conduct an insurance coverage audit. Coverage audits can reduce the odds of an uncovered incident undermining the project's profitability — or worse.

Audit points

Before launching a new project, make sure that all project contracts provide you with a full range of insurance benefits, including general liability, workers' compensation/employer's liability and commercial vehicle coverage, as well as payment and performance bonds. Obtain proof of coverage with certificates of insurance for your own policies, as well as any policies under which you might pursue coverage as an additional insured or intended beneficiary.

Keep in mind that your policies are secondary to the policies that list you as an additional insured. That is, if you have a claim, you'll make it under the policies that list you as an additional insured before turning to your own insurer.

In addition, change in coverage notices should be sent to both the named insured and you on policies that list you as an additional insured. Where necessary, ask that coverage terms be amended so that innocent intended beneficiaries (such as you) aren't adversely affected by the conduct of others whom they don't control (such as a named insured contractor who fails to comply with a requirement of the insurer). Here are some other factors to consider:

- Occurrence-based policies are generally preferable to claims-made policies. With the former, coverage extends to claims deemed to have *occurred* during the insured period, no matter when a claim is made. A claims-made policy protects only against claims made during the insured period; you're liable for any claims made after the policy expires.
- For claims-made policies, coverage needs to be extended beyond the project completion date, customarily 12 to 36 months longer. Otherwise, you're exposed to problems discovered postconstruction.
- Policies should be supplemented with excess or umbrella coverage, as appropriate.
- Policies shouldn't include any objectionable exclusions, such as completed operations exclusions.

Be particularly mindful of sacrificing costly claims because of exclusions and coverage period restrictions. Coverage can be severely curtailed, if not eliminated, by exclusions for mold, owner-owned property and contractual liability, among others.

Cover all the bases

Your insurance strategy should consider not only the risks to the immediate project, but also to your overall financial standing. Work with your insurance, financial and tax professionals to help you determine if you've covered all of your bases. ■

A Special Message from a Zinner & Co.
'Exclusive Service Provider'

Over the years, Zinner & Co. has developed a comprehensive list of professional service providers with whom we have both personal and professional relationships. These are service providers who hold to the same standard of care and sense of urgency that we provide to our clients each and every day.

As a result, we endorse these "Exclusive Service Providers" and recommend them to our clients to provide services that complement those *we* currently provide. We are pleased to introduce one of our "Exclusive Service Providers" to you here...

A Collaboration That Provides Real-Estate Investors With 1031 Tax-Deferred Exchange Services

BNY Mellon Wealth Management and Exeter 1031 Exchange Services, LLC, partner to provide 1031 tax-deferred exchange services to investors seeking tax-advantage strategies for acquiring and exchanging real estate and personal property. This partnership combines the expertise of a global wealth management organization with an independent company devoted exclusively to qualified intermediary services.

EXETER
1031 Exchange Services LLC

BNY MELLON

Features of the Partnership's Services

- **Assistance at every phase of a 1031 exchange transaction, including:**
  - Identifying which exchange structure or strategy best meets their financial needs
  - Understanding the steps in a 1031 exchange transaction
  - Interpreting IRS regulations and guidelines for 1031 tax-deferred exchange transactions
- **Ongoing status regarding the progress of each client's exchange transaction**
- **Information provided for meeting IRS requirements**
  - Deadlines for acquiring and identifying like-kind property
  - Satisfying like-kind requirements for replacement property
  - Meeting requirements for completing a build-to-suit or reverse exchange
- **Comprehensive documentation package delivered to client upon close of 1031 exchange**
- **Ongoing news on developments in the 1031 exchange industry**
- **Ability to finance a transaction, either as an individual or an LLC, even while Exeter is holding title to the property**

The right **ideas**.

The right **results**.

Achieved with the right **firm**.

With BNY Mellon Wealth Management and Exeter 1031 Exchange Services, Zinner & Co. is RIGHT behind you during your real estate transactions!

Contact Zinner & Co. LLP for a referral.

Zinner & Co. LLP offers expert professional guidance on a wide range of financial services — that's why you can trust the professionals at Zinner & Co. LLP to be an essential partner for your real estate planning.

Your Success is our Business.

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MANAGEMENT CONSULTANTS

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Qualified Intermediary 1031 Exchange services are provided by Exeter 1031 Exchange Services, LLC. All funds associated with a 1031 exchange transaction are administered by Exeter 1031 Exchange Services, LLC using BNY Mellon Wealth Management banking entities as the depositories and are subject to internal controls maintained by Exeter. BNY Mellon, National Association, Member FDIC