REAL ESTATE LOAN WORKOUTS:
Issues in Shared Appreciation Mortgages

Article contributed by: Doug Van Gessell of Sheppard Mullin Richter & Hampton LLP

Given the continued credit crisis and simultaneous deterioration of the real estate market, many borrowers of real estate-secured loans will turn to workout strategies in order to keep their loans in place. One common borrower strategy is to offer the lender a percentage interest in the future sales proceeds, and possibly the cash flow, from the real estate collateral in exchange for a deferral or reduction of the debt service due pursuant to the loan. Alternatively known as a "shared appreciation mortgage," a "contingent interest loan" a "participating mortgage" or an "equity kicker," these loans were popular responses to the high interest rates during the 1980s and the loan workouts of the 1990s. In this market, such loans play a slightly different role: incenting otherwise reticent lenders to loan money (or keep loans in place) for a combined reward of fixed and contingent interest that may outweigh the perceived risks of lending in the current real estate market. This article discusses issues related to such an approach.

General Concerns

In general, a shared appreciation formula should provide a lender a percentage interest in the proceeds of the actual or imputed sale of the property, less certain deductions for costs associated with the sale. The lender's percentage interest is based on its desired internal rate of return ("IRR") which is typically based on the discount rate at which the present value of the loan disbursements equals the payments of principal and interest (both fixed and contingent) made on the loan. To ensure that the target IRR is achieved, the lender may require a preferred return before the borrower receives its share of profits or cash flow. The borrower may also ask for such a preferred return on its equity in the project. The borrower may therefore insist that it receive a portion of the cash flow or appreciation periodically, or at least after the lender has been repaid its principal and its fixed interest, but before the lender begins receiving sums based on its targeted IRR. Also, note that some lenders will even attempt to base its shared appreciation on the greater of the sale price or the appraised value of the property at the time of sale, although this approach will be vigorously resisted by borrowers.

Given certain events that might reduce the lender's anticipated return on that sale, a lender will want to provide that all or any part of the shared appreciation will be paid upon any of: (i) the maturity of the loan, (ii) a default under the loan, (iii) a sale of the property, (iv) a prepayment of the loan, (v) a refinancing of the property, (vi) the placing of junior financing placed on the property (after deducting for improvements made with funds from junior financing), or (vii) the recovery of insurance and condemnation proceeds after a significant casualty or condemnation. The following sections discuss issues associated with those events.

Imputed Sale

If the real property collateral has not sold by the maturity date of the loan, the loan documents must provide for an imputed sales price for the real property (i.e., a sales price that the parties deem would have been received had the property been sold). In order to determine that imputed sale price, the loan documents should provide for an appraisal process upon maturity and payment to the lender of its return based on that appraised value. The parties should consider how the appraisal should be performed (i.e., one versus three appraisers, "baseball"-style or not) and how the costs of the appraisal should be shared. Since this appraisal process does not actually generate cash for the borrower to pay the lender, the borrower will probably need to sell or refinance the property in order to pay off the lender. The borrower

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might bargain for an extension of the maturity date, and an extended window period free from any otherwise applicable prepayment penalties in order to complete such a sale.

Acceleration and Default

If the borrower defaults before the property has a chance to accelerate, the lender is faced with the difficult choice of whether to enforce its remedies before the property has a chance to appreciate or continue to keep the loan in place in hopes of future appreciation. Some lenders might try to avoid this dilemma by bifurcating the loan into the shared appreciation component and the fixed rate component, but, due to concerns about enforceability and possible recharacterization of the loan as equity, many lenders choose instead to simply require a minimum amount of appreciation interest by either (i) creating a minimum percentage interest equal to their IRR, (ii) creating an extra interest accrual that increases over time, offsetting any appreciation interest, or (iii) simply adding the interest to the prepayment penalty. Given any such downside protection to the lender, the borrower might ask for a cap on the amount of appreciation available to the lender.

Early Prepayment

A lender may try to guard against losing its share of property appreciation due to a prepayment of the loan by either (i) imposing a minimum requirement for appreciation interest, or (ii) creating a prepayment lock-in period.

Formula for Deductions

The definition of "net sales proceeds," or the relevant deductions otherwise taken from the lender's shared appreciation interest in the sales price of the real property, is typically a much-negotiated item.

Payoff Expenses; Equity and Improvement Costs

The borrower will want to deduct from any shared appreciation: (i) the amount of its then-existing equity in the property, (ii) any acquisition or improvement costs and any operating defects funded by the borrower, whether directly or through loans not encumbering the property, (iii) all amounts, including any prepayment penalties, required to pay off any permitted financing secured by the property, and (iv) any principal amortization of any permitted financing encumbering the property, including the shared appreciation loan itself (to the extent there is not a fixed base deduction for the original principal amount of the loan). The willingness of the lender to agree to these exclusions will probably depend on the extent to which it has also received a shared interest in the cash flow of the property.

Closing Costs

In addition to brokerage commissions, title insurance costs, transfer taxes and recording costs paid by the seller/borrower, a borrower will want as wide a variety of deductions for closing costs as possible, so as to prevent it from having to subsidize lender's shared appreciation interest in the sales price by paying the entire cost of any new or unexpected closing costs itself. In addition, the borrower will try to have the description of closing costs be broad enough to include costs such as appraisals, mechanics' liens payoffs or other costs necessary to remedy a problem a the property which otherwise precludes the buyer from purchasing the asset. Of course, lenders will seek to limit or cap the categories of closing costs deducted from the share purchase price, and may want to attach a specific list of such costs.

Prorations

The borrower may also want a deduction for any net proration credit given to the borrower in the purchase agreement for rents, real estate taxes, utilities or other items, to the extent the shared appreciation formula doesn't already exclude those costs as part of the "net" sales price. If the lender does not participate in cash flow as additional interest, then the lender may resist a deduction for operational costs incurred in connection with the sale.

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Purchase Price Structure

If the purchase price is paid all in cash, the shared appreciation formula is pretty simple. But what happens if a portion of the purchase price is purchase money financing? First, the parties will have to determine what happens to the lender's lien. Is it subordinated to the debt, or is it replaced with a pledge of the purchase money note or some other collateral? Is the lender willing to take some of the collection risk related to the purchase money financing? Is the lender willing to defer payment of the purchase price as and when payable under the purchase money note? Does the lender receive a particular priority of payments received from the note? If the deferral of payment and the collection of risk are major issues to the lender, the parties might compromise by giving the lender a reasonable approval right over a sale in which the down payment is less than a certain percentage of the purchase price, and the credit status of any buyer that will be providing a purchase money note.

Shared Appreciation of Cash Flow

In addition to its percentage share in sales proceeds, will the lender also share in cash flow from the project? If so, the following issues occur:

Computation of Cash Flow Shared Appreciation

How will the cash flow be measured? Typically, the choice is between the gross income, net cash flow and net operating income. The lender will prefer the use of gross income, which requires less oversight of the borrower and less potentially dubious expense inclusions. However, it requires the borrower to assume the risk that its expenses will rise faster than its income and reduce its net operating income after debt service. The borrower will prefer the use of net operating income ("NOI") over gross income, since it will allow it to deduct its expenses. The borrower will also prefer NOI over the use of net cash flow, since NOI does not take into account extraordinary receipts, which may be attributable to the period of time prior to the origination of the plan.

Will the cash flow be determined on a cash or an accrual basis? With cash basis accounting, the borrower may have an incentive to defer income. With accrual basis accounting, the borrower may be faced with the prospect of having to pay shared appreciation on amounts the borrower has not yet received. The borrower will favor the use of cash basis accounting (with appropriate adjustments for income attributable to the period of time prior to the loan), and the lender will favor the use of accrual basis accounting.

Income Issues

The parties will have to determine what constitutes income for purposes of the cash flow. A distinction may have to be made between receipts from the property and income to the borrower. Tenant pass-through expenses paid to the borrower/landlord can be excluded from income altogether or included as part of both income and expense. The borrower will seek to exclude certain nonrecurring income items such as late charges, excess sublease rentals and reimbursement for tenant improvement costs in excess of the tenant improvement allowance.

Expense Issues

The lender and borrower will need to determine whether or not to include in expenses: (i) interest on loans (other than the participating lender's loan), (ii) amortization of capital expenditures, any disallowed capital expenditures and the size of any capital reserves held for the property, (iii) uninsured casualty losses, broker commissions and legal costs in connection with a defaulting tenant, (iv) amounts payable to agents and managers (including the borrower's own staff), and (v) expenses relating to environmental compliance and clean-up.

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Records and Audit Rights

The loan documents should obligate the borrower to provide periodic operating statements from the property so that it can verify receipt of its shared appreciation interest. It will also want audit rights that require the borrower to reimburse the lender its audit costs if a substantial discrepancy is discovered. The parties might also consider some form of alternative dispute resolution, such as mediation or arbitration, to resolve disputes over shared appreciation.

Usury

While most institutional lenders are already exempt from relevant usury exemptions, if the lender's shared appreciation interest, when combined with the fixed interest component, exceeds the relevant state's usury limits, then the ban might ordinarily be viewed as usurious to the extent it cannot be demonstrated that the shared appreciation is not truly contingent and at risk. However, many jurisdictions have removed most of this uncertainty by passing statutes specifying that shared appreciation loans are not usurious.

Recharacterization of the Loan as Equity Due to Excessive Lender Control

Both lender and borrower will want to avoid recharacterization of the shared appreciation interest as equity in the borrower. In determining whether or not to recharacterize the loan as a partnership, a court will look at: (i) the intent of the parties to form a partnership, (ii) the sharing of profits, (iii) the sharing of losses, and (iv) whether the lender is involved in the management and control of the affairs of the borrower. If the lender shares any of the borrower's losses, it runs the risk of being deemed a partner of the borrower. For the lender, such recharacterization might result in fiduciary duties to the borrower, liability to third parties, violation of banking regulations, a potential equitable subordination of lender's lien in bankruptcy and securities law compliance obligations. In addition, the lender may be deemed to have received unwanted constructive cash distributions under I.R.C. § 752 and the losses allocated to the borrower's members may be reallocated to the lenders. Such recharacterization for tax purposes may result in borrower's loss of its ability to take deductions for interest on the loan. Many jurisdictions try to avoid these results by clearly stating that a shared appreciation loan does not create a partnership or joint venture between a lender and borrower. However, it's unclear that a lender exercising excessive control over a borrower can take advantage of this provision and, in any event, Lenders should generally seek to avoid: (a) control over day-to-day management of the borrowers, (b) direct management through a lender-appointed director or stock pledge agreement voting rights, and (c) appointment of the officers and directors of the borrower. In any event, it makes sense for the parties to include an explicit disclaimer in the loan documents that the parties do not intend to enter into a partnership, and that their relationship is strictly one of lender and borrower.

Title Insurance

Since the shared appreciation component of a loan may result in the amount secured by the deed of trust's exceeding the principal amount of the loan, the lender can choose to either: (i) obtain title insurance in such larger, estimated amount of the entire loan, including contingent interest, or (ii) obtain a title insurance endorsement allowing the lender to subsequently increase the amount of title insurance applicable to the loan.

Conclusion

In today's tight credit environment, shared appreciation mortgages provide a potential additional profit incentive for lenders to make new loans, or restructure old ones, in a challenging real estate environment.

Doug Van Gessel is a partner at Sheppard Mullin in the Real Estate practice group and based in the firm's San Francisco office.

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