Financing Your Acquisition and Construction

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CLOSING COMMERCIAL REAL ESTATE FINANCING

1. STRUCTURING THE CAPITAL

1.1 Goal of the Capital Structure.

The primary goal of the developer should be to get sufficient capital to complete the construction of the project and to carry the property during the lease-up or sale of the property. The secondary goal should be to isolate and minimize the monetary risk for the principals of the developer.

If the developer has enough cash on hand to complete the project, then you probably do not need to read any further. Even if the developer has enough cash on hand, you may want to consider using someone else's money for part of the capital and save some of that cash on hand for another project. So read on.

1.2 Single Purpose Bankruptcy Remote Property Owner.

The property owner should not own anything or enter into any contracts prior to the acquisition of land. The property owner should be a single purpose entity. Most mortgage lenders prefer to underwrite on the property and not have to take into account credits and obligations related to other assets. The terms "single purpose," "special purpose," and "bankruptcy remote" are used in a variety of contexts throughout the lending market. Although the terms have generally recognized meanings, those meanings may vary greatly depending on the role of the entity and the type of transaction. A single purpose entity ("SPE") is an entity, formed concurrently with or immediately prior to the transaction, that is unlikely to become insolvent as a result of its own activities and that is adequately insulated from the consequences of any related party's insolvency. An SPE will have a series of restrictions in its organizational documents.

1.3 Guarantees.

Even though the lender wants its borrower to be an isolated entity for underwriting purposes, they will also generally want some additional collateral resources to back up the construction loan. These will be in the form of a guaranty or guarantees by the principals of the borrower.

(a) Non-Recourse Carveout Guaranty. Lenders want a draconian measure to prevent the borrower from engaging in deceptive or fraudulent acts. To accomplish this goal, the lender will require the principals to be personally liable for deceptive or fraudulent acts.

Typical items in the carve-out guaranty are the following:

(i) failure of borrower to pay to lender upon demand after an event of default, all rents to which lender is entitled under the mortgage and the amount of all security deposits collected by borrower from tenants;

(ii) failure of borrower to apply all insurance proceeds and condemnation proceeds as required by the mortgage;

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(iii) failure of borrower to comply with sections of the mortgage relating to the delivery of books and records, statements, schedules and reports;

(iv) fraud or written material misrepresentation by borrower, principal or any officer, director, partner, member or employee of borrower in connection with the application for or creation of the indebtedness or any request for any action or consent by lender;

(v) failure to apply rents, first, to the payment of reasonable operating expenses and then to debt service amounts;

(vi) a breach of the representations regarding hazardous materials;

(vii) borrower's acquisition of any property or operation of any business not permitted by transfer provision of the mortgage;

(viii) a transfer that is an event of default under the mortgage; or

(ix) borrower encumbers the property with the lien of any subordinate instrument.

(b) Payment Guaranty. If the lender is requiring a payment guaranty, the lender is looking to principals of the borrower for credit support. If the principals have a net worth in excess of the principal amount of the loan, the lender is effectively looking to the principals for repayment rather than the value of the construction project.

(c) Completion Guaranty. For a construction project the lender will want to ensure that they get a completed building at the end of the loan. The lender is sharing the risk that at the end of construction the property may not be valuable enough to repay the construction loan. In comparison to the payment guaranty, the principal of the borrower is only at risk for the value of the project in excess of the loan.

A completion guaranty will amount to something like this:

"Guarantor hereby absolutely and unconditionally guarantees to lender, its successors, transferees and assigns, that:

(i) The improvements shall be completed in accordance with the terms and conditions of the loan documents;

(ii) Borrower shall, until such completion, fully and punctually comply with all the terms, covenants and conditions of the loan documents;

(iii) Borrower shall fully and punctually pay and discharge any and all costs and expenses for the construction, equipment and completion of the improvements as provided in the loan agreement as the same may become due and payable and, except as otherwise provided in the loan agreement, also pay and discharge all proper claims and demands for labor and materials used in construction of the improvements which are or, if unpaid, may become liens on the premises; and

(iv) Except as permitted in the loan agreement, the premises shall be and remain free and clear of all liens other than the lien of the loan documents."

(d) Lessons from the Blue Hills Case. The case of *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank, as Trustee for the Registered Holders of Credit Suisse First Boston Mortgage Securities Corp., Commercial Mortgage Pass-Through Certificates, Series 1999-C1, and CSFB 1999-C1 Royall Street, LLC* presents some useful lessons for the property owner/borrower to consider in connection with the applicability of a non-recourse carve-out guaranty.

The significance of the case is that the court enforced a "bad boy" non-recourse carve-out guaranty against principals of a borrower.

In the *Blue Hills* case, the borrower settled a zoning dispute with a neighboring property. The principals pocketed the $2 million cash settlement, rather than depositing the settlement into the borrower's account. With the zoning dispute settled, the neighboring property owner was able to complete its property. The single tenant of the borrower's property did not renew its lease and moved into the neighboring property. With no tenant and no rent payments, the borrower stopped making payments on its mortgage loan and the lender foreclosed.

The lender was not happy to find out that the principals pocketed the $2 million rather than making it available to the borrower to pay the mortgage loan.

The court found that under the language of the loan documents the $2 million settlement for the zoning dispute was part of the collateral for the mortgage loan. Therefore, the borrower and principals transferred a portion of the collateral in violation of the loan documents. As drafted, the bad boy guaranty made the principals liable for the full amount of the debt in the case of an unauthorized transfer of any portion of the collateral. Therefore the principals were liable for the $17.5 million loss of the lender.

This case is the first I have seen that enforced a bad bay guaranty. It should be no surprise that it was found to be enforceable. The case also makes it clear that the collateral for a mortgage loan can be more than just the real estate, in this case, a lawsuit affecting the property.

By affecting with the collateral, the principals turned their $2 million windfall into a $17.5 million loss.

1.4 Independent Director.

Often the lender will require that the borrower have an independent director to isolate the borrower's bankruptcy risk. The vote of the independent director is required to undertake certain actions, most importantly, to file a bankruptcy petition or take other insolvency action with respect to the SPE. The provisions regarding the independent director are intended to protect against a voluntary bankruptcy petition being filed by the applicable shareholders, members, partners, directors, or managers.

If there were no independent director on the board of the SPE, and the parent of the SPE were to become insolvent, and, as a consequence, deem it advantageous for the SPE to file a bankruptcy petition, the directors of the SPE corporation could simply vote to file a bankruptcy petition with respect to the SPE, regardless of its solvency. The independent director is intended to help insulate against the risk that the shareholders, members, partners, directors, or managers of the parent of the SPE will be able to control the SPE and vote to file a bankruptcy petition with respect to an the otherwise solvent SPE.

The following is a generally accepted definition of "independent director":

- A duly appointed member of the board of directors of the relevant entity who shall not have been, at the time of such appointment or at any time while serving as a director or manager of the relevant entity and may not have been at any time in the preceding five years, any of the following:

- A direct or indirect legal or beneficial owner in such entity or any of its affiliates;

- A creditor, supplier, employee, officer, director, family member, manager, or contractor of such entity or any of its affiliates; or

- A person who controls (whether directly, indirectly, or otherwise) such entity or any of its affiliates, or any creditor, supplier, employee, officer, director, manager, or contractor of such entity or its affiliates.

There are several third party providers of the services of an independent director. Two of the most popular are and Entity Services Group (http://www.entityservices.com/independent/indserv-independent.asp) and CT Staffing Services (http://ctadmin.ctadvantage.com/CTWebAdminApps/CTWebAdmin/pubcontent/CTStaffingServices.aspx). Both require a payment of a fee, an indemnification of the independent director and D&O insurance or other financial backing to the indemnification.

The independent director will need to execute the organizational documents, so the documents must be finalized prior to the closing so they can be sent to the director for execution prior to the closing.

1.5 Separateness Covenants.

In order to increase the likelihood that an SPE will be insulated from the liabilities and obligations of its affiliates and third parties, the lender will require that the borrower agree to abide and, as applicable, its shareholders, members, partners, and affiliates should agree to cause the SPE to abide by the following separateness covenants with respect to the SPE whereby the SPE covenants, among other things:

- To maintain books and records separate from any other person or entity;
- To maintain its accounts separate from any other person or entity;
- Not to commingle assets with those of any other entity;
- To conduct its own business in its own name;
- To maintain separate financial statements;
- To pay its own liabilities out of its own funds;
- To observe all partnership formalities;

- To maintain an arm's-length relationship with its affiliates;

- To pay the salaries of its own employees and maintain a sufficient number of employees in light of its contemplated business operations;

- Not to guarantee or become obligated for the debts of any other entity or hold out its credit as being available to satisfy the obligations of others;

- Not to acquire obligations or securities of its partners, members, or shareholders;

- To allocate fairly and reasonably any overhead for shared office space;

- To use separate stationery, invoices, and checks;

- Not to pledge its assets for the benefit of any other entity or make any loans or advances to any entity;

- To hold itself out as a separate entity;

- To correct any known misunderstanding regarding its separate identity; and

- To maintain adequate capital in light of its contemplated business operations.

The separateness covenants will need to be contained in the organizational documents of the borrower.

2. CHOICE OF ENTITIES

2.1 General.

Most commercial property is owned in an entity rather than an individual's name. This section will briefly highlight some of the advantages and disadvantages of using particular entities and the specific needs of each entity at closing.

2.2 Nominee Trusts.

(a) Advantages. A nominee trust is a useful mechanism for shielding the beneficial owner of the property from public records and from the other parties to the transaction. They are also useful for wrapping around a general partnership which would otherwise would have difficulty showing authority at the land court.

(b) Disadvantages. A nominee trust offers no liability protection to the beneficiary of the trust. Transfers of interest in a nominee trust require the payment of deeds excise tax (See DOR Directive 95-5). Nominee trusts are unknown outside Massachusetts.

(c) At the Closing. The declaration of trust for nominee trusts needs to be recorded in the registry of deeds (or filed with the land court) in the county where the property is located. The nominee trust will have a provision, generally section 4, similar to the following, whereby the trustee may take only those actions authorized by the beneficiary as to the trust's property: "Except as hereinafter provided in case of the termination of this Trust, the Trustees shall have no power to deal in or with the Trust Estate except as directed by all of the Beneficiaries." The trustee needs to deliver a trustee's certificate to the seller or lender evidencing authority for the transactions. The trustee will need to have a direction from the beneficiaries authorizing the trustee to take the action. The trustee's certificate will need to be recorded with the deed to the property. Since it will be recorded, the trustee's certificate will need to be notarized. The direction of beneficiaries should not be recorded to keep the identity of the beneficiary from the public record.

2.3 Corporations.

(a) Advantages. Corporations are well known entities and have clear methods for approving transactions and demonstrating authority.

(b) Disadvantages. The main disadvantage to the use of corporations is the corporate tax lien imposed by MGL c. 62C §51, where the assets of a corporation selling all or substantially all of its assets are subject to the inchoate lien for three years after the transfer. It takes several weeks to get the lien waiver from the Department of Revenue to prove to a buyer that they are not taking the property subject to the lien. There are also the increased costs of an annual filing fee and paperwork for the corporation with the Secretary of State. Under the Internal Revenue Code, corporations cannot pass through losses to shareholders. Income from the property is taxed as income of the corporation, and dividends to shareholder are taxed again as income of the shareholder.

(c) At the Closing. Several documents are needed when a corporation is involved in a real estate closing. In all cases, you will need certified copies of the articles of incorporation, the bylaws, a vote and an incumbency certificate. You should obtain a long-form good standing certificate from the Secretary of State that lists the corporation's officers. If a corporation is selling the property, you will also need to address the corporate tax lien issue. If the property is not all or substantially all of the assets of the corporation in Massachusetts, the deed should state: "This conveyance is not the sale of all or substantially all of the assets of the Grantor located in the Commonwealth." If the transaction is a sale of all or substantially all of the assets of the corporation, you will need a corporate tax lien waiver from the Department of Revenue. Tax good standing certificates can be ordered online at https://wfb.dor.state.ma.us/webfile/Certificate/Public/WebForms/Welcome.aspx.

2.4 General Partnerships.

(a) Advantages. The general partnership is flexible in allowing distributions of the profits. There are no filings and therefore there are no filing fees. There is no taxation at the partnership level.

(b) Disadvantages. The general partnership offers no liability protection to the partners. It is also difficult to prove authority since there are no filings with the Secretary of State.

(c) At the Closing. The key document for a closing with a general partnership is the partnership agreement. There is no certificate available from the secretary of state. The partnership agreement needs to be reviewed to determine which consents are required to sell, mortgage or purchase the property. At the closing, you will need a copy of the agreement certified by a partner and a copy of the consent of the partners.

2.5 Limited Partnerships.

(a) Advantages. Limited partnerships are well established entities with clear statutes and case law regarding liability and authority. There is no annual filing fee for limited partnerships in Massachusetts. There is no taxation at the partnership level.

(b) Disadvantages. The general partner of the limited partnership is subject to the liabilities of the limited partnership.

(c) At the Closing. The key documents for a closing with a limited partnership in Massachusetts are a certified copy of the limited partnership certificate and a copy of the limited partnership agreement, certified by the general partner. Under the limited partnership statute, authority rests with the general partner, and any documents will need to be executed by the general partner. Under the limited partnership statute, limited partners can participate in the management of the partnership. Therefore, it is important to review the limited partnership agreement to determine if the general partner needs consent of the limited partners to sell, mortgage or purchase the property. At closing, you should get a certified copy of the limited partnership agreement, the certificate of limited partnership and the vote, if any, authorizing the transaction.

2.6 Limited Liability Companies.

(a) Advantages. Limited liability companies ("LLCs") are generally the best choice for ownership of commercial real estate. LLCs provide a flexible platform for authority of the LLC and the capital structure of the LLC. An LLC provides entity-level protection to the members and managers of an LLC. Unless an LLC elects to be treated as a corporation, there is no tax payable by the LLC.

(b) Disadvantages. Given the flexibility of LLCs, an LLC agreement can be expensive to draft. There is also a yearly filing fee of $500 and an annual report to be filed.

(c) At the Closing. The key document for a closing with an LLC in Massachusetts is a long-form good standing certificate with managers from the secretary of state. This certificate will identify who is authorized to execute real estate documents. This information is unique to Massachusetts LLCs. Other states do not require this information in the certificate organizing an LLC. If the LLC is organized in another state, the information regarding who can execute real estate documents will need to be provided in the qualification. The long-form good standing certificate takes several business days to be issued from the secretary of state. For registered land, you cannot record the deed or mortgage without a recent long-form good standing certificate. The land court will file the good standing certificate with the deed or mortgage. In Massachusetts if the manager of the LLC is an entity, that entity must also be an entity formed in Massachusetts or qualified to do business in Massachusetts. At the closing, you should have the LLC agreement certified by the manager, as shown on the LLC certificate, and, if required, the vote of the managers and or members. The LLC agreement needs to be reviewed to determine the necessary consents.

2.7 Patriot Act.

In 2001 the Federal government passed a law designated the "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism," known as the USA Patriot Act. Title III of the Act, also known as the International Monetary Laundering Abatement and Financial Anti-Terrorism Act of 2001, made a number of amendments to the Anti-Money-

Laundering provisions of the Bank Secrecy Act, which amendments are intended to make it easier to prevent, detect and prosecute international money laundering and financing terrorism.

In Section 352 of the Patriot Act, 31 U.S.C. § 5318(h) was amended to require the creation of anti-money laundering compliance programs by financial institutions. Under that Act, the Financial Crimes Enforcement Network of the Treasury Department ("FinCEN") temporarily exempted certain financial institutions, including individuals involved in real estate closings and settlements, from the Act's anti-money laundering requirements. The stated purpose of that exemption was to enable the Treasury Department to study the affected industries and to consider the extent to which anti-money-laundering requirements should be applied to them.

FinCEN issued an advanced notice of proposed rulemaking with respect to real estate closings and settlements. FinCEN posed a wide range of questions, including how to define "persons involved in real estate closings and settlements," the money-laundering risks posed by such persons, and whether they should be exempted from this requirement. Written comments were taken until June 9, 2003.

The Act would require every "financial institution," including "persons involved in real estate settlements and closings" to establish an anti-money-laundering compliance program that includes at a minimum:

(i) The development of internal policies, procedures and controls;

(ii) The designation of a compliance officer;

(iii) An ongoing employee training program; and

(iv) An independent audit function to test programs.

FinCEN points out that the Act, and the earlier Bank Secrecy Act, do not define a "person involved in a real estate closing or settlement as a financial institution." Also, according to FinCEN, the legislative history provides no insight into how Congress intended the term to be defined.

Therefore, a reasonable interpretation of the section could cover even participants other than those who actually conduct the real estate settlement. Among those potential participants are real estate brokers, attorneys, banks, mortgage brokers, other financial entities, title insurance companies, and even appraisers and inspectors. The guiding principal, according to FinCEN, is to include those whose services can be abused by money launderers, including those who are positioned to identify the purpose and nature of the transaction.

Of primary concern for diligent lawyers, is that FinCEN has mentioned that attorneys often play a key role in real estate closings and "thus merit consideration along with all the other professionals involved in the closing" process. The report specifically states that FinCEN does not believe that the application of the Act's requirements to attorneys poses any obligations inconsistent with the attorney-client privilege.

3. MORTGAGE LOANS

3.1 Conduit Financing.

(a) General. Over the last decade, a substantial and growing amount of real estate has been financed through conduit loans that have been securitized and sold as commercial mortgage backed securities ("CMBS"). CMBS has become an increasingly significant component of the total commercial real estate debt market. In 2004 over $93 billion of CMBS loans were originated. In the first 9 months of 2005 over $100 billion of CMBS loans were originated. The development of the CMBS industry has generally benefited borrowers through increased loan proceeds and competitive rates. But these loans have particular characteristics that make the closing process more complicated.

In closing a securitized loan product, you may be required to meet a series of complex and sometimes expensive requirements regarding the need for a new single purpose entity, adoption of separateness covenants, employment of independent directors, and delivery of a nonconsolidation opinion. Depending upon the size of the loan, some or all of these criteria may be imposed. Generally, the larger the loan, the more of these requirements will be applicable. Single purpose entities are always required. Separateness covenants can have a real impact on operating efficiently. These are binding legal agreements for the borrower to operate in a manner separate and distinct from any affiliates.

Including independent directors in the structure is modestly expensive and, like the requirement for separateness covenants, will impose limited operating restraints on the borrower. Non-consolidation opinions can be expensive to give and not all lawyers are equipped to give them, potentially necessitating retention of separate special counsel.

Prior to the recent meltdown of the debt markets, conduit lenders had become active in originating construction loans. Many of the principles and procedures from the conduit financing would have carried over to the portfolio lenders.

(b) Transfers of Ownership. Most loan documents will restrict the principals of the borrower from transferring their interests. Typically, a borrower may not sell, pledge, encumber, mortgage, assign, or otherwise dispose of its interest in the mortgaged property, and a direct or indirect equity owner may not transfer its direct or indirect equity interests in a borrower, including any equity interests in any of a borrower's constituent owners that should be single-purpose bankruptcy remote entities.

At the closing is important that the loan documents provide a mechanism for approval of any likely changes in the ownership structure of the borrower. If the principals of the borrower are individuals, borrower's counsel should make sure that the loan documents allow transfers for estate planning purposes and for transfers between the principals.

(c) Prepayment. As a general rule, construction loan documents do not restrict a borrower's right to prepay a mortgage loan.

(d) References.

- See Standard & Poors CMBS Legal and Structured Finance Criteria: http://www2.standardandpoors.com/spf/pdf/fixedincome/040103_cmbslegalcriteria14.pdf

3.2 Diligence Materials.

"Due Diligence" is a broad term that business and real estate attorneys and professionals frequently use. Typically the term is used to refer to the inspection and investigation of real property, personal property or a business entity before a buyer makes the final decision whether to consummate a transaction. Below is a list of topics that a buyer or investor in real estate should consider and review prior to closing the loan.

(a) Environmental Factors.

This category covers a wide array of issues, focusing on environmental regulatory schemes that may affect the property.

(i) Phase One Environmental Assessment. A Phase One Environmental Assessment ("Phase One") provides the buyer with a survey/overview of the environmental condition and environmental history of a particular property, focusing on the possible presence of hazardous materials. The report is intended to identify actual and potential problems (e.g., underground storage tanks, hazardous materials contamination) based primarily on a review of historical documentation, regulatory databases and a walk-through inspection of the site. If problems, or potential problems, are discovered during the course of the Phase One inspection, the report will generally recommend specific follow-up testing, remediation and/or studies in the form of a Phase Two assessment (defined below). It is important to initiate work on the Phase One report early in the due diligence process so that the environmental consultant has enough time to complete the project and, if problems are disclosed, there is adequate time to follow up with further studies and tests. It is important to note that a Phase One report typically does not include specific inspections for asbestos, lead (paint or in plumbing), radon, delineation of wetlands or review of environmental compliance.

(ii) Phase Two Environmental Report. A Phase Two Environmental Report ("Phase Two") is typically done, if necessary, as a follow up to a Phase One report and involves physical inspections and testing of the property, such as core samples, ground water testing, typically focusing on the specific issues of concern identified in the Phase One report. If the presence of regulated hazardous materials contamination is confirmed by the Phase Two report, further reporting, monitoring, investigation and/or remediation may be necessary, based upon the extent and magnitude of that contamination. If additional investigation and remediation activities cannot be completed prior to closing, the parties may need to negotiate an environmental agreement which establishes an escrow to cover the anticipated costs of such work and contains an appropriate environmental indemnity which will survive closing.

(iii) Asbestos. If asbestos is present or suspected to be present on the property, it is advisable to engage a consultant to prepare an asbestos survey and report. There are several important issues related to asbestos: (i) identifying whether asbestos is present, (ii) identifying the form of the asbestos, and (iii) determining whether abatement, encapsulation or removal will be necessary for the buyer's planned use of the property. If the asbestos will remain in the property, a consultant should be engaged to develop an operations and maintenance plan to prevent the deterioration of the asbestos.

(iv) USTs and ASTs. If underground storage tanks ("USTs") or aboveground storage tanks ("ASTs") are located on the property, there may be affirmative reporting, removal and/or closure obligations for the property owner related to those tanks. USTs and ASTs are also often the source of hazardous materials contamination. If USTs or ASTs have been removed from the property, you will want to ascertain that proper site closure procedures were followed and completed in connection with the tank removal.

(v) Lead Paint. Lead paint is most problematic in residential settings (i.e., multifamily housing) where child safety is a concern and where federal law requires disclosure to tenants and buyers in residences built prior to 1978. Lead paint can also be problematic in industrial settings, since it can significantly affect how repainting and refurbishing activities are conducted. For example, sandblasting and removal of old lead paint often will require significant precautions in order to avoid lead contamination problems.

(vi) Mold. Over the past few years there have been a growing number of lawsuits and insurance claims across the country related to the level of mold and mildew in buildings and its adverse effect on health and habitability. Mold is not as much of a problem in Massachusetts as it is in other parts of the country that are more prone to flooding and humidity.

(vii) Wetlands. The presence of wetland conditions can have a significant effect on the operation and development potential of a property. As a result, it is important to check with the applicable municipality to determine whether any portion of the property is considered wetlands or shoreline. Wetlands and certain uplands located near navigable waters are under federal jurisdiction (U.S. Army Corps of Engineers) under section 404 of the Clean Water Act, 33 U.S.C. § 1344, and there may be significant restrictions on the use or development of land in those areas. In addition, there are significant regulatory hurdles related to filling, cutting, or relocating wetlands areas. It is important to remember that wetlands are not always "wet" or obvious to the casual observer. Generally, the analysis of what constitutes a wetland is focused on vegetation and wildlife characteristics, rather than the presence of surface water.

(viii) Flood Zones. Flood zone designation can adversely affect the development potential, applicable building standards and the availability of financing, as well as insurance requirements and costs. Under federal law, mortgage lenders must have a verification that the property is not in a flood zone or that the borrower has flood insurance.

(ix) Endangered Species. The presence of endangered or potentially endangered plants and animals may significantly restrict the development potential and value of a property. Typically, initial inquiries on this subject can be made at the local planning agency to determine whether there are species of concern in the area. If there is the potential for the presence of such species or habitat on the property, the buyer should consider retaining an appropriate consultant to examine the property for the presence of the species and/or habitat in question.

(x) Railroads. If applicable, check with railroad(s) regarding access to sidings and mainlines located on or near the property. Contact the applicable railroad to determine whether there are existing access and trackage agreements and whether those agreements are assignable in connection with a transfer of the property. Determine whether existing stubs and sidings are sufficient and, if not, the cost, process and lead times for constructing additional sidings or stubs to the property. Under MGL c. 40 §54A, the Executive Office of Transportation and Construction must consent to building on any property used as a railroad right of way or any property appurtenant thereto.

(xi) Utilities. The buyer should check with the applicable utility providers to determine whether the property has adequate service levels available and determine the procedures for entering into provider agreements with the appropriate utility providers. It is important to determine whether development of the property may be affected by any utility-related moratoria or allocation programs, particularly with respect to water and sewer. If inadequate service exists or new service is required, the buyer should determine availability, timing and costs of upgrading the existing utility service.

(b) Zoning and Permitting Rights. The key item for a lender's diligence will be evidence that the developer has all of the necessary permits and approvals necessary to build the project. This evidence can be provided in a number of ways. Most important is actually having all of the necessary permits and approvals. I assume the other authors have provided the information on how to get these permits and approvals.

In Massachusetts it is common that a mortgage construction lender will require a zoning opinion from the developer's counsel. These are expensive and time-consuming. A zoning opinion will be heavily negotiated between the lender's counsel and the developer's counsel.

The borrower should be able to readily show what permits and approvals will be required for the borrower to develop the property.

(c) Title Insurance and Surveys. Lenders will want to ensure that they have a valid first priority mortgage lien on the property. To do so, the borrower will need to provide title and survey information.

The initial step in the title review process is the issuance of a title insurance commitment or preliminary title report. This initial document provides documentation of the current state of title for the property and includes the precise legal description of the property. The title commitment/report can be a vital indicator of title problems (e.g., some or all of the property is not owned by the seller). The commitment/report also provides the lender with a list of all current exceptions to title on the property such as unpaid taxes, easements, options to purchase, mortgages, judgment liens, liens, restrictions, equitable servitudes and other significant encumbrances and may contain information regarding appurtenant benefits to the property, such as access easements. It is usually prudent for the borrower to obtain copies, where available, of any item which is listed as an exception to title in the commitment/report, particularly any items which will remain on title after closing (e.g., easements, CC&Rs and/or equitable servitudes).

When dealing with registered property, the lender should carefully review the certificate of title as part of the title review process. All of the recitals and memorials on the certificate of title will generally be listed in the schedules of exceptions on the title commitment/report.

In connection with obtaining an ALTA ("American Land Title Association") lender's policy of title insurance, the lender will also require an ALTA survey of the property ("ALTA Survey"). An ALTA Survey is a comprehensive survey of the existing, as built, state of the property, which locates the parcel boundaries, existing improvements, adjacent infrastructure, and recorded and apparent unrecorded easements and interests. ALTA Surveys often are one of the most useful documents in the due diligence process, especially when they include one or more of the optional levels of detail available. First, with the physical survey, the lender can review and confirm that it matches the property the lender expects for collateral. It is often quite difficult from the legal description to determine the precise location of the property. Second, an ALTA Survey provides the lender with the precise location of utility and other easements and physical encumbrances which are described in the exception schedules in the title commitment, as well as illustrating the precise location of physical improvements located on the property. Once again, since it is often difficult to determine the location of utility easements based on the metes and bounds descriptions in the public records, the ALTA Survey is quite useful in disclosing potential issues or problems with the property (e.g., a utility easement running across an area where buyer wishes to construct improvements, encroachments onto or from adjacent properties). Finally, an ALTA Survey may disclose physical encroachments that are not indicated in the title commitment. These can include boundary fences that do not correspond with the true boundary, potential prescriptive easements and physical encroachments of improvements onto or from the property in question. Obtaining an ALTA Survey should be initiated early enough in the due diligence process so that there is adequate time to address any title problems disclosed in the survey prior to the end of the due diligence period or closing.

The lender should make sure to carefully review any easements, reciprocal easement agreements ("REAs") covenants, conditions and restrictions ("CC&Rs"), or similar encumbrances that may affect use of the property. As this type of encumbrance will continue to burden the property, it is important that the lender and borrower determine, prior to committing to close, whether it can live with these applicable encumbrances. Significant restrictions typically affect multi-parcel developments such as office or industrial parks with shared facilities. A lender should be cautious of provisions in any REA or CC&R that permit further restrictions to be placed on the use of the property in question (e.g., relocation of access roads, right of master developer to grant further easements on common areas, and the like) or expansions of the existing use of the property.

(d) Commercial Title Endorsements. Commercial purchasers and lenders typically require additional coverage from the title insurance company beyond the standard policy. Below is a list of title endorsements and descriptions of the additional coverage they provide.

(i) ALTA - Form 3 (Zoning). Informs the insured under an owner's or loan policy of the zoning classification under which the land falls and to insure the insured against loss or damage that may be sustained by reason of inaccuracies in the information supplied or a final judicial determination invalidating the zoning ordinance establishing such classification and resulting in the prohibition of such uses.

(ii) ALTA - Form 4 (Condominium). Provides special comprehensive title protection as to matters peculiar to condominiums. This endorsement is available to both owners and lenders, subject to review of each item of coverage. This endorsement is not intended to insure the title of the developer.

(iii) ALTA - Form 4.1 (Condominium). For use in those several states where legislation has given super priority status to liens for unpaid association charges.

(iv) ALTA - Form 5 (Planned Unit Development). Available for use for both owner's and loan policies in some jurisdictions. The endorsement insures against loss due to violations of any restrictive covenants, encroachments, prior unpaid homeowners' association dues or outstanding rights of first refusal.

(v) ALTA - Form 6 (Variable Rate Mortgage). Offers insurance as to the validity and lien priority of mortgage provisions providing for a variable interest rate.

(vi) ALTA - Form 6.1 (Variable Rate Mortgage). Offers insurance as to the validity and lien priority of mortgage provisions providing for a variable interest rate where such validity and priority depend upon compliance with particular statutes or regulations.

(vii) ALTA - Form 8.1 (Environmental Lien Protection). Insures a lender in situations where a mortgage is made on land used primarily for residential purposes against loss by reason of lack of priority of the lender's lien because of environmental protection liens recorded in those records which under state statutes impart constructive notice of matters relating to real estate or which are filed in the records of the clerk of the United States district court unless the lien is excepted to in Schedule B of the policy. This form also protects against lack of priority for any environmental lien provided for in any state statute in effect at date of policy unless otherwise designated in the endorsement.

(viii) ALTA - Form 9 (Restrictions, Encroachments, Minerals). Gives a lender an assortment of coverages dealing with violations of restrictions, encroachments and future exercise of a right to use the surface of the land for the extraction of minerals.

(ix) ALTA - Form 9.1 (Restrictions, Encroachments and Minerals) (Owner's Policy - Unimproved Land). Provides certain frequently requested protections for an owner of unimproved property concerning private property restrictions, encroachments and excepted minerals.

(x) ALTA - Form 9.2 (Restrictions, Encroachments and Minerals) (Owner's Policy - Improved Land). Provides certain frequently requested protections for an owner of improved property concerning private property restrictions, encroachments and excepted minerals.

(xi) ALTA - Form 10 (Assignment). Insures the effectiveness of the assignment of mortgage but does not cover matters of record after the effective date of the original loan policy, except to insure that there have been no releases or conveyances that do appear of record.

(xii) ALTA - Form 10.1 (Assignment). Covers the same items as Form 10 and gives additional coverage over certain matters occurring after the original effective date of the policy and before the date of endorsement. These matters, unless specifically shown in the endorsement, include: real estate taxes or assessments; priority over intervening defects liens or encumbrances; and federal tax liens or encumbrances.

(xiii) ALTA - Form 11 (Mortgage Modification). Insures the lender that the modification of the insured mortgage evidenced by the document referred to within the endorsement does not impair the validity, enforceability or priority of the insured mortgage.

(xiv) ALTA - Form 13 (Leasehold-Owner's). Provides additional tailored coverages for the lessee-owner of a leasehold estate, replacing the former ALTA Leasehold Owner's Policy.

(xv) ALTA - Form 13.1 (Leasehold-Loan). Provides additional tailored coverages for the lender for which the security interest is in a leasehold estate, replacing the former ALTA Leasehold Loan Policy.

(xvi) ALTA - Form 14 (Future Advance - Priority). Provides for continued priority of future advances.

(xvii) ALTA - Form 14.1 (Future Advance - Knowledge). Provides the same coverage as Form 14, but excludes coverage for advances made after the insured has knowledge of an intervening lien, encumbrance or other matter affecting title.

(xviii) ALTA - Form 14.2 (Future Advance - Letter of Credit). Provides similar coverage of future advances in situations where the "agreement" involves a letter of credit, surety or reimbursement agreement.

(xix) ALTA - Form 16 (Mezzanine Financing). Provides for direct claim of mezzanine lender on owner's policy in property not serving as security interest, but owned by borrower under mezzanine financing arrangement.

(xx) ALTA - Form 21 (Creditors' Rights). Limits the scope of the Creditors' Rights exclusion contained in the policy jacket.

(e) Opinions. Lenders typically request what are commonly referred to as the "authority" and "enforceability" opinions from an independent legal counsel to ensure the integrity of the transaction. Traditionally, these opinions are given in loan transactions with respect to the borrower regarding a number of legal issues concerning the validity and effectiveness of the transaction. The following list of legal opinions is typical:

(i) Validity, enforceability. An opinion that the applicable documents executed by the applicable party are duly authorized and constitute the legal, valid, binding and enforceable obligations of the applicable party.

(ii) Valid existence, good standing. An opinion that the applicable party is duly organized, validly existing under the laws of the jurisdiction of its formation, and is in good standing under the laws of such jurisdiction and any other jurisdictions in which it is required to qualify to do business.

(iii) Power, authority. An opinion that the applicable party has the full power and authority to carry on its business and to enter into the applicable documents and the transactions thereby contemplated.

(iv) No violation of laws or documents. An opinion that the execution, delivery, and performance of the applicable documents by the applicable party will not violate any law, regulation, order, or decree of any governmental authority, or constitute a default under or conflict with the organizational documents or other agreements governing or to which the applicable party is a party.

(v) No consent. An opinion that no approval, consent, order, or authorization is required in connection with the execution, delivery, and performance of the applicable documents other than those approvals, consents, orders, and authorizations that have been obtained in connection with the closing of the transaction.

(vi) Usury. An opinion that the payments set forth in the applicable documents do not violate applicable usury laws.

(vii) Choice of law. An opinion that the governing law provisions set forth in the applicable documents are enforceable.

3.3 Loan Application and Negotiating the Term Sheet.

Many lenders have take the position of short-cutting the loan document negotiation stage by loading the term sheet and loan application with all of the relevant terms of the loan documents. The longer the application or term sheet, the more likely you want legal counsel involved in the process.

In addition to the obvious financial terms, the term sheet may include limitation on transfer of ownership in the borrower. Typically, the lender will prohibit any transfer of debt or equity in the capital structure of the borrower. You will need to make sure that these limitations are revised to reflect the nature of the borrower's capital structure.

As discussed at the beginning of the chapter, guarantees are a key element and need to be addressed in the term sheet. If the principals are exposing themselves to personal liability (and they will be) they need to frame that risk from the onset.

3.4 Negotiating the Loan Documents.

The key points in negotiating the loan documents are (1) limiting the liability of the developer and its principals, (2) framing the mechanics for disbursements of loan proceeds and (3) preventing defaults.

Limiting the liability of the principals will be focused on the guarantees and the nature of the guarantees. When appropriate, the guarantees should be limited to the actual loss by the lender, rather than the full amount of the loan.

Framing the mechanics is discussed in the next section.

In preventing defaults, it is better to get a notice and cure period before the lender's remedies are available. Some defaults will be automatic for items such as a prohibited transfer.

3.5 Mechanics of the Construction Loan.

(a) Initial Disbursement. Most construction loans will have a lengthy list of items that need to be satisfied for the lender to make an initial disbursement under the loan. Since the lender is typically funding at closing and upon execution of the construction loan agreement, the list of items for the initial disbursement are largely a to-do list for the borrower.

(i) Title Insurance. Borrower must deliver to lender a mortgagee policy of title insurance on the current form.

(ii) Survey. A survey of the real property in form required by the ALTA/ACSM Urban Standards by a licensed land surveyor, dated not earlier than sixty days prior to closing, and satisfactory in all respects to lender and the title company, made by a licensed land surveyor.

(iii) Insurance. Borrower shall deliver to lender prepaid (for a period of not less than one year) insurance policies in amounts acceptable to lender. All certificates of insurance should include a 30-day notice of cancellation or material changes to the coverage.

(iv) Zoning. Borrower shall submit to lender zoning letters, a zoning report and, if requested, a zoning opinion of borrower's counsel, to the satisfaction of lender and its counsel.

(v) Opinion. An opinion of borrower's counsel in form and substance acceptable to lender as to the authority of the borrower the enforceability of the loan documents and certain matters affecting the project.

(vi) Plans and Specifications. All plans and specifications and site plans for all of the improvements to the project have been approved by the lender.

(vii) Construction Costs. Borrower has submitted to lender and lender's architect or other engineer or professional designated by lender a construction cost budget which shall include all costs to be incurred to construct the improvements, which budget shall be satisfactory to lender in its sole discretion. The budget must include a sufficient allocation for interest reserve to carry the loan throughout the entire construction loan term.

(viii) Delivery of Loan Documents. All of the loan documents have been executed and delivered to lender in form, substance and legal effect satisfactory to lender and its legal counsel.

(ix) Subordinate Financing. Lender has received a subordination agreement in form and substance acceptable to lender from any junior lienholder.

(b) Subsequent Disbursements. The mortgage lender will have some more specific requirement to address the ongoing construction of the project before disbursement. The primary goal of the lender is to make sure its lien is still in place and that construction is progressing as expected.

Lender will not disburse any loan proceeds if such disbursements together with prior disbursements would cause the loan to exceed a fixed percentage of the total project cost.

Provided that the borrower is not in default under the terms and conditions of this agreement or any of the loan documents and provided that borrower has satisfied all of the initial funding requirements.

No advance shall be made unless, in the sole judgment of the lender, all work usually done at the stage of construction of the project when the advance is sought hereunder has been done in a good and workmanlike manner according to the plans and specifications and in accordance with the budget for the project and all materials and fixtures usually furnished and installed at such time are furnished and installed; provided, however, that the lender may advance parts or the whole of any installments before they become due if the lender believes it advisable to do so, and all such advances or payments shall be determined to have been made in pursuance of this agreement and not in modification thereof. At no time shall lender be required to make any advances for construction costs or otherwise if the remaining amount to be advanced under the construction loan is insufficient to pay all remaining construction costs.

Lender will advance proceeds of the construction loan for materials stored on the project site meeting certain requirements.

The lender shall have no obligation to make an advance of loan proceeds if the borrower or the general contractor is in default under or fails to comply with any term, covenant or condition of any agreement with the equity investor or special investor, or if lender reasonably deems that borrower or the general contractor will be unable to satisfy any term or condition of any said agreement.

A certificate from an engineer or architect approved by lender, certifying that the work described on the application has been completed in accordance with the plans and specifications and budget approved by lender to the degree of completion as represented in the application for disbursement;

Statements describing in detail the amount of costs incurred for construction to the date of the request; the names of all persons or entities that have provided work or materials for the construction; the amounts previously paid to the date of the request; the amounts then due and unpaid and an estimate of the amount necessary to complete the work; that each of the aforesaid parties, is not aware of any change orders or proposed change orders (other than those change orders previously approved in writing by the lender); that to the knowledge of each of the aforesaid parties, all governmental permits, approvals and orders required to complete the project in accordance with the plans and specifications are in full force and effect; and that to the knowledge of each of the aforesaid parties there are no pending or threatened actions or litigation which may be brought by a government official or private party to interfere with completion of the project in accordance with the plans and specifications;

Partial and final waivers of lien (whichever is applicable) duly executed by each contractor, subcontractor, materialmen, supplier or laborer who has performed the work or supplied the material for which reimbursement is sought, which waivers shall certify the amounts paid to the contractor, subcontractor, materialman, supplier or laborer to the date of the waiver and shall be in form and substance acceptable to lender;

If there has been a foundation installed or other material improvements have been located on the property since the date of the last survey, an updated survey by a registered land surveyor, which shows all improvements, structures and utilities (if any) installed on the real property since the last survey and surveyor's certificate;

(c) Final Disbursement. The final disbursement will be held until completion of the project to ensure that the contractor finishes their job and all sub-contractors are paid. The lender will typically want to have the certificate of occupancy issued by the municipality. The lender will also want the architect to issue its certificate of substantial completion. If there are still punch list items to be completed, the lender will want to escrow funds for payment. Final lien waivers will be key to getting the last of the funds released.

4. CONVERTING TO A PERMANENT LOAN

4.1 General.

In establishing the capital structure, it is important to evaluate the timing for repayment of the capital sources. Many construction mortgage lenders may not be in market only for the construction portion of the project and not be interested in long term financing of the project. Many lenders in the market for long term financing of a project may not be interested in financing the construction of the project.

4.2 Convertible Loan.

If the lender is the market for providing construction financing and staying on board for the long term financing of the project, the loan documents should provide for the terms of the conversion from a construction loan to a long term loan. Typical requirements are:

(i) Borrower shall deliver to lender at least thirty days prior to the commencement date of the permanent loan written notice that borrower is prepared to close the permanent loan or lender otherwise notifies borrower that all of the other permanent loan conditions have been satisfied.

(ii) Debt service achievement has been obtained. If the debt service achievement has not been satisfied by the end of the construction loan term, this condition shall be deemed satisfied by the reduction of the permanent loan amount.

(iii) The project has met or exceeded ninety percent of the rental units being occupied by tenants paying rent in full during the debt service achievement period.

(iv) Borrower shall deliver endorsements to the existing title policies insuring lender in an amount equal to at least the permanent loan amount and deleting from the existing title policies the pending disbursements exception, completion of improvements exceptions and any mechanics lien exceptions, which endorsement(s) shall be effective as of the conversion date.

(v) The construction of the improvements has been completed and borrower has delivered to lender permanent certificate(s) of occupancy.

(vi) Lender has received a certification from the architect of final completion certifying that the work performed by the general contractor under the construction contract is fully complete, including all punchlist items except those punchlist items specified by lender's inspecting architect/engineer as incomplete and as to which up to 150% of the funds reasonably necessary to pay the costs of completion, as determined by lender's inspecting architect/engineer, have been escrowed with lender.

(vii) There are no uncured events of default under the note, this agreement or the other loan documents at the conversion date.

(viii) All applicable terms and conditions of this loan agreement and all of the terms and conditions of the other loan documents have been satisfied by the borrower in all material respects.

4.3 Take-out Permanent.

The more complicated arrangement is where the construction lender and the permanent lender are different parties. The construction lender will want to ensure that there is sufficient capital to pay off the construction loan after the project is completed. The permanent lender will want to ensure that the project is completed in the manner it expected.

The operative document is a "tri-party agreement" between the construction lender, the permanent lender and the property owner. The tri-party agreement obligates the permanent lender to fund the take-out of the construction loan, subject to the requirements set forth in the tri-party agreement. The permanent lender and the construction lender will be at odds over the conditions to funding with the borrower trying to broker the differences. The permanent lender will want the conditions to be more discretionary and the construction lender will want the conditions to me more absolute.

Essentially all of the covenants and restrictions in the construction loan will be carried over to both lenders. For example, if the developer needs to change the plans and specifications, the developer will need consent from both the construction lender and the permanent lender.

If there is a guaranty as part of the permanent loan, the tri-party agreement may condition the take-out on there be no material adverse change to the financial condition of the guarantor.

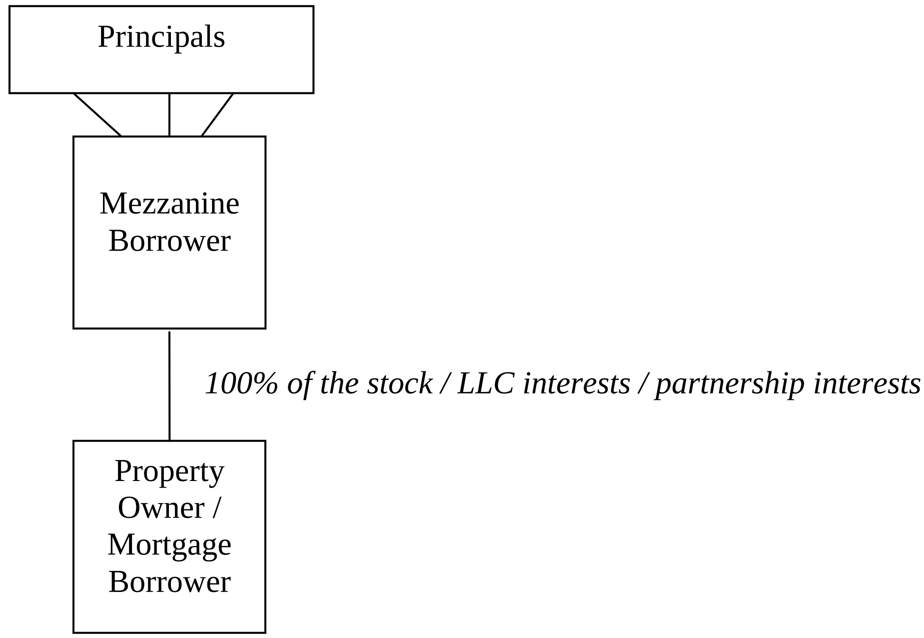
The tri-party agreement may condition on the take-out by the permanent loan on the project being conditioned by a certain date. Many permanent lenders will be unwilling to extend the timeframe. The permanent lender may need the deadlines to address capital availability and their own funding sources.

5. MEZZANINE LOAN FINANCING

5.1 Background on Mezzanine Financing.

Mezzanine financing is debt that is subordinate to (i.e. gets paid after) the mortgage debt. Usually, it is a loan to a company that holds all of the ownership in the company that owns the property.

Structure Diagram:



The loan is usually secured by the mezzanine borrower's pledge of its ownership interest in the property owner. If the loan defaults, the lender has the right to foreclose on the ownership interest in the property owner, but not to foreclose on the property itself.

Mezzanine lending used to be fairly exotic and only found in extremely large transactions. In the past few years mezzanine lending has become more common and used in smaller transactions.

Typically, the mezzanine lender does not have a mortgage on property to secure repayment of the mezzanine loan. Although a mezzanine lender may want the extra security of a second mortgage, the mortgage lender may not allow a second mortgage to encumber the property. The mortgage lender wants to ensure that the mezzanine loan remains subordinate to the mortgage loan.

5.2 Subordination /Intercreditor Agreement.

The subordination/intercreditor agreement is the key document governing the relationship between the senior lender and the mezzanine lender. A mezzanine lender typically seeks to obtain certain rights with respect to the mortgage loan to protect its investment, and the mortgage lender generally tries to limit restrictions on its ability to deal with the mortgage borrower and the mortgaged property.

The negotiation of an intercreditor agreement is one of the most difficult aspects of mezzanine loan financing. Some key issues to consider in an intercreditor agreement:

- permitted transferees of the mezzanine loan;
- conditions to taking title to the pledged equity interests;
- limitations on modification to the first mortgage loan;
- limitations on modification to the mezzanine loan;
- rights of the mezzanine lender to cure defaults on the first mortgage loan;
- rights of the mezzanine lender to purchase the first mortgage loan;
- certain control rights of the mezzanine loan; and
- voting rights in bankruptcy.

Since the mortgage loan documents would typically prohibit the mezzanine loan, it is important to the mezzanine lender (and therefore to the borrower) that there be an intercreditor agreement allowing the mezzanine debt.

Dechert LLP has produced a form of intercreditor agreement that has been widely adopted by mortgage lenders, and especially by conduit mortgage lenders. See Mezzanine Debt: Suggested Standard Form of Intercreditor Agreement by David W. Forti, Timothy A. Stafford: http://www.dechert.com/practiceareas/practiceareas.jsp?pg=lawyer_publications_detail&pa_id=32&id=1535.

5.3 Closing a Mezzanine Loan from the Mezzanine Lender's Perspective.

The key steps in closing a mezzanine loan are the execution of the loan documents and perfection of the lender's lien on the ownership interests. Other aspects of closing the mezzanine loan are the same as one would encounter in closing the acquisition of the property and closing a mortgage loan.

As the mezzanine loan is not a true real estate loan, the mezzanine loan documents are typically not governed by the law where the property is located. Instead they are usually governed by the law where the lender is located. The opinion of counsel from the mezzanine borrower will need to contain an opinion that the choice of law will be recognized and that the mezzanine loan documents are enforceable under state law.

Under the Uniform Commercial Code the interests in the property owner held by the mezzanine borrower will be governed by either Article 8 or Article 9.

If the ownership interests are "certificated," like stock certificates, perfection of the security interest is governed by Article 8. Otherwise perfection is governed by Article 9.

If the interests are not certificated, perfection is by filing a financing statement with the state in which the mezzanine borrower is formed. If it is a Massachusetts limited liability company, corporation or partnership, the financing statement should be filed with the Massachusetts Secretary of State. The financing statement should name the mezzanine borrower as the debtor, the mezzanine lender as the secured party and describe the ownership interests in the property owner as the collateral.

For "certificated" interests, the best method to perfect is by possession. At the closing, the mezzanine borrower will need to deliver the original certificates. It is good practice to also file a UCC financing statement as well.

At closing, the mezzanine lender will need comfort that their lien on the ownership interest is not subordinate to other liens. At closing, the mezzanine lender will require UCC searches on the mezzanine borrower showing that they have not previously pledged the interests.

5.4 UCC Insurance.

Give the growth in mezzanine loans, there is a growing market for title insurance products to give lenders comfort as the enforceability and priority of the lien. Title insurance companies have begun issuing UCC insurance policies.

Once of the first companies to do so was First American Title Insurance Company with their Eagle 9 UCC insurance policy, which started issuing its product in 2000. Several companies now have a UCC insurance policy available. A UCC title insurance policy insures the attachment, perfection and priority of a lender's security interest in the personal property collateral of the debtor. By insuring lien priority, the lender's policy also insures against mis-indexed filings and similar matters, and effectively covers the authority of the debtor to grant the security interest to the lenders.

5.5 Mezzanine Financing Title Endorsement.

Because the mezzanine lender does not possess a present ownership in the real property of the borrowing entity, it does not itself have an insurable interest in the land. Also, its interest cannot be insured under an ALTA loan policy, because it does not have a mortgage lien against the real property.

There is an ALTA endorsement for mezzanine lending that was adopted in 2004. The endorsement combines the coverage of a fairways endorsement, a non-imputation endorsement and an additional insured endorsement. The Form 16 Mezzanine Financing Endorsement protects the mezzanine lender with respect to (1) matters created, suffered, assumed or agreed to by the insured (Exclusion 3(a)), (2) matters known to the insured but not found in the public records and not known or disclosed to the title insurer (Exclusion 3(b)), and (3) loss the insured suffers because it has not paid value for the interest in the land covered by the policy (Exclusion 3(e)). The endorsement assigns to the mezzanine lender the right to receive payments otherwise payable to the insured under the policy. The endorsement also assures the mezzanine lender that no amendment of the policy can be made without its written consent.

The endorsement can be issued when the mezzanine loan is closed or it can be issued to amend the borrower's existing owner's policy of title insurance.

5.6 Remedies of the Mezzanine Lender.

The primary remedy of a mezzanine lender is foreclosing on the pledge of ownership in the property owner. This remedy will wipe out any equity the principals of the developer had in the project. The foreclosure on the pledge will not discharge any obligations between the principals and the mortgage lender.

One issue to focus on is the remaining liability of the principals under the mortgage financing. As discussed above, the principals of the developer will be obligated under some sort of guaranty to the mortgage lender. After the foreclosure on the pledge, the mezzanine lender has taken over the borrower and the obligations of the borrower to the mortgage lender. The mezzanine lender has not taken over any obligations between the principals and the mortgage lender merely by foreclosing on the pledge. For example, the principals may have full recourse to the mortgage lender under bad boy guaranty for the borrower voluntarily filing for bankruptcy. The mezzanine lender could cause the property owner to voluntarily file for bankruptcy. The principal would now be obligated under the bad boy guaranty, most likely for the full value of the loan, while the mezzanine lender can enjoy the delay and re-structuring of the borrower in bankruptcy.

6. JOINT VENTURES

6.1 General.

A joint venture can be an excellent opportunity for a source of capital. Unlike with a debt financing, the developer is generally sharing the upside and downside with the joint venture investor. Many joint venture partners will provide a promote to the developer, giving the developer a bigger piece of the upside as the returns from the project increase.

6.2 Institutional Investors - UBIT and REOC.

Many sources of capital for joint venture are investment funds, pensions plans and other sources of pooled capital. These investment entities are a vast source of capital, but have many restraints on how they can use the capital. The background on this is well beyond the scope of this chapter, but two items come into play that affect the capital investment: UBIT and REOC.

(a) UBIT.

Unrelated Business Income Tax is a tax levied on otherwise tax-exempt parties in income generated from certain sources. In the real estate investment context this often arises in the context of certain types of real estate assets. Generally, real estate investments subject to debt financing are exempt from UBIT.

UBIT arises when the real estate asset is not generated real estate rental income. The most common example of this is a hotel. Room rentals are generally not considered real estate income. This is further exacerbated by adding in the revenue from room service, restaurants and other room charges. Other common types of real estate that cause problems are parking lots, skilled nursing facilities, and golf courses.

The other real estate investment that causes a UBIT issue is real estate held as inventory rather than investment. This UBIT issue is most commonly seen in condominium developments and subdivisions.

Not all institutional investors are sensitive to UBIT. Those that are sensitive to UBIT have different level of sensitivity. There are two common ways to deal with the UBIT issue: master leases and internal debt. With a master lease, the complete project is master leased to an affiliate of the developer. The affiliate runs the operations and pays a rental fee to the joint venture. This results in extra fees for the developer. The second method is to use internal debt. The property owner will issue notes to the joint venture partners, thereby treating a portion of the capital as debt rather than equity. The interest payments on the notes would not be subject to UBIT. The internal debt combined with the mortgage debt and depreciation on the improvements may be enough to shelter any taxable income.

(b) REOC.

REOC stands for Real Estate Operating Company. This term is commonly used under the plan asset regulations of the Employee Retirement Income Security Act ("ERISA"). The plan asset regulations limit the types of investments that pension plans can make. Again, the plan asset regulations are outside the scope of this chapter, but you should be aware of certain features.

For an investor with a REOC requirement, the investor needs to make sure that the investment is an investment in real estate. That means the investor needs some management rights with respect to the real estate investment.

The issue will arise in connection with the funding of a purchaser's good-faith deposit under a purchase and sale agreement. The REOC requirement will necessitate that the purchaser have substantial input on the operations of the property once the deposit is made. The purchase will need input on leasing and property management decisions.

The REOC issue also commonly arises under property management agreements. Since the property manager will effectively control the operations of the property, the REOC investor will need substantial rights over the property manager. For instance, the REOC investor will need to be able to terminate the property, without cause, on 60 days notice.

6.3 Friends, Family and Employees.

A common method of giving incentives to employees of the project developer is to bring them into the equity structure. Then their hard work on the project can be compensated with some of the upside of the project's success.

Also, friends and family can be source of capital, assuming that your friends and family have the capital.

6.4 Securities Law.

With joint ventures and other equity investments, it is important to note that the securities laws are applicable. In particular, you should ensure that the investors are "accredited investors" under the Securities Act of 1933. By having all of the investors be accredited investors you can avoid the securities registration requirement. The federal securities laws define the term accredited investor in Rule 501 of Regulation D as:

(i) a bank, insurance company, registered investment company, business development company, or small business investment company;

(ii) an employee benefit plan, within the meaning of ERISA, if a bank, insurance company, or registered investment adviser makes the investment decisions, or if the plan has total assets in excess of $5 million;

(iii) a charitable organization, corporation, or partnership with assets exceeding $5 million;

(iv) a director, executive officer, or general partner of the company selling the securities;

(v) a business in which all the equity owners are accredited investors;

(vi) a natural person who has individual net worth, or joint net worth with the person's spouse, that exceeds $1 million at the time of the purchase;

(vii) a natural person with income exceeding $200,000 in each of the two most recent years or joint income with a spouse exceeding $300,000 for those years and a reasonable expectation of the same income level in the current year; or

(viii) a trust with assets in excess of $5 million, not formed to acquire the securities offered, whose purchases a sophisticated person makes.