REAL ESTATE FINANCE

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Mark Epley is your instructor. Is that Mark way in the back there? Wave your hand - tall, slim, handsome, red hair. Mark is legitimate, he's had a couple years out there in the real estate lending area so he'll keep me honest and interrupt if I tell something that ain't so. And the object of the quiz sections is really to put you through your paces on the number crunching that is inevitably part of the financial process and will move you through initially some of the basic exercises in computing interest and principal payments under various arrangements and terms, and then into a series of progressively more difficult case studies in which you are the underwriter and get to choose whether, in fact, you will lend and if so on what terms. But we will not allow you to say "maybe". You will fish cut bait. It will be in your name. There may be no right answers but you better be firm about what it is you say and have your facts right.

The other element is to remind you, the graduate students, to get your reservation in on the fish dinner as soon as possible so that we can get a nose count and know how much water to put in the soup. For those of you that hasn't heard - I managed to break a hip about two and a half weeks ago and so I'm always sitting a little bit to the southeast at the moment, as a result of that and will be for another month or so and so if you see me squirming up here, that's probably why. In any event, since I didn't walk into the hospital on it, I don't have to walk out of the hospital on it and speeds up the process considerably.

The subject of real estate finance is probably one of the most difficult there is to teach, as there's virtually nothing that I was teaching ten years ago or even eight years ago or possibly five years ago, that we're teaching today. It's a very highly dynamic area of really sort of improvisational adaptations to what is occurring of course in the capital markets as we have moved from highly insulated, somewhat artificial, delineations of a highly regulated capital market in this country with savings and loans and banks and credit unions and insurance companies had very clearly staked out territories in which they could operated and which we were probably pretty well insulated from the international scene, to a point now where we have virtually a deregulated financial industry and a capital market that is highly sensitive to whatever the Japanese or the Germans or whoever else become interested in real estate one way or another. And real estate continually improvises accommodations to that but the basic objectives of those accommodations remains relatively the same and so it's important to get the principles in a somewhat generic and basic format and then begin to see how the rather innovative structure at the moment attempts to provide for those principles through some type of accounting fiction or structural framework which allows real estate to survive, no matter what the (?) capital markets are doing.

Once upon a time a mortgage was a very simplistic thing. The word mortgage itself means debt place. And the old men borrowed from the Lord of the Manor presumably for a crop or for building his hut and if he didn't pay, he died - which made sense. Eventually the King of England realized he was losing a lot of yeoman that way and he went to his chancellors and said we've really got to come up with a different method in which perhaps the penalty would not be quite so extreme as I need those yeoman to die for me in battle as soldiers, rather than just as farmers and, therefore, is there some way in which we could begin to provide some balance between the rights of the borrower and the rights of the lender and ever since then, the mortgage has been outside the law of contracts, but within the law of equity. And we've moved from where it was absolutely off with the head to a point where you got to joist with the Lord which, of course, is really embarrassing to joist with the Lord who was on a horse and you were on foot and so forth. And to a point where finally you got to joist with his attorney. But basically the principle was still strict foreclosure - that if you failed to pay, in fact, you lost whatever it was you had in the property. There was really no strict accounting as to the equity as to whether the Lord was entitled to everything or not. It was strict foreclosure and everything went to satisfy the debt on a liquidated damages basis. Compare that to today in which the one case we're working on the Muzzie Ranch in California. That has been in foreclosure for 17 years and has not seen dollar one on its loan or its interest as the owners of the ranch went into bankruptcy and through a series of suits and counter suits, and so forth and so on, has continued to remain in possession of the ranch, continue to milk the ranch, continue to work all kinds of obscene deals, and the first and second mortgage holders haven't seen dollar one. So that the process has switched to the point where the debtor has the upper hand and will continue to have the upper hand simply because there are more debtors than there are creditors. And, therefore, in a democratic society whenever the pressure gets a little heavy on the borrower, the legislature is only too willing to change the rules of the game - midway through the strings and protect the debtor rather than the lender. Therefore the idea of a debt pledge may be more appropriate for the lender than for the borrower today.

It's amazing that under that set of circumstances that the borrower and the lender can get together at all. The borrower is borrowing, first of all, because he doesn't have any money. But even if he had money, he'd probably borrow because he feels that 1) real estate's too risky to use his own money. One the best risk management deals around is a non-recourse mortgage in which if the project works, wonderful, I can sell the property for a profit, some type of profit and you take a loan, if it doesn't I take a walk on it, I hand the property back to the lender and let him worry about it. So one reason for borrowing the money is that it's too risky for one. The second reason for borrowing money is that I want to expand my span of control. If I have $120,000 of my very own money, I could buy one four unit apartment building and have it all paid for or I could buy ten of them if I can find somebody that will give me 90% loan-to-value ratio and now I have 40 units and in many ways, my disposition has improved because I have a greater number of units, my expenses are more predictable, my cash flows are a little less erratic, after all if I have a 4 unit building and one vacancy, suddenly I have a 25% variance in my monthly revenue, where if I have a 40 unit project and I have 4 vacancies I have only a 10% variance to my monthly revenue. So from a statistical standpoint I'm in much more stable risk management position to my revenue stream, the larger the scale of operations that I might have.

The third reason for borrowing, of course, is simply that my profit centers really aren't into real estate at all, but in creating a deal. By borrowing money and building the project I create a general contractor's profit. I can sell land for my land development subsidiary. I create leasing commissions for my leasing department and insurance commissions for my insurance department and, in effect, what I'm really doing is subsidizing a revenue stream for a whole series of services that I would like to provide. And so the real collateral value for the loan isn't the real estate at all, which is what the lender accepted as collateral. What he really ought to have accepted is an equitable position in the insurance agency and the general contracting firm and in the land development firm and all of the other subsidiaries that are taking the skim off the dollars that have been lent on the real estate. But lenders almost never do that. So here you have a borrower that goes into the deal saying, 1) I don't have any money, therefore I have con somebody else out of it and 2) if I did have any money, it's too risky for me or 3) I need to expand my span of control so my management gets a little diluted but, on the other hand, I get certain kinds of risk management advantages or 4) I can skim the loan for profit centers and snake the money out, not through the real estate, but through my subsidiaries.

Now here's the lender on the other side, typically, a fiduciary of some sort who has pledged to 1) protect the principal of his savers, his insurance policy holder, his pensioner, whoever it is he represents and whoever it is he has pooled the money from and he's saying, "Hey, one of the reasons you gave the money to me is because it's saved. How come - what he lacks is something that's saved, he's lending it to a guy on the project that wouldn't put his own money in it." It's essentially a contradiction there. And second of all, he says is, "One thing I really want is regularity of income. I want to be able to anticipate that I'll get certain cash flow from it because there's certain commitments I have to make in terms of dividends to my savers and interest payments to my depositors and so forth and so on." And then three, of course, I want a periodic ability to readjust the payment to reflect the financial risk of long-term interest contracts, and so forth and so on. And, of course, the borrower is saying, "I can't have my interest varied all the time because my rents aren't going to vary. So what I need is a 25 year loan, fixed interest kind of thing and the lender is saying, gee what I really need to do with that is have a kick at the cat every year to find out where the interest rates went and we adjust the return on my money lest I lose my depositors and so forth." So you need to look at the motivations and the objectives of the borrower and the lender. One of the fundamental miracles of the

American Commerce is that they get together at all and that they do it as a matter of course and that they have devised contract formats and mechanisms which allow them to resolve those fundamental conflicts in their objectives and negotiate to find some way of allocating risk between the parties. Real estate finance is ultimately a course in risk management and a course identifying each element of variance in the assumptions under which we move toward a contract and allocating the responsibility for that risk and, perhaps, finding a mechanism by which we can shift the consequences of that risk. Who benefits and who pays?

In the residential area we have created tremendous risk management institutions which can specialize because of a theory of life’s numbers in dealing with those elements of variance. Think about a closing of a mortgage for a moment. It’s really a series of steps in risk management. As you go to the closing the first thing they want to know is do you have marketable title? And so a title insurance company sets forward and says, “We’ve gone through the entire history of this batch of U.S. patents and we say they have marketable title “except for exceptions one, two and three.” Oh oh, how you get an attorney to rule on exceptions 1, 2 and 3 and he says those are inconsequential and, therefore, if the Indians do really get the property back as the result of some federal decision in the future, we’ll give you your money back on the mortgage loan. So there’s a possibility that the title really wasn’t marketable, is laid off on a specialized risk bearing institution called a title insurance company. And then you say, “Gee if I was to have to get my hands on the collateral, I wonder if the building is really located on the site to which I now have marketable title?” And a bonded surveyor goes out and says, “Wait a minute, the building is set back the correct way and it’s not on the lot next door and nobody can make you move it and if I'm wrong my bonding company will pay and the Society of Civil Engineers will take away my license." And you've laid off exception number 2 on another risk variance institution called a bonding company.

And then you begin to look and you say, "Gee what happens if the building burns down and blows away before I get my hands on it as collateral?" And, therefore, you have a special mortgage clause attached to the insurance policy of the borrower that says in the event that the building should be damaged for any casualty reason at all, no matter what the insurer's done to cause it, the lender will be reimbursed for the amount of his interest at the time. Now I don't mean interest in it but I mean his property interest.

And then ultimately you get down to the point where you say, "I wonder if the appraiser was wrong and I thought I made an 80% loan to value loan so do some pushin' there against a price decline, but what if the appraisal was wrong? What if the economy changes and property values fall in the community? And so you go to a private guarantee company or the FHA and FHA says, you know, in the event that the mortgage is foreclosed, we'll give you all your money back, all your cost of foreclosure, all of your opportunity costs in the process and we'll get paid back if there's a mistake on the appraisal on the property or the property cycle changes (?). And notice we have a whole series of risk bearing institutions on the residential side that stepped in and covered the leaping assumptions that the mortgage lender has made or has been required to make in the process of making that loan.

On the commercial side we don't have that degree of specialization. We don't have those kinds of risk bearing institutions with the exception of title insurance, of course, and fire insurance. We tried it. There was Commercial Lease Insurance

Corporation and the local Verex at one time had an income property lending Guarantee Fund and they lost their shirt. It was a disaster. You either needed it or you didn't and, therefore, there was tremendous adverse selection against the insurer, in that not everybody used it and as a result they got all of the worst of the worst and it was a disaster.

Now, as a result, most of our risk management conclusions in the income property financery are the result of careful negotiations and structuring and just dividing up the risk characteristics among multiple parties. As you'll see in your lecture outline for next Wednesday, for a premise that a mortgage loan is a two party agreement just isn't so. Actually at the table each of the parties are representing a committee of interests. The borrower who comes in as the developer really is speaking for a series involving equity partners, he's probably speaking for his construction lender who says you get the following things in your program, the lender will make you a temporary construction loan. He's probably speaking for the general contractors who say you better set it up this way or we aren't going to build your building. And the tenants, of course, are saying this is the kind of lease we're going to sign, but the lender is saying we will only accept leases as collateral that have the following features and lock our tenancy in and you have to have 60% of your tenants to be class A credits and so forth and so on and so on. And so, as a result, the borrower is now speaking as chairman of the committee of ghosts who all have an interest in the negotiation process.

And by the same token, the lender isn't speaking for himself any more either. The lender may be anticipating that he's going to sell his mortgage to Salomon Brothers or that he has three other lenders who are going to participate with him in the deal in order to spread the risk, that he has a group of bank regulators that are looking over his shoulder to say what he can do and what he can't do. The board of directors and investment committee who has some pretty decided opinions of what they're going to do and what they're not going to do and so forth. And so pretty soon while you've had maybe only two people at the table like you used to, the borrower and the lender, but they're no longer speaking to themselves. There is simply a committee chairman representing a very complex set of interests on both sides of the table and now when we go on further and say, "Gee this is going to be a public/private partnership and part of the money is going to come from the public sector who's going to provide the TIF district and can provide some industrial financing and so forth. Now we've got three parties at the table and a series of interests that we have to resolve in terms of this negotiation process and the allocation of risk. It gets to be a very fascinating process indeed and each deal is less and less a cookie cutter kind of thing and a custom crafted set of negotiations in which some parties are more adept than others in terms of the allocation of risk.

Now, what are the fundamental principles by which the game is played? The first and fundamental one from a standpoint of the strategy of the lender, that we're going to call the pleasure/pain and bailout principles. Pleasure, pain and bail out. The original mortgage was built on pain. I take your life, I take your property, I take your credit reputation, I take your first-born, whatever. No more. The law has limited the degree of pain and custom has limited it even further. So it's another one (?) source of collateral security for your loan, is the continued pleasure of the borrower. You need to understand where the borrower's cash flow would come from. What are his interests? As long as his interests continue to parallel the repayment of the loan, it's obviously in his self interest to continue paying the loan. If all of his profits are made the day you close the permanent loan, and after that the project continues to be a drain because it's got a negative cash flow and it's a pain in the tail and it's a holy (?) headache and so forth, you got a bad loan. It doesn't matter what the value of the property is. The borrower no longer has a vested interest in sticking it out, staying with it. On the other hand, if you know that that borrower is going to enjoy management fees, insurance fee and continue to get a cash flow from that property each month and each year and perhaps an asset management fee, and so forth, from his investors and so on, you feel very comfortable that he's going to continue to make the payments on the loan so that the goose continues to lay the golden egg for he, the borrower, as well. You must understand where the profit centers are for the borrower and be assured that they track over time as offsets against the payments due to the lender. Because that is the primary motivation for repayment of the loan. You must understand the pleasure sources of the borrower and have confidence that they parallel the repayment cycle on the mortgage.

Failing that, you would like, of course, to be able to apply pain in a selective fashion to regain his attention. You can have absolute total pain, you know, for example, a deal like Sokloby's (?) down in Kansas City for a little three or four state trucking company and the gentleman has been very proud - he started with one truck and he has moved to maybe a couple hundred trucks and now he wanted his corporate headquarters but he wanted to borrow 100% of the money for his truck terminal for his headquarters, since he'd borrowed 100 percent for the trucks and the truck trailers and so on. And the lender said, "Fine, we'll do that." The last thing, of course, you want is collateral. It's the last thing you ever want as collateral is a truck terminal which is nothing more than a series of garage doors on the side of the building. And pretty hard to find an adaptable use for this series of garage doors. But the lender said, "Fine, I'll tell you what we're going to do. We're gonna take your route permits from the IPC and no payee, no truckee." We won't take just the piece of real estate, we'll take the going concern called the trucking company as our collateral, and the pain obviously to the pride of that individual was such, Gee, you make him a 110% loan and you can be confident that he would repay it. And if he didn't repay it, you had a going concern. The same thing with a hotel, you simply can't take a mortgage on the structure. They obviously all try to control the furnishings and the liquor license and the business license and the franchise and all of the other elements that make that a cash producer. Prudential once tried to acquire the Concourse on a foreclosure, a little difference of opinion with the ownership, they had failed to suspect any claims whatsoever on all of those peripheral matters and when it was pointed out to them in bankruptcy court that to foreclose the property would leave them with scorched earth, the furnishings wouldn't go with it, the elevators weren't even included in the package - they went to chattel to Westinghouse, that the liquor license was in the name of the owner who would walk out the door. The other elements that made it work as a hotel simply weren't secured by the mortgage. The mortgage was worthless. They couldn't use the shell of the building, it was only a fraction of the value which they had lent on. They had lent on the going concern value but they had secured in their mortgage only the real estate component. So you have to understand what are the pleasure sources and then what kind of selective pain can you apply. If your pain fails you fall back to the bailout position. What am I going to do with it, now that I own it? And if you want to be sure that you don't own it, then obviously you're going to need endorsements and other forms of credit enhancement which allow somebody else to end up owning it while you get your cash and principal back. So we'll want to begin to look at mortgage deals and that pleasure, pain and bailout approach. A deal must have two out of three. If you give away in your negotiations, two out of three, you're in big trouble. Northwest Mutual, for example, in the Towers Building on State Street. First of all, didn't understand the butter sources which were essentially building the building and taking the contracting profits right up front and getting the exaggerated value of the land to help that along. Second of all, they gave a nonrecourse mortgage which meant there's no pain that we can apply. The borrower can take a walk, thumb his nose at it, and there's no way you can do anything but take the properties. And once you take the properties, you begin to bleed because the property itself really didn't fit the market that wasn't characteristic of student housing at the time they had to foreclose. They didn't understand the bailout. The bailout was going into the student housing business which they weren't really prepared to do. And if they had thought it through, they would have never had a nonrecourse loan which leaving them only with that option. So having given away two of their three elements, they were sitting ducks as soon as the profit centers evaporated as far as the lender was concerned. Pleasure, pain and bailout.

The second major rule that we want to look at has been succinctly stated by Mr. Sam Zell - real estate he says, consists of only two things, monopoly and spread. Monopoly, obviously, has to do with the market. How do we offer a unique product and service that rented at full rental when others, of course, have excess space and so forth. Initially, we're going to take that as a given that, somehow, the project that is presented to us has that peculiar attribute of being able to generate a cash flow because of its astute marketing and positioning and real estate finance, then, becomes a game of spread. How do we make sure that the cost of financing are less than the net income available. Spread takes many forms. Spread, as always, can be related to leverage. The most simple and common definition of spread, of course, is that the cost of the financing is less than the income we'll earn on the capital. The interest and principal payment due on the mortgage each month are less than the net income generated from the project. And we tend to measure that spread by something called debt cover ratio. If you say the debt cover ratio should be 1.2, we're really saying that income should be 120% of the debt service payment - monthly or annually, as the case may be. That's one form of spread. When interest rates rise and income doesn't go very far we find that real estate finance creates artificial spreads by creating artificial constants. Constants typically reduce (?) principal and the lender says, "OK, tell you what I'm going to do. You're producing 10% on your capital, and that's not enough to pay me because interest rates are now 13%. So I'll tell you what I'm going to do. I'll charge you interest at 9% so that you can have a positive spread between your income and your loan payments and I'll take a participation that says if any cash increase, I get 50% of the cash increase. If you refinance successfully if interest rates fall later, I get 50% of the refinancing proceeds and if you sell I get 50% of everything over and above your original cost." That's really a false constant in which the lender is saying, "All right, I'll take some risk, but this situation is temporary and at some point in the future we'll be able to go to a more realistic rate (?) and favorable spread and when that happens, I will take my cut for sharing the risk for you."

The second type of spread has to do, of course, with downpayment. What's the relationship of the loan to the total cost of the property. I can borrow 90% of the total hard dollar cost - therefore I have to have a 10% equity. I may try, obviously, to, as they say, mortgage out - which is at one time was more feasible than it is today where I borrow 100% of the money. In some cases they even borrow 105% of the money. Mr. Kasuba, of course, was excellent at that. He could even borrow 125%, of course most of that was because he didn't build the building like he said he was going to, and as a result in the future it was necessary to rebuild the building out of income and put in the insulation and the features that were presumed initially in his plan, although they weren't explicitly stated. It was hard to imagine building a building in Des Moines without insulation and so the lender took it for granted that customary construction processes would follow. So another type of spread is, of course, what's the relationship of the loan to the total funds required.

A third kind of spread has to do really with the incremental arbitrage that's available because of 1) the tax laws 2) because of different financial markets (We can go and borrow our money in Europe on Euro Bonds and perhaps get our money for one and a half percent less than we would in this country). The process, of course, is how do we convert our commercial mortgage portfolio into a format that looks like a Euro Bond for European investors. Prudential recently sold some $300,000,000 of its commercial mortgages into a securitized Euro Bond package, which meant that its cost of funds was considerably less than they would have been in this country and, therefore, the (?) continues to spread. So we're arbitraging. We don't go into traditional mortgage sources of markets. We change the form and, therefore, are allowed to find our capital in other markets. Certainly the last 6 weeks of the semester we spend a lot of time looking at this very rapidly expanding area of securitization of the mortgage process so that we can make the mortgage look like any of capital element format at all. Whatever the investor would like. If it makes them feel better and they'll give it to us at a lower interest rate and we pick up 60 basis points here or there, on large amounts of money, that's a large spread. Sixty basis points on $300,000,000 is about $18,000,000 so it doesn't take very many basis points before we have something worth while to pay all these charges. Spread, therefore, is going to be one of the elements that we're going to be continually looking at. The spread between the net income available for the property, the spread between the interest rate on the mortgage loan and the cost of funds which we're pooled to make that mortgage loan possible.

The third thing we need to look at is what Harvard called the property, the people and the package. There's very much interrelated. If we're going to achieve that pleasure, pain and bailout structure, we need to know a lot about the people and the property and then structure our package to accomplish the appropriate balance of pleasure and pain. If we want to know something about the spread, we have to know a great deal about the property's ability to produce that initial net income that's going to be available to pay the loan and carry the debt service. And ultimately it becomes a people game. You'll hear that in your organization of your memorandums again and again. The property, the people and the package.

Now given those basic theoretical components, there is obviously one other element that we need to look at in terms of the prior condition of our analysis of income property. And the Wisconsin attitude, somewhat different from that of Harvard, would rank the analysis as follows. One, the politics of the real estate. The politics of the real estate has three sub-areas of concern as we look at it. One, of course, is going to be the entire array of land use controls that make real estate a public utility. But of more significance today is number two. What defense do we have against public subsidy of our competition? And three, what opportunity do we have for subsidy of our project? The whole rhubarb in downtown Madison about a convention center has nothing to do with the convention center. It has to do with the fact that both our major hotels, the Concourse and the Inn on the Park, have expanded, have remodeled without a single dollar of public assistance. They are paying the full capital rate borrowed at a time when the rates were closer to 13 1/2% than today, when they're at 10 1/4%. And the city council is saying, "We're going to build a third hotel." And we're going throw money at some developer through the public process of TIFs and UDAGS and industrial bonds and a city financing a mess of public spaces that would be required for that hotel and build a third one when the other two hotels are holding at 55-57 percent occupancy, which is break-even. And the mayor himself came out and said we have a real problem of equity here. We want to build a third hotel, but we'll bankrupt the other two, what shall we do? Well, if you hadn't got the mayor and ______ to build a hotel, that's all we have. So we have that problem of (?) equity, I'll don't know what we'll do? But there's your major fear today as a lender. I'm not worried whether my apartment building can be built attractive and managed well, if I'm a good operator. What I'm worried about is the Wisconsin Housing and Economic Development Authority, coming in right along side of me and building their own elderly housing projects, that can focus on the same middle income market and finance it with tax-exempt funds that gives them a 200 basis point hedge on their debt service and, therefore, is significant but shallow subsidy on the rents. If I'm doing an industrial park, I'm not worried that I can build a good industrial building and find a tenant for it and so forth, as long as I know the university isn't given away the farm down the road in order to demonstrate to the world that it's capable of doing an industrial park. And if the rent that $2.25 someplace in the market and they're willing to do it for $1.90 because they haven't paid any real estate taxes on their land for 30 years and they really don't know what the hell the cost of their land is, nor have they had to carry it. I'm in big trouble as a mortgage lender. But, by the same token, if I'm going to lend in a small town in which the primary economic base is a milk truck and the milk truck depends on how much the government is willing to subsidize milk. My project really is being subsidized. If I'm going to finance a farm dealership or a car dealership or some form of shopping centers in the community which is largely dependent on agriculture and agriculture is largely dependent on subsidies, my real estate is being subsidized. Now how vulnerable is my collateral to a change in the rules? If we're talking about legitimate borrowers and legitimate lenders, their expertise can produce a sound product, but they can't protect themselves against changes in the land use control rules or changes in the subsidy of the competition or changes to the subsidy which, in fact, is supporting the effective demand for their space. Just remember one underlying problem.

The second major area of concern is the management intensiveness of the project. If we're going to lend on a large scale basis, virtually an industrialized basis, if you will. We need to know that what we're doing is managerially stable. It's very hard to lend on a restaurant in which the entire success of the restaurant depends on the erratic personalities of the chef. But on the other hand, if we do a Boar's Head type operation in which the entire menu has been designed so that Sarah Lee and so forth, can pre-freeze it and ship it to you in bulk and all you need to do is thaw. And that if you're doing steaks, the steaks, the steaks have different thicknesses so high school students can do steaks that are medium rare or well done, simply by choosing one with different thicknesses and cooking them all the same amount of time. We can industrialize that kitchen and stabilize that managerial element and suddenly we have a very interesting piece of collateral. Now when we get somebody with an MBA in marketing who knows nothing about cooking or an MBA in management who can really handle the personnel problems of a restaurant staff. And we can run that operation in multiple copies and it becomes a highly attractive collateral type of package. We're really concerned about management intensiveness. One of the reasons pension funds don't like apartment buildings is that apartment buildings depend largely on the personality and the skills of the manager who is running it. Where, on the other hand, if you do a triple net industrial lease back and you get one tenant in the building and he's got to cut the grass and shovel the snow and so forth, you have to go out once a year and find out if this building is still standing, if the roof is starting to bubble and so forth and so on and what kind of housekeeper they had, but it's not very managerial intensive. And you could probably find a management firm that could run it without a great deal of skills. The managerial intensiveness is the second major underwriting concern.

The third element of concern is the stability of the income stream. Isn't that ironic in terms of prioritization? But unless you solve the first two problems, there's no way to evaluate the income stability. It is premised on the first two elements. And of course income quality is going to be a matter of a whole series of factors, not only are we concerned about who the tenants are and what the credit ratings are, but what kind of industry are the tenants in? If you were the Silicon Valley a few years ago with loans, you figured WOW, those began (?) ______ and you have B class tenants and the industry is on the march and so forth, how can I go wrong with an industrial park for a high tech computer building? How far wrong can I go? Well, they discovered it. One of the elements that create income security. The fourth element that we're going to be concerned with is then what are the elements of the financial package? Obviously, we're concerned with how it's structured, what the risks and motivations are, but one element that we're going to look at again and again is the staying power of the borrower. What preparation can we make for the possibility that this estimates were inadequate in terms of cost. And as you'll see we'll create all kinds of standby arrangements for this. We'll have accessible partnerships, we'll have letters of credit that will step in on specific funds latent defects in the building or cash deficits during the first couple years of operation. We may, in fact, even have an asset enhancement borrower. The savings and loan association that comes in and says that for the first three years we will stand by and fund any cash shortages of the project - called a gap loan and then change every time, of course, we have to put some of the funding into it, we get more of the ownership sort of thing. We'll find even that in case of bond/mortgage bonds debate, because of the bankruptcy laws, you oversubscribe. If you need to borrow two millions, you sell the bond for two and a half million and $500,000 stays behind with the bond trustee so that if the project gets in trouble and the bankruptcy court says there will be a slight moratorium on further payments to the preferred creditors, the bond trustees can continue to make timely payments to the bondholders out of the excess funding that was part of the original bond subscription. Notice, of course, that all types of financial structure.

And finally, the last major item - consort (?). The next major item how is the tax law. Ironically, again one of the major tools for enforcement of the mortgage is because the tax law says that foreclosure is tantamount to sale at whatever debt was eliminated as a result of the foreclosure. It is, in fact, a constructive sale as the law says and, therefore, if the constructive sales price is higher than your depreciated value, there is a taxable gain at the time you are being foreclosed. Quite often the taxes that you will owe the federal government, either as a result of accelerated depreciation or as a result of other features of the tax law currently under capital gain and so forth may greatly exceed the amount of money it would take to make the signers go forwards and hope for a better day. And so many investors see the wisdom that they would rather deal with the lender by making their contribution toward the payment of the loan, than dealing with the IRS who is less patient and selective. Of course, ______ for the taxpayer. One of the big friends of the mortgage lender is accelerated depreciation. We need only point out the consequences of a constructive sale, to get renewed vigor in terms of payment from the owners of the project.

Then finally, we need to know what we will call the liquidation plan. If we're an individual owner, we have to have an estate plan. Where will the property go on death or disability of the borrower and how will we dispose of it? What role will we play in the general liquidation of the estate. If we're talking about a corporate and therefore, presumably immortal borrower, we need to know something about what the corporate plan is. We have many finite corporations that say, " All right, our strategy is as follows. We will build, own and operate this building for ten years or twelve years and after we go through the third re-leasing cycle, we will sell the building and enjoy the appreciation created by aggressive leasing and progressively higher net income. And we will then distribute the profits to the shareholders at that point." Whether you call it a finite trust or whether it's called an investment corporation, or whether it's simply a closed-end fund for a pension fund, presumably the entity which is the borrower has a game plan as to what they're going to do with the real estate, when it is they're going to sell it and take their gain and what it is that may position themselves most favorably for sale. After all if the game is to sell the building after 18 months and realize the developer's profit and the leasing profit, you better have assignable financing - financing which the next buyer can enjoy as well. But if the game plan is to hold it for ten or fifteen years, it depends whether the assignment is possible on the mortgage or not really is not a factor that you are not going to negotiate very hard about. It may be that if the notice is not callable, you can get a lower interest rate. It may be that the lender would like to have one callable so they can have another kick at the cat when the interest rates rise and maybe that will make it seem more attractive and get a lower interest rate and so forth. At any rate, all of those elements become part of the underwriting process. The political exposure, the degree of management intensiveness, the financial structure, the tax factor and ultimately the liquidation plan.

With that we'll quit for today. We'll see you.

. . . Four types of risk in income property lending. The first is going to be the "business risk". Business risk has everything to do with all of your assumptions about revenue and operating expenses down to the net income line.

The second type of risk is going to be "financial risk". Financial risk is going to have to do with the adequacy of net income and the timing of net income so that it's available to meet the debt obligations of the enterprise on schedule. So it has to do with the adequacy of net income and the timing of net income so that it can meet the commitments of the debt structure of the property.

The third type of risk will be "interest" risk. Interest risk really has to do with the fact that interest rates are going considerably more volatile and therefore either the borrower or the lender may find that changes in the interest rate cause great changes in the value of their investment. Mortgages are like bonds, if interest rates fall, after the deal is made at 10 percent and now rates are at nine, the mortgage can be sold often at a premium to reflect the fact that the coupon rate currently requires something less than the contract rate. By the same token, if interest rates rise, the lender is watching a good part of his capital investment devalue simply because if he were to try to sell it, he would have to sell it to yield the current rate, not the contract rate that he made on the deal and it would be a significant discount applied to the mortgage. Rather than, of course, take the discount, he has lost considerable liquidity in his portfolio since he does not dare sell at the current rate, lest he have to book the loss on the difference between what he had invested in it and what it will sell for currently.

And the fourth problem is what we call the "social/legal" risk. The social/legal risk has to do with the fact that the rules of the game may change during the course of a long run contract. The bankruptcy laws have changed several times in the last ten years and for a lender who made the loan under the assumption that he would be able to foreclose and so forth, and now finds that Chapter 11 instead may be very favorable and attractive to the borrower and actually prohibits foreclosure for a period of time, that may come as quite a surprise relative to the rules that were in place when he made the deal. In addition, of course, social/political risk or at least social/legal risk may change because the legislature decides that farmers are in need of a moratorium to give them a chance to work out their problems or because, for one reason or another, the judge determines that equity is better served and the borrower is better protected if he simply stalls on the foreclosure process as he is entitled to do under the rules of the game.

Those four kinds of risk are going to govern, of course, the commercial lending transaction and, of course, at one time it was simply the financial risk that was presumed to be the problem and lenders always assumed that if they lent 75% of the value of the property, that they could always foreclose on part of the property, sell it, and get their money back. You still see a good deal of that static and rather old-fashioned attitude among bankers who really don't look at the business enterprise at all - who never looked really at what is the cash flow forecast going to look like for this portfolio. How soon will it rent up, at what rate and how will it operate and are the pro forma operating expense program and so forth, as presented, realistic? There are many who don't look at that at all still today and say, "Why do I have to worry if I'm secured by the right to foreclose on an asset which is going to be valued maybe seventy, you know, maybe a third more than my loan?" They never look at the assumptions underlying the appraisal which assumed that it got built and that it got rented and that it operated like they said it was going to and so forth. But other lenders, of course, become much more sensitive to the fact that much of the success or failure of the lending institution has been the result of the interest rate. That the volatility of the interest markets and their ability to exploit low cost funds when they were available and to avoid a trap of a loan portfolio that had fixed interest rates that turn obsolete as rates rise, is much more significant to the profitability of the lending institution than perhaps the first two items. And then they're beginning to perceive the fact that the continual war between the borrower and the lender and whose rights shall prevail goes on and that there are a lot more borrowers than there are lenders and therefore there is a lot more political rape in favor or protecting the borrower no matter how dumb and how stupid and irresponsible he may have been, than there is in protecting the money lender who is, presumably, sophisticated and knowledgeable and capable of protecting himself. Risk, therefore, has shifted over the years in terms of the underwriter but will obviously be the major management factor in structuring a deal.

What kinds of tools do we have to handle this management from right out of 560, of course, we have one information - the more you know, the fewer surprises you're going to have. Much of what passes for risk is just ignorance. The developer who says, "Gee I had the most beautiful subdivision in the world and then God put rock in it so it's useless." The soil tests and a few moorings would have discovered the fact as to what the geology of the soil conditions were. It should not have come as a surprise. It was an ascertainable fact. Information, therefore, is your number one risk management tool. And you want to reduce the frequency with which projects get into trouble and to the degree that they do get into trouble you want to reduce the severity of the loss.

The second, of course, is incentive, both positive and negative to reduce frequency and severity of loss. You create penalties, progressively, for those that fail to pay on time or fail to meet certain objectives in terms of rent levels or occupancy rates or operating characteristics. And you can also create positive incentives to get them more money when they do, in fact, perform according to their expectation. We'll see how that works later.

A third method is insurance. Insurance occurs when someone has evaluated the frequency of loss, the severity of loss and is trying to establish a premium that will accumulate a sufficient pool of funds that the limited number of people who have the loss will, in fact, be compensated by the premiums collected from the majority. We're beginning to see a little of that, for example, the insurance company in Chicago, CNA, will now insure a payment of a limited partner's subscription to the project and should he fail to do so, they will ante up the money and then go back and collect, for whatever reason, from the limited partner. Insurance, to share the loss, means that there is a mechanism to estimate the loss and collect a pool of money sufficient to meet the losses, that will occur. Guarantys only shift the loss. There may be no insurance mechanism to estimate the number of dollars that will be lost in order to collect a pool of money sufficient to pay the losses. Guarantys are also available today from major financial institutions - a way of exploiting their creditors. How? - in collecting fees, very significant fees as a result. A good example of that would be mortgage guaranty insurance which is insuring in part against the cyclical economic downturn in the community which would cause people to lose their jobs and default on their mortgage, cause home prices to fall and cause, obviously, significant losses to the mortgage lenders on those homes. There is a premium, but there was no way and is no way to estimate under an economic cycle what the total losses might be and therefore it is not strictly an actuarial type of insurance, but simply a guaranty. That should be spelled with a "y" instead of a double "e". A financial guaranty is "ty". The father-in-law endorsing the mortgage for his daughter and son-in-law to own is issuing a guaranty.

You can shift the risk by contract. That's probably the most common way to do it real estate. We provide a triple net lease and say, "OK all the operating expenses belong to the tenant. If real estate taxes rise, why you'll pay the increase in those, pro rata." We're shifting the variance on future expenses and characteristics of the project to the tenant. We do the same thing in contracting. The general contractor gives a fixed price because his subcontractors have given him fixed prices for various components of the property. If he's really astute as a general contractor, he will promise nothing to his client that his subcontractors haven't promised him. And then, of course, he is reasonably assured that his subcontractors are capable of fulfilling their promise. Properly structured, the general contractor simply should have no risk at all assuming, of course, that he can enforce his contracts on his subs. Much of real estate is really intended to allocate the risk of the project by contract. And we'll see a variety of very complex relationships as we begin to allocate the risk of a given event and how it will fall sequentially on the different parties. At what point does the construction lender pay the piper and at what time does the permanent lender, at what time does the limited partner have to put more money in the pot to cover the cost overruns etc., etc. And these negotiations as to who takes which risk at what time and to what degree become the essence really of the financing negotiations. We may also limit our liability by the way we structure things, particularly in mortgage lending and commercial lender there is what is called a nonrecourse clause and, in effect, or an exculpatory clause. An exculpatory clause says, in effect, that the only remedy of the lender is to take back the property. Now if you remember your business law, a mortgage is actually two contracts. There's a note which determines the amount of money owed and the terms of repayment and that can be enforced in the courts under contract law. You can sue for specific performance or you can sue for damages as the result of failure to perform under the note. The mortgage is the second contract. In effect, it says that if you don't want to take the first two options if they don't work, the third option would be to have a lien on the property and then to have the property sold in order to repay the debt. An exculpatory clause says, "Look, sorry, the first two don't count." You can't sue for specific performance, you can't sue for damages. The only thing you can do is to take back the property and hope that the asset will sell for whatever it is it is owed to you. Most major commercial loans are made with exculpatory clauses today which explains why (names several Madison developers), Manns, and so forth are perfectly willing to take gigantic risks because all they have to do is walk away from the property if it becomes necessary to do so. In effect, the commercial loan is what we'll call a straddle in classic risk terms, it's almost a hedge. You have a call on the up side if the property succeeds, then you can sell the property at a profitable price and pay off the loan from the profits. If the property doesn't work you exercise exculpatory clause and say, "Here Mr. Lender it's all yours." That's called a put. You have the option to put it back to the lender. The lender will be very upset with you and issue all kinds of dire statements but ultimately all he gets is the property. For example, a number of years ago James Wilson Plaza, which is that office building down on Wilson Street, looks like a boiler works, was built with initially a $3.6 million mortgage from Metropolitan. And then everybody else decided to build an office building too and, as a result, it didn't rent very quickly and they got themselves deeper and deeper in the hole and pretty soon they had a second mortgage from a real estate trust that made second mortgages. Pretty soon they had a third mortgage in the personal name of the developer and obviously they didn't have enough means to cover all of them. At the same time, they were having a tax case with the city, the city was saying we don't care if it's vacant or not, it costs that many dollars to build. Well the city lost that. We were able to prove that the building was worth $3.3 million at that particular point in time and, of course, confirmed that. And, at the same time, we turned around and structured a deal in which it was sold to a local syndicate of medical people for $7 million. There's only one catch. They only had to pay $700,000 down and owe $6.3 million for the next ten years. They add to pay interest on the $6.3 million annually, once a year, and they send a check to the developer/partnership that sold them the building. And the developer/partnership that owned the building leased it back for an amount exactly equal to the interest on $6.3 million. So far so good? So the checks passed in the night and canceled each other out. At the same time the seller continued to operate the building and gradually improved the rentals and two continued to have the loan from Metropolitan Life on what was now a fee first of all covered by Metropolitan Life, second of all covered by latent (?) contract to deliver title ten years later to the buyer. A couple other little features of the deal were that they took the $700,000 downpayment and paid off the second mortgage lender at about $.30 on the dollar because at that time the real estate trust was broke and the bankruptcy people were only glad to get something back on their money rather than nothing and so, as a result they eliminated the second mortgage, left enough money to pay off the third mortgage and so now they owned the building subject to the land contract with only one mortgage on it and they got Metropolitan Life to increase their loan from $3.6 to $3.9 million so, in effect, they got $1 million out of the deal, paid off all their debt and had a little money to wander around town and buy dinner. Now what really happened there? Well the syndicate, first of all, because they're the equitable owner under the tax law, gets to take all of the depreciation. The previous partnership couldn't take the depreciation because under one feature of the tax law they weren't all equally liable. Their general partner friend had had to get a third mortgage and sign personally and, as a result, it reverts back to the "at-risk" rule which says that you can only deduct that which you invested in the property and none of them had invested anything in the property and so there you were. So, as a result, selling the depreciation didn't cost them anything because they weren't entitled to it anyway. But for the buyers of the building, the depreciation, even if they defaulted at the end of ten years, and never exercised their right to close on the building, would give them a 10% after tax rate of return on their investment of $700,000 - not bad. What would happen at the end of ten years when it came time to ponying up the money to close. Obviously they were going to have to find $6.3 million some place. The debt service on $6.3 million at the time this deal was made (interest rates were about 15 or 16%) would have required rents to go to about $28 a square foot which, obviously wasn't likely to happen unless inflation stayed where it was over that period of time. On the other hand, if the rent went to about $15 or $16 a square foot, they could have borrowed the money at 9 1/2% interest and made the deal go. So they're speculating one, that either rents are going to rise or that interest rates are going to fall because that's the only way they can close on the $6.3 million. If neither of those two things happen, basically defaults on the land contract and say, here, it's yours again. Under the IRS laws if the seller and the buyer renegotiate a land contract there is no taxable transaction to the buyer. So, in effect, they can take a walk without even being worried about the fact that Uncle Sam might otherwise tax them on constructive receipt. By the same token, the seller is saying I got myself out of a jam, I get to operate the building and keep the positive cash flows for ten years and they don't want it, I may still own the building. That's a classic straddle in the commodities market which, is really saying, "Hey, they're offering me $65 a square foot for 120,000 square feet of GOA payable in ten years. In effect, they have a call on the building at $65 a foot ten years from now. That's not an unreasonable deal. They probably couldn't build it for $65 a square foot ten years from now, right? But by the same token, if rents don't rise or interest rates don't fall or they get out of the mood and they don't want to have this building at all, they have a put back to the seller. In the commodities market that's a classic straddle. And notice the buyers are speculating in two commodities markets. One, of course, is the cost of constructing a class A office building for more or less than $65 a square foot and the second, of course, is a commodity called money - interest rates. If interest rates fall, the value of the property is going to go up. If interest rates rise, they say here, it's yours again and I'll settle for the tax shelter. That's a classic straddle and the interesting thing about that straddle is that it's a perfect straddle as they say, because it doesn't cost you anything. Notice the buyer still has a return on his $700,000 investment even if he defaults as a result of savings. And the seller manages to maintain control of the property and the leasing commissions and the management fees and whatever surplus cash there may be for at least ten years and then they may get the building back. So everybody wins except, of course, the Internal Revenue Service. Yes? Question: How does the mortgage holder win? Chief: The mortgage holder can't stand to lose. The mortgage lender, Metropolitan Life is the first claim on the property. The only way he could lose is if the property fell to something less than $3.9 million dollars. Since he was there first in terms of time, all of the other claims are subordinate to the first mortgage. Question: Robert: Why did they make the mortgage in the first place if the building hadn't leased up?. Chief: Well, of course you don't know that when you commit. You come up with a development proposal and you say, "All right, if I build it and it's free of liens" and so forth, I on such and such a date they'll close and they did and, then discovered, of course that the building had negative cash flow. Now lenders are a lot smarter to attach all kinds of conditions to when it is they'll close in terms of whether you've achieved occupancy, whether your cash flows have reached a certain point, and they'll probably scale it. They'll say, "All right we'll give you $5 million but we'll only give you $3 million for openers, when you reach this point, we'll give you another million when you reach this point, and your last million when you achieve, you know, the following specifications. And as a result they can tippy toe in and they may also write some big conditions in their contract which allow then to fly the coup together. Lenders don't learn very fast and they're extremely competitive and so if you've got one damn fool that's making all the loans, the other ones will do what the damn fool is doing rather than sitting back and letting him go down the pike. One of those things that's never been understandable in the financial institutions. In any event, notice what we have there is a classic hedge and straddle. We can have other types of hedges in real estate. We can have options who say until I get my zonings I may or may not close on the property or until I get such and such a tenant I may or may not close on the property. I can have conditional sales contracts which say I don't know whether we're going to achieve the net income we thought so I'll tell you what I'm going to do. I'll give you $2 million now and then at the end of three years we'll take the average net operating income, multiply it by ten and if that's greater than $2 million, I'll give you the difference. If it's less than $2 million why

I'm sorry, you don't get any more money. So we have all types of hedges that we can structure into our real estate. So you want to begin to look at how we limit our liability for losses - exculpatory clauses, limited partnerships, corporate shells etc. Then we'll begin to look at how we begin to hedge against futures that are uncertain or unclear and can we make it a perfect hedge or we likely to get nicked for something. And as lenders become more sophisticated of course they want to make sure that there's some pain inherent in the deal, so that you are reluctant to default even though the pain may be relatively negligible. It may be simply embarrassment.

Risk management. We're going to use all of these tools in the process of making a deal. We already talked the other day about the mortgage closing as simply a demonstration of the static risk management. We're really saying on each of the assumptions, "Gee if it isn't true, who's going to pay the consequences? Does he have marketable title to pledge? If he doesn't, we'll have a title insurance company step in and say that as a result of this hidden flaw, you no longer have marketable title, let the realty pay the loss. Second of all, I wonder if the property is located where we thought it was? And the bond engineer goes out and says, "Yes, it's set back appropriately, nobody can make you move it etc. and if I'm wrong my bonding company will pay." And again, you've shifted the risk of that assumption to a professional risk management group. Third, you say, "Gee, I wonder if the collateral will burn down or blow away?" So you require at the closing that he buy a property insurance policy that will reimburse the lender, no matter what the borrower does. The borrower could build a fireworks factory under the building, violate all the conditions of the insurance, and, nevertheless, the lender would be paid off. The insurance company may have to go back and sue the policy holder but that is not the problem. And then you say, "Gee, I wonder if we over appraised it? We were supposed to make a loan, 80% of value or 90% of value, but appraisers have been known to be wrong before, I wonder if, in fact, it's really going to be worth that at the time he tries to sell the property and recover our capital as we go into default?" And we have various types of guaranty agencies that step in. Certainly in the private home area there are private mortgage insurers, FHA on a private home and so on. But now they've also moved into apartment buildings. FHA will insure an apartment building venture and say, "Gee if it doesn't work, tell you what we're going to do. We'll give the lender all of his money back - his principal, his interest, the costs of foreclosure, whatever costs of repair he had to put into the building in order to make it marketable and so on." Small Business Administration may step in and do that. As a matter of fact, an interesting sidelight on the current convention center, Mr. Barburg our notable hotel entrepreneur, got his start by building a hotel attached to the convention center in Eau Claire. Realizing it wasn't going to work, he got the Small Business Administration (SBA) because of his political connections, to insure a lease of the hotel. So he created Sufficient Management Company which leased it from his building company, got MGIC to insure the lease and then when he wasn't able to make any money in the hotel, MGIC stepped in. I understand they've paid over a million and a half dollars so far into the project which has never been able to stand on its own two feet. So there are fall (?) guaranties available for commercial property occasionally. Most of them today are available from the Small Business Administration. Another one that survived that way for several years is the Sheraton here in town. The owner realized it wasn't going to carry enough cash flow so he leased it to himself and another corporation, got the Small Business Administration to insure the lease and when operations didn't produce enough cash flow to pay the mortgage and so forth, why the SBA had to step in and pay for several years until they were finally able to put the project into receivership.

Finally we use a lot of Letters of Credit particularly for specific things. For example, let's say that we're building a new apartment building and the developer, first of all, has promised that it will be fully rented when he starts to operate. The lender may say, "I'm not so sure it will be fully rented so I'll tell you what I'm going to do. I'm going to require enough cash on a Letter of Credit to cover six months of vacancy and I can draw on that Letter of Credit any time I want because there isn't sufficient income coming from the property to make the mortgage loan payment. Secondly, I'm not so sure about the quality of your construction, so I'll take a second Letter of Credit for $100,000 to cover latent defects." Suppose it turns out that you forgot to put in proper heating coils and that window air conditioner and heating system or you forgot to paint something or insulate something and so forth. There's a fund I could draw on to complete that particular flaw in the construction. And today we use public debt such as a public housing bond, typically they will subscribe say, two and a half million dollars of bonding for a $2 million loan and the trustee will keep $500,000 in a cash investment account so that should they borrow or miss a monthly payment, timely payment, he can make a distribution on schedule to the bondholders whether or not the project is succeeding or not. All of these are ways of stabilizing the cash flow characteristics of the security and the collateral characteristics of the property. But most of those are static. Most of those are saying, some fact on which we depended may not prove to be a fact at all and therefore we need a way of shifting that to a professional risk management institution.

Mortgage underwriting is a much more dynamic element. It's not so much the facts that we're concerned with in underwriting, as it is the assumptions we have to make about the future. Assumptions are only testable ultimately in the future, they're not discoverable nor are they of such common character that they're insurable. After all we have lots of data on whether titles are good or bad or whether buildings will burn or not burn and if so how much damage there will be and so forth and so on. But we don't really have very much about how quickly people will rent office space and at what price and so forth. There we're moving into a dynamic area of assumption which requires obviously a high level of judgment and discretion together with some research of the patterns with which we think we're working. It requires managerial control of the project. Cost control doesn't mean necessarily that you build it for cheap. Cost control means really that you build it for what you said you were going to build it for - that you did your estimating well and then you control stock so that it came out on budget.

Second of all we need capacity to absorb surprise. We need to recognize that there will be some variance between our plan and business plan and what, in fact, will occur. What kind of standby resources do we have. Do we build it into our financial package or does our client have sufficient capital of his own that he can reach into deep pocket and fund the shortfall. And we'd want to be assured that he had that kind of money on hand so we have him set up an escrow. We want to begin to look at the degrees to which we'll limit liability - limit liability for what? Is it carte blanche - all the timely exposures? or do we want to begin to articulate that? For example, we may require that the investors cover the construction period personally so that we know there are funds to finish the project. Only once we get to a project that is 80% occupied can we move to the point in the financing where the exculpatory clause come into effect. Or if that's not acceptable to them, then we will say fine, you can add an exculpatory clause in the construction contract too but now here's five Letters of Credit that you will provide for various issues within the construction process so that we know there are resources available to do that. And, in addition, we will set up a series of gradually increasing pain as we'll see in a couple lectures hence on the letter of commitment whereby if you fail to do this you lose this profit center, if you fail to do that you you lose this profit center and gradually, of course, the pain will get to a point where we have your attention and you will execute whatever our (?) and on time.

We may want to look at the quality and the character of the project and the developers. We may want to look at the rental assumption. What kind of assurance do we want that there will be tenants available at a certain price or should we require that it be pre-leased? Or shall we require that 60% of the condominiums be sold before you can begin construction. There's a whole series of for instances and assumption and we can begin to craft our underwriting so that we lay off the risk that one of those key assumptions may run amuck. And that's really what the underwriting process is all about - it's not the statics - not the cookie cutter kinds of things that the lawyers seem to be primarily concerned with. But really beginning to look at it in terms of the business plan and structuring responses and the control in a reasonable way that moves away from the traditional business plan as the events of the project unfold. Anyway, underwriters are just now getting to this. It's kind of interesting at the graduate banking school, the American Banking School every summer in real estate and it's interesting how much resistance there is among the bankers to using a cash flow model of saying, "Gee, I wonder what it's going to look like over ten years." "Don't tell me about that, I look at normalized income, multiply it by ten and lend 75 percent." And they should point out that income as they defined it isn't cash available for distribution at all. There are other deductions for tenant commissions and tenant improvements and asset enhancements and what's more if you make a concession that they don't have to pay rent for the first three months of the lease or sometimes more than that, on a five year lease there's some places in Denver you get two years free rent if you sign a five year mortgage. Well your net income statement doesn't have a lot of cash available for making payments on the loan under those kinds of terms and so forth. But bankers have been tending to resist that and only gradually has the perception comes through that hey, this is a business and we really have to have a business plan for five years, maybe ten years and we need to program the cash flows of that business to find out what's distributable and available to the lender after the business has had whatever cash it needs to survive.

The next part of the lecture isn't on your notes so you may need to take that out. The lender begins, obviously, with the objective of getting a certain number of dollars out at a yield which is greater than he can do in something more passive and requiring less attention and currently there is about 175 basis points spread between a commercial mortgage interest rate and ten year treasuries. That spread may wax and wane a little bit but may get as high as 225 basis points. But it's a relatively narrow window in which to manage a portfolio at a reasonable cost and enjoy, obviously, a return which they feel is commensurate with the risk differential between a good commercial loan and the treasury.

The first step, obviously, is choosing loans which, by the nature of the business and the borrower, are going to be self-enforcing and move through the normal contract process with few hitches and certainly no big surprises. The second level of loan, however, is likely to require some hand crafting in order to neutralize what are perceived as flaws in the business plan or weaknesses in terms of the borrower, etc. And what kind of tools does the lender have to accomplish that? Well, the first thing of course is he can have a statement or loan policy statement from his board of directors as to the kinds of properties besides a loan and the budget per dollar lent for negotiating the final arrangement. That's really the first stream. Some institutions won't lend on hotels, others won't lend on apartment buildings. Some institutions won't lend on anything less than $1 million. Some won't lend on anything less than $5 million because it's just not cost effective to assign a knowledgeable and skillful loan negotiator for two months' work to come up with a million dollar deal. So each lending institution will have a series of screens which, first of all, identify the target objectives.

The second step in the process is how do we solicit those kinds of loans. How do we let the world know that we would, in fact, be willing to consider. Each lending institution has its own style. Some operate through correspondences who actually stop the loan deal around a couple of different lenders, others solicit deals directly, others have become so well known that they are simply contacted directly by the borrower. I would say probably 60% of their business comes from previous customers with whom they've had a successful and happy relationship. If you've had a loan with Northwestern Mutual you probably will go back to Northwestern Mutual on your next project if you're happy and if you're not happy, you'll probably go to one of the others. In a few cases lenders become known as having a very special interest in hotels or elderly housing or large shopping centers. And there may be only 4 or 5 or 6 lenders in the ball game. And it's all done directly between the developer and that lender. I remember a number of years ago being out at New England Life and at that time the loan portfolio consisted of nothing less than $50 million loans on shopping centers. So they had about $2 billion outstanding and they had two very nice ladies in the office but when the check came in on each of the loans you entered it by hand in the books and stamped it for deposit and that was their entire loan administration program other than two guys they had negotiating with the shopping center folks. And I can always remember Dick Jacobs going up to one of the mortgage/bankers meetings in which all the high-powered insurance company execs. were there and he starts a lecture on shopping centers and he looked each one in the eye, looks at Teachers (TIAA) I owe you $125 million and he looks at Northwestern Mutual and I owe you $60 million and he looks at New England Life I'm into you for $90 million and he said wouldn't it be funny if found out that you didn't know what I was talking about. Now that's gall. There was a very nervous laugh through the whole deal. Now, obviously, loan portfolios have grown since that time and there are others that are big enough to play in the game that New England Life is playing in at that particular point in time but, nevertheless, each lender has a style and the style is reflective of their scale or their access to capital of their residual good-will that they have built up over the years with those with whom they do business.

The third step is, of course, underwriting the specific deal. Trying to decide what it is they're willing to do if they're going to do it at all and on what terms. At that point they issue a Letter of Commitment. Ironically, the application by the borrower is an invitation to an offer. A Letter of Commitment from the lender is the offer. And the acceptance of the Letter of Commitment by the would-be borrower is just that, it's the acceptance of the fact that we're gonna make a deal and we're going to close. These Letters of Commitment can be at two levels of effectiveness. One can be called a Letter of Intent. A Letter of Intent is a fairly broadly worded statement that says, you know, we're interested in your deal, we think we can make an agreement, there's a number of procedures that we're going to have to go through, any of which may nix the thing but at least now we've got an agreement to agree. Agreements to agree are not enforceable in the courts other than you can incur damages if you rely on that and incur costs in doing your due diligence or your underwriting costs and then for some reason somebody, you know, makes gaits or runs and so forth - a couple of the eastern courts, not so much in the Midwest, but in the east will, in fact, assess the damages, for lack of good faith in moving forward on whatever the Letter of Intent had said. But other than that, it's not an enforceable contract. The Letter of Commitment <u>is</u> an enforceable contract and generally contains within it liquidated damage provisions relative to either party welching on the deal. Lenders welch on deals, often because of the interest risk. They made the deal two years in advance when interest rates were 9 and a half, now interest rates are 13, and they're sorry they have to pay out the money. And so they find some excuse under the contract to squirm out of it and say you said it was going to be red brick and it's yellow brick and that's a whole different deal and so sorry we won't go. Or they say timing is the essence and you didn't move in by September 10th, you moved in on the 11th, and sorry the deal's off. And they can be sued. In some cases lenders get themselves into trouble because they don't make timely disbursements under the contract. So it's a two-way street. The Letter of Commitment binds the lender as well as the borrower once it's breached. Once you get past the Letter of Commitment, then you go to closing. And as we'll see when we get into the closing thing, there is an infinite number of documents which must be moved through progressively to finally create the contractual web that represents what appears to be a fairly simple loan agreements. That contractual web process may be so complex that in many cases there'll be 50 or 60 attorneys present and they will spend two days in rehearsal going through the proper sequence before they actually go through the actual closing. It can be a very expensive detail oriented process. Once you've gone through the closing, at that point you go through the servicing of the agreement. Nobody intends to make a bad loan but servicing really determines whether you did or not. Can you train the borrower to live up to his agreement? And the number of tools that you have really depends on how well you negotiated your Letter of Commitment. When we look, we're gonna look at a really tough letter of commitment in a couple of days. And you can see they've had servicing problems in the past and they know exactly how they're going to keep them under control in the future. And so the entire Letter of Commitment, or at least a good part of it, is really intended to discipline and constrain the borrower.

OK, I guess you've all had enough?

. . . not in your packet. This is the complete set. I'll introduce really the subject for today which is enforcing the mortgage. The mortgage then, as we contemplated is, I believe, at the beginning was relatively easily enforceable at the outset because it represented a debt flow. But more recently the problem of getting the money back to the lender with interest according to the terms of the contract is really the major beef of mortgage lending. Almost any idiot can lend money and many idiots do. As we have seen, most of these idiots never get their money back so that in the case of the savings and loan associations, for example, currently the FDIC is about $25 billion in the hole if they were to, in fact, move in and close some 400 savings and loan associations that are broke, but which they can't afford to close because they simply don't have the resources to meet the obligations. So the essence of the strategy of the lender is how do we enforce the mortgage? How do we create a series of provisions within the contract? How do we create a political atmosphere and a legislative framework within which we can, in fact, make the mortgage work once the money is gone, has been invested in the building and, in many cases perhaps a building that we really don't want to own. As you'll recall a mortgage is a two contract process. We have the note which is enforceable either as a contract either for specific performance or for breech and the damages that may be involved in the breech. What represents a breech of a mortgage loan?

The basic mortgage note contains what are called covenants. And the covenants not only control what the monthly payment will be and payment shall be made and so on, but it will control a number of other aspects of the property. One, for example, payment of the real estate taxes at an appropriate time, maintenance of the insurance at a certain amount and character, refusal to waste the property so that you that in the legal sense of waste the property so that you destroy its collateral value and finally, of course, that you covenant to maintain the property so as to protect its collateral value and so on. There may be technical covenants relative to certain kinds of property as well and we'll look at those as we custom craft deals in the future. But a failure to observe any one of those covenants is, in fact, a breech of the mortgage and can bring into play, at the option of the lender, what is called the acceleration clause which says that all the money is now due and payable because you've failed to do thus and so. At one time the acceleration clause was automatic and, of course, one way for the borrower to get out from under a mortgage that he felt the interest rate was too high on, or he didn't want to pay the prepayment penalty on, and so forth, was to deliberately violate one of the covenants in order to trigger the acceleration clause which would allow him to repay the money. And so lenders finally figured that out and the acceleration clause, of course, now is at the option of the lender as to whether he wants to impose that immediately due and payable character of the property. Instead, enforcing the mortgage really becomes a series of progressive management steps and the first defense of any mortgage and its enforceability is the servicing skills of the lender.

The first element of the servicing skills begins before there is in fact a loan in what we call the commitment letter. And the commitment letter will create a series of sanctions and penalties which can be imposed progressively on the borrower so they fail to do what it was they promised to do under the covenant and we'll look at a letter of commitment a little later. One, that's a really tough letter of commitment, by the way, and you will see that all the way through there are a whole series of very painful little stimuli that will cause the borrower very quickly to maintain timely and full payment and to observe all of the covenants because it becomes very costly not to and, of course, the loan servicing presumed that someone is monitoring the loan, knows the terms, and there's a prompt response to any breech of any of the covenants. That means that you are inspecting the property from time to time, that there's a way of monitoring that they've made the tax payments, that there's a way of monitoring that the insurance is in force, etc. etc. Quite often loans give you the great trouble simply because the servicing people are not on top of it and it is months before they know anything is wrong. As a result, this requires a very excellent data processing system that will alert you on a Monday that people failed to make the payment on Friday when they were supposed to and a friendly phone call may go out and say, "Gee maybe this is crossing in the mail, but we're missing your check, etc. etc." So first of all you need a prompt response by recognizing that some covenant has, in fact, been breached or that there is a delinquency in the payment. Assuming that it is not a momentary oversight, at that point then, we need to begin to evaluate what is the cause, can it be directed and is it something that really requires a serious review of the loan commitment. If you'll look at the one page Chart A that we handed out, you'll see that there's really a hierarchy of response. Something like 20% of all loans in force probably go delinquent in one way or another each year. Probably most likely simply a momentarily late payment by a day or two, but in any event you need to know the delinquency occurred and then what is the cure? And to pursue that cure to contact the borrower and see what can be done. If it can't be cured because of momentary oversight or administrative error, we now begin to look at, gee, what can we do to work this thing out temporarily. Now the response to the delinquency really needs to begin to analyze what was the cause? One, was it just poor management in which case we need to discipline and train this borrower to run his business tightly according to the very specific terms of our mortgage agreements. Is it poor marketing? Or is it external conditions which are really not in the direct control of either the lender or the borrower? The last thing you want to do is take over a building which a borrower is absorbing the losses on when there's nothing that can be done about it if you owned it. You'd much rather have him bleed for as long as he can bleed before you take over the property and have to absorb the deficits and so on. On the other hand, if it is something that is within the control of the borrower, if properly motivated, and so forth, then at that point the lender has to take that kind of position and begin to train and condition the borrower to think positively. The workout typically addresses in a hierarchical fashion perhaps a temporary postponement of the payment of principal. But they would like particularly for the auditors to maintain the current payment of interest. If they can't maintain the full payment of interest they might say, fine, make a payment of half the interest. The interest rate is 10%. You've got enough cash flowing out of the project to cover 5% of the interest and we will take a deferral on the other 5% and add that to the balance due on the mortgage for the time being, but in addition as a result of now becoming a venture capitalist in your project, we'll take 20% of the cash flow in future years when it exceeds the required debt service limitations. They may raise the ante and say, "Gee I think what we're going to do at this point - we think it's a management problem. We're not sure what you're doing with the money. We're going to exercise our rights to have the tenants pay us their rents directly. We will take out of those rents what we're due. We will then pay the operating expenses, and so forth, of the property and if there are any funds remaining, we will forward those to you the landlord, and so on. And so there's a whole series of progressive steps which they can take. Question: Wouldn't that be specifically mentioned in the transmittal letter? Chief: No, that would be negotiated at the time that the breech occurred and so forth. Some of it will be, the assignment of the leases is a standard requirement of the commitment. Question: How can the borrower - he's in a pretty weak position at that point - how can he defend himself besides threatening to go into _______ - you know, from some onerous? Chief: Well, there is a limit as to how far the lender can push his advantage before he moves into what is called impacted equity. At that point, if the power of the lender is so great that he exacts unreasonable requirements of the borrower, the borrower could go into court and block the lender's sight to do that, but I'll have him go to Chapter 11. OK? We'll look at lender liability just a little latter because the lender begins to move into all kinds of problems. For example, when he decides to exercise this right to the leases and to run the shopping center and so forth, he now takes over as a trustee and he has the liabilities of a trustee to the borrower for managing the asset. If he goes in and takes over the construction to finish it for example, he now takes on the liability of the general contractor and so forth. So there's a whole series of tradeoffs in terms of how deep the lender wants to become involved in the property and risk these other liability exposures. We'll talk about that a little as the week progresses. So the workout really has to be negotiated to fit the circumstances. Hopefully, it's short term and the project will be back on schedule and capable of carrying its debt requirements and so on. Sometimes those workouts are fairly elaborate and may, in fact, impose some cram downs on other interests that may require that investors put in more money or that they assign additional property as collateral. It is a fairly creative process with the idea, obviously, of protecting the lender. And, in addition, may require that, for example, the borrower sign an agreement in exchange for all of those things that he won't go into Chapter 11 for at least two years or require some other type of additional security that will appease the legal problems of the lender and collection.

Now, if the property or the borrower I should say is in some difficulty and it doesn't appear that he can work his way out very quickly, obviously the preferred way of solving the problem is a voluntary sale of the property for an amount equal to or greater than the debt and at that point they liquidate the mortgage and go forward without any record of failure or default. Failing that, the lender may feel that the time necessary to execute a foreclosure, and so forth, is too long and someone needs to protect the property, it could petition, of course, for a receivership of the property. In many cases, that is already built into the loan agreement in some states and a receiver would be appointed to collect rent, make payments to subcontractors and so forth and the court supervised plan would carry the property forward and protect it from milking by the borrower. While the receivership is in process for the immediate operations of the property, the lender may decide to go forward into a petition for foreclosure. Here a little divergent is necessary from the chart simply to remind you as to the difference between title theory states and lien theory states. The early colonies, the early eastern states, are all title theory states and title theory states, in effect, said that the mortgage is a deed and that title has been transferred to the lender to secure his loan. Subject to one little clause called a "defeasance" clause and the defeasance clause says that this title transfer is defeated as long as the borrower is living up to the terms of the agreement. so that for the final title to transfer there has to be a condition subsequent, mainly a breech, caused the deal. But once the breech has occurred, title is now technically, legal title is with the lender. The borrower may have some small equitable title and therefore it is necessary for the lender to go into court and ask the judge to extinguish the rights of redemption of the borrower. But because the lender has title, he is immediately entitled to go onto the premises, take possession, begin collecting rent and otherwise protect what is technically his property. It is really a rule of strict foreclosure. How strict depends on the state and many states make distinctions between residential, farm and commercial properties. Farm properties typically have a longer period before they can take possession. Residential properties may be a really short gun, I think it's 30 days in Tennessee and Texas and you're out, boom. Commercial properties have a little varying, for example, in the state of Wisconsin you have up to two years to foreclose on a commercial property. But you can foreclose on a single family residence within six months under certain conditions.

Now, title theory is the minority. The more recent states with the agrarian populism that characterized our legislature operate under a lien theory state. And the lien theory law says that, in effect, the lender has the right to go into court and request that the judge sell the property and then apply the proceeds necessary to liquidate the loan to the lender's interest in the property. Notice it is not directly intended that the lender take over the property. The lien simply says there will be a court enforced judgment on the proceeds of a sheriff's sale. So as a result, until such time as the judge determines that there shall be a sale, and subject, as we'll see later, to _____ for a redemption, the borrower remains in possession of the property entitled to the rents, entitled to the profits and can continue to do so without disturbance until such time as there has actually been a sheriff's sale and a transfer of legal title to a new buyer. That is a relatively delayed process, for two reasons which may seem a bit confusing and that's understandably so. When you petition the court for an auction sale of the property the judge has a wide degree of latitude in the court of equity to decide how soon that sale should be and what the rules of the sale may be. If he decides that the borrower is a pretty good guy and has a short-term problem and so forth and the lender is being kind of unreasonable, he can go into a slow stall and it may be 18 months before he sets up the sale and there's really nothing the lender can do about it. And that period of time is called the period of equitable redemption. During that time there will be a public advertisement announcing the property is going to be sold at auction and that anyone who has a claim on it, mechanic's lien, some other judgment on the property of one form or another, has to make themselves known. The judge reviews all of these claims and then ranks them in terms of the order in which they will participate from the proceeds of the sale. On many properties that can be a fairly complex process as there may be more than one loan with various historical origins. There may be mechanic's liens, there may be tax judgments of one form or another on the property. It can get very messy. Then he will announce there will be a sale. It is not unknown in small rural areas where the power structure takes a fancy to obtaining the property or a friend of the judge think they would be a nice thing to add to their portfolio, that the sale is announced for the men's room of the court house at 3 in the afternoon on Saturday. And we had a real large crowd there to bid! On the other hand, they may put it in a kind of a public auctioneer and there will be considerable advertisement on the fact that this property is going to be auctioned off at a particular point in time and so forth.

The lender generally shows up at that auction in order to protect his interest. He doesn't want anybody to steal the property for half what it's worth, so the lender generally has his agent there prepared to bid but typically prepared to bid only the maximum amount which the lender is owed and the lender is entitled to so that he can cause the bidding to rise hopefully to a point that is much closer to his claim so that his loan will be repaid. If the property is a real dog and everybody knows it, what happens is, of course, is the lender ends up being the only bidder. And therefore, under the lien theory states, the lender ends up owning the property but only because he bid the most at the public auction. Notice that's distinct from strict foreclosure title theory in which he's already presumed to own the property - all he's doing is eliminating the equitable title and the right to redemption of the borrower. Now, occasionally of course the bidding may frustrate the lender.

There's a wonderfully story to tell down in White Water with those six or eight unit buildings on a cul-de-sac on the West side of the one part of campus and they were all financed by a savings and loan out of Racine or Kenosha and they got into trouble financially and they were going to sell the whole package to somebody on a sweetheart deal and they're having the auction in the courthouse at White Water and some little old gray-haired lady in tennis shoes comes in and when they get to building #3, why the lender bids let's say $40,000 and she bids $40,010 and the lender is stymied cause his agent has authorization only to bid an amount equal to what they are owed and she just bid $10 more than that. And this is breaking up their sales packets that they've already present to somebody else and they're trying to convince her, "Well, you know, this isn't just a walk-in bid kind of thing, she's got to have a cashier's check." She says, I know that she says, "The banker across the street is waiting because I didn't know what I'd have to bid to get it." So they went back and forth and, sure enough, she traipses over to the bank with everybody and the cashier check is cut and bingo she owns the building and breaks up the set and it turns out she's the housemother there and she just wanted to protect her job so she decided to buy the building - disappointed some sort of investor on the east side of Wisconsin. But there's a lot of little surprises, you know, that go on at the auction and as a result, it is not a very favorable way to dispose of property.

Now, in addition, once there is a sale, you can not deliver a warranty deed. What you deliver to the buyer at the auction is a sheriff's deed and the sheriff's deed is subject to statutory redemption which says, "Hey, the borrower still has, depending on the state, one month to six months to raise the money, pay off all the costs and reclaim their property." So you end up with something that is less than marketable and sometimes somewhat difficult to finance. And because not everybody wants a sheriff's deed and not everybody can finance a sheriff's deed because they can't use the property as clean collateral for financing, properties generally sell at a discount at the auction.

Now notice in the mean time the lender's hands are tied unless he has made three arrangements under the term of his agreement that 1) he can have the tenants send him the rent checks directly and that he can therefore take what's due him, pay the necessary subcontractors relative to the property and so forth and then disburse the money back to the borrower. He, obviously, also has to anticipate other operating responsibilities in order to protect his investment during this relatively long hiatus through equitable redemption, the final auction sale, and then the statutory redemption period which follows the auction sale. That differs in virtually every state in the country to make it an, obviously, more interesting game if you are operating in various parts of the country. Now, given that, refer back again to your chain of command, your petition for foreclosure, the judge reviews and establishes all of the claims on the resource and sets an equitable redemption period and sale date and any time during that period of time, the borrower is entitled to come in, cure his breech, pay whatever costs have been incurred by the party to the resolvents, redeem his property and that's the end of it. You may, if you can show that management sincerity and so forth is not there, request the judge to put it into receivership while you await the ultimate sale of the property.

Finally we have an auction and that auction may result in a sale to a third party for a sufficient amount of money that it pays off all of the claims off on the property. The second alternative is that it sells to a third party but for something less than the claim so that the lender still has additional funds to come to the property. At that point the lender may do one of two things, one, he may go to a guarantor and we'll talk more about credit enhancements later, but essentially he has to go to what's called a judgment guarantor that says once the lender has pursued all of his rights against the property, the balance may be covered by the third party guarantor on behalf of the debtor or the lender can go back to the court creditor and the clerk of the court and secure what is called a deficiency judgment. And a deficiency judgment allows him then to attack the personal property proceeds as a general creditor of the borrower. Now of course if the borrower is in deep trouble there's going to be a lot of other general creditors and he may get $.25 on a dollar or he may get nothing or he may have to garnishee for five years in order to get the balance of your money but at least now you have been transferred from a preferred, secured creditor to be able to stand in line with the rest of the general unsecured creditors of the borrower.

The third alternative, of course, is for the mortgage lender himself to bid at the auction and acquire the property. Hopefully, of course, the property in good management and with good marketing will ultimately sell for whatever the amount of the loan or the claim may be and minimize the loss for the lender. Good example, the buildings Northwestern Mutual owned the Regency and the Towers Building on State Street, both of which they acquired through the foreclosure process - that's why it's called, of course, an inadvertent equity. And since neither one would sell for what they had invested in it, it was necessary for them to go forward and manage it and ultimately turn the properties around so that now they're now producing a positive cash flow but if you look at the rate of return on the total cost of reaching that point, it's still not very impressive. Now, quite often, of course, the lender may be able to be selective about which properties they acquire and which properties they don't. One of the best ways to learn real estate is to go work for a bank workout department and be sent out to look at a project and come back with a recommendation - do we bid at the auction? Do we, you know, sue somebody for fraud or whatever? And it's a very messy problem in terms of, what right of action you're going to pursue and do I want the property? Do I want some other form of bailout in the form of a guaranty or do I sue the original borrower for misrepresentation or fraud or conspiracy to defraud and so on? For example, we're involved in a case presently in which the money was lent on the shopping center at the time of closing, it was 98% occupied and three months later it was 36% occupied and virtually all of the tenants showed up under new names at another shopping center by the same developer. Having put a private detective agency on it, an investigative accounting firm on it, it was discovered that the tenants that were remaining were being paid by the developer a check so that if their rents looks like they were nominally $1,000 a month, they were paying $400 and the developer was sending them a check for $600 to cover the balance and so forth. Well, that's fraud and it's a conspiracy which has been repeated several times in this market by the same developer and on several lenders and the last thing they want are a couple of dying shopping centers so they're pursuing under criminal statutes to box the developer in and make him see that it's in his self interest to give the money back and rescind the deal, rather than go off to federal prison for an undefined length of time. So the bailout is always in foreclosure.

Now, obviously the key if you're going to use foreclosure is that 1) that you must first of all give notice that you are now imposing an acceleration clause, that there's been a breech, that it is no longer possible simply to correct the breech and go forward, that you are accelerating the total balance due. It has to be an unequivocal demand by the lender. And it's often interesting that people who write business letters who find it somewhat awkward and unpleasant tend to try to soften the blow and in the process have not written an unequivocal demand for the money and therefore when it gets to court, gets the ground cut out from under them. They said, "Gee you said you could get us the money or this or this or, you know, and so forth." And therefore you haven't exercised the acceleration clause under the terms of the contract and therefore if you go forward with your case, all you're going to collect is the amount of money that is now overdue and not the total balance. So the key word there is unequivocal demand. Then there'll be specific terms in the mortgage in terms of who that letter has to be addressed to, what type of mail, whether it's registered or certified and what are the exact terms of the response. So that has to be executed with precision and finesse because the courts tend to protect the borrower at the expense of the lender.

A second element which is standing by a little of late to provide at least some indemnification or support of the lender. They must be notified each step of the way as to what is transpiring. Or as we will see later as we look at credit enhancements, you may have violated the terms of their guaranty and they'll be able to slip out from under it. Once the lender has decided on this election and given notice he does not have to accept an arrears payment. If he chooses to do so, he can modify the terms. You can say, "All right, I'll let you simply make up the balance due, but now the interest rate is going to be 10 1/2% rather than 9% because you've demonstrated that you're not a great risk and that there's extra administrative costs here and so forth and so on. Before he has exercised the acceleration clause the lender always has to accept an arrears payment and forgive the defaulter. After acceleration clause has been exercised the lender is able to negotiate whatever modification of the original agreement he wishes if he wants to accept the arrears payment that was in the form in the contract. But what happens, of course, is that at the lower levels of servicing the lender has an employee who accepts partial payment or a loan officer who settles for a promise to pay in ten days, you know if the check is in the mail sort of thing, and that immediately compromises the lender's position because he is not strictly on an acceleration basis so once the lender takes the hard line on the acceleration he is committed to a course of action from which it is very difficult to withdraw. Therefore, he wants to be very sure that this really is his only alternative. One option, of course, of the lender is to remain on a reasonably friendly basis with the borrower and say, "Gee, Charlie you've dug yourself into a deep hole. Bankruptcy is only going to cost everybody. Foreclosure is simply going to delay the thing and cause you to bleed further and so on. Why don't we just work this out in a nice friendly fashion and you give us the deed in lieu of foreclosure?" And you voluntarily give us the deed. Now this is loaded with a variety of pitfalls both from a tax standpoint and from a court standpoint if they're leaning on him a little hard. And the borrower can legitimately say, "Gee, why should I give up all of the rights that I have under bankruptcy and foreclosure and be a good guy?" And so what they may do is buy them off. Gary Schmuck, we don't like you, you cheated, you buried the money in the basement and all that good stuff but, nevertheless, I'll give you $250,000 and we'll buy whatever equitable rights you still have in the property and you fade into the sunset and we'll get on with setting things running. And so quite often the fact that the borrower is now in deep trouble and ultimately the justice wheels will grind away and eliminate his equity, is when the borrower is in his strongest point. It's one of the great ironies of our foreclosure law that the individuals who have the most tenuous equitable interest are often the ones who come out of the foreclosure process the best if they play their cards carefully. They will be paid off to go away and get out of the way and to give up whatever tenuous equitable interest they may have had in the property. Now there's several problems to that. One, of course, is that the lender by taking title, takes with it all of the encumbrances that come with the title. So if the mechanic liens weren't repaid, well now the lender gets to pay the contractors again for what he thought he paid them for the first time. There may be title flaws of one form or another in the property. Today in the age of hazardous materials, once the lender has taken title, even equitable title, he is now subject to the super fund rules that say, "OK now you're in the chain of title, you have to help clean this one up." And your friend the industrial enterprise that was there dumped their PCPs out the back door and it has leeched into the water table and is now moving out towards the boundaries of the site and it's going to cost you $500,000 to dig that all up and remove all of those hazardous materials or your building has asbestos and the GSA tenant will break the lease because it has asbestos unless you remove it at a cost of umpteen thousand dollars, etc. And suddenly the lender finds himself, you know, in the position of the landlord with all of the liabilities attached to that. And you really have to think about that.

For example, classic case, we worked on a number of years ago with a little savings and loan down in Ohio. And they made a loan to a developer that was selling a condominium camper unit in which you essentially got a little chunk of land, maybe 60 by 100, and the condominium was only so wide, etc. and as part of this development which was essentially in the flood plain of a small creek in Ohio there was a 9 hole golf course laid out in the flood plain. A Wee Willie Waterslide and a big fish hatchery and the developer was promising the buyers of the condominium unit that he would operate those for 20 years as amenities to the project. Now the lender has a clause in it that the developer couldn't do anything to encumber the property but, on the other hand, they read his advertising and they didn't say anything about the fact that he promised to keep all of those things operating. Well, he never did sell enough condominium pads to make the thing go. But he sold enough so that there was like 300-400 owners in this development and now the lender has the choice of foreclosing on the property and taking over the liability of operating these amenities for the next 20 years to make good on the existing deals or taking a walk on the property. Well at that point they were into it for $450,000 and, you know, what they should have done is taken a walk on the property because the present value of the operating expenses of that commitment was well in excess of and probably close to a million and a half dollars. And at that point you just have to say, you know, fine I'll fall on your sword, get a new loan. But, no, our heroes decided that the problem was a marketing problem and they found a guy in Iowa that was marketing condominium camp grounds and he said, "No problem. Be happy to come in and straighten that one out for you. Oh, by the way, most of my time right now is spent on re-financing my project in Iowa so if you would lend me $900,000 for my project in Iowa I will chance the boat and it will solve the problem." Well, they lent him $900,000. So now they're into a $1,350,000 loss and they have now foreclosed on this other property so they're now incurring the operating losses of the amenity package that goes with the condominiums. Along comes a guy out of now southern Missouri who does have kind of an interesting track record on condominium/recreational property development and he says, "I'll solve your problem in both places for you in Iowa and Ohio but, oh, by the way, I need another 3 million on my project in Missouri." Well, they went out to Missouri and its a really impressive project and they've got very elaborate community center and amenities and marina on the Lake of the Ozarks and all of this good stuff and so forth and so they lend him 3 million and he takes over and he's a whirlwind and in 6 weeks sails are humming and everything's going great and he's flying back and forth in his Beechcraft between the three and unfortunately flies into the ground and killed himself. At that point they are into $4 1/2 million dollars and the bank calls us in to evaluate the property. Well we have a negative value in Ohio of about $1.5 million as best we can figure the present value of that deficit was, we had a zero value in Iowa and now we go down to Missouri, which is nice in the summer on the Lake of the Ozarks and it turns out that all of the collateral which they thought they had in terms of community building and the tennis courts and the marina and so forth had already been deeded to the homeowner's association so that the mortgage only fell on the back woods which had never been developed. It didn't cover any of the apparent facilities and the appraiser that he had, you know, down from the bank couldn't read a legal description. So he didn't realize that the only road in was owned by the adjacent property owner who promptly put up a barrier and wouldn't let 'em cross it and then offered to buy it for about $.20 on the dollar so that, in effect, they had maybe all together a positive $250,000 worth of collateral on the three properties against the $4.5 million dollar loan and went busted. So as a result you have to really understand the nature of the collateral and what is the consequence of going into a foreclosure or a deed in lieu and quite often it's easier to take the loss than it is to acquire the property. If there are irremediable laws in the property the lender isn't going to do any better than the dummy who owned it in the first place and they have to be very, very wary of exercising their right to foreclosure or acquisition through a deed in lieu of foreclosure. The second major element of course is that if they do acquire the property through a voluntary transfer and then the creditors close in on the transferor under the bankruptcy laws, the bankruptcy judge is very likely to view the transfer of this one good asset to the lender as a preferential treatment of the lender as a result of his stronger than average bargaining power and set it aside and, in effect, take the property back with whatever improvements, of course, the lender has made in the meantime. Now, the peril therefore of foreclosure or deed in lieu of are such that it doesn't always represent a viable enforcement technique for the lender. And the lender may need to anticipate that when he makes the loan so that he finds alternative ways of bailing out and recovering his capital other than taking title to the property or pursuing his rights under foreclosure.

The next step in the process are, obviously, the bankruptcy laws. Chapter 7 and that area of bankruptcy law typically is imposed by the creditors but in the more revamped bankruptcy statutes under which we are working since 1978, Chapter 11 is really designed to protect the borrower from his creditors and give him time to, presumably, reorganize his financial affairs so that, in fact, the debt structure can be carried by the property. And it has two very major threats to the real estate lender. The first is that by simply going into Chapter 11 there is a stay of execution placed on the foreclosure process until such time that the judge has been able to review the situation and the lender is able to establish to the benefit of the judge's curiosity that some terrible hardship is being worked on the mortgage lender to the benefit of everybody else by not letting him go forward and foreclose on the property. So Chapter 11, in effect, says, "Sorry, whatever we said you could do under the foreclosure laws is not applicable until such time as we decide to reinstate it.

And the second provision is what is called a cram down provision. And the bankruptcy laws are designed to let you get your principal back but it doesn't necessarily have to allow you to get your interest back. So if they look at the mortgage loan and they say, "Gee that's a shame it's at 13% interest. The best prospects of this property are that it could pay 6 1/2% interest. We're going to change the terms of the contract and we're going to pay 6 1/2% interest for say, three years or five years and provide may some other kinds of strip bonus, rather speculative, future interests in the property the lender to compensate him for the difference and we'll simply restructure the debt in order that what remains is something that the project can afford to carry within the net income available for distribution on debt service and so on. So as a result, the average real estate lender is terrified of a Chapter 11 bankruptcy simply because now there are multiple classes of property and while the privileged character whose principal is protected, the nature of his original bargain may not be protected and he may find himself locked in for a long period of time into a workout arrangement in which he is not in a favorable position at all.

. . . during the real estate crash of the early 70's to be incredibly in favor of the real estate individuals and a Wisconsin boy, Dr. Tesuma, who was able to prove to the world that bankruptcy was in fact an unfortunately circumstance to be avoided, but was, in fact, a legitimate tool of tax on his financial sources and, as a result, Tesuma who, at that time, was the nation's largest landlord with about 500,000 apartment unit all of which were underbuilt, over-financed and which had been milked considerably was able to bash most of the major lenders and banks in the country by simply getting a very skillful bankruptcy attorney to represent them and the lenders were appalled at the degree to which their contracts had just simply revamped under the cram-down provisions and they were told that, sorry you're not going to get 10%, you're going to get 4% interest because that's all the project can pay, and we're going to set up a schedule of payments to the other nonsecured creditors and simply postpone the ultimate collection of your principal and the idea of the present value of money and so forth really didn't occur to anybody, it was going by the letter of the contract. And so in 1977 and 1978 there was concerted effort by the mortgage banking industry to revamp the bankruptcy laws so that they would have fewer surprises and at least have more of a chance of collecting the debt. It's not quite clear that they clarified anything. There are tremendous areas of the bankruptcy law which are unclear and Congress is still working on further revisions and the establishment of judges that were specifically trained and focused on this particular specialty was also a relatively new idea and so, in many cases, the bankruptcy judges themselves. CRE simply creating the laws that go along by precedence. The two basic philosophies under the bankruptcy code are 1) liquidation of whatever assets the bankrupt may have to meet the demands of his creditors and there are some very limited exemptions to the assets such as a homestead exemption so that the family isn't put out on the street and certain minimum other exemptions to protect his personal property in the hope and (?) those on his family and so forth. But otherwise in essence the assaulted debtor simply gives up his assets subject to those exemptions to the court and the court goes about some form of liquidation process to raid what money it can for the benefit of the creditors, so that they're paid off in pennies per dollar on the claim and then to the degree that there's a debt remaining, the debts are simply discharged by the court and eliminated. The object is really to allow the bankrupt to retain interest in his future income. He can not be garnisheed by the creditors that are not paid off in full. They can not attack his future assets. In fact, he can start over and that essentially is the incentive for turning over and vaulting all of your assets for liquidation. The second philosophy and posture of the Bankruptcy Act is reorganization. The premise that you are currently cash poor but that ultimately your assets will be more than sufficient to meet all of the claims and that what you have is really a crisis in timing rather than a shortfall between your assets now and your liabilities. And it's really going more toward technical insolvency than true insolvency - just the inability to meet current payments and realize the fact that the assets that you have are either submerged or relatively illiquid and that with time your business assumptions will work out and resources will be adequate to repay everybody. And these two chapters, Chapter 11 and 13 are the ones, of course, that provide for that type of reorganization. 13 is simply for individuals who have a regular income and have debts that under a certain dollar limit and really represent people who get into trouble from a trade credit standpoint or something of that sort and so Chapter 11 is the one that really concerns us as far as real estate is concerned.

Chapter 11, the debtor retains control of some or all of his assets but in exchange pledges that his future income and resources will gradually be repaid to his creditors according to some refinancing and repayment plan. And this plan of course in its execution will be supervised by the bankruptcy court. The premise of course is that there are various levels and priorities and plans. You have, obviously secured debtors that have specific claims on certain assets, such as a mortgage lender, such as the loan that financed his car and so on. And then you also have unsecured creditors that may get less than 100% on the dollar on their claim and if there were, in fact, excessive debt, the unsecured creditors might be wiped out as they were in Chapter 7 but that is less likely to occur.

A Chapter 11 proceeding is not necessarily initiated by the creditors at all. It can be, in fact, initiated by the entity in trouble and it quite often is, in order to achieve certain time advantages over the mortgage lender. It requires first of all that the debtor divulge all of his assets and all of his liabilities. Secondly, give us the history or a statement of the history of his business activity and what he perceives as the causes of his current embarrassment of technical insolvency. Third he has to submit a plan of reorganization and that plan has to outline each and every creditor's debt, secured or unsecured, the nature of the collateral that that debtor may hold and how the debtor proposes to go about paying off that particular creditor. This plan then is reviewed by the bankruptcy judge and then submitted to a committee of creditors who get to vote as to whether they're going to accept it or not. Ultimately for the judge, particular in real estate, the critical decision is going to be are we better off to sell the assets that are available, because the funds that could be raised by sale will be more than adequate to meet all our claims. Or, is the current market value such that we're better off to let it go forward as a going concern because as a going concern under the management of the bankrupt, it will eventually generate enough dollars that it can meet all of these claims if simply given time to do so -

and that's a tough call. Now one of the immediate advantages for the bankrupt who files Chapter 11 is that there's an immediate injunctive stay referred to as a 362 if you want to exact against any foreclosures and that stay is extremely broad and even includes protected persons who have no notice of the filing from taking any action whatsoever to collect pre-petition debt from the debtor. In other words, everything goes into a freeze mode. The sheriff's sale might be the very next day but, sorry, it's off. And this stay prohibits commencement of any lawsuit continuation of any lawsuit against the debtor, any act to obtain possession of the property from the debtor that's his or his may be coming to him from an estate. Any effort to protect or enforce liens, any actions on a claim to take what is called setoff - let's say a bank has a cash deposit from you and a claim against you - ordinarily they would be allowed a setoff. For that matter, by the way, if owe the federal government money, they can take your social security account and setoff and so on and all of that is verboten by simply having moved into Chapter 11 and the judge is saying freeze where we are, we're going to take inventory here and find out what the claims are, organize them in terms of who's entitled to what and when and get a firm grasp on what is occurring here before anybody can change their position relative to anything else. Now relief will be available, but in order to obtain that, the creditors have to go through a series of very specific procedures in order to demonstrate why they should be entitled to proceed to enforce their legal rights.

Now should a creditor be in such straits that there really is no equity at all and there's really no reason to believe that there will be any if he's allowed to go forward, and so forth, why the court will very quickly remove that stay and allow people to proceed under the rights of their agreement. So the first thing the creditor has to prove that there is a real equity here that he would lose if anybody moved too quickly or the judge didn't recognize the fact that what we had was a crisis in timing rather than a matching of assets against liabilities. For example, in the case of the Concourse, Prudential, at one point the owners had not made a number of their mortgage payments and when they started to make them again, well by that time the Prudential had exercised their acceleration clause. If you'll recall once you've done that you're going to have to move forwards, you can't go backward so they wanted to take over the hotel and have it sold at auction and get their money back. And the owners of the hotel started making their mortgage payments into an escrow account and went into Chapter 11. Ironically, it was right at the time when the interest rates were rising so that they were making money on their escrow account relative to the interest they actually owed on the mortgage and when they went to foreclose it became apparent that Prudential had failed to protect their claim on the personal property such as the window air conditioners and the elevators and the furnishings and so on. So it was very easy to prove that it was necessary to sell the hotel they could only sell it on a scorched earth basis - they didn't get the name, they didn't get the business, they didn't get the furnishing, they didn't get the elevator, they didn't get the kitchens, they were all secured chattels to other financing and therefore there was no way they or anybody else was going to be satisfied by selling the hotel because the hotel would sell at such a discount if it were stripped out of all of those elements - they really didn't get a going concern at all. As a result the court ruled that they would go forward to work out a settlement rather than simply sell off the assets since, in this case, the lender had failed to protect the priority of his position in the assets anyway.

Now, the protection provided the equity owner, of course, is going to be dependent on his ability to have a business plan and a refinancing plan and quite often might require that he bring in new capital or additional capital to the enterprise in order to provide liquidity, in order to, perhaps, buy off a couple of adamant creditors that say, you know, in our class we're going to, you know, go forward and demand to just liquidate everything and so he may have to devise a plan which creates a certain category to creditors that gets paid off 100% and within that category maybe one hard nosed sun-of-a-gun that otherwise threatens to disrupt the rest of the plan. So it requires a certain amount of creativity as to how you rate classes of creditors and plans for their repayment and refuse the major centers of legal resistance to the plan. The opportunity to protect the various interests under chapter 11 are virtually infinite and clever attorneys for the debtors can tie that property down forever. We're verbally involved in one in California which has been in Chapter 11 for 11 years and in which the first mortgage lender, Traveler's Insurance Company, which is no slouch and which can afford the best legal talent, has yet to collect any penny, number one on a multimillion dollar farm loan simply because you have a partnership position and you've got partners suing each other relative to fraud and misallocation of funds, etc., etc., etc. They, in turn, set off different pieces of their acres in one time in a trust for the children so every time they get some kind of resolution one or the other children sues to argue that it's inequitable to their position or whatever and the result is virtually all of the income from the property has gone to legal fees trying to decide if and when they can sell the property. And, in the mean time of course, farm land has deteriorated in value so 11 years ago while it was quite adequate to payoff all of the claims had they been allowed to do so, today it means only the first and second mortgage holder would get paid off and the creditors would get about 20 cents on the dollar and the only ones who will get paid in full and will be paid in full will be the attorneys. And there's still no end in sight, for example, the original operators continue to operate the property and enjoy management fees and income and so forth from the property in the process, which I thought was kind of intriguing, they have sold off some of the irrigation equipment and so forth and so on and gone to dry land farming in order to generate additional cash so that at least three families of one of the partners are making a living off of the ranch very handsomely and when it came time to - finally the judge just recently ruled that they had to sell the property - their strategy was to argue about the appraised value and get the judge to set the listing price significantly above any price which you are likely to sell it for. So now even though it's on the market the listing price is so high that you're not likely to get an offer and if you do get an offer it's going to be so much less than the listing price, the judge, of course, is going to be inclined to deny the transaction as not realizing the full asset values of the ranch. So as a result, one of the last things you want to tumble into with the lender is a Chapter 11 proceeding. And, therefore, you may have to go to considerable lengths, as we talked about the other day, to buy off the creditor, give him money to go off and do something else, to trade him for another property - saying, "Gee, you've got an equity in this one that's $400,000, this is really . . . you know - we're able to do, tell you what we'll do, we'll buy this property over here free and clear for $400,000 and trade it to you for this one." And since he probably has none of his own money in it in the first place, that's not a bad deal. Certainly a very gracious form of extortion.

Creditors, of course, are not always disadvantaged by bankruptcy proceedings. Knowledgeable judges, and we are creating a cadre of knowledgeable bankruptcy judges -

know when they're being hornswaggled and can have a great deal of discretion in arbitrarily disposing of petitions and arguments and going forward with whatever will get the cash into the hands of the creditors. But in many cases the real estate situation is so complex with mechanic's liens, tenant's claims, various types of partners, verbal lenders, guarantors, and so forth, that the judge may take considerable amount of time sorting the facts out and trying to figure out who the good guys and the bad guys really are.

The judge may appoint a trustee if he feels current management is the problem. But by and large Chapter 11 leaves the property in the control and the possession of the debtor. The secured creditors will often find the judge setting aside certain emergency steps that they may have taken in order to provide some preference on the assets. For example, it's not unusual for the bankruptcy judge to say that this property has been in trouble for some time, that it was publicly known that it was in trouble and therefore the last six months payments to the mortgage lender were preferential payments and ask for the mortgage lender to give them back - put them back in the pot. As a result of that in many cases today commercial lenders are using a bond form of lending in which maybe 2 1/2 million dollars is made as a loan to the bond trustee who now advances $2 or $2.1 million to the project and retains $400,000 of cash in the trustee's account, the bond trustee's account, so they can continue to make timely payments to the mortgage bond holders while the judge sorts out who's entitled to cash from the project and perhaps put the moratorium on monthly payments on the underlying mortgage that secures the bond. There may be a variety of claims that funds provided one or more of the creditors were to the detriment to others. Defenses to that might be, "Well, that wasn't for an old guy, that was for a new guy and he didn't pay me for the old truck, that was a payment for a new truck that we gave him and so forth." Or that that was a normal payment in the course of doing business and it didn't have anything to do with the debt, that was for services that we provided or whatever. And obviously the judge has to hear these petitions as to whether these payments were preferential and therefore should be refunded to the bankrupt entity or whether they were a normal course of action. The second element, of course, is what do you do about assigned leases where the lender is now collecting the rents, sorting out what's his, and putting the rest back in the pot. What do you do about fraudulent conveyances? It's now unknown that someone realizing that they're about to go into the tank disposes of some of their assets to friendly hands and what then? The judge can revoke any of those transactions up to within a year prior to the filing. He can go back and demand additional payment if he feels the payments were inadequate. He has very very broad powers to protect the assets from those kinds of transactions.

One of the more interesting problems for real estate interests relative to the bankruptcy laws, not necessarily relative to the mortgage but, what if one of your major tenants in the shopping center goes bankrupt and hasn't paid the rent for four or five months and then goes into Chapter 11. You can no longer evict them. Most leases have language, boiler plate language, which states that should the tenant go bankrupt that the lease is terminated so that the landlord can presumably find a healthier tenant who will pay on time and so forth. Not so on the bankruptcy laws any more, you're stuck with that tenant but the judge does say that while his location and while his ability to continue business at that location is one of the assets of the business that's to the benefit to the other creditors, the fact that you're now inflicted on having to have him as a tenant gives you priority standing so that the rents due after the Chapter 11 is declared are immediately payable according to the terms of the lease and they have first priority on the assets of the bankrupt where the rents prior to the Chapter 11 declaration - you stand with everybody else waiting for your money. As a result, you may as a landlord be inclined to put the tenant in bankruptcy so that you get first claim on his assets rather than necessarily, in the old days, try to avoid the bankruptcy lest you have to lose the lead. At some point, however, the judge can decide to grant the lease as the problem. Maybe the tenant was paying too much rent - maybe the location isn't right for instance. That was the business error which added to the problem. At that point the judge can simply arbitrarily unhinge him and give notice on the lease to terminate the lease and now the landlord is on his own to find a replacement. The maximum the landlord is entitled to is 12 months rent. Doesn't matter if it was a thirty year lease and we're in the second year, under bankruptcy, the maximum damages he would be entitled to would be 12 months' rent. And if the resources aren't there, the judge simply doesn't pay it. There's

many many nuances under the bankruptcy law and I don't need to bore you with all of them, nor do I expect you to know all of them other than the very broad discretionary powers given to the judge the stay on all forms of enforcement actions that occur immediately following that and the fact that there is a generally prolonged procedure from getting yourself out from under that income injunctive state and being able to go forward with whatever claims you feel you may have on the bankrupt. As a result, the law, while somewhat more favorable to real interest than it once was, is not the panacea that the mortgage lenders had hoped and the Chapter 11 remains generally the terror of most real estate lenders. They will go at great lengths to avoid getting dropped into the pot with all of the other creditors.

OK, the second subject I want to talk about today is now laying the ground work for actually making the mortgage loan. For the lender, as we've seen, his first concern is what tools do I have to enforce whatever contract I make? For the borrower, of course, the first concern is how much money do I need? And immediately following that is the question of what am I willing to give up to get it? Obviously, I'm going to give up a certain portion of my cash income in the form of debt service. I'm going to give up a certain degree of flexibility into what I can do with the asset. If I can sell it or refinance it or allow partners in or redesign it or whatever, good. I'm also going to agree to endure a certain amount of administrative hassle and there are many people who will not go into the FHA program purely because they won't endure the FHA hassle. They like the terms, they like the money, they like the fact that it's nonrecourse but just dealing with HUD is more than their nervous systems can tolerate and, therefore, if they choose between doing their project and not doing their project, they would just as soon not do the project. Others have no problem dealing with HUD whatsoever. They have a mindset which allows them to follow relentlessly through the process. Those who can do that really have a monopoly operating in that field simply because of their ability to tolerate the frustrations of doing business with the government. You have to have a budget. You have to know what your own resources are. You have to know what kinds of terms will work on your project. At what rate can I repay it? When can I begin to repay it? Will my partners co-sign or do they want nonrecourse, must they have non recourse? While beginning a negotiation process, you must know what your basic objectives are, whether they are non-negotiable, what your like-to-haves would be and if they're negotiable and a number of things you are willing to negotiate away if that seems to ease the way toward successfully closing the deal.

Once you have a pretty good specification of what you want and what you're willing to give to get it, the next question is where do I begin my search? There are an infinite number of routes to the capital markets. The first question, of course, is what type of property do I have and who lends on that type of property and how much money do I need? Is the local savings and loan capable of handling that or is it more money than any of my local lenders would be able to make available in any one project and therefore do I have to look beyond? Do I want to go directly, do I want to go through a mortgage broker, do I want to use an investment banker? And today there are financial counselors that will help you put together a package and tell you what your best strategy is and so forth. More often than not, the route to the money is not the most what appears to be the direct route. For a long time in Madison, one of the major savings and loans, mostly allied to a brokerage house and a law firm and if you had a major deal you generally head to the law firm first and you have a nice chat with one of the major principals and if he liked you and they liked you and they thought it was a good deal, why you were a shoe-in because the board at the savings and loan which the brokerage firm belonged to (?) and whatever council told them to do, they did and therefore it was important to have council in camp before you ever got there. And if you knew that was the way in, that's the way you went in. If you think you're going to do business with a certain insurance company, and they pay for a certain investment banking house, obviously, that's the way you're going to go. So you have to very carefully decide what are the protocols of my approach to this particular lender that I think is most likely to finance this type of fund. Those social protocols are extremely important. I have a good friend and former high school classmate named Crazy Harry who has no sense of protocol whatsoever - great ideas. He's been very successful building million dollar houses on spec in the San Francisco area. Decided to go into New Town building in downtown Minneapolis. He got absolutely killed - lost a couple of million bucks in no time flat. He really didn't have any sense of how it was you went about that and how it was that you got the community folks lined up on your side and how it was that you got the lenders lined up on your side. It is an extremely critical element and one of the things you learn only by experience and by knowing the turf. What's the power structure that controls access to this lender, that lender or that banker or whatever. There may be certain lenders that you can't go to. Some may, of course, be financing your competition. Some may have a favorite general contractor. If you happen to know that you want to go to a certain bank and you want to be favorably regarded, it may be that you're going to have to deal with a certain general contractor because he's got certain problems that let's say the liquidity and the bank would be only be too happy to see and get another construction contract which will cause the cash to flow again and maybe solve some of the other bank's problem. By the same token, there may be certain people that you just don't like. My father taught me at least 25 percent of the people you meet, he said, are going to be smarter than you so don't do business with them at all. And that's probably very good advice. Who are you going to be doing business with? What kind of long term relationships do you have with them? Are you likely to be able to build a long term relationship with them? There's a lot to be said in terms of the construction of our banking system for the old way of doing things and having a small bank of being a big account at a small bank so that if you get into trouble, you know they're going to work with you. Now, of course, they could care less. They're looking over their shoulder at the FDIC auditor who's coming in and the bank is headquartered in Appleton and is now doing business in Oregon and they've decided it's a bad farm loan. They could care less if they put the farm out of business. Their object is to collect their accounts and make their aggregate bookkeeping look however the FDIC wants it to look and if that means taking your farm out of business, they will. There is a great deal to be said for personal relationships in which you can depend on them when the chips are down. That you're not going to be dealing with a different hot shot MBA, every six months as they rotate them through the bank. Since you're dealing with the vice-president of the bank who's been there for 15 years and that handled your account in the past, knows you've always paid your bills, and that you're basically a good guy and if you get a problem it is something to be worked out rather than something to be punitive about. So from the protocol standpoint you want to decide who you're going to do business with, whom you're not going to do business with, how you're going to make that presentation. Generally, there will be a preliminary conversation about your general project and its specification and character at which time the lender, the mortgage banker or broker will tell you the parameters of eligibility and the process for application. They'll probably provide a checklist of documents and contracts and other materials which must be complete before they will begin any cursory review or underwriting process. With your invitation to solicit an offer from the lender, they may require some sort of fee, refundable if they reject the application, but retained as part of the loan charge if they offer a loan commitment on the terms you have requested. And then you reject it. In the past most of the document preparation, appraisals, feasibility studies and so forth were the direct responsibility of the borrower. Today we're going through a major change in lending philosophy which will require that the lender hire his own appraiser. The lender hires his own market and feasibility work and obviously the loan application fee will have contained funds that cover all of the anticipated costs. And the letter of commitment will probably have a whole paragraph on the additional costs that the borrower will be expected to pay as you move through the legal drafting process. All that becomes part of the initial dance done by the borrower to anticipate financing. One choice, of course, that the borrower has to make very early on is do I go after one particular lender rather than simply throw this on the street and see what comes up. It is almost always better to go after one particular lender, perhaps two or three in sequence so that suddenly they don't feel that this is the package which is being shopped and that they're going to have to compete with everybody in the business and that some damn fool will undermine all their work by low-balling it along the way and so forth. Typically what happens is that after you try a number in sequence of those most likely to do that and you still haven't gotten financed, at that point you may go to a mortgage broker who takes the package and circulates it among 100 different lenders to see what may bob to the surface. But at that point it's fairly common knowledge that the project is being shopped and that obviously there are a number of good judgments which have decided this is something they didn't want to finance which, of course, is not good for the public image of your project either. In some cases mortgage investment brokers or mortgage bankers will handle the package and presentation of only one thing or some, for example, specialize in FHA and have an excellent record in securing FHA approval and commitment letters and so forth and you might go that route. But with very specific controls on who it is they can show it to and in what sequence that decision is going to be made. It's not something that's done lightly by simply walking into the bank someday - how would you like to give me five million dollars for a shopping center at such and such a point? Direct me to your closing officer. Once you have made that initial contact, the sequence we are going to look at is, obviously, one, an underwriting process which will involve considerable dialogue between the borrower and the prospective lender. Second of all, the lender internally is deciding where are the funds going to come from to meet this official obligation. Are we going to sell commercial paper, do we have internal funds, is there somebody about to pay off their loan? You know, how does this fit our portfolio diversification plan? There may be a variety of internal constraints on the prospective lender that have nothing at all to do with the inherent quality of the loan, but it simply doesn't fit his portfolio at that time or his cash availability at that time. The next step then is if the lender decides he can do it and has decided what the risk factors are going to be, he will attempt to put a price on it and then will take a look at that in that there are multiple factors in the funds. He may look at you in terms of one, what other business have you got to give him? Does this, for example, give him a chance to enter the market which he's never been in before that he'd like to make an appearance? For example, Continental Bank moving into California made some deals that they wouldn't have made otherwise in order to make the presence under the noses of the California Bank saying, "Nay, we got some of your best customers," and so forth and, of course, it looks bad to penetrate a new market to undercut a little bit the terms that otherwise were prevalent. There may be, let's say, offsetting balances. If you're a large property management firm and, as a result, you keep large deposits on the bank as we'll see later, they will give you some credit on your interest rate for the margin being earned on that account over and above whatever cost of funds they perceive as appropriate relative to that account. And there may be a tradeoff between how many points you want to pay up front for the deal and what interest rate you want to pay on the deal. A variety of elements will go into the pricing framework and at that point they will issue a commitment letter which is really an offer to loan the term money on these terms. The borrower can either accept it as it as it is sent out or try to negotiate some of the terms which he finds most onerous in the commitment letter. But when the borrower finally accepts the commitment letter, you now have a deal. At that point you begin to move towards a closing with all the supportive documentation starting to fall into place. And upon completion of the closing you get your first draw on the loan. It is remarkable in commercial lending transactions if you can do all of that in 30 days - 45 days is probably more difficult and many of the closings may go on for many months. You know, as you iron out the documentation and even, in fact, invent the documentation in certain circumstances.

One last element the on the lenders issuing of a letter of commitment. Obviously one of the fears that you are now going to take his deal and shop it. Going to somebody to see if you can improve on one aspect of it or another. Typically there will be time fuses on that so that you have a very short period of time in which to accept or reject this offer. There may be deposits that must be made that would be forfeited if you reject his offer and take another. And there may be, obviously, time limitations on how quickly you're going to have to close in order that the bank may provide matching access to the capital or where the time factor is unlimited, there's obviously going to be some variables that are going to slide with the deal. Instead of providing faxed numbers you will provide formulas which determine when and if you close, what the interest rate will be, what the fees will be, what the effective yield will be in order that they can continually maintain an ability to match their loan commitments with their cost of capital estimate. OK, we'll pick up on letter of commitment. Bring your lesson outlines on Monday.

. . . the closing process and documents. I thought I might go through the package that you had to go through, at least emphasizing the major elements - your readings also include some materials on that. The lender is beyond the preliminary conversations with who decided to deal is going to require the following minimums in that a loan proposal package.

The first is number one, demonstration of control of site. They don't want to have you simply speculating with them and basing their understanding time on a project where you do not have tight control of the site. Now that may be an option to purchase which has sufficient time to run that you obviously put your deal together before the option expires, and so forth. It may involve a joint venture agreement with some of the equity types but there must be some sort of written evidence that you control all of the parcel that you may need for your project.

The second element that they're going to require is that you provide evidence that you have all of the zoning entitlements required, variances required and so forth and can, in fact, have or do, in fact, have all of the necessary permits. Again, they don't want you simply taking their underwriting time on a project in which what you're really going to do is get the loan first and then be able to go back on the planning and permit people and say, "Gee, you know, if you don't give me my permit, then the city is going to lose this opportunity for $20 million worth of construction and jobs and taxation etc. etc. etc."

And they don't want to be in the middle of that kind of routine and so they want to make sure that you can demonstrate your ability to give them the necessary title.

A third major element today is that you must be able to demonstrate environmental clearance. Environmental clearance has a whole series of subcategories, obviously. One is related to hazardous materials that may be in the ground, may be in the old structure that you're proposing to remodel. State superfund agencies will provide inspections to clear your site of responsibility for soil contaminations of one form or another. You may require an engineer to go through and determine that there is no asbestos hazard in the old building that you're going to renovate. It may require that you demonstrate that the radon level in that particular area or that the geology is such that they're not going to have a radon problem, and so forth. There's a whole series of elements that go with environmental clearance. Most of our environmental laws today require that anybody with an interest in the land becomes jointly liable for the costs of cleaning it up and therefore a lender that goes in in a title theory state, in effect its title is subject to the feasance clause and where they have decided it's necessary to foreclose the property could become liable for an environmental cleanup problem that was greatly in excess of the loan amount and it certainly would be a surprise, in any event, because of how many dollars it would have to lay out in order to protect their interest. So the environmental clearance becomes a very significant factor in protecting the lender from incurring the surprise liability. Once you have control, once you have the title, once you have environmental clearance, the next thing they want to know is how well you have done your homework relative to the market. Can you demonstrate that there is effective demand for your product? Clearly they would much prefer to see you have a signed lease on the single tenant building from a triple A credit. Barring that, they might require that 50% of the condominiums that you were going to build be presold or that 50% of the space in the building be preleased. Falling back from that, they may require that you have a market and feasibility study demonstrating that there is a shortage of space - that this meets the requirements of those that would be in the marketplace and so on. At one time this was a very sloppy area of it. Everybody in American wants to make a deal and they tended to rationalize - gee this is such a pretty picture in the rendering that how could anybody not want this sort of thing. Let's go ahead and finance it. Now they have some rather interesting phenomenon taking place. In the savings and loan industry they are already under something called "R-41 C" which you learn more about in the appraisal process. And the "R-41 C" says that one, that the institution must have a very specific appraisal management program that begins with the board of directors and the officers and that they determine the quality and capability of those that provide appraisals. Two, that the appraisal must be done for the lender and paid for by the lender so that they have right of action against the appraiser for malfeasance or negligence in the execution of that study. Three, it requires that the project to be built, that the appraisal include a complete market analysis and a complete feasibility study as the underlying premise of the appraisal and that the appraisal then further show benchmarks of value as the project progresses. You can not simply assume that if the project were completed, it would be worth "X" dollars. You must show that on the way to that point, were it to be somehow aborted because they're only rented 50% or ultimately the only security was the land, and so forth. What would be the dollars coming out? What would be the real collateral underlying that report. And finally, it requires that the lending officer himself sign the appraisal and indicate that he concurred with it. And if that process is not followed, the directors and the officers become personally liable for their negligence as fiduciaries in protecting the savings and the capital of the institution - heavy stuff. If you go to your financing and savings and loan institution today and you ask your appraiser to do an “R-41 C” appraisal I’ll guarantee you it will cost at least three times as much as it would, were you to go to an insurance company with the same proposal and definitely three times what it used to cost to come up with a piece of paper with a rubber stamp, whatever it was that was going through. At the banking level, the FDIC has been roundly chastised by Congress as negligent and their appraisal process they are gearing up and they have been instructed to do something very similar to “R-41 C” or explain why not. And, as a result, they are in the process of implementing their own appraisal regulations very similar to that. The third element of that is that Congress under Douglas Barnhart, the democrat from Georgia, it is going to introduce or just has introduced this last week legislation which requires that any governmentally insured capital or savings entity would be required to follow “R-41 C” or something very similar. And that the appraisal industry will be required to establish appraisal standards and a certification board very very similar to that which is existent in accounting and that that will have to be implemented and all governmentally insured lenders can only use certified appraisers. So as a result that’s changing the ball game very very significantly in terms of market research to establish the effective need or the product that you’re going to provide. They want to reduce all forms of speculative construction lending or development loans which are simply based on the premise that if, as and when it’s ever completed, it would be worth X. But if the fraud has been about 25 billion dollars on that kind of lending in the past, and they hope to bring that to a screeching halt.

Once you've established effective demand, obviously, it has to be effective enough that it can support the cost. And therefore, you must have one, a very detailed schematic plan and here, of course, the developer is into a rather interesting problem. He would like to know that he is going to be able finance the project before he spends a great deal of money on it. On the other hand, if he doesn't spend some money on it, he's not going to have control of the site, not going to have the assurance of getting his permit, not going to have the clearance for the environment, and he's not going to have a market research project, and he's not going to have a set of plans that's detailed enough to give the lender assurance that, in fact, the moneys that he's asking for plus his own equity will be adequate to finance the project. So more and more he's being forced to put in a lot of front end money up front before he has any assurance at all that he can finance the project. In the old days, you could come in and, in fact, in Alaska when we up in Barrel there's a little place up there called Peppy's North which is a Mexican restaurant in Barrel, Alaska totally staffed, by the way, by illegal immigrants because there is nobody from the border patrol in Barrel, Alaska. At any rate, the lady that runs Peppy's, who is the local entrepreneur in Barrel, went into the bank with a piece of two-by-four that was about a foot long on which she had drawn the sketch of her project and got the financing. Now the other half of the story is that you will find out that their business manager is the banker who made the loan and a little conflict of interest there. So you may be able to do that in Barrel, Alaska but you can't do that here any more. You can't have something drawn on butcher paper and with the good old guy, a coach, and I've been to the Rotarians with him for the last fifteen years etc. etc. etc. And it's just a little old million and a half dollars that we need to do the project and that they go forward. The bank auditors simply are not going to sit still for that kind of file any longer. So you're going to have to go forward with a fairly detailed set of plans and proposed specifications for the project in order that you can work out a budget for that particular property. Therefore, really, the developer today, instead of going the old line way of one, creating, you know, schematic plan and passing that past the lender and then gradually changing the specifications of the plan while the lender wasn't watching, and then so forth, and then putting out for bids and so forth is gone. Typically today you start with the contractor and the property manager on the team so that you have credibility to your cost estimating both for the construction and the operation of the building. If you don't get that kind of detail in house, you're going to need that kind of detail to get the loan, hence you bring those people and have those kinds of data bases, as it were, on the team up front. The details for the budgeting are provided in your handout, your first handout for today and this is one of the better itemized checklists I've found so I thought I would share it with you. The first page is the summary page of the various components with the estimate, both the direct and indirect costs. And, by-in-large it's the indirect costs which kill you. The indirect costs which the lender is going to flyspeck as much as possible and wants to know what kinds of capacity you have if those indirect costs run amuck. If you have a good builder and a good contractor, he can be reasonably accurate in estimating the direct costs of whatever it is you're going to build - if he's done his homework. The indirect costs; however, are a little more nebulous - a little soft. After all you're not quite sure how long the rent up period is going to be and what the carrying costs are going to be during that period of time. You're really not always sure what the financing costs are going to be, if, let's say, that you're borrowing at two points over prime and they recalculate the construction loan interest rate every month, you can get yourself into serious trouble very quickly. And it's ironic how banks feel that they've protected themselves against the risks. I can remember being out at Chemical Bank with some hot shot Harvard MBA explaining that they didn't have an interest risk because their projects were all financed with say at three and a half points over prime and every month as prime went up, their interest rate went up, and so they didn't have interest rate risk. And so we look at one of their projects in which the initial budgeting was for 16 million dollars worth of interest on a hundred million dollar project remodeling a building on Park Avenue. And I said, "Wonderful, what was that based on?" And he said, "Well it's high end was at eight and a half and we added three and a half to that and so forth." And, "I said gee, that's really neat. What happens if prime goes to 14 in let's say the seventh month of the project when now two-thirds of the money is expended, what's the total interest cost?" And he sat down with an NP12C and figured it out and he says brightly, "Thirty-seven million." And that was how much swing there was in their interest reserve of 16 million in the budget. OOPS, jeepers well that's only what? 15 from 37 = $21 million dollar variance. I asked him if your contractor had 21 million dollars, you know, in net worth to cover the difference. "Well, no." I said, "All you've done is built into your deal guaranteed bankruptcy for your borrower which means you're going to end up owning the project and never see the money." But, nevertheless, it gives you some sense of how much variance can occur in something called the indirect cost. Ultimately, that is a real tough to budget. Then if you looked on the succeeding pages and I certainly not going to go those with you, but I think you really ought to read them to get some sense of the detail and the care with which you've got to put together a building budget. And just on the indirect project cost breakdown you've got what's it going to cost to get the contract forms together, your zoning permits; in zoning it's going to cost multiple thousands of dollars by the time you have your planner, lawyer, you know, couple of engineers and so forth show up at a city planning meeting. If you really want to bleed privately in the back room, go to a planning meeting, show up at 7 o'clock at night with five professionals at night with five professionals along who are billing out at $100 an hour and the city council now goes into a slow sloon on some, you know, poopy issue like where can we put Crazy Leg's street signs. You see three hours of debate on that issue and you just blew $1,500 and haven't had your say yet. Now comes midnight - OK you've been there five hours at $100 per person, per hour. You now have got $2500 into it and they haven't said word one. And at that point, some goof on the council says we're going to adjourn until Tuesday, it's too late, I can't think straight any more. And you've got nothing said, you didn't even get a word in edgewise and it just keeps doing it. It's extortion.

Easement permits - you suddenly discover that, you know, in order to construct what you need to construct, you got have to have a place where you can bring your train onto adjacent property or you need some place to store materials on the sidewalks or on the adjacent vacant lot and so forth and that requires utility permits, building permits, plan checks by the state engineers to see that you've met all those various constraints, site surveys and blueprint costs, they're no minor item by the time you have to get a full set of blueprints to three different major firms that are bidding plus all of the subcontractors that are bidding, you can have quite a stack of paper there. Site surveys are not cheap. Consider the site survey, for example, of a rail yard which has not been surveyed since the railroad was built. And try to figure out from the titles where the site is. You know, that's going to cost somebody probably $25,000 just to get a boundary survey of the railyards, or Alexander project over there. Sewer connection fees, shop drawings, soil borings, topographies - all of these. If you're in Hawaii you've gotta pay a Chinese priest to come over and bless the site and that's probably expensive help too. There was a nice little cynical going there but, nevertheless, parts of the building ceremony and one of your indirect costs. Today, subsurface investigations can be extremely expensive in terms of now we're looking for hazardous materials and so on, but determining what kind of water tables, soil, geology etc. etc. that you have. And so on. That requires a great deal of careful workmanship, some of that will be done by the time you make your loan application, but obviously some of it is something that you hope to finance with the loan itself and you will need a budget number for that and ultimately to be submitting data to the lender as the project goes on as to the degree of variance in your estimate.

When I was a home builder we had the first computerized cost system in town. We would present our banks with about three inches of output every month which, of course, was effectively eluding - his understanding - they didn't understand it. Therefore your best defense is to tell them everything, because that just overwhelms them. But we also realized that one thing they were watching was our gross margin and our variance on our construction costs by project. Once we figured out that was what they were watching we created a bubble line account called "Tuition" in our general administration and we always charged our serious mistake to our tuition account so that it didn't effect our gross margin. Our budget kept coming on pretty close to budget with a one or two percent variance - and if we went over that then the mistakes got charged to tuition. And finally after a year or two of that, I made a very big mistake out on the west side and I didn't check to see how deep the sewer was or what the soils were and in my cost estimate I might have put in $2,500 for collateral. It cost me about $7,500 because I was in sand and I had to go down 18 feet at the road point in order to find the sewer and it cost me $7,500 in the days when $7,500 was a lot of money and I had the gall to put all my $8,000 into the tuition account that month and he noticed that and he said, "Gee, what seminars did you go to?" I had to say that was the College of Hard Knocks out on the West Side. Fortunately by that time our building company's statement was such that they didn't take alarm but if that had happened a year earlier, that would have probably have been our total capital and we would have been put out of business. But, nevertheless, as the initial budget estimate we're going to be held for, they're going to wonder, you know, how are you doing and why did that vary and what went wrong in your estimate, and so forth? And why you allow that is when you have some variance because not everything is foreseeable. By the same token, if none of your estimates ever work out, that's the last loan you're going to get from that particular lender, it may be the last you're going to get anyway. We could bore you to death with all of the items on here, but I would like you to go through here and get some sense of what the estimating process is about and how much detail you're going to need in your specifications and your plans by the time you go in for your loan application if you're going to convince the lender that you have the project under control and well thought out and if effective demand will justify the capital cost that are going to be involved in the project.

In addition you will identify certain elements which both and the lender will agree have a high level of variance. And at that point the lender is going to require that you have capital to cover that variance. He might require a letter of credit that says that if you discover that the soils are such that you're going to have to do some soils work and additional foundation work, that you have a $250,000 Letter of Credit drawable on demand to cover unexpected soils problems and so on. And he may require that you have a $100,000 Letter of credit to cover latent defects or another $500,000 to cover operating losses because your rent up doesn't go according to the number of units per month that you said it was going to, but in fact takes three times as long to rent. He wants to know how are you going to fund that. Where's that capital going to come from and be assured that they standby resource is available to meet that potential variance in the cost estimate which neither he nor you can forecast but you are going to be expected to fund.

In any event, on this package the lender has to make a decision. In fairness to the lender, one of the reasons he's going to be a little grumpy but, on the other hand, also expect that there will be some changes in the initial plan is that you may be asking him for a commitment which he's not going to close for as much as two or three years - a shopping center going into the initial construction stage - the permanent lender may not, in fact, actually close on that loan for two to three years after the time that he has underwritten it and given you a letter of commitment on it as there will be a great deal of work to do and leases to be signed and tenants to lead through the building before, in fact, he has to close on it. By the same token, the construction lender is of course going to be a little skittish until these numbers are pinned down so that he knows that one, he can finish the building to meet the specifications required by the code so that he can turn over the project to the permanent lender and recover his capital advanced during the construction period. Since many deals today are done with what is called a tri-party agreement which means that the borrower, the construction lender and the permanent lender all make certain guarantees and commitments as to when each has met their obligations. There will be a three-cornered negotiation of that loan packet. Once there is a preliminary commitment with a great deal of conditions as we will see when we read a letter of commitment on Wednesday and Monday of next week as well why everything moves forward to advance some sort of closing. And that closing becomes a fairly complex execution of all of the risk management features of the deal for all parties. And this commercial mortgage loan closing checklist that we've given you is a pretty good summary of that. Most of it's self explanatory and I'm not going to bore you with all of the elements but at least with some of them.

The first element which nobody thinks about is, of course, where are we doing business? Quite often the lender is from out of state. Is it rules of real estate and the state where the lender is located, or is it the rules where the property is located? And why is that important? Or shall we choose a third state all together? And then we will have to behave in such a way as to reinforce that situation. For example, most of us would rather have the loan made subject to the rules of our own state so that there is a negotiation that's going to be in the court house closest to us and our local lawyers will presumably be familiar with the law. We aren't going to have to hire some expensive out of state group to represent us at a point remote from where we feel we have an understanding what the situation is and so forth but usury is a major factor. And it may be that your state had a particular onerous usury law and therefore you would be less better off for you and the lender to get together in another state that has no usury law at all and negotiate the arrangement there and close there even though the loan is going to be for your particular property in your particular state in order that that third state's laws will apply and control on such matters as usury and so forth. So you want to know where am I doing business? Whose state laws are going to apply? That's always a tug of war. The lender will always present you a form that says you're doing business in Delaware or New York or Massachusetts or wherever he's located and your attorney scratches that out and then, you know, eventually depending on how bad anybody wants the deal, one side or the other kind of relents on that. You have to begin to look at what constitutes interest under the usury law. Generally loan fees or points of any kind that are part of the charge for the use of money, commitment fees are part of the charge for use of money, any prepayment premiums that you pay are part of the interest factor and in some cases the legal fees that you pay may be part of the interest cost. On the other hand, the price that you pay for the appraiser, the price you pay for the survey, similar services of that sort of thing would not be included in the interest cost. Now why is that important? Well, first of all some states say that if the lender is guilty of usury he loses the right to enforce the mortgage, that's important. In other states he's subject to very significant penalty. Most lenders today write a clause into the mortgage which states that under the terms if, for any reason, the interest that's due would exceed the maximum permissible on the usury limit, they waive their right to collect it. So it's important that they not only waive the right but they do not collect it. They can't give it back later if you catch them. So let's say you have a variable rate contract or a contract that says in addition to 8 and a half percent interest I'm going to get 20% of the cash flow after debt service. You see there's a little bit of nobody knowing how high is up there. And there's a point at which you can cross that mysterious usury law. And so they had to be very careful about where they are. If it looked like they're going to cross it, they want to make sure that the loan is made in states which doesn't have an adverse usury law. And that becomes, obviously, you know, very important. Computation of interest, how are we going to do that. What's the spread? What's the acceleration? Are we going to take credit for compensating balances? For example, let's assume that you're a national bank and that this development firm has escrow accounts with you and property management accounts with you - keeps all of their client's real estate taxes accumulating in your bank. You may have several million dollars worth of compensating balances at that particular bank. They may just decide that on the average you have at least a million dollars with them on reserve at all times. They will give you credit for so many basis points for that million dollars which is earning money for the bank, against the interest rate on your construction loan. Or, if they don't have those compensating balances - you can have them at another bank! - the bank's going to make a grab for it and say "OK, you want the real estate loan from us, then you'd better move those bank balances to us, and when you do, then you will get this kind of credit to the interest rate on your construction loan. So those become a factor and to be negotiated or at least determined in house by the lender. There may be other certificates of deposit or other accounts which would be available at the bank for the law of offset so that if the loan gets into trouble, they could seize those kinds of things. One of "American TV's" big assets is that they have a ten million dollar CD. As a result, the bank is only too willing to advance as much credit as necessary to purchase whatever opportunities in bulk that come along. And, of course, everybody else's credit manager sees that on their balance sheet and they all extend them too much credit but they get away with it because simply they have that asset on the books.

The type of borrower may also be a factor for the lender - is it a corporation? In which case there's, obviously, going to have to be documentation that the board of directors gives the officers authority to go forward and do this transaction and so on. It may be a limited partnership in which the nominal people involved aren't really involved (?) personally and so forth. The type of lender may also be a factor as to whether it's a regulated lender or a non-regulated lender. GE Credit, for example, is a non-regulated lender - can structure their deals a lot differently than, let's say, a bank could or even a life insurance company could. And, as a result, are able in many cases to do deals that would otherwise not be possible.

You ultimately need to understand what are the mechanic's lien's laws in the state in which the property is located and how it is we are going to protect ourselves against that.

The loan commitment - obviously, it may be a standard cookie cutter kind of deal. There may be staged take out basis that will lend you a minimum number of dollars for the building when 60% occupied. And then at several point beyond that will give you additional funds to achieve a certain occupancy, average rental rate, etc.

Stand-by loans are quite common. In many cases a construction lender will not make a loan unless he knows that there is a permanent lender in the background who will step in and cash him out when the building is finished and occupied. Quite often when you want that, the interest rates are a little bit onerous, you think the rates are coming down, so you make the deal at a time when interest rates are 15 or 16 percent and you get a standby lender to agree for several points that he will close on the loan if necessary, hoping that he won't have to. You hope that he won't have to because the interest rates are too high. But two or three years from now when it comes time to close, you're able to go back and finance the project at a more reasonable rate of interest or on more reasonable terms because it's now rented. It's no longer a speculation as to whether it's going to achieve its market and so forth. And the standby lender gets a couple of points for being there in case you need them and they're not able to find alternative financing.

Gap lending can be different types of gaps. One gap may be a timing gap. Let's say that there's a construction loan that has to be paid off on December 31st but your permanent loan says that they won't disperse their funds until the building is 70% occupied and that's not going to occur until June of the following year. A gap lender would come in and pay off the construction lender and cover that six month gap until you were eligible to finance with a permanent lender. That's one form of gap. The other type of gap may be if you didn't borrow enough to cover your real costs. You thought you needed \$10 million but it turns out you needed \$11 million. The one million dollar additional funds would be covered by a gap lender on a second mortgage. Either way, gap lenders charge an arm and a leg for that - typically take part of the project as a cost of doing business for them. But at least you don't lose the project or all of it. You might lose 15-20-25% of the cash flow and the future profits in the project in addition to the interest rate on the loan and in addition to points paid on the standby basis.

A backup lender, again, is a type of gap financing which simply says if lender A fails to close, lender B may come in and do that and so on.

Now for the general provisions of the closing. First of all, we really have to know who the lender is. That sounds like a simple, you know, sound statement but even if we were doing business, let's say, with Prudential. Prudential has multiple divisions and multiple funds and you really have to specify by where this goes. So when we look at a letter of commitment on Wednesday you're going to see that, in effect, this life insurance company has three alternative places it can put their money and it sets it up in such a way that says up to 100% of the loan could be placed with so-and-so, up to 50% of the loan could go with this division and 25% of the loan could go with this one. The lender may be required to do that because he is afraid of being accused of a conflict of interest. Let's say he has a good loan come in and he would like to put all of it in the general account with the lender but a couple of his pension accounts say, "Hey, wait a minute, the investment committee that represents me, the pension fund, in my segregated account gets first crack at everything that comes in the door of the lender." And, in any event, I get 25% minimum of anything that comes by that I like. So they have to give him first swing at it. And then maybe there's another division that says, I get 25% of everything that comes if I like it. And so, in effect, the loan may be divided up between three different entities within the same umbrella organization. So it's very important to know who are the lenders because not only may they have different standards but they may also have different degrees of patience with you, should you get into trouble. Your grumpy the old pension board, the minute you're in difficulty, they want to foreclose and throw you out of the place and so forth and so on, and others may say "Well, cool it, we've had other good deals with this guy and he's a good guy and it's not any problem and so forth and so on." And sometimes it's very hard to wrestle with that. A borrower may not want to have to convince three different boards of directors to go along with him especially when you're in trouble. So you've got to spell out up front, who's the lender, then who's the borrower, obviously. What is the entity? In the days when the money was rolling freely lenders weren't too particular about that. The guy presumably coming in for a loan and they say, "Old Judd is the biggest landlord in the country and you've got enough worth of $100 million and so forth but old Judd never signed anything. It's like going in and getting a loan for Trammel Crow. In the past years Trammel didn't sign anything either. So, as a result, who cares what his net worth was or whatever. You know, it sounds like it was Trammel Crow and a man did one of his partnerships and the man borrowed some of his senior partners and so forth but he might not be on it. Today they don't do that any more. Today they make the senior partners go on it and because the senior partners may have to go on co-signature, they're having trouble. That's one of the reasons Trammel Crow is breaking up. And some of the general partners are saying, "Hey, wait a minute. I'm not going to sign on anything that I'm not running." Just because the partner down in Atlanta's got a project that has to have some more co-signatures on it and I'm running the deal in Chicago, forget it babe. I'm not going to take his risk when I have no direct input in the control. And suddenly that system starts to break down as they require those kinds of signatures from the borrower. Loan terms are pretty self evident. Let's come back and talk about that.

Liabilities to the loan. There really is - if there's anybody signing personally on it and so forth.

The next thing is describing the security with specicivity. That's absolutely critical today because so much of the real estate project may not be real estate at all. It may be furnishings and equipment. It may be franchises. It may be leases that, you know, put various people on the property and so forth. And you have to understand very very carefully just what makes that collateral valuable and be sure that you have all elements of that collateral pledged to secure the loan or you're not going to have a going concern operation and therefore, obviously, you're going to be at some loss as to how to make that work.

Most of these items I think are pretty clear. I'm not going to - on item #10 - a dragnet clause is really what is called a future collateral clause and what the difference is - let's assume that you have a hotel, for example, and you can put a chattel on the furniture and then with time you gradually replace the furniture. Now, ten years later, you foreclose the property, you know, you could make the technical argument that the original security that you had was the original furniture, but that's all been replaced so you don't get to have any of the beds and the chairs and stuff that makes this a hotel. So a dragnet clause is an after acquired property clause that says whatever to add to this enterprise in the future that wasn't there when you put our mortgage on it automatically gets incorporated into the collateral. Then you bought the land next door to add some parking - that would be after acquired property - would automatically be subject to this loan even though the land wasn't there when the deal was made. OK? Any after acquired property that goes into the deal after the loan is closed.

Tri-party or buy-sell agreements we've talked about a little bit. In the past what would happen is that the borrower would get a kind of open-ended letter of commitment from the permanent lender that says you know, if you build it to the following specifications and it appraises out at $6 and so forth, then we'll be willing to close for $10 million when the project is completed and it was a little "iffy" but that was enough for the construction lender and the construction lender would then make his deal based on that and then along with, you know, the part you were finishing out, several things would happen. If the interest rates rose, the permanent lender was sorry he committed on those terms and so he would find one of the conditions in his letter of commitment and reappraise the property low and say, “Gee I’m sorry, I can’t lend you $10 million, I can only give you $7.5 million now on the deal because interest rates are higher and that’s all I can pay and if that won’t do the trick, I’m sorry you can go elsewhere - hoping, of course, that they would go elsewhere.” Or they would balk on some other basis that this center was going to have Kohler plumbing and it has American Standard and therefore you violated the specs and so I can foreclose on the loan. They would find some excuse to back out of the deal because they’d rather make the deal at a higher interest rate. On the other hand, if interest rates went lower, now the borrower’s sorry that they made the deal with the permanent lender and he’s going to find an excuse to walk and break the deal with the permanent lender and all of a sudden he’s out there on a limb and now he can’t get somebody else to go on the project with him - let’s say he’s not renting up well, or whatever. And now the construction lender is stuck because he was expecting to get liquidated by the permanent lender but the borrower did something to screw that up and so now there’s no permanent lender to take out the construction lender and/or the construction lender would screw up and not, you know, advance the funds so the building was completed on time and the permanent lender backs out and now the poor borrower is left out on a limb largely because the construction lender didn’t treat him very well. And, you know, all of these things would cause the house of cards to come down and somebody would get bankrupt and it was usually the developer that got his clock cleaned and so following that they began to develop these tri-party agreements which really says, Mr. borrower, you can’t take a walk. If the construction lender does this, this and this and completes it on a certain point of time, why the permanent lender has to take the loan - no ifs, ands or buts about it. There's no kind of vague conditions here that he can make up reasons later. And second of all, you Mr. borrower can't take a walk and finance it, shop it, and find a lower interest rate because the project is now rented out much better than it did when we first started on this deal and so forth. Everybody's locked into going forward with it so that there's a certain mutuality there. Now, the reason they call it a buy/sell agreement is that the permanent lender would like to enjoy the priority in time the construction lender had. He doesn't want any liens that sneak in ahead of his particular date of his loan. So rather than make out a new note, he buys the original note from the construction lender and therefore gets the benefit of the date when the construction note was filed and as a result, he's prior to everybody and when he takes over on the permanent loan there's nobody that can leap in with a prior mechanic's lien because there's that little window of light between the time the construction lender satisfies the loan and the permanent lender files his new note. So that's why it's called a buy/sell agreement. It's part of the tri-party agreement and the original construction mortgage is simply bought by the permanent lender. Everybody understand that? And that can be very important over let's say a project that has three years in the construction phase with tremendous numbers of mechanic's liens and other kinds of suits potentially coming into play, to be able to have the date three years earlier so that you have priority in time over everything that came after that and be a very valuable defense for the permanent lender. Hence buy-sell. Other factors we'll look at when we look at the letter of commitment in terms of 11 through 27. Notice the shopping center provisions - you need to have the major leases in place - the operating agreement that everybody has agreed to. The definition of completion is a critical element. And a shopping center - what you're really doing is building an industrial building which is left virtually raw and the tenants finish the building. Now the tenants finish the building up to the point where they're even pouring the floors and building the demising walls and so forth. Essentially the developers stubs out and brings the utilities to the edge of the space and so forth, gives them a roof to put their HVAC system and so on and after that the tenant is finishing out most of the space. Now what does the loan - what collateralizes the loan? Most of that attaches to the building and becomes a fixture and so to some degree your tenant improvements are creating collateral value for the lender. There is no way they can take the walls and the floors with them when they go and so on. On the other hand, much of the tenant finish in terms of cabinetry, casework, decor and so forth may be totally demountable and the tenant can take it with them when they go and therefore, even though it looks like a fairly elaborate piece of real estate none of it's available as collateral for the loan. It might include the hanging ceiling and light fixtures in the ceiling and so forth which belong to the tenant. They have to define that type of thing in a shopping center pretty well. Not only that, you need to know much he's going to provide for tenant finish as part of the rental program and so if he's spending $20 a square foot to move a tenant in, you're not going to advance him those moneys until, in fact, the tenant is moved in, those improvements are completed and you as the lender are confident that the rental income will now start to flow with which to repay the loan. Office building provisions have many of the same problems as we'll see later in the semester. There's little differences between them.

Leasehold mortgage provisions. Leasehold mortgages are where you're improving property that's actually owned by somebody else and rented. And the first thing you need to do of course, is permission for the owner of the building to modify and remodel - that's what's meant by estoppel letter from the lessor. The lessor can not come in and sue the lender or for that matter the tenant because he says, "hey, I didn't give you permission to remodel the building. Put it back the way it was etc. etc. etc. etc. And what's more you still owe me money for this particular situation and until you do that and pay that off, you can't do whatever it is you're going to do." In fact, there has to be some notice and opportunity to cure any deficiency. You want to know that the landlord simply can't jerk the property away from you because you defaulted in some way - let's say on the ground lease or the master lease of the program. The lender needs to know, you know, some time in advance - sixty days notice let's say that the tenant is now and somehow has breached the lease and there's something that he should have done that he didn't do and the lender in order to protect his investment may have to go in and do it because the tenant doesn't want to or can't afford to or whatever. But he can't have this whole property reverting back to the landlord and losing all of the collateral value because obviously the loan is subordinate to the landlord's interest. First Wisconsin in their heyday of making stupid mistakes made a construction loan on a ground lease in Palm Springs, California and the guy was already in default for two years on the ground lease. So he figured well great if the bank wants to build a building on my land, let 'em. And they did. And after he had the building all done, he came in and said, "Sorry your 60 day grace period expired about two and a half years ago and the building is mine. I love it. So you want to have some conversations with the landlord and have him understand that it's your land and he can do with it as he wants. Anyway, it's a good checklist to give you some sense of how much homework needs to be done before you're going to close the loan. ...

The first page on the handout. Oh, one other comment. When you're looking through the outline divided out on Monday, take a good look at the category called Evidence of Final. There are really three major components to that, which are not always considered by the truth as evidence of title. Section 1, of course, has to do with the deeds as evidenced and the availability of title insurance from legitimate title insurance companies. But a second major element of title are the exceptions on the title insurance policy which can be fairly detailed and fairly elaborate. It is also possible to use the title insurance to defease an encumbrance on the property. For example, a converter of the apartment building to condominiums down on Lake Shore Drive in Chicago acquired a building that had been built in the early 60's and it had like an 8% mortgage on it at a time when interest rates were about 12% or 14% and he wanted to pay off the mortgage to a New York Mutual Bank. And the Mutual Bank for reasons not at all clear to anybody but themselves, refused to accept repayment and insisted on going forward with the loan. And I think the issue was not that you couldn't have prepayment but that there was going to be a 5% penalty for prepayment and the developer said you gotta be out of your gourd why would you want to leave money at 8% when you could get the money back and invest it at 12%. Therefore I won't pay the prepayment penalty and the Mutual Savings Bank says you gotta pay it because it's in the contract. And he said no I don't and he went to the title company and he left on deposit with the title company, enough money to pay off the mortgage. As a result, the title company wrote the title policy as if the mortgage didn't exist. So, in effect, the title insurance simply ignored the existence of the mortgage and an escrow trust at the bank continued to make the monthly payments with the Mutual Bank in New York and they can sit there to their 8% loan for another 25 years if they want.

Well, about a year and a half later, somebody woke up out there at the bank and said, "Well maybe we will accept our money without the prepayment penalty." But, nevertheless, you can defease that type of problem with the title by leaving on deposit with the title insurance company whatever moneys it would take to correct that flaw should anybody challenge it in the future.

The third element of title, and a very critical element that people ignore, is the survey and the plat of the site. People don't realize that when you file a plat for a subdivision it is, in fact, a transfer of property rights. The acceptance of that plat, in effect, dedicates the streets and the right-of-ways. But it may also dedicate a park area. So if you had a plat map that says public park drawn on a particular area and you file it, that is, in fact, a transfer of that land to the public interest. And that may be true of stormwater corridors and public utility corridors and easement across the property, and so forth. And, therefore, it's critical to look at the survey because it further refines what is nominally the title to the land. And so those elements all together - the deed, the title insurance, the acceptance of the title insurance and the survey or the plat or the combination of survey and plat for the property, define the title. The surveyor may find, for example, that a portion of the land is encroached on by the adjacent property. Well, now you've got a title problem. And you get the encroachment to relocate. Or is the encroachment on your property on their property going to be a difficulty? Many of you remember a year ago or a year and a half ago when Jim Cain made a presentation on a redevelopment project in Washington DC. The building which they were renovating turned out to be encroaching on the adjacent piece of property by about a foot and a half. And the adjacent property owner was very sticky about that. He wasn't about to issue an easement etc. to allow that to continue. They had to buy the parcel next door in order to clean up the encroachment. So all of those elements become part of the total title that we talk about when we talk about budging the title for collateral to the loan. Obviously the lender wants some fence up - how clean or how confused that may be.

OK, with that, let's turn to the handout for today. We're going to dwell on this for several days so be sure to bring it to class in the future. The first page is a fairly simplistic one which anticipates the contents of the letter so we'll spend only a little bit on it. This is a memorandum to the board of directors of three entities - probably an overlapping board - but nevertheless, Union Mutual Life Insurance Company, a Union Mutual Stock Life Insurance Company of America and the Union Mutual's own pension fund for Pension and Insurance Corporation. And if you'll notice on the right-hand side towards the top it says that those that actually participate in the loan - it says Union Mutual Life up to $10.515 million and then Union Mutual of America $2.2 million or something - I can't read the fine print - and then Union Mutual Pension $3 million. Well, the reason is conflict of interest here. What they're really saying is "OK, every deal that comes into Union Mutual, we will give a right of first refusal to the pension fund so if they think it's a good deal they can have first crack at it, but their capacity is $3 million - probably as a matter of policy of the pension fund or they don't want more than $3 million in one deal, so they've got first right of refusal on the first $3 million. The Union Mutual Stock Company has first right of refusal on the next $2 million and then everything that's left will be Mutual Life's and then, obviously that limit has to be high enough to cover the total transaction so that if the first two decide not to exercise their first right of refusal, or have, in fact, refused, then there's still a place to put the total loan. So they are anticipating the fact, in this case, that there will be participation and they will be up to 20 in that pattern. In this case, notice, there's a broker, John Smith, Inc. He will be paid by the borrower, not by the lender. The loan amount is $10.415 million. Notice the gross yield is going to be 12 and a quarter, the net is 12 and a quarter because they're doing their own servicing - it is direct servicing. If there had been a servicing fee of .25 or 25 basis points, then the net yield would have been reduced by the amount of the servicing. The term amortization is pretty self-explanatory - ten year term - 30 year amortization. But, at the end of seven years there's a possibility of Union Mutual, in fact, unilaterally raising the interest rate, but by not more than 250 basis points.

Corporate or personal liability - none. When we get into the letter of commitment, look at that very carefully - not what it says but what it do is a little different. What they're saying is there's no liability on the "note". But in this case you'll see the borrowers are expected to put up letters of credit. They're expected to put up some other guarantees on their own signature and so to that degree, they have personal liability, but it's not on the mortgage note per se.

And then they have other investment terms here. No prepayment provision - the hold back, we'll get into a little later. It's a fairly complex one which recognizes the games that used to be played with that. The date of purchase - when will the life insurance close. Notice they have themselves a little window - will close in the fourth quarter of 1983 but then they have the right to stall until the first quarter of 1984. So if the insurance company's cash flows aren't quite meeting their commitment, they have a little wiggle room. On the other hand, you'll notice that the borrower doesn't have the same degree of latitude. He's got a window to hit a certain occupancy rate, and so forth, or he's dead in the water. You will find this letter of commitment extremely onerous and relatively unfair to the borrower. So while it's called a letter of commitment, it's really the offer that the insurance company is making to the borrower and the borrower is going to have to come back and negotiate some of these things out of here because he may find this too much of a handcuff on his future options. The loan ratios are then pointed out to the board of directors in terms of debt cover, the default point, the loan to value ratios, the estimated value of the property - $14 million, the loan per square foot. They apparently have a risk range category which they understand, we don't know what roman numeral III is. And then they have a few sell factors. This is a requirement of the board of directors to ratify a commitment. Generally, the loan committee has already reviewed it, determined what the provisions of the loan should be, and without going forward with what they think is a deal - and they're getting the directors to ratify it, so this is not the loan committee's action but simply a ratification by the directors.

As a result, positives and negatives are in the way of summarizing the deal and virtually all the board of directors will see at that one page on both sides for the deal. One of the things that always impressed me about loan committees and the board of directors - committees on the board of directors that ratify those - is the scope of knowledge and awareness that those people have. Almost invariably there would be somebody on that investment committee that probably knew this research firm, knew this developer and would have something to say pro or con on it and so that they're really not operating quite as - what shall we say - as depersonalized or institutionalized as it would appear. The real estate world is a relatively small world and once they get on the investment committee, their scope of awareness of different markets and different developers and products and project elements is just incredible. It's something that's always impressed me about the real estate world is how small it is once you really get into it. Everybody knows everybody else, their projects, their past and their future and if it's relevant to the loan, it will be brought out.

OK let's take a look at the letter of commitment - as this will bore you to death, we'll just about read through it so that you can understand it. And in many ways that complicated little words have a meaning all of their own and it's not the big paragraphs that get you, it's the small phrases that kill you. This letter, when properly signed and accepted, will constitute an agreement between Union Mutual Life which agrees to lend to the Wittmill Realty a Massachusetts Realty Trust the beneficiaries of which are Stephen White and Daniel Jones, each with a 50% interest which agrees to borrow in accordance with the following terms and conditions.

OK, as you know, Massachusetts has a special structure which they call a trust which goes on permanently,like a corporation, but provides beneficiary interests to whatever members of the trust that are there, in this case, only two of them, Stephen White and Daniel Jones, so that there is no personal liability in that case, directly. Only the trust is on the mortgage. So it operates like a corporation, but it's not. It grows out of the times when corporations could not own real estate for investments but only real estate that was peripheral to their basic purpose. A steel company could own a steel mill, but they couldn't own a property for rental income and so forth. And so the trust was created as a way of getting around that limitation on corporate power. Because it has some very interesting tax ramifications, a full pass-through to the partners and so forth and so on, it is quite often used as a way of at least providing a vehicle which doesn't get disrupted by the death of one of the partners and doesn't get disrupted by divorce and so forth and so on. And it sails along serenely above all those types of things and still is a single tax conduit. At its option, Union Mutual Life may cause the loan contemplated herein to be made by one of its affiliate companies or may issue a participation in said loan in affiliate companies. We've already seen that.

Assignability. Under no circumstances is this commitment letter assignable. That would not necessarily be the case, for example, if we had an FHA commitment to insure, it's quite often assignable. There are companies which are packagers which put the concept on the site and secure the financing but then sell the whole package to a contractor builder to go forward with the project and in effect get a fee for packaging financing and the product and the lease and so forth and so on. But in this case, no way. If this was a personal deal between Stephen White and Daniel Jones and therefore they have to be in the front. And as we'll see later that there are constraints - they can not even sell their interest in the trust or assign it to other folks and so on.

Loan Amount - $10,415,000 maximum. The final amount will depend on the average annual rents achieved from 128,000 square feet in accordance with the following schedule. The average rent arm's length, is $10. They'll get $9,460,000. On the other hand if they get $11 on the average, $10,415,000. And you'll see that language on the next page and so forth, very carefully defines so that that you can't have insider deals, you can't have, let's say, affiliated corporations coming in and leasing space and then just to hit the occupancy level. In the old days lenders would say, "Well, if you have 80% rented with . . .Whoa." They might put in dead tenants, you know - they pay their mother-in-law something to lease space in the building in order to hit the 80%. And, of course, they would give away incentives which meant that the effective rent was significantly less than the nominal rent on the contract. And, of course, then suddenly there wasn't enough cash coming out of the project to meet the debt service. Well, here's a lender that's been that route, learned all the lessons and says, "Hey, wait a minute, we're going to have arm's length leases that are producing an average annual rent per square foot of $10." Now if you want to give them an $8 rent in the first year, you jolly well better have $12 the next year etc. so that it works out that way. So they will audit the leases and make sure that, in fact, you are achieving those elements. And that will determine the amount of leverage you have on the project. Or you better be sure you can build the whole thing for $1,460,000 or you're obviously going to have a shortfall.

Term. Ten years for the 30-year amortization schedule - the payments to be in equal monthly installments of $109,138.41. At maturity, the outstanding principal balance of approximately $9,575,000 plus any accrued interest will be due and payable without repayment provisions. In addition, the lenders reserves the right to collect the lease payments, one-twelfth of the annual real estate taxes and insurance premium to be held in a non interest bearing escrow account. But now that infers that that free rate that is only active should 1) the mortgage become delinquent. Here is a prime example of selective pain. Saying, OK if you screw up on the monthly payment, then we don't trust you any more, we're going to get one-twelfth of each of those elements and what's more we hold the money and you make no interest on it. As opposed to you setting up a sinking fund and saving that each month and earning the interest on it and then having it available to pay the taxes and insurance as they come due. So notice this is your first example of selective pain being applied to discipline the borrower into not being delinquent.

Two. Real Estate tax payments and/or insurance premiums become delinquent. If you can't manage your affairs to meet those bills, then we'll do it for you.

Three. Fifty percent or more of the leaseable area is leased in and managed, the tenants are no longer responsible to pay real estate tax. In other words, you promised us in your pro forma that there was going to be a full pass through for real estate taxes to the tenants and so forth and yet if they're not able to do that for at least 50% of the space in the building in your leasing program, then we're going to make sure that we save out of your collections the money necessary to meet those obligations.

Four. Union Mutual doesn't receive a copy of the paid real estate tax and insurance bills within 30 days after the due date without penalty.

Five. Ownership of the security changes except by divide or descend to a family member. In other words, again, discouragement for any buyer stepping into this deal. Supposing that the loan occurs after the fifteenth day of any calendar month. Interest to accrue to the last day of the month shall be due and payable at the closing. A little deduct there to even things up.

If there's any payment provided for in the promissory note more than five days overdue, a late charge of 3 cents for each dollar of such payment shall be assessed. That's really heavy interest. Right? If you owe $100,000 a month and if you're 5 days late, it's a $3,000 penalty if you're 5 days late or more. In addition, a default interest rate of the loan rate plus 5% will accrue on the entire outstanding principal balance of the loan if the loan payment is not received within 15 days of its due date - Tighten the screws down a little more. Nothing like a little pain to get your buns lightly over the top. And this interest will commence to accrue retroactively as of the next day after the due date and will continue to accrue until the late payment is received. Now remember we're talking about a 12 1/4% interest rate to begin with, so now we're talking 17 1/4% or virtually 1 1/2% per month. Think that's done by your bookkeeping office that didn't make the payment. That's applying a little discipline. In the event this loan is now or in the future serviced directly by Union Mutual . . . they shall have the right to require any time during the term of the loan, loan payments be made either by bank wire transfer or in some other manner satisfactory to us in order that they will receive immediately available funds. None of this check is in the mail Buddy! Ye shall wire it. They're controlling float aren't they? They have $100,000 coming in every month, they want it there on time to reinvest according to whatever schedule they may have. In the event that part of the loan is held back at closing for rental achievement and/or completion, then the monthly payment to principal and interest shall equal $109,138.41 minus the amount of interest only on the holdback amount. In the event that all or part of the holdback amount is never disbursed, then the monthly payment shall be readjusted to repay the principal balance over the remaining amortization period, however the term shall remain the same. In the event the interest rate is adjusted at the end of the 7th loan year as provided for as per interest rate paragraph, the monthly payment will also be adjusted based on the new issue rate to amortize the then outstanding principal balance over the remaining loan period by equal monthly payments applicable first to interest, then to principal, provided, however, that the term of the loan shall remain the same. So a bump in the interest rate at end of the 7th year will also now mean that a whole recalculation of the amortization thing and based on 23 years to go on the amortization. For those of you who can do your present value numbers, that's a significant bump. We're no longer talking about a 30 year loan, we're talking about a 23 year loan and we're talking about a loan at a higher interest rate.

Interest rate is 12 1/4% per annum, Union Mutual shall have a unilateral right to increase the interest rate at the end of the 7th year. The Union Mutual's then current market monthly interest. The interest rate may be increased up to 2 1/2% by the written notice if such increase is given 120 days prior to the end of the loan year. In the event the interim rate is increased at the end of the 7th year, the required monthly payment will be adjusted in detail etc. Under no circumstances will the interest be less than 12 1/4%. In other words, it can up if that serves our purposes, but in no case can you expect it to go down. That's not exactly fair. Nor will the interest rate charged hereunder exceed that which is permitted by law. Notice that the usury constraints that we talked about the other day so that if for some reason the Massachusetts usury law were modified in the interim, there would be a cap on what they could do.

The borrower agrees that if he's unable to close the loan within the fourth quarter of 1983 he shall pay a fee to Union Mutual for the privilege of closing the loan within the first quarter of 1984 which would provide Union Mutual an overall yield of 12 3/8%. Now think about that for a moment. How big a fee does it have to be to be to equal 1/8th of a percent on $10,415,000 for a, you know, 10 year stand. That's a fairly sizable penalty. Notice, he has to pay for that but they can stall and not close until the first quarter of 1984 at no penalty.

Prepayment Provisions. In the event Union Mutual notifies you that it intends to exercise its option to increase the interest rate, you may elect within 120 days of receipt of notice to prepay the loan in full with no prepayment premium. In other words, try and find a better deal and within 120 days. Otherwise there will be no provision for prepayment for the life of the loan. Now if interest rates fall and they wanted to sell the property this is going to be a significant discount on the property. You're seeing deals today that are locked in to say, 12, 13, 14% deals which seemed like a good deal at the time, and now when you sell them, the buyer says, "Fine, the market value's $2 million but I'll give you $1,650,000 because the balance represents the present value of the interest in excess of the current market rate and so as a result, the property value is devalued by that kind of prepayment limitation. If the principal sum is voluntarily prepaid due to default and acceleration, prior to the end of the term there shall be a prepayment premium equal to the higher of 10% of the principal amount prepaid or the amount necessary to maintain the effective yield of the subject investment for its full intended term with the principal amount prepaid and invested in U.S. Treasury securities having the same or approximately the same maturity of the subject investment. Now this maintain the effective yield clause is probably the most typical type of prepayment penalty in commercial loans today. In effect they're saying we're going to lock in a yield at 12 1/4% for 10 years or be damned. And if for any reason, you have to buy your way out of this baby, then you are going to have to fund with sufficient additional funds, that the effective yield is going to be 12 1/4% even if all you can get on Treasuries is 8%. So you can imagine where treasuries right now - on ten years are what?, somewhere between 8 1/2 and 9%. Who's a finance major here? - read that every morning in the paper. Answer: 9.4% Chief: 9.4%! Oh golly gee, that's hardly a 2% penalty a year for a prepayment. At any event, look at that language carefully because that is probably typical of the majority of commercial mortgages today. They are trying to, in effect, avoid puts by the borrower who sees an opportunity to enjoy a lower interest rate by refinancing and lock in the rates which they enjoyed when interest rates were high. And then comes, of course, the forgiveness, notwithstanding the foregoing. No prepayment premium shall be required on involuntary prepayment made with condemnation awards or proceeds from fire and casualty. Now that was probably added by the attorneys for the borrower who can see the day when, for some reason or other, part of the parking lot, came up with $100,000 prepayment and there's a clause later that says all of those funds have to go to the insurance company and then they can decide whether to rebuild or not and so forth. That's probably unacceptable to most borrowers anyway. But here we'll link that to those other clauses that are coming down the trail.

Security. Shall be evidenced by a promissory note secured by First Mortgage covering the land and 160,000 square foot office research and development building to be built thereon located in such and such . . . The land containing approximately 643,000 square feet is described in the loan issuance and supporting data transferred to Union Mutual by the Jones Company with the actual legal description of record to control. The actual legal description shall be forwarded to Union Mutual within 30 days after the acceptance of the commitment. Obviously considerably in advance of the closing. Promissory note shall be executed by Dewitt Realty Trust with no personal liability. Prior to loan closing Union Mutual receives from the borrower on an unconditional irrevocable letter of credit in the amount of $1,100,000 issued by a bank and in a form satisfactory to Union Mutual. Now here's where the personal liability comes in. Notice the only asset of the Dewitt Realty Trust is this project and no bank is going to issue a letter of credit, you know, made up on a whole cloth. Where did the letter of credit come from? It came from

Mr. Jones and his partner who were willing to sign and probably segregate assets at the bank that says if the letter of credit gets cashed, bank this is a tool to get your cash out and get your money back. But notice they make a big tadoo about that they're not on the mortgage up front. They're in fact on the better side on the back side. They're on $1,100,000 right up front, personally. And they'll be issued by the bank in a form satisfactory and expiring not earlier than 16 months from the initial funding of the loan. The letter must be payable on presentation with absolutely no accompanying documentation with payment only by wire transfer to a bank account designation by Union Mutual. In other words, no hassle note. If we feel we have the rights because of further failures to be outlined below to be paid some portion of that, we got it. If the borrower fails to make any of the first 12 monthly debt service payments to Union Mutual. Union Mutual shall have unilateral right to draw against the letter of credit. So that's just against operating deficits during the first year. If they want to make concessions to the borrowers which postpones payment of the rent, they are free to go right ahead and do that, but we know where the money comes from no matter what. In some cases, the letters of credit might be tiered - you might have a letter of credit just available for payment on delinquent loan payments. You might have a second letter of credit for payment on latent defects which might have to be enforced for three years or five years. You might have a third letter of credit that was for payment of operating deficits during the first six months of operations. So they could be rifled toward specific purposes and that way how deep the pocket is relative to contingency is defined. That can be a little tricky, for example, currently if you'll remember there's an elderly housing project down on Park Street across from Madison General where the brick job proved to be faulty. The project was done on a turnkey mode with the Wisconsin Housing Economic Development Dept. actually financing the construction and taking back letters of credit including one for latent defects which was to run for three years and so forth. But when they closed the loan and transferred title to the City of Madison, they simply canceled the letter of credit. So now the Economic Development Authority is being sued by the City of Madison for the cost of replacing a brick job because if they hadn't canceled the letter of credit, on the closing there would have been resources available to pay for the repairs. So it gets to be messy little things after awhile.

Mortgage to the end corp. Security documents will provide the title to or any interest in the premises securing the loan contemplated herein shall not be changed by sale, assignment or otherwise, nor shall the management thereof be changed without the prior written consent of Union Mutual, which consent shall not be unreasonably withheld. But Union Mutual may condition its consent upon an increase in the interest by up to 2 1/2 percentage points. Now, many loans do not say that explicitly. There now are legal precedents that say that to require an increase in the interest rate is not an unreasonable request of a lender. So even if the letter of commitment doesn't say that but did require that they have to get their consent, then the courts have simply said that it's certainly in the interest of the lender if market rates have risen to try and improve their yield and that's not unreasonable use of this concern. So that's a fairly restrictive clause. Notice in the day of highly volatile interest rates at a time when borrowers want fixed interest rates, they take the interest of the lender to build as many features into the loan as possible that allows them to reopen discussion on the interest rate. As a result, going in the deal, it appears that you have a fixed interest rate. As the history of the deal evolves and events change, there are opportunities to reconsider it. And even though we talk about ten year loan or a seven loan or a 30 year loan, it's really only as long as you don't change any of the provisions. Because the minute you tinker with something, you open up the whole can of worms for renegotiation. Now if interest rates fall, why that's not going to be a major problem. But if interest rates rise, obviously, the borrower is then in some jeopardy or he's going to have to take the deal he's got.

Union Mutual may condition its contract. In the event that the interest rate is increased as herein provided, the borrower again may elect to prepay the loan without premium within 120 days after the notification. The interest rate is so increased, the monthly installment payments will be increased accordingly and either you or the new owner will pay all legal and other fees and expenses incurred due to the necessity of amending the existing document. OOPS. No reason why not to hire the best law firm in town. Why, they're not paying for it. Should the premises be sold, pursuant to a purchase option in a lease to a tenant occupying no less than 80,000 square feet, for its business purposes Union Mutual shall have the right to approve such tenant at the time of sale and if such approval is given, shall not increase the interest rate. Good marketing loophole, obviously negotiated in by the developers here that said, "Hey, we're in a tight rental market, if possible to get the tenant that we want, we'll have to put in an option to sell the building to them at some point in the future and if that occurs we don't want to 1) trigger the increase interest rate and we don't want that to be screwed up by the other assignment provisions. So that's obviously negotiated by the borrower who has in the back of his mind the possibility of a major tenant who leases with an option to buy. It would be very expensive to put that in after the fact even if you can negotiate it in now.

Union Mutual shall also have the right to charge a transfer fee for processing any application seeking the consent to transfer the premises or any part thereof that changes the beneficial ownership of the borrowing entity or any sale of the stock of the borrowing entity. A change in title by devise and dissent or by transfer between the beneficiary and the borrower shall not be considered to be a violation of this clause. Excepting provided for the proceedings at the sale of the stock of the borrowing entity or change in the beneficial ownership shall be considered to be a sale of the premises. If the property be sold without prior written approval of Union Mutual, Union Mutual still has the right to require the balance of the loan be repaid in full. In other words that kind of deal that will cause acceleration of the deal. Notice the estate plan that has to be part of the mortgage loan commitment. It is quite possible that one of the partners will die or be disabled and have to transfer interest - might be divorced, etc. - and you've got to build that kind of flexibility in up front.

Lease approval, assignment and subordination. Union Mutual shall have the right to approve all leases which are executed prior to closing and during the term of this loan. Understood the space shall release to arms-length tenants for minimum terms of five years at minimum annual rent of $10 a square foot. Landlord responsible for management and expenses of a capital nature and the tenant responsible for all other expenses. Union Mutual shall receive an assignment of all existing and future leases and an assignment of rent, incomes and profits at our option all tenants shall execute subordination and attornment agreements or subordination nondisturbance and attornment agreements. An attornment agreement is recognition by the tenant that he can be required to send his check to somebody else other than the landlords. And notice this is obviously therefore a lien theory state where they couldn't get their hands on the premises quickly enough but they want their hands on the revenue. Hence the assignment of all leases. Now, the difference between the two. Subordination and attornment says that if we take over, and we don't think this is a very good lease, down in the foreclosure we could extinguish that tenant's lease. Let's say there was a lease in there for $9 a square foot. They didn't feel was the market. They would require a subordination and attornment agreement for that tenant that says, "OK, if this guys defaults and we have to take over and so forth, we can either force you to change the terms of your rent to the market or we can force you out of the building." The alternative is that if you have a real good tenant, the last thing you want to do is extinguish his interest in the property. In that case you do a subordination nondisturbance agreement that says even if we foreclose the tenant's interest is not disturbed which means i.e. he has to continue paying rent to the end of his lease. So one thing to keep in mind is a foreclosure extinguishes all claims on the real estate so if the tenant isn't protected by a nondisturbance agreement, the tenant finds himself out as well as the owner. You may not want to give the tenant that excuse. Think of a shopping center that isn't going very well and you have a subordination and attornment agreement with Sears. The minute you foreclose on the developers, Sears says, "Hey, I don't have a lease either here, Good Bye." You don't want that obviously, you've destroyed some pretty good value in your center. While Sears would get a nondisturbance agreement, in this case the lender voluntary subordinating his interest to the tenants. OK? That's why it's called a subordination clause there, the switch by the way is that in the second case, subordination nondisturbance really is the lender subordinating his interest to the tenant to guarantee him quiet and nondisturbed occupancy during the term of the lease. In the first case, subordination and attornment means the tenant is subordinated to the lender. You gotta watch out - the word can go either way and you have to read it in context.

Security Agreement. As additional security Union Mutual will receive first lien on all equipment, furniture and furnishings and any additional or replacements thereto. That additional replacements thereto is what's called an after acquired property clause and it just sweeps up everything that comes into the property later. ... which are owned by the borrower and are to be located on the premises. An inventory if required of equipment furniture and furnishings shall be submitted to Union Mutual at least two weeks prior to closing.

Annual Statement. Annual operating statements of the property and current rental listing each tenant, space occupied, annual rental certified as to the correctness by representative of the borrowing entity are to be forwarded to Union Mutual within 90 days after the end of each fiscal year. Notice, 1) it's certified and 2) forwarded means sent by mail and as a result were you to have certified something that you knew to be wrong, that would be now fraud through the mail which is a federal offense and gets the lender considerable clout if they point that out to him later. You know, in case we can get this straightened up in a friendly fashion, we'll turn this over to the Attorney General for the federal government. The Union Mutual shall have the right to require annual operating statements to be certified by a certified public accountant, but shall not unreasonably exercise that right. It's very expensive to get an audited statement. But it's another little piece of pain which can be applied should you and the lender get into a hassle about what's happening and whether you're telling them all there is to be known about the project and its operating expense characteristics. Union Mutual shall be advised of the borrower's fiscal year ending at least 2 weeks prior to the disbursement of funds. Such requirement shall be included as a covenant in the security instrument. The notice stated to do that is breach of the mortgage and at the option of the lender means they can accelerate the balance due. So whenever you see a little provision tied in to a covenant it has significant ramifications. What time is it? 2 minutes.

OK last clause. In all legal matters including required mortgage documents other than loan documents, status of zoning, etc., are subject to the approval of Union Mutual's legal division. Union Mutual shall also be represented by special counsel of its choice from the state in which the property is located. Special counsel will be responsible for drafting all loan documentation for Union Mutual's approval and providing all other attorney services necessary to Union Mutual's opinion to facilitate the closing of the transaction. At the closing special counsel must be in a position to deliver an attorney's opinion acceptable to Union Mutual regarding the validity of the loan, which opinion shall also state all necessary and applicable zoning, development and utility regulations, environmental laws, ordinances, and regulations to any state federal or municipal having jurisdiction over their property had they been complied with in the development of the property. They are not going to find an attorney that's going to do that. There's a clause right there that needs a little re-writing. In effect what they're really saying is that the attorney who has put this all together is now going to guarantee us that it's true. Now it's nice to ask for that. Whether they're going to get it is something else again. But now look at the clincher. Obviously, a few law firms might do that for a price. Admitted they now have malpractice insurance which is sufficient to cover that kind of warrant. But, in order to render this opinion special counsel may require opinion from counsel of the borrower covering some or all of these matters. In other words, we're going to push the buck back on you. Your attorney is now going to validate all of these things etc. Then it says, whether or not the transaction contemplated hereby are consummated, borrower agrees to pay all costs involved in the closing of the loan, including but not limited to the fees, expenses and disbursements of Union Mutual's special counsel. Recording fees, title insurance fees, title examination fees, legal fees and service costs - that is a major expense. There's a blank check that the borrower writes if he buys that clause. Because obviously the special counsel is going to figure out what his malfeasance fee is going to be and that's going to be part of his cost and that get's passed to you and now all of a sudden you're paying for a fairly major guarantees here that our environmental legislation and so forth and so on that, in effect, may have the whole house (?) fall on them.

. . . Commitment letter that was handed out in the previous session that we continue to labor our way through there which I think is quite illustrative of what the issues are and the sort of negotiation between the borrower and the lender. And what you take away from this course that ultimately the loan (underwriting) exercise in risk management and allocation of risk for the assumptions that were made in the project. Top of page 6 we begin with the title. We talked about that briefly in the past. Title is just a free thing. In this case the title insurance policy has been endorsed and finally the survey which provides the physical representation of the stated facts controlling the title. In this case, they insist on 1) not only the baseline boundary (I'm not sure what form 6 is in this case so I can't answer your question on that.) But also notice that the insurance company will have to be approved by Union Mutual. There's a great deal of small title insurance companies who typically don't have the capital to handle a major project. And so they would be only three or four major companies in the country and any attempt to coverage will be subject to Union Mutual's approval. You'd be surprised at how much time before the closing you will spend arguing about the exceptions to the title. In that, the title insurance company doesn't want to promise anything relative to any flaws that are known. They're really in business to cover only the unknown surprises and, therefore, having fly specked the chain of title from the original U.S. patent to whatever the date of closing is going to be, they're going to find all kinds of little clinkers in there. And, as a result, they're going to be listed in the back to look pretty bad. Now you have to decide which ones of those are significant and which ones really are clerical errors dating back to the 1700's and so forth. And you can spend a great deal of time arguing about that, providing certain kinds of adjustments. I remember at one closing we were doing a single family home in a subdivision out here near the west side of Madison just on the Midvale Boulevard and at the closing it was caught that the deed restriction required approval of the home plan by MR. So-And-So who was the original developer of the plat. Well this is an old plat, this was an in-fill site which had been attached to the farmhouse next door for Lord knows how long and we could not close until we finally located him in a nursing home in Phoenix, AZ and had to get an attorney with the plans in hand to go over there to get him to sign it that he had approved our plan. I don't think he could see them but the title insurance company would not approve it and the lender would not close because there was always this remote possibility that somebody would take humbridge and require you to relocate the house because it wasn't approved and so on. So you can get yourself into all kinds of little sticklers in that rather simple little form. The survey, again, the borrower tries to reach mutual for approval prior to the pre-closing and (?) disclosing all the improvements, encroachments, easements and rights-of-way. That also gets to be a little messy. Let's say you have a retaining wall on the property and the top of the retaining wall because it slopes slightly inward to keep it from falling down, has crossed over that imaginary lot line. So now the top feet of your retaining wall now encroach on the property next door. By rights they could go into a legal action and require you to remove your retaining wall at considerable expense or could otherwise screw up the plan in one form or another and, therefore, can you provide evidence that the property owner next door will give you an easement for that. Or you may find that a joint foundation wall on a project - yours encroaches on to their site slightly and so on. As Jim Cain found in his project in Washington DC ultimately the only way out was to buy the building next door, that was the only thing they would settle for. So they ended up just to clean up the title in terms of the encroachment revealed by the survey, buying the building next door.

In downtown Madison the First Wisconsin Bank Building which is just alongside the Tenney building, is on a plat that at one time had an alleyway running through it in the mid block and then there was a second alleyway bending down and coming back onto (what is that Butler) or whatever street is behind it and those two easements benefited the Tenney building among others and the owners of the Tenney building wanted out and the building required a great deal of investment and upgrading and so forth. And they just held out and eventually the bank in order to clean up the easement for an alley that nobody was using had to pay $1.8 million for a building that was worth $1.3 million just to extinguish that easement on the survey. So we're not talking about, necessarily, small problems when we're looking at the survey which so often beneath a single family home place, you know, kind of a throw away kind of thing.

Improvements, encroachments, easements and rights-of-way. The survey must show the state of fact acceptable to Union Mutual and the title company issuing the required title policy. That's to be prepared and certified to by a duly registered land surveyor or engineer (That means he's bonded) and be revised and recertified by the Construction Company two weeks prior to closing to show the improvements have been constructed in accordance with the plan and specs. In other words, what has been proposed and what is built is sometimes not quite the same. They need to know if the set back's right or somebody modified the building at the last moment with a little design feature which now makes it nonconforming relative to deed restrictions or the zoning and so forth. I can remember I did that on a house at one point when I went out to look at the site we were setting the corner boards on the house, I decided it was set in very much nicer and we could save a tree if we just moved it back five feet. So we just arbitrarily moved it back five feet. Oh, holy catfish, we would have thought that we had violated some major ten commandments of that and the lender was very very upset by the fact that the survey of the house completed didn't match the survey as originally on the plat - that we had moved it back five feet. In this case it didn't violate any zoning ordinances and so forth. But if we had been off one way or another on the side lot and now encroached on the side lot, you would have a sticky little problem there. You would have had to buy additional land from the next homeowner or moving your house just two feet to the left or something. Somehow when people have to negotiate about that your bargaining position isn't very good because he's probably a little sore about the whole thing. OK.

Insurance Requirements. Union Mutual's interest shall appear as first mortgagee and the insurance must contain a so-called standard mortgagee clause. There are three ways to make the insurance available to the life insurance company. One, of course, is for them to buy their own policy and be the named insured. The second is of course, to be an assignee under the policy, in which case it gets no more rights than the insured themselves have, the building owners. And the building owners can do a lot of dumb things that might suspend the insurance - aside from not paying the premium - they might introduce a fireworks factory or change the risk or something of that sort, which would suspend the coverage. Or they can burn it down themselves and if they were actually accused of arson, why then the policy isn't collectable either. And so they invented, just for mortgage lenders, something called a standard mortgagee clause. And the standard mortgagee clause, in effect, creates a separate policy agreement between the insurance company and the lender, even though the policy is bought by and the named insured is the borrower. Now under that standard mortgagee clause there's nothing the borrower can do to void the coverage by being stupid or, you know, being cheap for that matter. Even if the borrower burned the building down, the insurance company lender would be paid off. Now the borrower would go to jail but that's another problem. The second element is if the borrower fails to pay the premium. The insurance company has the right to step in and pay the premium with no gap in the coverage. In other words, if the coverage was suspended in the interim, they simply continue to have full coverage. Third, if there is some condition in the property that prior inspection reveals would otherwise suspend the coverage for the borrower, the lender, in this case, has to be notified and then they can go in and correct, let's say, the fact that the sprinkler system isn't working or the alarm system doesn't meet standards or whatever the case may be. So that standard mortgagee clause is extremely powerful and if the fire insurance company has to pay off to the lender, they then have a right of action against the named insured for that amount if, in fact, it was paid when the named insured wasn't covered. Said insurance shall be issued by a company or companies having a Best range of at least A class and in an amount not less than the full replacement cost of the building as to all risk coverage (that's pretty expensive stuff) and 90% co-insurance. Does everybody understand co-insurance? OK. To protect the consumer many many years ago, it was determined that actual cash value of damage was, in fact, cost to replace less straight line depreciation and the premise was that any asset, any gradually used up asset would be recovered out of your cash flow and so if you bought a ship for a million dollars and half way through it, it sank, you still had $500,000 to recover out of your operations and, therefore, you would be repaid the $500,000. Then in the U.S. a number of people sued on the grounds that that wasn't meeting the principal indemnity - that they weren't quite back where they were before. And in a great classic case called the Gulf Breeze Cottage Case involving a little ma and pa hotel in Galveston where the roofs were blown off in a little tornado or hurricane they argued that before the hurricane they had a motel in which all the rooms were dry and $10,000 in the bank and that after the hurricane, after they had gotten their actual cash value in terms of cost to replace the roof less depreciation, not only did they not only have any money left in the bank, they were $5,000 into the bank for a loan because the $15,000 represented the depreciation and therefore, the principal indemnity had been violated and they had not received full protection under the insurance and the courts agreed with them and said that, in effect, in partial losses they had to replace and restore the property. Well, for protection of the consumer they had standardized the fire insurance contract and put it into the statutes word-for-word in all 48 states and they had to go back and change the language in that and interestingly enough when they had repassed it to make it simple to read, they had left out the term when they said actual cash value, they had forgot to put in the parentheses (cost to replace less depreciation) so part of the Gulf Breeze case was that the language was ambiguous and was going to be construed against the insurance company. Now they couldn't go back to 48 legislators and come back and put that in. To the legislators that would be paying for the problem - that would be taking something away from the policy holder given to them by common law precedent that wasn't in the statutes, so they couldn't change the laws. So they said OK, as my father told me the guy who would succeed in this world is the guy who is, when he is being run out of town, makes it look like he's leading the parade. The insurance companies executed that maneuver beautifully, they came up with a replacement cost endorsement that said, "OK if you will insure to 90% of value, we will then, you know, repair all partial losses on a replacement cost base but, if you don't insure to that amount, we will only reimburse you on an actual cash value basis (cost to replace less depreciation)." So they got it back in that way by appearing to give you something on the front page that they took away on the back page. So it becomes imperative that you maintain insurance equal to 90% of the insurable value of the asset. Some policies say 80% but more typically today it is 90 to 100%. So the co-insurance clause really says that you will collect replacement cost of the damaged property if insurance equals 90% of insurable value or more or actual cash value (cost to replace less depreciation) if you don't. Then, there's two other elements to that little co-insurance clinker. While you have to know what insurable value is, and its insurable value at the time of loss not when you buy the policy, but at the time of loss. Now if you have inflation and you bought a building three years ago that the construction costs have now gone up 10%, you could have been fully insured when you bought the building, but now because of inflation the insurable value had gone up, the amount of insurance relative to that, will have gone done, you'll break through the 90% barrier and that's expensive. You could get 89% and all the way back to cost to replace less depreciation which might not give you enough money to repair the building. OK? So that's a major problem, so you have to insure relative to where your values are currently, not necessarily where they were when you bought the policy. Hence the language which says 90% co-insurance is both an agreed amount the agreed amount is the amount agreed on in the base year that says OK, if you buy $10 million you meet the 90% insurance thing. That's to cut the insurance company off from arguing later when you have the loss that you had only 89% coverage the day you bought it. That gets rid of that so that says the agreed amount and if you meet the co-insurance when you bought it. And the inflation guard provision says and in addition we will assume that the amount of coverage you have will rise with the inflation factor. So that any time they have a loss, shall we say that the 3-year policy period or 5-year policy period the amount of coverage that you have will meet the 90% co-insurance thing. Too many people got sandbagged, you know, as inflation took property values up and they didn't adjust their insurance. Now you pay extra for those features in the commercial area. Many of the residential areas, you know, like Allstate or State Farm and so forth build that into one of their marketing features on a single family home so that quite often you don't have to get a special endorsement to do that. But on commercial property you got to have to be specially endorsed and you pay extra for it. So this is the Cadillac policy. It's all risk, it's got 90% co-insurance clause, it's got agreed amount coverage up front on the first year and inflation guard going after that. After all, since you're paying the premium, expense means nothing to the lender. So now the appraiser that did fire and extended coverage, you know, for its appraised value has only missed by 125% on the premium. Significant factor. Then further on they go on to say, initially liability coverage shall be $1 million combined single limit policy in the amount of $1 million for personal injury. Now personal injury has to do with things like civil torts - let's say you violated somebody's privacy, you committed a civil rights infraction, you slandered somebody - that's a personal injury - and it's very easy to do in the business area today. If you have a credit report that's negative on somebody and you show that to somebody that doesn't have the need to know, you've violated the privacy of that individual and if for some reason it disrupts something else that he's going to do, you can be sued for that. There's a great deal of confidential information which you just can't flash about other than beginning to expose yourself to either interference with a business relationship or slander or liable or so forth, depending on how you use it. So that's what the $1 million personal injury is for. A lot of people forget to insure for that and yet that is a major exposure today if you are in the real estate business. $1 million in any one accident having to do with an individual, that would be bodily damage or bodily injury, as opposed to personal injury and the $1 million for property damages. That's a fairly expensive coverage to get. And once you move beyond the million and they start requiring $2 million or $5 million, you're probably into the Lloyd's of London market for the top $3 million of that. One or two million is a pretty standard issue today. Umbrella policies carrying you above that amount starts to cost money.

Rental insurance shall be in effect for the entire life of the loan. Rental insurance covers the rent roll - it's like consequential loss coverage in other business areas and, in effect, while the rents are abated because the building was damaged by fire, the tenant can't use it, or for that matter the tenant is allowed to break the lease and move out. This would replace the rent for at least six months while you're rebuilding and repairing the building and so forth, therefore maintaining the cash flow and the cash flow is therefore available for the lender. This should cover any loss of rent for duration of up to six months. These requirements should be incorporated into the mortgage instrument. That's a very casual way of saying that this is a covenant violate any and part of this clause and that "zap" we can go and accelerate the balance due.

The next clause is extremely onerous - probably most commercial developers would fight this and redraft the next clause. It says, in the event of loss or damage by fire or any other casualty, Union Mutual would re-release the insurance proceeds as restoration progresses subject to the following conditions: the borrower's not in default under the mortgage (aw common on guys, you gotta rebuild it anyway, who are we kiddin? you know) and second of all the improvements will be at least 80% complete after the restoration under leases approved in writing by Union Mutual. Well, it's quite possible that you'd have a major tenant after a big fire, who would exercise his right to depart. And now you have a 30% vacancy but they won't let you repair the building because you don't have 20%, you know, vacant and they're going to make you use your own money - which you may not have your own money and you end up in a Mexican standoff because the borrower doesn't have the money to rebuild it and the lender won't replace it or if he does replace it, he's going to say, "Well, all right, tell you what I'm going to do. I'll let you do this, but I'm going to raise the interest rate about a half percent on you since the market has sailed." - which of course is what the lender wants to do. He wants to create confrontations in which the outcome is to give him a higher interest because the market has moved upward. This is the kind of thing that a borrower would really fight. The amateur would not see any threat in this at all and the professional simply would not allow the lender to control the funds. He might set up an escrow account which will allow him to go forward with the remodeling or there might be something to the effect that the borrower has control of the first $250,000 worth of repair and after that it's a joint matter, but can you imagine what it would do to this project if you had $100 fire and now you got to go through all the correspondence with Union Mutual to get your $100 back after you had made repairs and so forth - extremely onerous clause. Yes? Question: In that reading that we read on controlling borrowers, lenders controlling the borrower. They talked about how you could potentially sue your lender if they were using undue control over. Chief: Yes, that's called impactive equity. Question: And isn't that something that could happen under clauses like that? Chief: Yes, if the lender got stuffy and unreasonable about it and put the developer out of business, he could sue them. And this is one of the things that could prevent foreclosure. In other words, the lender would say, "All right, you're under default and I'm going to foreclose." And the borrower would come right back and sue and say it was your unreasonable behavior that put me into foreclose and got me into this pickle and therefore, 1) you can't foreclose and 2)I'm entitled to damages for all of the rents I lost and my business reputation and this hurt. And it happens. It happens all the time. The borrower counter attacks. This is a bad clause from both standpoints.

Union Mutual approved the plans and spec. "Well, come on guys, all we got to do is replace a little partition next to the water cooler that burned. What's with this?" And there are sufficient funds among (?) to replace this facility as certified by the architect, approved by Union Mutual. Come on now.

Well, there's a classic case of where there's going to be a confrontation between the borrower and the lender as they work out the commitment. Now notice the rest of this. The borrower provides suitable completion of the performance bonds. The insured does not assert any defense against the borrower or tenants pursuant to the insurance policy covering the improvements. Union Mutual shall have the option of applying any surplus remaining after we build into the indebtedness. In other words, if you really do this efficiently, I get to keep that too. Phooey! As a builder I can remember the first house I ever built was a classic example of committee at work. I listened to everybody's advice - ended up with a Queen Anne front, Mary Ann rear. Couldn't sell it for about 6 months and finally sold it to a lady that wrote cook books for fish and seafood. And given my particular propensities I had a recipes for seafood as the wallpaper pattern in the kitchen which just turned her on. Talk about her poor husband, he finally had to borrow additional money for a second mortgage from his new employer that just moved to Milwaukee and it was the very first week that they owned the house, she was cooking one of her special deals for company and she had like 8 pots on 4 burners and something spilled over and she burned out the kitchen. And they called and called the guests off for dinner - it was a disaster and they called us the next morning just when our painter happened to be at my house, I was just settling the bill with him for the house and man, we were out there like a shot and we had her kitchen completely redone and all new cabinets and the whole 9 yards when the insurance people got out there to look at it. And we made more money on redoing the kitchen than we had on the house. You know. So if there's a little surplus to be had, try not to leave it behind with the lender. Such are the conditions that would customarily be required by local construction lenders or otherwise reasonably complete on that. There's a classic clause just written to see if you're going to buy that or not.

Condemnation Avoidance. Individuals shall receive notification of all compensation, rights of action and any award or claim for damages for any part of the premises taken or damaged under the power of eminent domain or by condemnation or sale approved thereof. Huuahh. The borrower isn't going to buy that either. Part of your award may be obviously for diminution of the property value, part of it may be for a parcel that's leased, let's say, a temporary construction right away and so forth. And there the lender is trying to pick it all up. And you got to sort out that which is for a dilution of the collateral values here or a reduction in the income power of the property and that part of the award which is for the (?) and temporary easements for construction and perhaps even awards to tenants for interrupted business and so on. Union Mutual may elect to apply the proceeds of the award to the reduction of the secured debt, or it may apply the proceeds available under such manner and under such conditions as Union Mutual may require to reimburse the borrower for the cost of building or restoration. Well, Phooey. You know, it'll go into a fund and we'll take care of the restoration and so forth and then figure out if there's any reduction in collateral value and go from there. Another clause typically would be rewritten by a strong borrower and may be simply accepted by an weak one.

Other Terms. Loan disbursements. We talked about this earlier just briefly but the sum of $8,332,000 less the 125% of the cost of the claim shall be disbursed during the closing period which shall be no earlier than October 1, no later than December 31st to fund additional construction less tenant finish improvements and landscaping. Completion of delivery of the loan in accordance with all terms and conditions of this commitment. You'll recall they also had to put a provision in earlier that they could close in the following quarter as the will of the lender, but not at the will of the borrower. So now if you're a developer/contractor and you've got to meet those specs and you gotta get that window. And now you go into a three month strike with the concrete truck drivers or something, you got big problems. You're going to pay big money to have somebody deliver concrete at night when nobody's lookin' or you're going to settle with the union at whatever price they want, because you've gotta hit that target. You've got to be able to close that particular deal at that particular date. And this becomes a very confidential date. Because everybody involved in the construction process would love to know what that window is so they can extort whatever they can from the developer/contractor. So it is not one of those things, that if you are a party to, you are going to mention to anybody as to the date. Extremely critical piece of information, very private to the borrower. The remaining portion of the loan fee determined in accordance with the following schedule again, less 125% of cost to complete, shall be disbursed in a single increment on 128,155 square feet of the total 160,000 are leased under approved leases at first year rents on the following basis. And we've gone through that before, but obviously you wouldn't . . . blank place on the tape . . .

All leases shall be delivered to you (signed) for its approval forfeiting for any funding disbursed the tenant must acknowledge that it is in occupancy, open for business paying full minimum rent and that its lease is in full force and effect. That is called an estoppel clause. Another point of real extortion between the tenant and the developer.

An estoppel letter really says that as a tenant I don't have any basis for denying the payment of rent - that whatever the borrower, in this case the developer, promised to do for me, he has done, that I have acknowledged that because I'm in the space, I'm paying full minimum rent and as far as I'm concerned the lease is a deal and all the terms and conditions have been met. The lender obviously doesn't want to be stymied later to get the leases signed and the tenant says, "Hey, you never put the carpeting in or the ceiling in here and I'll be damned if I'm going to pay a nickel until I get what our deal was." Or he didn't get me in for 3 months after the date I was scheduled to get in and I had to pay the following rents at my previous location on a penalty basis and that cost me $150,000 so you pay me the damages for being late, I'm not going to pay you the rent or I'm going to apply all rent to the damages until such time as I've got my money back you're not going to see anything. Well you can imagine that if you have a tenant that's kind of a schmuck and a developer who is kind of marginal, they're going to be at each other's throats. And many a closing has died because the tenant or tenants will not provide that estoppel letter that we've accepted it, we're satisfied and we don't have any reason not to pay our rent. So, again, if you're a tenant and you're moving into the premises and you're a little unhappy because, you know, it hasn't been finished off the way you thought it was going to be. You don't sign any estoppel letter until you get it done and you have the contractor against the wall. Sooner or later he's got to go to the well, and close the permanent loan and he needs that estoppel letter and as a tenant that puts you in the driver's seat. Now, you know, if you have a real problem with it or the concrete crack that's showing up and the footings aren't right and so forth and so on, it can get to be a big hassle. In the event any remaining funds have not been disbursed within 12 months of the date of the initial disbursement Union Mutual's obligation to disburse such fund will end. So you got a 12 month window after you close to achieve the rest of the occupancy and the rest of the tenant finishes and so forth or you're going to have to put that in with equity. Union Mutual will not be required to disburse any remaining funds if there is a monetary default in the mortgage whether cured or uncured. Remember that little clause that said if you miss by three days and so on and so forth. Well, in addition if you miss by three days, they're not going to have to close on the rest of it. Well why would they need that to be that picky? Well one of the reasons is the interest rate may have sailed since they made this commitment. Then probably all things can be made if you'll adjust the mortgage to the market rate - particularly if it's higher than it was with us initially. Or if there's a nonmonetary default that has not been cured within 30 days like the insurance factor and so on. After the floor loan is closed and prior to the time the borrowers quality for additional disbursements there must be no lien intervening between the first and any subsequent persons. They don't require a letter on that and that means all of the mechanics have been paid and so forth and so on.

Completion. Improvements shall be satisfactorily completed in accordance with plans and specs approved by our company. Said plans and specs shall have been approved in writing by the borrower, contractor, surety guarantors and the appropriate governmental authority responsible for compliance by plans and specifications with building codes and other laws and regulations. That will become a very impressive set of documents when that's all signed but now you're into the project and along comes somebody that says, "Gee, I'll rent the top 2 floors if I can have a stairwell and atrium connecting the 2 levels. Errrr. Now we got to go back and get plan revisions and we gotta go back and get all of these folks sign off on that again. That kind of changes - the kind of the thing where you take your marketing guy to one side, whisper in his ear a little while and see whether you can't get him to accept the two floors as is. Any change in the final plans and specs without Union Mutual's prior approval, may, at our option again, constitute a breach of commitment. No use setting up one little thing to trip over, so that the letter of commitment didn't quite confer with the letter of commitment as it might appear. Now we get to the tough part. Completion will be evidence by letters from the borrower. And notice the letters again, a little bell rings every time we say letter - it's fraud through the mails if you represent something in a letter that isn't so. That a party to your trial based on that letter will be the federal government who has no sense of legal costs whatsoever and given a war of attrition you don't want to go to war with the government. Union Mutual's inspecting architect is required. The supervising engineer or architect indicating the premises has been satisfactorily completed in accordance with plans and specifications and a letter from the Jones Company certifying that they have made a thorough inspection of the property that construction is complete in all respects and that occupancy is as represented by the borrower. In addition, Union Mutual will receive a permanent, unconditional shell certificate of occupancy from the appropriate municipal tacky. Now here's where it gets a little authority. Municipal authorities know what they're doing when they're signing off. So let's assume this building was built as part of a redevelopment project or whatever and they're not real happy about the landscaping work. They decided the color of the front door wasn't what they wanted. They can go into a swoon on the certificate and just hang you there. Classical example is the University Square Shopping Center. The University Square Shopping Center is in an

Urban Renewal district. They had to approve the plans with the urban renewal folks beforehand and the architectural committee that they happened to have. And now they're just about done. Well, the rendering showed that the wood siding was going to be at an angle, diagonally indicated presumably to add a little more pattern and so forth. And it came time to do it fire proof cedar boards were not available anywhere so he used fireproof cedar plywood. That's a fire zone and therefore you have to have fire treated materials on the outside. The point to follow is taking a piece of plywood and laying it diagonally, you lose 50% of the board, right? - if you cut it off at an angle and so forth - and what're going to end up with is a whole bunch of lines where you match one board to the other and so forth, it's a mess - so he laid it vertically. So the City of Madison's urban renewal and architectural experts decided they didn't like that aesthetically. What's more one of the store fronts on the inside of the mall, they didn't like that either. They had never submitted the drawing to them for their final approval and by-George they were going to know who's in charge here. So they wouldn't give a certificate of occupancy. Now the guy's got a construction loan running at 15% and he's going to close on a commitment that he's gotten earlier on a shopping center loan at 9%. And there he is, he can't close on his loan. The meter's running with a 6% interest differential - 1/2% a month on the full cost of the project - because the plywood isn't on the loose diagonally. Well at some point you just throw in the towel. You go out and you buy your own cedar forest, you get a couple of boards and do it the way it was on the drawing. The developer/contractor was absolutely livid. Because this is really where it gets down to does the community like private development or don't they? Are they pro-business or aren't they? These are the little tests. What's required to get the occupancy permit. Now in Chicago it's pretty well understood how much you're going to pay the building inspector to get it. In fact, Mel Simon was telling us the story at lunch one time that he was going to do some work in Baltimore and he had finally gotten the permits for a shopping center in Baltimore and the building department, this was many many years ago, presented him a mimeographed sheet as to exactly how much went to each of the inspectors if he wanted it inspected when the work was done. Otherwise there was a 3 month waiting period before they would be able to get around to it because of their very busy schedules. He did not build a shopping center in Baltimore he said, "To hell with it."

The final certificate of occupancy with the completed tenant spaces will be required with the funding of the economic holdback. Finally, at the time of closing no part of the building(s) and improvements shall have been damaged by fire or other casualties and not repaired to our satisfaction, nor shall there be any condemnation proceedings pending. How's that for a cautious position on the part of the lender? Just what a condemnation proceeding pending is, is really a messy piece of land probably scratched right away. I mean, is the highway department making noises about widening the highway in the year 1995 or have they actually laid out the right-of-way and issued the jurisdictual offer and you're now fighting the jurisdictional offer. When does the call of eminent domain fall? - when the project's announced or when they finally get down to what it is they're going to take and how much it is they're going to pay for it. And that language doesn't reveal any of that so you start all over there.

Advertising. Union Mutual shall be granted the right, subject to local voter's rights, to display a sign on the property during the construction period referring to Union

Mutual Life Insurance Company is providing the permanent financing and (a very friendly and warm-hearted fact).

OK. Next clause. Appraisal. Union Mutual shall receive an MAI appraisal of the property and proposed improvements which shall be satisfactory to this company and shall be completed by an appraiser approved by the company within 90 days of the date of the commitment. Upon completion of the construction the appraiser shall certify the value to be the same or in excess of the value arrived in his appraisal obviously doesn't propose (?). Today that would not be generally acceptable. For a savings and loan association they have to employ their own appraiser and it would go on further to indicate the appraiser would have to meet the standards of R-41C which is a long involved statement as to what an appraisal shall be etc. And the lender will be required to sign off on the fact that he concurs with the appraiser's findings. Furthermore, the appraiser would be expected to indicate that he would have to show progressive increments in value at different stages of the project. He can't just say if completed, according to all our dreams and fantasies, it will be worth $10 million. You have to start to say that the land as vacant, if it were sold as it stood right now is worth $400,000. And then when we get the zoning it will be worth $1 million. And when the construction is completed with the rental program underway it will be worth $6 million etc. In other words, he has to show progressively how the collateral value is showing value added at different stages of the project, which is a tough assignment. But the lender is not permitted to have his loan running out in front of that value increment. This is the way savings and loan associations and banks have been hornswaggled willingly for years. They make the loan based on the fantasy value that this all goes according to plan and it all rents up like we said it was going to rent, it will be worth this much when completed. There's too many things that can go wrong in the interim. And so the appraiser is going to be expected to show different points of the collateral value and the loan is going to have to fall behind that so that it is fully collateralized by the estimated value of the project. Yes? Question: Could you clear up something about R41 C thing. Some think that the value has to be cash or the equivalent of cash attached or physically attached. Is that going to have a bearing on how much the lender is going to lend to the person then? Chief: Well, what that's really referring to is that in many cases properties might be bought with some financing by the seller. Let's say the seller takes a wrap around second back OK? So now the value of the property is enhanced by the nonmarket value financing. See? What they want is what it will sell for cash without any special benefits from the seller. All right? Because otherwise we could create any number we want. OK? My daddy says, "what's so tough about real estate?" He says, "If you get to name the terms I get to name the price? If you get to name the price, I name the terms." We always do business with present value. OK? So those cash equivalents to value are the critical element. There's a lot of other things that get hidden in there as well. And, for example, the seller might be granted the management contract so they are therefore dropping the selling price a little bit and recouping it on the management contract. The seller might be granted concessions in terms of renting out his own space for a period of time. More and more today partnerships when selling the property, if you were to look into the miscellaneous records you would find the general partner being bought off by the buyer of the property so that the recorded price of the property would be $2 million but off on the side someplace there's $200,000 to the general partner to let go of whatever interest he has. So cash equivalency he wants to get down to how many dollars did you actually pay for the land and building, period. Now you'll also notice that our R41 C makes a great emphasis on the fact that the appraiser has to break out that which is being paid for the land, the building and the real estate owned and that which is being paid for personal property, tangible or intangible. Tangible personal property would be the furnishings and kitchen equipment and things like that. Intangible might be the franchise. You got the Holiday Inn franchise and you paid $100,000 for that and so forth. Those have to be separated out. So, this appraisal clause is of the old days. Obviously, there was a tremendous conspiracy between the appraisers and developers because the appraiser was depending on the developer for his fee, he was likely to say, "How much money do you need?" And what's the loan rate supposed to be? In what was called a forced approach to value, was to take the loan desired divided by the loan ratio required and that was the appraised value of your property. And the developers phoned around and explained that to the MAI's and, you know, a really sharp MAI picked up on that, "Yea I can see that's worth $5.0 million now." "Well, can you write that up in 90 days?" "Well, gee I really have a backlog." "Well there's an extra $5,000 in this for you if you can get it done." Well, in that case, I can rearrange my schedule." "You want $5 million again?" And the major appraisal companies were some who were the most guilty of that. Made as instructed.

Financial responsibility. Watch this, remember when Mr. (?) made a big deal of the fact that nobody was personally accountable watch what's going on here. Borrower and each partner, controlling shareholders and beneficiary in the event the former is a partnership, corporation or land trust are collectively referred to as the borrower must in the opinion due to be financially responsible at each closing. Financially responsible shall be interpreted to mean that the borrower is solvent as evidenced by financial statements which are current as of the closing, is not bankrupt, has not commited any acts of bankruptcy, has no outstanding liens, suits, garnishments, bankruptcy or court actions which could in the reasonable opinion of Union Mutual render the borrower insolvent or bankrupt and has had no material adverse change in financial condition since the time of application to Union Mutual. There's nothing like a good divorce or a change in their material financial condition. So if you're going to be a developer, either be single or be happy. There's a very famous hotel project in Muskeegal, Wisconsin that was built by a developer named Schradell, and Schradell had been extremely successful in the Milwaukee apartment market and got involved in this fascination with building this resort hotel in Muskeegal. In fact, many of his apartment projects were the first place that if you were married in Milwaukee, you would then move to one of his apartment projects. It was called Schradell's cradle. And he got into the hotel and then his wife sued him for divorce on the grounds of infidelity and lost to the courtroom which saved his construction loan. He was then sued by another lady on a paternity basis on three counts of kids 14, 10 and 6 and she won on them all, the judge granted his wife another hearing and he lost. He was never able to complete the hotel and the hotel is vacant to this day. The golf course is still used in Muskeegal but the hotel was never finished. It was the result of a material adverse change in financial position. Should borrower not be financially responsible at the time of closing, Union Mutual retains the right to terminate the agreement and to retain all commitment fees. Now notice that, and retain all commitment fees.

Financial Credit. Union Mutual's obligation to fund will be conditioned upon its receipt and approval of current financial statements that have been signed and dated.

That's also the basis for fraud through the mail. And a Dunn and Bradstreet did a retail credit report on Steven White and Daniel Jones. Fair Credit Reporting Act is inclined to (?) public law anyone, by the way? Notice is to inform you in connection with your application for a loan we may make an investigative Consumer Report to determine information as to character and general reputation personal character and mode of living. This information may be obtained through personal interviews with your friends, neighbors or other with whom you are acquainted. Additional information as to the nature and scope, the nature reflects (?) and further upon request made from a reasonable time after you have received the letter.

Management. Union Mutual reserves the right to approve or install professional management of the property at any time the loan is 45 days in default. Remember the management fee is probably going to be one of the major profit centers during the early years of the project. Here's another example of selective pain being applied to the timely payment on the loan.

Notices. At the time of closing tenant occupancy, if any, will provide Union Mutual with satisfactory estoppel certificate. (remember we talked about that earlier) Color photographs . . .

Secondary Financing. No secondary financing shall be placed on the property except in an amount equal to the amount of the hold back which Union Mutual does not disburse at closing. In other words, if you've got funds for tenant improvements, you've got to have some way to do that, it's probably in the interest of Union Mutual to meet those tenant's requirements the day they moved in, because that obviously breaks the income stream which supports the loan, so they'll let you do that. Union Mutual shall have the right to approved the second mortgagee and the terms of said second mortgage. Union Mutual subsequent disburse all or part of said holdback and the amount of secondary financing shall be reduced by the amount of the disbursement. Otherwise, no secondary financing can be placed on the property without prior written approval of Union Mutual, which approval shall not be unreasonably withheld, (but that gets a little tacky as well).

Financial information. A certificate of cost. Certificate of cost in this case - after completion and prior to funding of the Union Mutual’s mortgage, borrower shall provide the company with a detailed breakdown of actual cost and certify as to the correctness of these costs. That goes further if you have a federally insured mortgage, say an FHA apartment project, that certification of cost means that they can reduce the amount of money lent. In other words, if they had said they were going to lend 90% of cost, that’s all they’re going to lend is 90% of cost. If you brought it in cheaper, they can hold back some of the funds. Second of all, that certification rule requires of who the subcontractors were so that you met whatever requirements there are in terms of minority employment, etc. That you, in fact you will provide a very detailed audit of the number of hours spent on the project, first of all by each type of employee, second of all by race, by sex and show that you have met all of the government fair employment standards, and if not, you’ve blown it. That process can take as long as two or three months on an FHA project. So certification of cost, if there’s government insurance involved in it, there’s a very extensive detailed provision which assumes that you’ve maintained adequate records during the construction process, that you can produce the required data, or otherwise you’re dead in the water.

OK!

We’re on page 10 of the Letter of Commitment so we shall continue to grind through that ad nauseum. Obviously, each item in the letter of commitment is, as we’ve pointed out before, really the subject matter of negotiations between the borrower and the lender. It has to be addressed in the original loan package. In turn, it becomes part of the underwriting policy for decisions of the lender and therefore looking at the letter of commitment, you are really looking at what the underwriting process has determined is necessary to make this an acceptable loan. And you are really anticipating the struggles that you will have at the closing to provide the necessary documentation and so on that will finally close the deal. And we had gotten down to certificate of costs under item 14 on page 10 which is the inspecting architect/engineer.

This is always a real sore point in that the relationships between the owner/developer, his architect, his general contractors, his subcontractors and the lender are governed, in part, by precedent, common law precedent, in part by the web of contracts which controls the deal, generally beginning with the contract with the architect for the owner which is an AIA form which has to be generally modified to be acceptable to the owners. That, in turn, says that the architect shall control the contracts with the general contractor and there are two sets of those essentially. In addition to the plans and specifications which determines what it is the general contractor is going to build and how he’s going to build it, there is a set of what are called the general conditions of the contract, which control everything from the insurance that is going to be provided by the general and the clean-up provisions and all of the scheduling matters and who is responsible for what in the event of delay, process for change order, on and on and on.

And then, of course, the general contractor go out and let subcontracts to a variety of people who are going to work on the project with him and he has built into that various controls that are hopefully are consistent with his general contract and with the general conditions controlling everybody. And, hopefully, of course, the plans and specifications are clearly understood by everybody, which isn't going to be true either. And so you start out with a very complex web of contracts, many of which are out-of-sync. Second of all, you impose on that level, insurance contracts which in recent years have been significantly modified so that it's not always quite clear who is responsible for the consequences of the error. Let's say some feature is misdesigned and dysfunctional. Is that a design error? Is that an installation error? Or was it simply the result of somebody else's error? Let's say the floor loading wasn't proper and as a result something settles and is now out of alignment and so forth, does this particular piece of machinery not work because of some other subcontractor's failure or because of this installer's failure or was it improperly designed or was all of that done correctly but it wasn't properly inspected. Let's say that purchasing of the in-the-wall heating and cooling units was done by the owner of the building and it was supposed to have a 5 megawatt heating coil in it and the manufacturer in attempting to skimp a little bit, sent 2.5 and so as a result the air temperature drops to zero and now everybody in your motel is freezing to death and nobody discovered that until, you know, that particular set of conditions appeared and now whose problem is it? - depending, of course, on who purchased it and under what level of responsibility, who was supposed to inspect it and so on. So now load onto that this clause on top of all that by Union Mutual. It now requires independent consulting registered architect to 1) review and critically evaluate the adequacy of the plans and specifications of the project and contract documents, compliance with applicable building land use environmental regulations and the total cost estimate tests and related matters will be determined by the company. Secondly, review and frequently evaluate any changes as to the items which will naturally occur during the construction project. Three, inspect the project on a monthly basis as construction progresses to determine the stage of construction compliance with plans and determine the stage of construction and specifications of quality of design and materials and so forth. . . for upon completion to certify that the project has been completed substantially in accordance with approved plan and specifications for the project. You would learn in Rod Matthews' class that substantial performance is a very mooshy term. There's no protection in this world so nothing is going to quite be as planned but when have you substantially complied with that? Now if the lender wanted to get on with the loan, his definition of substantial, you know, slides pretty much towards the perfection and as a result you can get into a fairly good negotiation hassle as to whether this substantially complete or not. And that in the best judgment the project does not violate applicable laws, regulations, ordinances, all necessary permits and approvals have been obtained, and consulting architect or engineers will be selected by this company shall perform its work on behalf of this company, Union's funding of the loan and performance under the commitment shall be dependent upon conformity of the project to the requirements of Union Mutual which may be based in part on the recommendations of the consultant. Now, a lot of people feel that that is redundant but it really isn't. Let me give you a story which I think is fascinating coming out of the ULI. The Urban Land Institute has a significant part of its buying any of its bi-annual program, holds what they call a design review session and any one of its members can bring a project into that review session and they pick out the best experts from their membership to critique it. And they may do this for 2 1/2 hours after a brief presentation by the developer of his concept or his problem as the case may be. And this involved a project to be built in New Orleans now known as Canal Place by a very prominent New Orleans developer by the name of Canissaro who's not in my idea the most socially sensitive individual I ever met but, nevertheless, well connected in New Orleans. And he owned a three block site, two blocks of which are in the unicar or French quarter and one block was just outside the architectural constraints of the French Quarter and he proposed a mixed use project for the three blocks. At that time the real estate depression was on and the land loan which he had with Chemical Bank was in arrears and the bank was pressing to bring that up to date because the auditors were questioning his ability to pay, etc., etc., at that point in time. And, of course, the way forward is if you have a little loan that you can't pay, get a bigger loan that you can't pay but now your bank is your partner rather than your creditor. So he proposed this three block project. Well, the people is the French Quarter who have very strict controls architecturally to main the integrity of the French Quarter which is a big tourist draw, pounded and pounded and pounded on him until finally the project got squeezed onto the one block that was outside the French Quarter and that was the first phase of the project. And essentially you have retail on the first level with a, as I recall, a Nieman Marcus was to be the lead tenant, it was kind of a retail thing, and then there was parking on the 3rd to the 6th floor connected by spiral ramps to the ground much like the one that comes out of the back of the John Hancock tower in Chicago and then on top of that there was office space. And about 40% of the office space was leased to, I believe, it was the telephone company and the balance, 60%, was on spec. And there was about, somewhere in the neighborhood of 450,000-500,000 square feet of office feet on spec in New Orleans. And now he comes in with his project in New Orleans with Bernardi, Wooster and Emmons from San Francisco as the architects. Now they are the darlings of California architecture and they really had a fine architectural firm, there's no doubt about it. But, nevertheless, they were out of their class in New Orleans. Now the panel that ULI had assembled included Mr. Hines who had just done Shell Plaza which is one block from the subject property we're talking about, Trammell Crow, Snitzer, who was kind of Mr. Office Building in Texas, they had somebody from the Koll Company etc., etc. I was at the end of the line as a research fellow, they pay me to go to those meetings and then they have to do something with me. So they put me on the board with this group to critique this project. And since our fund happens to have an office building in New Orleans, I had some sense of the market which is bad and in fact it was our worst investment by a long shot and so forth. So anyway, this group starts to take this building apart. First of all Hines pointed out that the foundation system was entirely wrong, it was a California foundation system that was intended for seismic conditions when the foundations in New Orleans have no bottom. You don't hit bedrock in New Orleans. What you do is you float the building on the piling. The idea is to get enough friction in-between the pilings and the materials that it's going through that the coefficient of friction holds up the building. So they require an entirely different piling system. And then Snitzer came in on the air conditioning - when you struggle with the humidity and the heat problems in New Orleans the wall system was wrong, the HVAC system was wrong. He just decimated it. Trammel Crow came in on the marketing and pointed out that the floor shapes were wrong for the New Orleans market - there was the small office market, not a large office floor market and the fact that the telephone company had taken 40% of the building was irrelevant to the design of the rest of the building because they're a large floor user and the rest of the market was going to be small floor users and therefore they had the wrong module etc. etc. They just tore the project apart. Handed the guy that represented Mr. Canissaro his head in his hand and said, you know, start over. And he thanked them very kindly and said, "Well, we've already closed on our construction loan. Ahhha, thought you guys would know about it. Ha." So Mike Robbins are out in New York following (that was in San Francisco) like two weeks later, Mike and I are teaching a class on how to make a mortgage loan to Chemical Bank's mortgage underwriting department. We got 60 guys in the room and somebody asks the question, do we as a commercial lender need our own architects and engineers because our clients bring in the top firms in the country. And I said, "Yes. Let me give you an example, not knowing of course that this was Chemical Bank's loan." After a couple of moments several guys turns out laughing and rolling in the aisles and the three vice presidents in the front row are going apoplectic. So then I say, "Look if you don't believe me you can get the tapes from ULI which they did." And they spent six months with their own architects and engineers re-designing the building - everything that design panel had said was true. And they were making the mortgage loan to build the building, mind you, so that the land loan would no longer be in the book which is not a real good reason, of course, for going into the deal in the first place. They were simply taking a couple million loan and making it a bad $60 million loan. Well anyway, the upshot of it was that I went to lunch with the three guys that were turning apoplectic and they confessed that well, it's true that we didn't exercise all of our usual underwriting standards but the joint venture partner for Mr. Canissaro is the Shah of Iran. Now we're in August. Robbins and I are back for course II in January, there are the same 3 guys and I can't resist, I have to say, "What do you hear from the Shah of Iran?" Needless to say, at the last seminar we didn't have them. But they brought the file on him, they showed that they had been able to replace the Shah with another general partner etc. etc. etc. and ultimately we met them at one of ULI meetings, the vice president of the Chemical Bank came over with a big smile on his face and he said, "Well, we finally made a construction loan, Eatna has just closed on the permanent financing and big mouth here had to say, "Yes, Eatna financed Renaissance Center in Detroit too." Well we're now persona nongrata. Anyway, a good classic example of the premise, you can not assume that because it is a big name architectural firm, they know what the hell they're doing relative to a specific situation or turf in which their expertise may not have prevailed before. And two, what they bring to the table if the client isn't strong enough to control the architect, the architect may not be sensitive at all to what the marketing of the building may be all about. The architect is going to impose his will on what the building shall be and how it shall look and is going to play for the grandstand rather than necessarily the market. Now Hines can deal with strong-minded architects, Hines can deal with the Skidmore Owens & Merrill's or the Bernardi, Wooster's and Emmons because Hines is even stronger willed than they are. And given the size of commissions that he can contract while he can provide, if you will, the cosmetics of high-style design it is going to be consistent with the economics of commercial real estate and the economics in terms of the rents and the workable areas and just how much money we're going to spend and where we're going to spend it and what it's going to look like. Now if you don't do that, you get First Wisconsin buildings like that in Madison which not under the control of a commercial developer and it has a horrible operating expense ratio. So the bank really can not simply assume that a respectable and high style design firm really has designed a building that's supportive of the collateral value of the loan, that can produce the cash flow necessary to repay the loan. Good example, if you're ever in DeMoines (Iowa), the main bank in DeMoines, I don't know if it's First of Iowa or whatever, again designed by a high style architectural firm and because of the exterior form that they wanted, I think it's floors 3 through 6 have no windows because they provide a very strong looking base to the overall architectural effect which is wonderful except you can't rent those three or four floors. So you have to challenge whether the building will be a machine for making money which is the only way you're going to get repaid. So the function of the architect is not only an inspecting one but obviously very much involved in the economic stability. I see a hand way up in the back. Question: If you have an inspecting architect or engineer and there is a problem with the building after it's done because it didn't meet code or some inferior materials used, from a liability standpoint, who does the lender have recourse against? Chief: Well he hopes it will be the architect. Question: The original design architect or the inspecting architect? Chief: Well, what you end up to is, whose legal draftsmen were best? The contract with his inspecting architect is going to try to impose that kind of liability for undetected error in the design on the inspecting architect. The inspecting architect, on the other hand, is going to try to open up some windows in that liability that perhaps suggests that if he's only responsible for what he can see and so forth and so on. Obviously, he's going to be very reluctant to write a blanket guarantee of the building that he only inspected monthly. So ultimately it gets down to the function and size of a pea. And the knowledgeable lender, when he's dealing with $100 million office building project, in essence has an architect and engineer in residence. They have their own little trailer on the project. They have their own set of blueprints and they inspect daily, I mean continually. Because there are so many ways to cheat on a construction project that if they aren't really nosy about every little thing, they open up the window air conditioners when they arrive, find out what horsepower electric motor is in there relative to what the specs call for, relative to what was delivered. And they're there when the footings and the pilings are going in to make sure that contractor drives them as deep as he was expected to or pours that concrete as thick as he was expected to and so on. And by in large in many communities the contractor is, of course, trying to corrupt that inspection system. They'll only be too happy to give you a shot gun and a little vacation to go duck hunting on Monday, Tuesday and Wednesday while they are pouring the basement floor so they can make it 2 inches thinner than it's supposed to be and so forth. And so it gets to the point of war and the bank that wants to be sure that's its collateral is everything that it was supposed to be will have somebody camped on the property. There are firms which do that kind of thing. Matt Walls, who was our speaker here with our first 795 session started out in the construction business doing that sort of thing. It's a real horror story - of all the different ways of cheating on the job which you had to detect. For example, he had a painting contractor who was supposed to do three coats. And couldn't trust the guy at all so he had to finally specify three different tints in the paint so that you could track where they had been with coat 1 and then coat 2 and coat 3 was the final darkest tint in order to keep track of the guy. You had to be there when they were putting in the footings and the pilings to make sure they were safe enough and so on. The construction game is a tough game and the general contractor may be perfectly well intentioned, but some of his subs may not be and so there really have to be another pair of eyes that are objective and incorruptible and that means you're going to pay them a large fee. And it also may mean that the fee that you pay them for that may be considerable less than the cost of correcting the undetected but latent defect. In many, for example, I think it's the FHA form the architectural inspection fee is 1 1/2% of the job. And it takes it about 1/4 of the total architectural fee.

Then it goes on. Union Mutual's own consulting architect engineer shall have no responsibility whatsoever for any personal design or structural failure. In other words, we're inspecting but it's your architect that designed it and therefore if it fails, it's his problem. This is a real problem for lenders because particularly now at the FHA level there are homeowners who have sued successfully won against FHA saying your inspectors went out, looked at the house, said that it was built in conformance with FHA standards and then it turns out that 1) the soils weren't appropriate for the kind of slab foundation they poured, the house broke up in little pieces and I as a consumer citizen figured the US government was protecting me and they weren't, and they didn't, and therefore not only am I not going to pay on my mortgage, you're going to pay me the damages that result from having to relocate etc. etc. etc. And they have successfully won. So it's a very confused area of the law apparently as to who gets to rely on whom. The borrower shall pay, notice, for the expense of the consulting architect or engineer at the time of this commitment letter to be acceptable to be required a deposit with Union Mutual $2500. Union Mutual will then pay directly for periodic billings which result of that work is performed and any difference between the actual architectural consulting fees and the estimate must be settled by you before the time of closing. There's that little beeper again. If you're ever going to get out from under that construction loan phase was are you going to do. And notice the privity of contract between Union Mutual and the consulting architect. It's characteristic of all of the professions now except accounting that the professional has liability only to the individual with whom he has previously contracted. And, hence, the need to collect the money, make your own contract as the lender with the consultant and so on.

Tri-party agreement. At Union Mutual's option the loan will either be preclosed and/or a tri-party agreement shall be entered into between the borrower, income lender and Union Mutual, which agreement shall be satisfactory for Union Mutual and will the loan will be funded upon completion of construction and upon compliance with terms and conditions in the commitment. A preclosing means that the money would be all disbursed into an escrow account and the meter would start to run; you would owe interest rate on the loan and at the same time the proceeds would be invested in short term governments or something of that sort and an escrow agent would be operating under the terms of this commitment letter to disburse the funds accordingly. The reason for doing that is that the permanent loan then has priority of time over everything else. It was the first deal closed and filed on the public records and, therefore, even though it may be preclosed a year and a half or two years before it would be completed, it would have prior claim to any type of mechanic's lien that might have otherwise leaked in and destroyed a first lien position of the lender. Hence the reason for the preclosing. A tri-party agreement, as you know, is called a buy-sell agreement and in effect within that agreement the construction lender transfers the original mortgage to the permanent lender so that you get the benefit of the date of recording of the construction loan now going to the benefit of the permanent lender. And again that date would be prior to the possibility of any mechanic's lien. I can not stress that too much with the development projects. The Wisconsin law is such that all mechanic's get the benefit of the date at which construction commenced. And the definition of commencing construction can be as faint as simply having somebody unload the bulldozer on the site waiting the word to go. So one of the things the lender really is obliged to do is go on the site and make sure that nothing has occurred that commenced construction because otherwise the date of his filing of the loan is after the date at which all mechanic's liens have their point of priority in time. Now it doesn't mean that the mechanic has to have done the work at all. He might be the last person to work on the project, but in terms of his priority in time, it goes back to the point at which the first mechanic worked on the project. So it's a very ticklish point to make sure that your mortgage has priority in claim in time. And, therefore, the preclosing or the buying of the note of the construction lender is a critical element of that. The preclosing shall occur and/or the tri-party agreement shall be executed within 90 days of the acceptance of the commitment letter. In the event the preclosing or execution of the tri-party has not occurred, this commitment at Union Mutual's option will be terminated and this company will take as earned any fee required in the paragraph entitled commitment fee. Errrrr. Again, notice all the options (?). You would probably want to re-draft that paragraph.

Now we come down to commitment fee. As part of consideration for issuance of this commitment as to the lender's obligation to loan the money in question, the commitment fee is $5,220 or 5% of the loan amount will be paid by the borrower at the time this letter is accepted. With the understanding that such fee will be returned to the borrower only as the loan has been properly closed and delivered in accordance with the terms and conditions of the commitment. Provided such closing and delivery takes place during the closing period which shall be no earlier than October 1st, no later than December 31st of the date on which Union Mutual's commitment hereunder terminates, unless the borrower exercises the right and specifies the interest rate paragraph etc. in such case its expiration date will be extended to March 31st, 1984. Union Mutual shall be entitled, but not obligated, to extend the termination date but not beyond such time as all requirements of the commitment have been fulfilled. The company reserves the right to disburse funds and close the loan any time during the closing period. If said loan does not so closed and deliver Union Mutual shall retain the commitment fee. Time is of the essence in the performance of all obligations of this commitment. Various states interpret that in various ways. The state of Wisconsin is absolutely hard-nosed on that feature. When you see time is of the essence, you're in trouble because for reasons perhaps not even of your own making, you blow that date, it's all over.

Let me give you an example, a case that we were in. A retail store leased ground to build what is essentially a discount dime store sort of thing. It's a small chain in Wisconsin and Illinois and as part of that agreement, it said that if the discount store failed to pay the ground rent on time for the ground, that the landlord, the owner of the land, could, at his option, make a put to the store owner that he had to buy the land at such-and-such a price. If the owner decided not to buy the land at that price, then, in effect, the owner of the land got the store. Now, this particular operator is apparently a little sloppy, he fails to pay the rent on time on the ground. Now the ground isn't a particularly attractive piece of ground anyway. It's in a shopping center which is kind of going sideways and our investor wants out so the price under the contract looks pretty good. He sticks it to the retailer and says, "Fine, here's the put since you can't pay me for the rent, pay me for the land, it's yours." No response within the 60 days that they had to make up their mind. He got the letter. It was registered and all that good stuff. "Time is of the essence" is in the contract. At the end of 60 days, the owner of the land says, "Fine, the reverse has now taken place. You didn't buy the land, so the store is mine." Sends them an eviction notice. Now the store is only about 9 years old. It's got a 20 year mortgage on it. And that point he has the attention of the store owner, saying, "You've got to be kiddin'. Here's the rent for the land." The owner of the land rejected the check for the rent, went to court, and Wisconsin courts backed him up. Time is of the essence, there was a procedure which was followed which seemed to be somewhat harsh, but, nevertheless, realistic. If you can't pay the rent, buy the land. If you can't buy the land, the store goes to the land owner. And he lost the store. And he's still left with the note to pay on the mortgage, by the way. Notice the mortgage wasn't any better than the terms of the ground lease. The only thing he had to pledge as collateral for the money that he used to build the store was, in fact, his rights to the land conditioned by the land lease. And the land lease was very clear, what would happen if he didn't pay the ground rent. Now at the last moment the lender came in and said, you know, he would be happy to pay the ground rent. Obviously he would since he was now unsecured. But there was no provision in any of that for the lender to step in and pay, he had no right to do that, and he didn't, and he lost the whole thing. So time is of the essence is a critical term and given the development process, subject to all the contingencies that interrupt the best-laid plans of mice and men, you've got to be very careful about that phrase where you see it appear and what it refers to. Another good example of that, by the way, was on the Square. Thirty on the Square with the Rehnabaums drug store - the drug store on the corner there on Thirty on the Square. And that lease came up for renewal virtually on the day that Rehnabaums merged with Walgreens - or was taken over by Walgreens, however you want to look at it. And, as a result, I can remember Gordon Rice saying they're going to drop that one through the cracks and they did. It was a very onerous lease. The original builder of Thirty on the Square was a klutz and the building went into bankruptcy and in fact Gordon Rice acquired it under the bankruptcy sale and largely as a result of really poor leasing, Rich gave the Rehnabaums the first floor at a giveaway price and the basement for free - mainly for storage, but they immediately put a terrace room restaurant in the basement and used it, obviously for income space. It was a very onerous lease and really depressed the value of that property. So now they are going along just fine they've entered the first 20 year term comes along and they got a ten year renewal option and they forget to execute the renewal option and there is a 'time is of the essence' line in the lease. They were dead, bang. The minute they failed to exercise the renewal Gordon Rice sent them an eviction notice. There was all kinds of due and bye about whether it was right, etc. That was a great Madison watering place and so forth and it gives the perception that the owner was really bad guy. And, no, he simply exercised his rights under the lease and they went to court and in that particular case we had to set the rent for the court at market rent and that's what he ended up paying for it. And, you know, Walgreen's was really upset about it but it did work out that it happened to fall right at that time when their lawyers were preoccupied with other matters and they didn't look at their tickler file and they blew it. So time of the essence is a critical fact, a very simple little line, but they mean it.

Next page. Paragraph 12. We're almost to the end of this but . . . It's understood that the commitment fee does not permit the borrower to have the option of not completing the transaction. That is, if the borrower fails to do so, it does represent monetary damages. Union Mutual specifically reserves any and all rights that it may have including and not limited to specific performance. That's pretty strong. That means that if we can show consequential loss over and above the $520,000, we're entitled to that too. Let's say interest rates fell to 6% and this was going to be a sweetheart deal. They could have the present value of the interest they lost under the deal. If they had spent money underwriting this thing, they were entitled to recovery of that. And if they wanted to go through with the deal and you had already made another deal with somebody else, the courts would probably force the specific performance. This is particularly very harsh language. Now, the $520,000 is often called the walking around fund. Too often lenders found that they could negotiated the deal, they didn't have enough earnest money up front and now after the project comes out of the ground, looks good, leases up and so forth, another lender comes along and says, "Gee, you're really paying too much interest on that deal given the risk factor and so forth, I'll be happy to make the deal at 8 3/4%." So the developer figures out, "Gee, what's the difference in the interest rate between the deal I already got a letter of commitment on, and what this fellow is going to do for me?" And he decides - you know the present value difference, let's say, is $500,000 and I only have $50,000 down as a commitment fee, therefore I'll take a walk and leave my $50,000 behind and I will take the better deal now that the project has materialized and the risk factors are much more objectively measured. Well, the lender is saying to himself, "Uh ahh I went through all this deal, I've programmed my cash flows and committed to this project and turned down other things I could have done with the money. You are not about to go walkin' around." And so in this case you've got a 5% front end load on it. And, hence, they're also saying that's not liquidated damages, that's just the beginning. We shall go forward under specific performance. Now they recognize that developers don't have $500,000 just lying around in cash and so they said, "All right the sum of $104,000 must be in cash. The remaining $416,000 may be in cash or an unconditional, irrevocable letter of credit by a bank and in a form satisfactory to us and expiration not earlier than May 31st, 1984. The letter must be payable on presentation with no accompanying documentation with payment only by wire transfer to a bank account subjugated by Union Mutual. In other words, bang! they make the call and the cash is there. That presumes, of course, that our heroes, Jones and Smith, in this case have apparently resources on deposit at the bank that issues the letter of credit so that the bank knows how it's going to offset and recover its advance under this particular call. Release (?) the money, continues to be at work as it were for the developer. The Union Mutual acknowledges receipt of the check for $104,000 and a letter which represents 100% of the commitment fee as well as a check for $2500 which represents the deposit to the inspecting architect. Notice there's a little deposit there.

Deferring option. Disbursement of funds at the control and governing may be at the sole option may be deferred until . . . We talked about that before. The end of such deferment. The company reserves the right to disburse the funds and close this loan at any time during the deferment period upon 30 days notice. Notice the borrower doesn't have the same right. The borrower is ready to close within the 4th quarter of '83 and Union Mutual elects to exercise its deferment option, the fee which would bring Union Mutual's overall yield to 12 3/8% is specified. The interest rate paragraph will not be applicable. How generous. In other words, our fund got to be otherwise occupied more profitably for another quarter and therefore we won't charge you for being late since we didn't want to close. Notice there have obviously been other negotiations taking place here. So the last paragraph extinguishes the other possible meetings of the mind which may have occurred or ambiguities which might in the future come into court and confuse what was the intent of the parties and so on. So this last one kills all that. It says: this letter supersedes and replaces our letter of July 1. Said letter and your letter of July 12th are hereby declared null and void and have no further force or effect. So, obviously, there was an initial offer that got rejected. A counter offer came in July 12th. As a result of that, this letter is now going out and they are extinguishing all of those other elements so that do not become a confusion at a later time. Please indicate your acceptance of the above by signing and dating the enclosed copy and returning it to us not later than August 26, 1983. At this time this commitment will be considered firm. After you've put $500,000 into it, it oughtta be firm. If the letter has not been received by that date, we have no further obligation to you hereunder. How's that for a silly closing statement to what is supposed to be a long-term working relationship. So, what you've got here is a classic hard-nosed letter at a time when everything was on the side of the lender. Money was in short supply and they're really stickin' it to the developer. The developer can decide, "What I really want to do is build it now, this is the best deal I can get, or wait and give them just a little warmer good-bye."

Now, the letter of commitment ultimately hammered out, then becomes the business plan for this 90 days' interim in which all of the documents and the necessary data has to be assembled in order to go forward with the closing. One of the things that's really hilarious about the convention center project is that they're going to negotiate the general principals with a grin. There is no way Mullens can get a loan commitment in 90 days on a program that 1) hasn't been designed, 2) hasn't been costed, 3) there's no agreement in place with the city. They're proceeding to build or presumably to get a commitment on the hotel before the city has decided what kind of convention center is going to be built. And now think about this. You've got one of the two major hotel feasibility firms having issued a major report at the behest of the city, mind you, that said 1) there isn't adequate hotel demand for another hotel and 2) the convention center on the south side won't work, it should be on the north side. The south side is by far the worst of the three alternatives and perhaps the worst alternative you can consider. Now Mr. Wild at the Concourse Hotel says, "Gee, let's get a second opinion." This other major hotel feasibility study is a rook - is Laventhal & Horwath. So he said, "I think I'll employ just out of the goodness of my heart. They can do their own independent study and let's see what they include." Now, here's Mr. Mullens deciding to go to a life insurance company or some other major financial institution who is a fiduciary and trustee of funds, and they have brought this at their disposal the two major hotel feasibility firms in the country and that they both concur that a) there's no demand and b) the South side's the wrong place to be. How could a board of trustees with fiduciary responsibility every make the deal? They can't because if the loan went into default just one day, the policyholder could sue the hell out of 'em for saying, "Hey, guys, what were you smokin' on?" Here's the two national experts which all life insurance companies require issue a positive feasibility study, before you can get the loan, that says this is a bad idea you know for multiple reasons. Any way where is Mullens going to get the loan from? Come on guys. Are you going to sign personally on it? Did you ever get a bank to sign personally, here, sign here. You gotta wonder and say to yourself, " Hey, what did we just agree to last night?" The city doesn't know what it's going to use for money. Two of the alder persons said, "I haven't been able to find anybody in my constituency that's in support of this idea. The mayor, of course, says now that we have a positive feeling about this, we don't need a rubber rent note. Come on. Jerry Mullins is great cuz he dragged this thing right into the ground. There never will be a convention center which is exactly what he wanted in the first place. Who is going to give him a letter of commitment like this on a building that hasn't been designed on a site with in which we're not quite sure what the city's going to do. And, in fact, I think the resolution said that Mr. Mullins and Barber can go forward planning their hotel while the city independently goes forward to decide if they want to build a convention center or not. Just, you know, fantasia. Incredible. But, oh well.

The (?) has moved off (?). (laughter) And the canopy of our time is the editorial page in the Cap Times in the State Journal. "Intellectual lack of wit." OK.

OK. Now. Documentation. The lawyers move forward from the letter of commitment moving through that checklist for closing and as you'll see all of the documentation must be in reasonably good form in time for the closing. Assuming the letter of commitment is accepted, the first swath is starting to tick on the developer. If he gets himself into trouble, let's say, clearing the title, or gets into difficulty with the community getting the building permit, and the other entitlements, variances, easements etc. that may be required, or the city is expected to do something in the way of providing infrastructure and getting that installed and so forth in time for the note, he can't close. And he can blow his financing. As a result, if this is tight financing, it's tough to get and he has to save this commitment and Union Mutual is going to continue to deal with him with all the warmth and trust that they gave him in this letter, he's going to have to really throw money at the problems as they come in front of him in order to solve all of those problems and have the appropriate documentation for the closing. Time is the great dictator to the developer. And it begins with this letter of commitment. Obviously the more things he can have under control beforehand, the better. But the more things he has under control before he has the letter of commitment, the more sunk costs he has before he knows that he can finance it. So he has an interesting tradeoff to make in terms of how far can I go forward in let's say, closing on my land and making sure I can get the title. Or do I keep the option and hope that me and the owner can close on the land in time that I can provide the necessary title insurance and so forth at the closing. How far do I have to go forward by moving my plans from the schematic stage with a working design stage or have completed my bidding so that I can prevent a very tight set of specifications, because if I have a relatively loose set of specifications, everything is going to be a change order and the change order process in here is pretty clumsy, I don't have any discretion at all. I got to prove everything. So he has a very interesting tight rope to walk between the sequence with which he provides for each of the elements and does he do that before the commitment letter or after the commitment letter. And how much money does he spend solving those problems so that he can meet the deadline established by his commitment letter. And by the same token, the lender has a rather interesting problem. If the whole concept is relatively schematic and vague; how does he write a commitment letter that really ties it down unless he creates all kinds of windows by which he can escape, because as the project evolves either because of the political process or time process it's either, from the lender's standpoint, not an attractive marketable project or the economics has been gutted by the community that says, "Gee, we're not going to let you build 12 floors, we're only going to build 6 floors because 6 floors is more suitable to the ambiance we're trying to create in our commercial area, etc. and we're not going to let you have a parking ramp, because we think people outta ride buses and now is the lender locked into the deal?" So how are you going to write the letter of commitment if those factors haven't been already determined. Obviously, you're going to write it in a very broad, lots of escape clauses and so forth, and then do you really have a letter of commitment or do you simply have a letter of intent? A letter of intent, nominally, is not binding on anybody. It's simply an agreement to agree in the future as more facts become known. And it may impose on each of the parties, certain duties that they have to go through. The lender may want to go through due diligence and handle all the problems in the deal and so forth. The borrower may have certain things to complete first such as get the zoning that's required, get the permits that may be required to move forward and so on, and when those things are in place, then we'll get together and draw up a commitment letter. In most parts of the country a letter of intent is technically not enforceable but either party that backs out for reasons that would be determined as not in good faith. And not in good faith means, "Gee, somebody offered me more money so Phooey on you," is responsible for the damages to the other party in terms of their out-of-pocket expense and time lost and so forth. There are now a few cases that indicate the letter of intent may also permit them to sue for specific performance or sue for consequential damages as a result. So at some point this letter of commitment is not so much an agreement as it is a letter of intent with agreement to agree when certain conditions have been satisfied that would permit them to go forward to the closing. OK. Critical Document - lots of time spent on its negotiation and obviously ultimately becomes a dictator to the developer to the point of the closing of the loan.

????000 . . . positive patterns for a real estate club interest adventure (?) kind of thing and trying to get some sense of what you might prefer, if any of those sketched on the broad, indicate your preference and leave the paper at the front of the room as you leave or on the back credenza as you leave for marketing research. Secondly, the Wisconsin realtors would like to give away $500 and they elect to give away two $500 scholarships, one to an undergrad, one to a graduate student. The rules of the game are 1) you must be a resident of Wisconsin and 2) a real estate major. And what they would like you to do is submit 2 undergraduate names, addresses and telephone numbers to them and I will select the two with the highest grade points of those that give me that information. The same would be true for the two graduate students. I need your name, address and phone number and where they can find you in Madison and where you call home in Wisconsin. They will pick one of each of those pair of individuals. So it’s sort of Russian roulette, you know. If you have a lousy grade point and you’re only one of two people that submit their names so throw your name in the pot anyway and then the Wisconsin realtors would like you to come out to their headquarters which is on the far east side and interview with their foundation board briefly and they will pick one of 2 undergrads and 1 of 2 graduate students for a $500 scholarship. I need those by Wednesday at this time.

The second element is that the real estate club is preparing a collection of resumes for distribution to the alumni while they're in town in October and if you are interested in 1) either a full time job - they're coming out with a program in the near future or if you're interest in an internship, please give us a resume so that we can include that in the packet. If you want an example of a 1-page resume, I have a whole carton of Wharton resumes - 1-pagers that you can use as a format if you wish. It seems that the committee on that wants those by October 14th - is that correct? And the 2 packets for internships and full-time jobs will be included in the packet for each alumnus attending the alumni reunion. We only have 900 alumni and 308 have already signed up. So that's pretty good market penetration as it were. OK.

Just an item on hazardous waste liability for lenders. As you know there's a federal statute known as CERCLA standing for Comprehensive Environmental Response Compensation and Liability Act - otherwise known as the Super Fund Act. And essentially any parties involved in ownership or cleanup of a site with some sort of hazardous waste material can be liable for the total cost - deep pocket theory. There's one interesting exception however. It says that it does not include - liability does not cover a person who without participating in the management of the facility holds an interest upon ownership primarily to protect the security interests of the facility - i.e. a banker with a mortgage. Recently there's been an interesting case which has had to apply that rule involving a paint company that went bankrupt. And paint manufacturing, of course, having a significant number of types of chemical based problems. And there were two banks involved in the bankruptcy. One bank involved was foreclosing on the plant itself and the bank was determined by, the courts, entirely outside circle liability and had taken steps to protect its interest in the property by foreclosing. It did not participate in the business operation of the site. It had secured the building against vandalism, inquired about the approximate cost of disposal of various dumps located on the property and made visits to the property to show it to prospective buyers. All of these actions occurred several months after the plant operations had ceased. Another bank involved in the same case argued that its involvement had been limited to actions taken to protect its security interests. But after the bankruptcy filings before the closing of the bank, the second bank had frequently visited the site. Provided day-to-day supervision of the plant by a bank employee, reassigned personnel, ordered manufacturing changes and therefore the second bank was liable for cleanup of the site. The Super Funds statute also created another possible limited protection for lenders - the so-called innocent purchaser defense. The provision protects owners who made all appropriate inquiries of the previous ownership and used it as proof they had no reason to know of hazardous waste conditions to be exempt from liability. It's unclear however this protection will extend to lenders who do not know of a hazardous waste condition at the time of the loan or learn of it prior to foreclosure since the inquiry must be made at the time of acquisition. It is not clear when if you acquire the property - when you made the loan and received the lien assignment and if you're in a title theory state, obviously you'll acquire it at the time that you make loan at the time it was transferred to you subject to defeasance clause. In a lien theory state why you really haven't acquired anything other than the right to try to acquire it in a court later. So lenders are beginning to face more and more exposure to operating liability should they take over a property in foreclosure. OK.

We want to talk about leases today and perhaps Wednesday. The quality of income for commercial property ultimately is dependent upon the character and craftsmanship with which the leases have been negotiated. There is always obviously a tension between the strategy of the lender who would like nothing more than triple-A credit leases for a term at least as long as the mortgage and the developer who, obviously, would like to fill his building with whomever is available, not always sensitive to credit qualities. And because he hopes there will be inflation and he could roll that lease at a higher rent in the future, he would rather have shorter term leases. So we've seen a complete change in Madison from a time in which a premier property had a 20-year lease term or 25-year lease term or a 25-year mortgage to a point during a rapidly rising inflationary phase of the late 70's, early 80's where they wanted 3-year office leases where they could frequently roll the lease at higher rents and, of course, take advantage of that market, suddenly realizing that once it's overbuilt, the 3-year lease means that your tenant can move or bargain rather harshly with the landlord to stay there and so it probably would be more desirable to have a significant percentage of your leases on at least a 10-year term so that your break-even point is covered and then some of the other leases on a shorter term, partly to give you some up-side potential if the market moves up, partly to allow you to move that tenant out, particularly in a shopping center where they don't do a good retailing job or they aren't compatible with the mix of shops and so forth that you would like to achieve or because you promised the guy next door that he could expand in three years and you would rather have a larger tenant expanding than a smaller tenant who's paying more rent. In any event, the quality of income is going to be very directly reflected by the quality of the tenant, to his ability to pay and, of course, what he contributes to the overall image of the project. But a good deal of the quality depends really on the nature of the lease which you have negotiated with that tenant. And because virtually every income property today - the landlord, the tenant and the permanent lender are really a three-way negotiating process. You have to have some sense of the minimum that the lender will accept. And some sense of what good risk management would require in the loan. And as a way of a very basic synopsis as to what the lender looks for in a loan, we have this little two-page handout that you should have received. The first thing the lender is concerned with is what specific spaces are, in fact, leaseable or rentable in the property and where is their location in the property? The price schedule then for those spaces may be indicative of how aggressive the developer may be or the vulnerability of that particular project because there are certain spaces which are not particularly desirable and which either because of view or lack of same or because they're not immediately adjacent to pedestrian traffic, and so forth, might not be desirable. So you really need to define what are the various spaces that we have to rent, where are they located in the project and how do we propose to price those spaces?

The second element, of course, is defining what is rentable space. The tenant ultimately is interested in that space which he can carpet - that's the useable area. The space taken up by the columns and the projections into rooms of heating systems and thickness of the walls and so forth are really of no great usefulness to the tenant. He's interested in the effective cost of what he can carpet and what he can utilize.

The second element that we talk about is demised space. Demised space has different rules in different communities but, essentially, it's from the inside of the outside wall to the outside of the corridor wall and from midway from one side wall to the midpoint of the next side wall. That is space that is enclosed and presumably available exclusively for that tenant. Demised space. The corridor wall and the two side walls being the demising walls. But that may not be the leaseable space or the rentable space. More and more today it is customary today to then assign an additional amount of space as a loading to represent the pro rata share of common space that will be part of the responsibility of the tenant. So you might have a 10% load. You're renting 2,000 square feet of space in terms of the demising area that may have 1,800 square feet of carpeted space that's useable but they're going to pay rent on the basis of 2,200 square feet because of a 10% load for their share of corridors and public wash rooms and lobbies and whatever else may be defined common area. In a multiple tenant building it is very seldom possible for all of the tenants to compare notes and therefore it's quite possible that the total leaseable area will exceed the gross building area of the building. Landlords tend to be a little sloppy on their accounting, generally in their favor. Therefore, if you take GLA, gross leaseable area, that on which the tenants are paying rent and divide it by gross building area, in many many markets you will find it to be 102% of the actual enclosed space of the building. And the amount of actual useable space, carpeted, as it were, for the tenant may be only 85% or 87% of the amount of space that he's paying rent for. And that will, of course, be a function of how modern the building is and whether columns intruding into the area, structural elements and so forth and so on. So the lender wants to know. What's the specific space we have to rent and how is it dimensioned? How did we arrive at that amount of leaseable area? And without knowledge of that we don't know how efficient the building is, we don't know what our potential revenue is and so forth.

The second thing the lender needs to know is, who is specifically going to be the lessor, the landlord? It's not unusual for the developer to be one entity and then lease the building area on a master lease to a second entity. They lease the entire gross building area and then proceed to retail what they've rented wholesale. The question is what kind of assets and resources does this intervening group have? For example, when Treasure Island was in its hay day, which was a subsidiary of Penney's, it appeared to be, obviously, very well financed as a subsidiary of Penney's. What they did was they set up one Treasure Island of Wisconsin Inc. and the only assets of Treasure Island of Wisconsin, Inc. was the lease on the building which was built to suit and leased to them on a long-term basis. All the merchandise in the store was on consignment from the parent corporation. They dealt with a zero checkbook balance and borrowed what they needed daily from the Penney's company to cover the deficit. As a result, they had no assets other than the lease. The fact that it was a subsidiary of Penney's didn't mean anything because unless you've got Penney's guarantee there were no assets, no resources behind that lessee of the building. And lessors can set up the same way. The parent corporation sets up a subsidiary. The subsidiary master leases the space and has a limited number of dollars of resources with which to guarantee their commitments. In effect, a non-recourse borrower if they happen to be the borrower on the project. You need to know who that is and not only are you concerned with their credit, you're concerned with their character. There's too much money in this country floating around from those funny no-necked Italian fellows that are looking for a way in which to launder their proceeds. And a major life insurance company that suddenly finds themselves lending to folks from the Mafia, and so forth, have a real public relations problem if that comes to the surface. Most of the major lenders have a former CIA or FBI individual who do nothing but research those kinds of things where they think it's important and necessary to do that. But they have to be very, very careful as to who it is they're doing business with, not because they won't get paid necessarily, but simply because they have learned in the past that from self-righteous standpoint it's not a good thing and also, sometimes from a negotiation standpoint it's not a good thing. I remember Don Evans when he was working at American Appraisal Company they were called into Saint Louis on a major industrial warehouse that was leased by a defense contractor and they did an appraisal of the warehouse which was in the pension fund of a very large national union and it was under a relatively, at that point, unfavorable contract rent. But they were stunned to find out that the appraised value was less than what they paid for it. So they asked why and the American Appraisal Company explained to them that the rent was too low. Oh, they said if that's the only problem, we can correct that, and they did. They let it be known to their tenant that the rent would have to be adjusted on their 20-year, now 3-year old lease, and it was readjusted. And as a result, they could come in and reappraise the property to the desired number. And so as a result you don't really want to be in business with folks that have an unfair bargaining advantage. What I'm saying is you want to know who the tenant is. Who is the real lessee for the space and do they have any resources? Not only do they have any resources, but are they compatible with the other tenants who are in the building? Classic case, Mr. Rubloff from the Chicago mortgage banking firm, would tell on himself about a property down in LaSalle Peru, Indiana as he pointed out which had as its economic base, Westclox Company and high jacking on Interstate 70. In that case they built a shopping center between LaSalle Peru and the one space it was leased to the Murphy store chain as an anchor from which there was a clause stating that there could be no other discount stores in the center and the other was leased to J.C. Penney and Co. who had a clause in their lease that they could assign it to any of their subsidiaries, which they did, Treasure Island. Murphy's took umbrage at that, saying that was a discount house and violated their lease and stopped paying their rent. So as a result you need to know you can't have it just floating out there, that anybody can be the tenant because that may conflict significantly with who the other tenants in the property may be or what they have contracted for. So you need to know who's the specific entity that ultimately is going to be the lessee and what are the resources of that entity in terms of their ability to pay the rent and meet the obligations under the lease.

The next thing you need is a very specific description of what real estate elements are to be leased. First of all what shell is going to be provided by the landlord? What finishes are going to be provided by the landlord and the tenant? And what services are going to be provided by the landlord? Not only what but when? You've seen office leases, for example in the major cities - they'll point out the heating and air conditioning is on from 7am in the morning to 7pm in the evening and it may or may not be on on Saturday morning and if you want it on Saturday morning there's an extra charge for that - simply as a way to control their energy costs and so forth. When do the elevators run? Most modern office buildings are very specific as to what hours of the day the elevators are available, otherwise you have to call the security guard and he'll come up and retrieve you when he gets damn good and ready and so forth. And those are all part of the very specific description of what you get for your money - which space, which finishes, which services. Obviously, a very significant element in the control of the operating costs of the property which, in turn, mean, obviously of the control of break-even point and recovery ratio and so on.

And then finally you want to know what specific exemptions from the improvements provided by the tenant remain the property of the tenant and can be taken with them when they go. We've been doing a small specialty shopping center in which locals are coming in and bringing a candle shop or a music shop and so forth. It's fairly customary to require those new tenants to virtually completely outfit their little store all by themselves. And if mama is just setting up her first venture now that the kids are at school and she's going back to work and so forth, the objective of both the lender and the developer is to get that family to sink as much money into tenant improvements as possible because that, in effect becomes the security for that lease. That lady will continue to run that little specialty shop even if she's only making a buck and a half an hour because she isn't going to take a walk on $15,000 of family savings that they put into that store. And it's really important to have that lease read that all of those tenant improvements go to the landlord so that if they walk and close the door, they just left that all behind. On the other hand, if we're talking about a regional shopping center, the more we can say belongs to the tenant, the more confused the local tax assessor's going to be. And if there's disbursal fee and there's no personal property tax, the better off we are in defining his personality available to the tenant. And he can remark (?) as to what his removable as a tenant. There's probably not a chance in hell that the tenant is going to take it with him when he goes, but at least the lease will read to the effect that they could do so that they have the argument of this is personal property, this is tenant property and if you're going to collect taxes on it, go see the tenant, it's not my problem etc. etc. etc. So the lender needs to know that.

OK, once we're done with the definitions as to what really the tenant thinks he got for his money. The first thing the lender needs to know is when does the lease begin? - seems like an innocent question. First of all, what conditions would allow the landlord to cancel? One, he may have the right to cancel if he doesn't get specified financing prior to construction. Or, two, if the developer died or is disabled before a certain date of a certain percentage of completion. A development is largely an exercise in personal skills. And if your relatively small developer is willing to carry on and execute the project all bets are off if something happens to you or you're disabled and so forth. Or what if there's impossibility of performance either because of acts of God or labor conditions or government regulation or whatever - any one of those might permit the landlord to cancel the lease, even though it's hard to without (?). More serious, of course, as far as the lender is concerned is what conditions would permit the tenant to cancel? First, the tenant, if he's wise, and we're talking about a new project, is going to require that it be completed and meet certain performance specifications. Most typically it's going to be the ability to hold a certain temperature, a certain humidity relative to the out-of-doors and if the heating system doesn't work or the air conditioning system doesn't work at the option of the tenant, he can take a walk on the project. Maybe there's other things that he has specified have to be present in the project, such as another tenant. The drug store will say, "Fine, you got a lease with me, unless the grocery store closes for no reason, in which case I'm back to a month-to-month and I can terminate any time that I want. So he can create conditions subsequent that, in fact, convert what might have appeared to be a 10 or 15 year or 20 year lease essentially into a short term month-to-month at his option depending on whether he perceives his marketing program has been adversely affected.

The second would be according to scheduled time period. Penney's says, "Fine, I'm going to move in in August, I'm going to take possession of the building in August. In August, I'm going to finish putting in my tenant improvements, and so forth. I'm going to start training my sales force and employing my people in September so that I'm in position in October to take advantage of the Christmas buying season. If I can't move in on August 15th, forget it, I won't move in until the following August 15th." Bingo, they've had it. Obviously there's all kinds of rents you're not going to collect if you don't meet that time period. And quite often the developer is going to have to pass that on to his contractor and say to the contractor, "OK in the penalty clause if their building isn't ready for occupancy by August 15th, that's going to cost you X dollars against your construction contract for your failure to meet that schedule." In other words, he lays off the risk for that Penneys postpones occupancy against his contract to developer. Are there any other conditions relative to other occupancy? The tenant may require that at this medical office building that there be no acupuncture, Christian Science Reading parlors, and Hindu medicine men in the property and that if they do, at his option he's going to terminate in 30 days' notice. Just like the Murphy's vs. Penney's kind of thing. Assuming the tenant were to cancel, the lender's interested in what are the remedies to the landlord. Has the tenant broken anything in terms of tenant deposits or escrow funds? Is there some kind of liquidated damage provisions whereby the landlord at least gets some money as a result of that. Are there other guarantees on the lease that might perhaps provide damages - other penalty rents or assessments and so forth on the tenant that is leaving? And, finally, what are the remedies of the tenant. Assuming that you don't meet whatever conditions were in the initial lease. Does that simply mean that we postpone the commencement date as in the case of Penney's? Or does that mean they can move in with a rental abatement because the other tenants are not presently in the center. Let's say you're a little merchant and you said, "Fine, I'll pay $12 a square foot to be alongside the Gimbals, Marshall Fields and whomever, but if they're not in when I move in, I only pay $3 a square foot until such time as those major tenants have moved in the space." That would be a rental abatement pending completion of these other factors. Can a lease be terminated at the option of the tenant? Are there penalty payments which can be assessed? For example, let's assume an office building where you promised that they could occupy on such-and-such a date - now you're two months late and he has to stay in his current office location for an additional two months and they have an overstay provision which says if you overstay the term of your lease, you'll pay 200% per month of what you were paying under the lease just prior to that point in time. That an expensive stay for that tenant. If he's wise you're going to have laid off that risk on the developer and the new landlord that says, "OK, if I've overstayed, you pay." How many dollars is that going to cost the new borrower/landlord? How's that going to affect his budget and will that effect his ability to repay the loan on schedule? Maybe the tenant will have no remedies left whatsoever? He has no where to go but that's it, no liquidated damages. Obviously, depending on the negotiation skill of the landlord borrower and the market demand for the property, those terms are going to be more or less onerous and more or less broad in terms of how they can terminate. Once the tenant has moved in and the building has been certified for occupancy, the lender wants to know what conditions would allow him to terminate then? The fact that it says this is a ten year lease on the front page doesn't mean anything until you read the rest of the lease. First of all, given the tendency, the trend toward personal service, professional kinds of organizations today, the smaller the tenant, virtually everyone has a clause that says that the death or disability of any one of the partners in the firm, the firm has the option of either going forward with the lease or terminating it and having to provide let's say notice within 60 days of their demise or disability as to what their intent is going to be. Give the estate time to decide, "Gee, this little insurance agency - if I sell the insurance agency, use somebody else. Do they just want to buy the book of business or do they want the location that comes with it, because people identify with that and that gives momentum to the renewals and so forth and so on. The estate has to have time. It's a very significant part of estate planning or the individual within a professional service kind of industry. So, the fact that you've signed a 20 year lease for it, isn't any better than his mortality and morbidity rate and, again, the estate generally is in control as to whether they sell the business with or without the location. And, of course, if the space is very favorably rented, it's at a contract rent, let's say, that's at $5 a square foot and the market rate is $10 a square foot, one of the assets of the estate would be to sublease and pick up the spread between the contract rent and the market rent on the space. Second of all is what's called the "changing conditions" clause. Most leases have some kind of feature of that sort. Some of them are very broadly worded. For example, General Motors Acceptance Corporation might have something to the effect that if their total dollar volume of business in a defined trade area fell by more than 20%, that they would have the privilege of consolidating their offices and give 60 days' notice or 90 days' notice that they were going to close this office or that there was a computer company in sales of the XYZ model that this office happened to be marketing and servicing the quantity on a certain point, again, they could consolidate and close this office. Sometimes the change in condition clause is very broadly and vaguely worded simply because either the landlord wasn't very sophisticated or because the tenant was very sophisticated. The changing conditions clause always has to be read with the penalty in the event you terminate the clause. Item D: cancellation of liquidated damages. If you're a major corporation and you're coming into the market and you're going to rent 10,000 square feet in this little 30,000 square foot building, you're doing that landlord a big favor and, as a result, if you sign a 10-year lease, you'll probably get a discount. The retail rate on the space might be $12 a square foot triple net and they'll give it to you for $10 so that 1) they have a class A credit on the lease roll that looks good and 2) you're going to go for 10 years, so that looks good and of course tenant improvements are amortized over a reasonable period of time and so forth. So that's not loss on the major tenant comes in he'll say, "Gee, if I promise 10 years and I save $2 a square foot every year on 10,000 square feet, that's $20,000 I would save over the life of the lease, I would save $200,000 over that by signing a 10 year lease instead of a three year lease." So then he says, "All right, I'll tell you what I'll do. I'll give you the 10 year lease at $10 a square foot, but my liquidated damages formula is such that I only pay, let's say, $35,000 to terminate any time after the second year. In effect, it's cheaper for them to sign a long-term lease and pay $35,000 to get out of it because even at the end of, you know, 2 years they will have saved $40,000. And so you do have to look at the contract in its entirety. You know, what rights do they have to cancel? What penalties do they pay? How does that relate to the discount that you gave them for signing a long-term lease versus let's say a three year lease. And good negotiators know what the trade-offs are. Many shopping centers carry what are called guaranteed occupancy and operation clauses. What it really says is that if you have a department store there, that they're going to guarantee that the life of the lease, that 1) it will be fully occupied, fully stocked and that you will operate it according to the time tables established by the merchant's association, and so on. Helpren tells us that those are not enforceable. You can not force somebody to be in business if they don't want to be in business and yet you see those all of the time, certainly a major harassment but somewhat limited in enforceability.

Generally there's a bankruptcy clause. In the old days if the business filed bankruptcy, the landlord had the right to evict them immediately. Under the new bankruptcy laws as you know, that's not possible. The location is regarded as one of the assets to be marshaled and reviewed by the bankruptcy judge and that the only thing that changes is that once bankruptcy is declared, the landlord has preferential claim on the assets of the bankrupt for the rent that is due during that period following the bankruptcy and before a decision is made as to whether to retain the space or not. So the bankruptcy laws have definitely tied the hands of the landlord.

The assignability clause is a real stickler. Some landlord simply will not permit a lease to be assigned if you're going to bow out, you will negotiate a payment to cancel but he will not permit you to assign the space to anybody else because he wants to pick up whatever is expected to be the increment in the rent, because the market has been moving upward and he wants to be able to capture that increase in his asset value. In other cases he fears that he will lose control of the ambiance that he's trying to create, let's say in constructing a shopping center or a medical office building or some other prestige sensitive kind of real estate and so forth. And it's pretty much generic space they're talking a language to the effect that while you have to approve the assignment by the tenant to another tenant, it can not be unreasonably withheld. And what's reasonable or unreasonable is obviously a messy piece of common law, but in any event, it may be fairly broadly stated. And the landlord comes from the lender's standpoint, even though he's happy to know it's assignable, assuming there's no decline in the credit quality of the tenant so that's there's continuity of the rent. He's really not interested in speculating on the up side because as a lender typically he's not going to participate in that anyway and he wants some kind of continuity of cash flow over which to make the regular payments. The landlord, on the other hand, may want to be able to speculate on the up side and play hard nosed about permitting an assignment of the lease.

Another element, of course, is to what degree the lease depends on what we'll call overage rents or percentage leases. In the old days these were a very significant source of revenue for the shopping center. In more recent times we are beginning to see some move away from that, simply because of the difficulty of administering it and the friction that's involved in it. But there is a feature which is called implied good faith. And if you get a percentage lease in there, the tenant is obliged to work his little heart out to create some overage or percentage rents. He can't open another pizza shop across the street and refer all telephone calls to the cheap space across the street where he doesn't have to pay the percentage rent. The landlord could sue him for that and pick up the difference.

Permitted use clauses. Permitted use clauses at one time got to be fairly constrained. This is probably not in the best interests of the lender although it may be in the best interests of the borrower. For example, University Square Shopping Center. Because the primary developer of that was Mr. McCormick that owned Parson's (pizza restaurant) he was very very firm about what other kinds of food stores could be there and one of them was pizza and Italian. Therefore, even though a number of other pizza chains wanted to locate in University Square, they couldn't was because one of the reasons that crummy little building was built on the kitty corner side so that Godfather's pizza could get into the market because they were not permitted by the nature of the leases to be in the University Square. By the same token, the little Mexican shop there was a hot dog shop beforehand, very carefully defined food items that each of those food stores could sell and therefore very, very difficult to replace the tenant if it goes out. That's probably not in the best interest of the lender who would like to maintain a continuity of base rent payment. It may be in the interest of the developer/operator who feels that he can get a higher percentage rent because of the lucidity of a particular food line or a particular merchandise line and so on. Ultimately it is a real spinning match, it's a real source of irritation and tenant discontent. Let's say that you have a Walgreen's as happened in the West Towne. In Middleton Walgreen's gets ready to expand it's line of sundries, goes out of the restaurant business and now starts to encroach on the Ben Franklin line. There was no clear definition of merchandise as between those two stores since (?) the Ben Franklin (?) began to lose out. How do you decide when, you know, Walgreen's and the local food store are encroaching on each other's sales in a particular line of food and so on. And in many cases shopping centers had an attitude for a long time of very carefully controlling the line and price ranges that various merchants within their organization could market so that they could get a better spread of sales and would get higher overage rent from those that were successful. Preventive usage gets to be a very tough sticky situation. And lenders, by in large, don't like them. Another good example is Park Regent Medical Building down on the corner of Park and Regent. When that was built the developers thought it would be clever to put a deed restriction that it could only be used for medical purposes or medically related tenants and that would make it more exclusive. Well, it didn't work very well and what's worse is with the changing medical economics that there are fewer types of tenants that can go into that building. You're not getting individual doctors any more and so forth. They tend to be grouped by clinics, they tend to group my HMO's and they have a floor at least or maybe two floors of individual doctors who, when they decide to retire, there are no more of those kinds of folks around to replace them. And they are locked in but they have a very difficult marketing situation of finding tenants to replace those spaces that are medically related. And as a result it hurts the resale price of the property as people begin to look at it and say, "Gee, given the changing medical economics and so forth, I don't really think I want to get into a building into which I'm locked into the leasing to the medical tenants of which there are fewer and fewer and I don't have the right to fill up the space up with somebody else if they're perfectly willing to pay the right price." So permitted use clauses are fairly redundant regarded as threatening to the lender.

Casualty loss events. If nothing is said in the lease about casualty losses under most state laws, either party has the right to cancel. That's not good news to the lender. Obviously, he would much rather have something that requires the tenant to stay in the building for a certain number of months assuming it can be repaired and so forth. It might be an abatement clause that says during that time rents would be reduced or non-existent while the building was being repaired, depending on what percentage of use the tenant had and so on. And then you would have to buy rental insurance to cover the difference between the abatement and the market rent in order to keep making payments on the loan. If there's a definition of total construction loss, then perhaps the tenant has the right to move out. It gets very messy. For example out near the Raddison Inn out on Mineral Point Road there's an office building on the corner and E.F. Hutton is one of the tenants and I forget what the other one is. The one tenant had a clause that required them to come back if the building was rebuilt within 12 months. The other one had nothing said as a result of good negotiation on the tenant's part and as a result when the building burned down they were able to pick up and move to a superior alternative in the Mineral Point area. E.F. Hutton had to move out, set up his business in another shop and when it was rebuilt on schedule and so forth, then had to pick up and move back at their own expense and that can be obviously now an inconvenience to your customer base but fairly expensive when you consider the cost of moving, changing telephones, new letterhead etc., etc., etc.

Condemnation events. The lender, of course is always concerned that something is going to happen in the public domain which will extinguish the value of the property. Let's say that the property is an office building that depends on an office parking ratio of 4 cars per thousand and now they widen the intersection and put a new lane on the road and the building is left with 2 cars per thousand adversely, obviously, affecting its ability to 1) market to new tenants and it may very well be that several of the major tenants had a feature in their lease that said that if their parking ratio was ever less than 4 to 1 they had the right to terminate on 30 days' notice. Obviously the security value of the building is decimated. And there is very little that the landlord can do about correcting for the deficiency. Now he will collect the difference in the value of the building before the taking and after the taking under the eminent domain award but now who gets the money? The lender, is the loan reduced by that amount? The share pro rata as the loan is to the full market value or does some of it get shared with the tenant under what set of rules and so on? Condemnation events have to be anticipated and the lender has to be very careful he understands. For example, in Seattle we appraised property a number of years ago what is now the new Westgate project and the land was owned by Sea First Bank who was our client and it had in some time in the past been leased to somebody who built the building to operate their own retail store and some time after they had built it and leased it, they subleased the building to another tenant who then did some remodeling and went on to run his own store. And now along comes the eminent domain act. Well, in both cases, both of the tenants still had loans outstanding, one that built the building on the leased land, the other one to remodel the building to fit their operations. And when we came in to appraise the project - let's say this total project was worth $500,000 - when we read the leases we discovered that the tenant who now occupied the building, who still owed about $50,000 on his leasehold improvements, had a clause in his lease that said that he would recover 10% of his leasehold improvements during the first 10 years of his occupancy if there was a condemnation award. This was the 12th year of his occupancy. As a result he got zilch. He still owed money on it, but under the terms he had nothin. The guy that owned the building was to get compensation based on the basis of 4% per year for the first 25 years of his occupancy. This was the 27th year of his occupancy. He got zilch. All $500,000 went to the land. Neither of the mortgage lenders had read the lease in terms of condemnation events and what, you know, they would be entitled to. Obviously, you want your loan to end before the occupant loses any right to the condemnation award.

Specific conditions that identify the grounds for condemnation so that any number of those types of things that could occur. Loss of franchise for example. If you have a car dealership - Ford yanks your dealership - you don't need the property any more so you have the right to terminate. If so, what's that gonna cost and so on.

And finally subordination position. Is the tenant going to be subordinate to the lender in which case if the lender forecloses, the tenant now has to negotiate with the lender for a new lease. Or is, in fact, the lender going to be subordinate to the tenant so the tenant will enjoy quiet enjoyment during the full term of his lease. And obviously the lenders want a good deal to say about that and that gets to be a sticky point in the negotiations between the landlord, tenant and the lender. Obviously, ultimately the lender is going to be really concerned with the rent formula. How constant is the quality of income? And to what degree is the potential variance between expenses and availability of income going to scrunch the availability of cash with which to make the regular payment on the loan. Obviously, first he needs to know the basic minimum rent. Second of all what adjustment is there going to be to that rent over time. One time we use the CPI index or similar kinds of things. That was favored by landlords when the CPI index was going up very quickly. Now that it hasn't gone very far very fast, they get impatient so typically they prefer an automatic bump. Every year it goes up 3% willy nilly or every 3 years it will go up 6% or something of that sort and be an automatic step increase and they would rather go for the sure thing than to rely on the CPI index which 1) gets changed by the government every time it makes the government look bad and 2) you know, doesn't necessarily move very quickly into something bad. If you're betting on deflation, it might go down instead of up. That would never do. So there's a gradual tendency to move away from a CPI type index. It's difficult to enforce and it doesn't always work to the advantage of the landlord in terms of how much he'd going to get, and the lender can't count on it either. We'll come back to the . . .

In terse statement, the investment committee which can make this loan, if so, on what terms. If not, why not and you've got to organize the subject matter by the terms of one property, what are the pros and cons, in terms of the property risks to the lender, etc.? Who are the people and is that good or bad and what does that do to the quality of the loan opportunity. And finally, what kind of package are you going to specify or require? Package obviously being loan terms and guarantees, theories, warranties, conditions, (?) things like that there. And you will do it with the terseness and harsh prose of a veteran Western Union telegram writer. Assume the investment committee does not care about your previous career as a fiction writer in the style of Thomas Thoreau. Use your words economically, efficiently and on the point. Question. Chief: We'll get into that.

I'd like to continue and pick up on leasing and more on lesson 2 of the handout from the previous lecture. And we're talking about the (?). Assuming the lender is now informed on what it is you're renting and what the base price is supposed to be and so forth and when it would be that the leases would commence and how it might be that those leases would be terminated prior to their stated term. Obviously the balance is concerned with the degree of stability and the liability of the income statement. And that begins with the basic rent. And lenders are getting smarter than they used to be. At one time they took the face rents of the contract at face value. And, of course, the owners spent a lot of time pretending that the contract rents were, in fact, what they were going to receive. So rather than cutting the rent, they would give you a trip to Europe which you when you signed the development lease or send a new Mercedes home to your garage or whatever. So far as the lender was concerned it would appear that the face rent was, in fact, the real rent. Now they realize of course that that's not so - that they're really concerned with what is the effective rent. So the fact that it says $12 a square foot is the basic minimum rent, ain't so if you're giving away 3 months' rent every year to get that tenant in for a 5-year lease. In effect, the effective rent is $9 a year. So you want to begin to look at that basic minimum rent, not in terms of just what it says on the contract page, but what is truly the effective rent in terms of dollars coming into the cash flow. They've had enough of this economic value based on the nominal contract stuff. They want to know hard dollars coming into the deal right up front. That basic minimum rent in terms of effective dollars as DeWitt stated very clearly, had to be a certain number. If you did better you got $11 a square foot instead of $10 a square foot, you got a better loan so there was certainly incentive to improve on that. And they had a little qualifier in there. They said it had to be with arms-length tenants. Many a developer has created tenants or taken partnerships from tenants in order to reach the occupancy clause in order to achieve the rental target necessary to close on its permanent loan. To do that today would be fraud. And you could go to jail for that if the commitment letter has stated clearly that that is the case. And you in your letter back have indicated that in terms of the tenant roster and so forth that you have that those are third party tenants. If you have any interest at all in any of the tenants because you're a limited partner in their business or a shareholder or in many cases, for example in the case of restaurants which are hard to finance and so forth, the developer often takes a position in providing working capital for expansion of that restaurant. That would have to be identified and probably that lease would then be discounted by the lender. Many lenders not only require a minimum effective rent from third party arms-length tenants, they would require two other constraints. One, that you achieve a certain percentage of occupancy by credit rating so that you had 40% of class A national credit, 40% regional credit and only 20% local credit and so forth. Which means, obviously, you may have to give a discount. If you have a hole in your building and you need IBM to come in as one of your tenants, and IBM knows that, they're going to nick you down from the $10 base you're trying to achieve to $8 and a half so that you can meet that 40% allocation to national credit. That means some place else you're going to have to pick it up. Somebody else that you renting to at the regional level or the local level is going to have to pay $11 and a half or whatever variance off the targeted median rent, effective rent is going to be. Hence, you get a great deal of subsidy of the national credits by the local credits in order that the building will achieve that minimum effective rent that has been specified by the lender. The second element in terms of the occupancy requirements would be to reach a certain occupancy level by a certain point in time or you'd be required to put up additional security. So not only do you have an allocation of space by credit ratings but you need to achieve those rent-up levels by a certain point in time prior to the closing in order that you can close at all or close at an amount equal to what's necessary to pay off the construction lender and get on with the project. So the developer is typically under some very strong pressures to attract certain kinds of tenants and do it in a certain period of time. George Bockel tells a wonderful chicken and egg problem of the Bockel Building in Milwaukee which was built some years ago. Essentially at 26th and Wisconsin Avenue which at that time was breaking very unusual ground. It was the first major office building built in downtown Milwaukee and it wasn't being built in downtown Milwaukee. 26th and the Avenue was not regarded as a premier office space area but that happened to be where George owned a square block. He gets into a chicken and egg problem in which the lenders say, "Gee, George, show us that there's a market for space out there and we'll make you the loan." And the tenants are saying, "Gee, George, show us the loan and we'll sign a letter of intent." So now you've got a chicken and egg problem going. You've got to get a certain number of quality tenants signed up or you're not going to get the loan and if you don't get the loan, the tenants aren't going to sign up. So finally George thought it through and here it goes back to your protocol of renting again. There was a fellow that was with Milwaukee Mutual Savings and Loan, an Irishman who wanted to be the largest lender in Milwaukee - the largest Savings and Loan in Milwaukee. And he wanted it to ace out First Federal which at that time was the largest one. So he went to him and he pointed out that the guy had advanced $20 million dollars of this project, that would increase his balance sheet to a point where he would look $2 million bigger than First Federal and now he could say that he was the largest savings and loan in Milwaukee. Well, this president is no dummy. He says, "OK, George, I'll make you the loan but on the following conditions. If you don't hit these percentage allocations by class of tenant by a certain point of time, I'm going to sell all of your other real estate in Milwaukee and that's the money I'm going to advance you on the loan." So he put a blanket mortgage on all of the other property that George Bockel owned at that time - it was a considerable amount of relative rag-tag slum property and so forth - but it added up to $2 or $3 million dollars and the president says, "George that goes on the auction on August 1 or whatever the magic day was, and we're going to liquidate it and that's the money I'm going to advance you to finish the building." So now he's chugging along. He's got a big hole on the front first floor of the building and he's supposed to have a bank in there to meet the terms of his loan. The only other prospect he's got is a bar that had been down on 6th and the Avenue for years and they're hot to move into this area. Now no office building has ever succeeded with a large saloon on the first floor, because it's a vat. If you're going to have a bar in an office building, you bury it in the basement or you put it some place where it doesn't show, but you don't have it on the first floor because it takes away from the "A" class image of the building. Like two weeks before his deadline when he's about to get sold out by his friend at the savings and loan association, the M & I Bank calls him and says, "Gee, Gordon, we'd sure like to have a branch at that location. Do you think it would be possible to get some space on the first floor and some parking spaces for a drive in window at the back?" And George said that because it was just his friend at the M & I Bank, because he was basically a good guy at heart, said that he could do that and he had a crux. So he dodged the bullet. I think he had the letter of intent from M & I by 24 hours before the auction and was able to finish the building with the loan that would finish the build out. So those constraints on effective rent, by class of tenant and achieving a certain percentage of occupancy or signed leases, sometimes letters of intent, become the critical element.

Now letters of intent are typically simply an agreement to agree. And at least in terms of the legal mythology are not enforceable as contracts. But if you have a letter of intent from a major tenant who says he's going to come into the space and that's the basis on which he meets an occupancy and that major tenant backs out for reasons that are not of good faith, you can sue him for the damages that result. Because at this stage as you go forward and in good faith with that letter of intent. So those of you that sign letters of intent in a tone that it may not cost you anything, that's not quite true. You may dig yourself a major hole in terms of damages for reliance, where let's say, somebody else comes along and says, "Gee I've got a better price for you", or, you know, "That's legal and around it and we'll dump that landlord and we'll try that project over here." So the lender wants to be very very sure that the cash flow which is going to account for the repayment of his loan is, in fact, locked in and that those leases are not simply paper numbers which have been riddled by concessions and where the payments have been, you know, postponed or waived or whatever. The second thing he's concerned about, of course, is that that revenue stream will, in fact, get down to the net income available for debt payment. And he knows that obviously there's a whole series of operating costs that have a prior claim. And therefore he wants to be sure that the budget for the operating expenses is 1) very very certain and 2) if there's any variance that it's going to be shifted back on the tenants. So that the greater quality of gross receipts that has has, the second thing that he's concerned about is the quality of the budget estimates for the expenses that will have a prior claim on those receipts before there's money available for debt service. So as a result he's very interested in what kind of pass-through arrangements you have. Obviously a triple net lease to a major industrial firm on a single tenant industrial building is very attractive to the lender as long as he can't do anything stupid to cause the lease to be breached, he knows that no matter what the operating costs are during the term of that lease, that that net income is going to be available for paying off the loan. As a result, he may be happy to settle for a lower debt cover ratio, a higher break-even point on the project etc. But failing that, he wants to be able to see just how much variance in the expenses will be pushed through on the tenant so that his spread is between his debt service payment and the expected net income isn't corroded very quickly by operating costs. You would think that that would be fairly common sensical and basic, but you would be surprised how many folks don't do that or at least haven't done it in the past. So you have office buildings in Florida, for example, in which the electricity was included in the base rent. And unfortunately electricity in Florida is all generated by diesel generators and the electric company, Florida Power and Light, has a surcharge monthly which reflects the price of oil in the international market and rather than have to file a new rate change every month, they simply bill all of the people proportionally in terms of the hours they use for the variance between what the price per barrel of oil was when they set the rates and the international price per barrel it is as of that month. And you saw electric bills move from maybe $.80 a square foot to as high as $2.25 a square foot during the oil embargoes and various problems and that might have exceeded the debt cover ratio that was available to protect that lender. Suddenly that lender now faces the problem of having to take over an office building in which electric costs - nobody knows how high is up and obviously, those have to be paid or you've breached the lease and the tenants don't have to pay. Obviously it wants to be assured that these little surprises are nailed down. So it's going to look very carefully at the kinds of pass-through features that the lease provide and the capacity of the tenant to meet those payments. It doesn't do any good to pass it through to somebody who can't afford it and therefore is going to default on the lease.

We have different types of clauses over the years. We've talked about it before but I'd like to remind you of some of them. The traditional pass-through clause was called an escalator clause. And the escalator clause simply said that if a certain cost, say real estate taxes, exceeded the taxes in a certain year called the index year, the entire increase would then be prorated among all of the space in the building. Now if you have a building that's 20% vacant, that means only 80% of the increase in real estate taxes is going to be paid by somebody because the other 20% is unoccupied and the landlord is going to have to eat it. Therefore, the escalator clause becomes more and more dangerous as the occupancy of the building falls as far as consuming the cash available for the lender. Remember the real estate tax lien is always prior to that of the first mortgage lien. So if the sheriff files a real estate tax lien on the property, you've now violated the first lien requirement as far as the mortgage is concerned,which means the mortgage lender will have to step up and pay the real estate tax if the owner of the building doesn't. So as a result, they get a little skittish about that type of real estate tax escalator clause. On the other hand, in some of the older buildings, where the leases go back quite a way, the base year may be significantly before the lease in question. You can sign a new lease this year and it would state that as far as the escalator clause is concerned the base year was 1975 which means that in the very first year of the lease you're going to get hit for an additional payment. The rent is, in fact, higher than the contract rent that appears on the face of the lease. So you need to look at those escalator clauses, decide what is the base year, when does it kick in? The alternative to a base year is what's called a stop loss clause. It says when real estate taxes get over $2 a square foot, the tenants will start contributing pro rata. That came about because tenants got smart, they realized that if we're building a new project and we started on January 2nd of this year, it's not going to be on the tax rolls until the following year and the taxes due for the following year won't be payable until the second year. So that if you take the base year as being the vacant land on January 1, the escalator kicks in right away. The tenants said that's no fair. Then I'm paying everything on the building, why didn't you say so. So as a result they said, "I'll tell you what we're going to do. We'll start paying the increment in the real estate taxes after it exceeds $2 a square foot." That's called a stop loss clause.

But what if the initial assumption of the developer was that it was going to be at $1.50? From the time it takes it to move from $1.50, let's say in the first year of operations, until the time it gets to $2, the landlord gets no help at all and therefore one of the subtle concessions that a major tenant can get is a stop loss floor or ceiling before he has to start paying that's higher than everybody else. Maybe the rest of the shopping center is at a $1 a square foot, but Gimbals says, "Give me a call when the real estate taxes get above $2 a square foot." Then, as a result, there isn't the degree of help that it would appear to have in the lease. And simply to say yes there's a pass through to the tenants on a stop loss at $2 a square foot, doesn't tell you anything, or at $1.50 a square foot unless you've read all of the leases and you know that all of the tenants are being treated the same and two that $1.50 is where the taxes are now. So the lender really have to look at that type of stop loss clause and begin to see what's really in place rather than simply take for granted the fact that there's that feature in each lease.

Utility expenses and other similar type of item - and again the utility expense is obviously also going to be related to the construction quality of the building. Any tenant that goes into a deal with a utility pass-through has really got to look at that building and say, "Wait a minute, hold everything, is it insulated? Is the roof insulated? What kind of HVAC system do we have? Has anybody updated the switching systems so that we're not getting nailed on the surge rate - that we can turn our power on gradually and turn it off gradually to avoid the peak rate charges and so on." And if that hasn't been done, most tenants won't go into a utility expense stop type of arrangement. So what does the developer have to go back and do? Because, well, "Tell you what I'm going to do. I'm going to design my building so each tenant has his own heating, air conditioning and ventilating equipment on the roof and not only is he responsible for the electric bills or the gas bills and so forth, but he's also responsible for the maintenance of that unit and the replacement of that unit when it wears out. Because he may want to maintain his store at a certain temperature like 67 degrees and a low humidity because he finds that sells more merchandise if he is selling Pendleton shirts and sweaters and so forth and wants his customers to be a little chilly. And somebody else may be selling holiday wear for the Bahamas and want to keep theirs a little warmer and so forth. And some people may maintain theirs better than others, so by tying maintenance and replacement responsibility to the same tenant, if they choose to under maintain it, then they can replace it sooner. If they want to run it really cold, then that's their problem, etc. And so as a result, one of the things that you start to move at is the fact that proper design of the building can mitigate your dependency on these kinds of escalator clauses. They can begin to directly assign costs to the tenant in which we don't have to collect it. He's going to begin to deal with the electric company directly. He's going to pay his monthly bill, he's going to have to maintain his mechanical equipment and so forth. The more you can design the building to segregate that, the better off you are. And that becomes true even in renovations of older buildings in which once-upon-a-time there was a single boiler and a single compressor in the basement and so forth. When you go back and renovate that building, pretty soon you have individual HVAC's on the third floor roof serving particular zones in the building and you match those zones to your leasing pattern and what was a traditional office building with a central HVAC, becomes one that's highly assignable and accountable to specific tenants. Again, because you can convince the lender that even though this is an older building, less efficient to operate, the quality of income is stable because the variance that's assigned to these costs has been laid off on the tenant and therefore the net income expected from these leases, can not be eroded in future years by unexpected increases in the operating costs and so on. There's a significant factor in those operating costs and replacement costs particularly relatively short-lived items like motors and pumps and fan systems and so forth. The more you can begin to shift those kinds of items down on the tenant, the higher the quality of income, therefore, the lower the debt cover ratio that will be required, therefore the more money you can borrow for a given availability of net income. And ultimately, of course, that's the name of the game.

One of the big steps forward in that area has been the move away from overage rents which lenders have never counted in their financing schemes. Overage rents were always regarded as returns to management, rather than to the real estate. Presumption that sales were higher than expected was due to good marketing, good merchandising, but because it was only a contingent payment, it was not considered to be available for the lender. And therefore, it was not included in the income available to support the loan. Because of that as well as because of the accounting difficulties of auditing overages, you're seeing a move toward contract bumps in the rent. That every year the rent goes up by 3%. Since that's not all vested contract rent, the lender feels more confidence in using, let's say, the net income in year 3 after the project has filled up and shaken down and you now have tenants that have substantial investments and tenant improvements and so forth saying, "all right, I'll take the debt cover ratio applied to the net income in year three, I will lend that to you in year one." As a result, the debt cover ratio may be 1.05 in year one because the lender is betting that you will get those bumps in the rent that are built right into the rent structure. So obviously, a step lease is preferred to an overage lease since the increases are no longer contingent but are a vested contract right of the borrower.

Another area, of course, that developers are getting more savvy on is the fact that escalators always have lag in it. If I have a real estate escalator, it says if the real estate taxes next year are higher, then I will collect that increase from my tenant. So you go through this year, fine, that's included in the gross rent. Now the assessment is bumped on January 1 of the second year, but the taxes due on that aren't determined until November of that year, and you are billed in January of the third year and so you pay the taxes and now you have to go back and bill your tenants and they drag their feet, so that the incremental cost isn't collected until the middle of the third year some time for a cost initially incurred during the second year. Now that comes up toward the end of the third year lease, you can imagine what's going to be the first concession the landlord's going to make when he walks into the office and says, "How would you like to renew your lease?"

And the tenant's going to say, "Well I don't know, I just received your billing for the real estate tax escalator for last year and I was surprised to find that I owed another $1 a square foot." "Well, that's a formality that we're required to send out to all the tenants, but we really treasure your business here and why don't you just tear that up and we'll start to negotiate next year's lease." So as a result the bargaining position of collecting then from the escalator is kind of undermined during a soft market. One of the first concessions you can make gracefully without having it appear immediately to the lender that that's what you're doing. Remember the lender is entitled to all of the leases and people assume they're enforcing it but he doesn't necessarily monitor all of them to find out whether you are or not. So the escalator is 1) is this lag in it and 2) tends to be billable just about the time that you're trying to establish good relations with the tenant again.

Compare that to common area maintenance fees - what is called CAM. Common area maintenance fees initially started out to be essentially striping and snow plowing and the landscaping outside of the plaza on the parking lot and so forth. And it had a rather unique feature in the shopping center business, but is now common clause to all of the others as well. In this one there was a loading for the management fee called the penny ante accounting. So the expenses were $100,000, if you prorated $115,000 to all the tenants and you picked up a $15,000 fee as part of CAM for doing all the busy work.

The second interesting part of CAM is that as it grew up and became a common business practice was that it was accessible to the tenants in the building period. So if you had a 20% vacancy, the other 80% of the occupied space paid all of the $115,000 of CAM. The landlord didn't have to bite the bullet for the 20% of the vacancy. Now since that time the tenants have gotten a little smarter and some of the strong sophisticated tenants come back in and say, “OOPS, wait a minute, now I’ll pay all of the CAM as long as you have no more than 15% vacancies but after that, you know, you start to have the landlord share with us on those CAM rates.” So the first two features that were very nice was 1) you got a management fee for doing the busy work of penny ante accounting, 2) it was prorated to whoever the tenants were in the building and the landlord didn’t have to bite the bullet on the vacant space and 3) it was collectible monthly in advance with a 13 month over/under adjustment so that if extensions were over the 13th month, you collected that too and if it was under you had a little credit against what was due in the 13th month. Now notice that eliminated all of the float, all of the delay and it really became part of the monthly business of doing business and it didn’t get in the way of negotiations because essentially you were talking about a number that didn’t appear to be that large, it was 1/12th of something rather than the whole nut in one billing. So if you were talking about $1.20 a square foot a year, in CAM payments, you would only give them $.10 a square foot a month and the average tenant didn’t really mind $.10 a square foot per month as a major issue or source of friction between he and the landlord. Whereas if that $1.20 had showed up on his doorstep the day before the landlord shows up to renew the lease, you know, it’s a major bone of contention. So again, the lenders see that astute use of CAM and more and more expansion of the definition of what expenses are included is something that very much stabilizes the income of the project and allows them to have either a lower debt cover ratio and therefore, lend more money on the project and possibly even a lower interest rate. They regard the risk quality has moved up significantly and therefore, instead of charging you 10 1/4%, they’ll charge you 10 1/8%

or if he says they want that piece of business, they'll charge you only a half a point to make the deal instead of a whole point. It's obviously a variety of concessions the lender may make because he perceives the stability of the income stream to be greatly enhanced by the fact that the variance in operating costs and maintenance costs have been laid off on the tenant and in an affordable way so that the tenant doesn't have to get a surprise hit two or three years downstream from current operations.

The final element in terms of the quality of income, is back to what we were talking about at rent commencement. What kinds of conditions would permit abatement of rent? Nothing like the phrase abatement of rent to strike terror in the heart of the lender. Some, again, skillful national negotiators are able to make that abatement clause extremely broad so that some national catastrophe in which the snow emergency closes a shopping center for two days would entitle them to an abatement for that month of 1/15th of their rent if they couldn't do business during that period of time. In effect, making a natural act of God and penalizing the owner accordingly. There may be obviously an abatement for road repairs or a breakdown of the boiler, you know, that they can't occupy and do business in reasonable comfort. There may be abatement for disruption. For example, a major factor of regional shopping centers has been this litigation as to whether the mall or shopping center is, in fact, de facto public space, so that those that would like to hold a small public disturbance in the general comfort of the mall could do so, or whether the mall had the right to eject them because they are now on private property and they were not licensed or permitted to hold that disturbance. There are many leases that have provisions in them that should business be disrupted by that type of disturbance because the landlord presumably is unable to maintain order and discipline within his property would be entitled to abatement. So you need to begin to look at what kinds of deals, particularly the major national are driving as the penalty or price of getting that nationals tenant in and meeting that, whatever, percentage requirement that has been imposed by the lender. Obviously those percentage allocations by the quality of credit and so forth, become highly privileged information as they can jeopardize the bargaining position very quickly of the developer.

Ironically, there are certain types of high quality tenants that can actually hurt the borrowing power of the building. For example, simply a blanket lease to the general administrative offices will probably hurt the credit power and quality income of the building. It's not because the government doesn't pay the rent, or pay it on time, but because the government may have certain exemptions, for example, the GAO will not pay rent if it's discovered that there is asbestos in the building and they will move out at the end of the first opportunity within the lease as a result of that in the building. And it's scary for the lender who as he's going through the GAO office looks down and says, "Gee, that looks like asbestos tile rather than linoleum" and at that point what do you do? Well, of course, what you do is initiate a recarpeting phase of the project and you quietly go in and take out all the old tile and recarpet as a business enhancement. And you don't bother to explain to somebody that maybe the tile was asbestos tile or whatever. But anyway you begin to upgrade it. But more to the point relative to the federal government is that the federal government has a lot of agencies which don't attract very desirable people. And, if you get a federal probationary office out of your building, some of the folks loitering in your halls are not the kind that are attracting other tenants to the building. So, for example, one of the major disasters that Trammel Crow suffered early in the game was building a major office building in downtown Houston and renting 50% of it to the federal government who then moved in everything - the welfare departments, the correction departments and on and on and on. And the rest of the people in the building didn't want to come to work. The kind of folks they were riding up and down the elevator with would make them feel very secure. And you can imagine all of the various confrontations they had and as a result the building failed drastically despite the fact that the lender had originally made the loan on the grounds that 50% was leased to the federal government, how could you lose? Well, they found out how you could lose? And, ultimately, what's his name, an office building developer (can't remember his name) he came in and literally broke the lease of the federal government and pushed them all out. And his attorneys after a long battle forced the GA off completely and then completely redid the interior of the building and turned around and leased it to the general market. So in looking at what is a quality tenant, you also have to take a look at gee, how that can affect the balance of the marketing of the building and the federal government may not be the best tenant you can have, depending on which agency of the federal government is going to be there. OK, so much for leasing formulas and what the lender is concerned with at this point. Oh, one other thing, I'm sorry. Typically the lender will, as we pointed out before, require assignment of each lease to the lender and require the landlord to send a letter to each tenant indicating that the XYZ lender has this assignment and that the tenant may be notified some time in the future that he will send his rent check directly to the lender rather than to the landlord. And it's kind of a tricky piece of business in public relations because as far as the tenant is concerned, it sounds like the landlord is already in trouble. The lender doesn't exactly trust him and may move in any minute to put their hands on the money. So it's a very difficult piece of public PR to write that letter and maintain the lender's right to request that the rent checks be sent directly to them at some point in the future should, in fact, the borrower somehow default on the loan. And still maintain the good will of the tenants who are immediately a little skittish. Second of all, of course, not all tenants are the ones that you want to be subordinate to and continue to collect rents from and therefore, the lender may also require that where he feels you're making a bad lease to a local credit or he has some skepticism whether that tenant is appropriate for the project, he may require that the tenant subordinate his right to client possession to that interest of the lender so that when the lender forecloses the building, the tenant's lease is also extinguished and then can either negotiate what the lender feels in the market rent or he can clean that tenant out of the project in order to improve the asset according to how the lender sees it and that also is a ticklish piece of business.

Finally, one other element that is not here in the rental formula is the fact that many of the major tenants may have an expansion option in their lease. That expansion option may permit them to give the 90 day notice and that annually they could increase their space by 10%. So if they have 10,000 square feet to begin with, they're entitled to another thousand square feet and if after three years they could have 3,000 square feet and so forth. Two elements of the expansion clause are critical. One, does it carry a contiguity (?) i.e. contiguous clause? Does that major tenant have the right to expand into space immediately adjacent to its existing space? And if he has a ten year lease and has the option every two years to expand, now you as the landlord, can only put a smaller tenant into that expansion space that has a three year lease. And that three lease may have a feature in it that if you need to relocate that tenant, you're going to pay all of his moving expenses and his telephone relocation expenses and his new letterhead etc. etc. etc. to put him someplace else in the building. So you have to begin to identify what are the conflicts between the expansion rights of the major tenants and the term and relocation rights of the minor tenant who would be dislocated if, in fact, they had anticipated the fact that they were going to be dislocated.

A second related problem to that expansion element is if it's not a contiguity clause, then you put them anywhere else in the building. If you're in a reasonably good bargaining position, you can allow tenants to expand in the building, first right of refusal of available vacant space but not necessary contiguous to their office. As soon as you have that contiguity clause in there - 1) it's a dead giveaway to the lender that your bargaining position is relatively weak and 2) that you are going to take a certain rental loss on that space immediately contiguous to that potential expanding tenant. You'd be much better off to insist that the tenant lease all of the space that he thinks he's going to use and that the landlord then sublease the surplus space in some sequence so that there is no break in the continuity of rents collected which, of course, guarantees the loan. Otherwise, if you're in the position where you've got to bump the tenant. You're going to have periods of vacancy in which, you know, six months to go before tenant "A" may expand, tenant "B" has moved out six months early and now what are you going to do with space for six months? Nobody can afford to move into it and you can't afford to reorganize it and so forth, and therefore, the total efficiency of the building will be adversely affected if you don't correctly match the expansion potential with the relocation character of it. And, in many cases where you have major tenants coming in getting the early concession - taking 30% of the building - there's some very significant restrictions

(?) which have to be accounted for in the balance of the leasing program. Question: In downtown Chicago where office leases go for about half the face amount of the rent, what would somebody do in that scenario that you just suggested? - that the tenant needs all the space and then sublease it. I mean, what could you do to kind of make up that money? Chief: In terms of who? the borrower/developer? Right. Well, first of all you have to say about the tenant that has the expansion rights, he really ought to pay for a call on additional space. So that if the subleasing rents are lower than the base rents, then he should really look at some of that spread as his call option - that's what he's paying to have that on a standby basis. And that may be cheaper than for him to have to pick up and move to another building because he got 50,000 square feet of space and now and he needs another 10,000 square feet. It's much easier to expand than to relocate. You see. So to some degree you're going to negotiate the fact that part of that spread is going to be picked up by the tenant as the price of the expansion call. OK? The second element about that is to what degree do you have to finish the space for the subtenant. Do you take it as it is and just work with a big open space or do you have to finish it and how quickly do you have to amortize that and so on. And typically what happens is the subtenant gets almost no tenant finish - it's sort of a take it or leave it sort of thing up front. The third problem is very much related to the landlord in terms of what kind of concession does he have to give to find a subtenant. And that really goes to the heart of how truly efficient is his building. The fact that he nominally has so many hundred thousand square feet of GLA but 50,000 of that is under expansion options and so forth at half price. He really doesn't have a 400,000 facility at all he has a 350,000 square foot building.

. . . will be title insurance which is used increasingly and in many creative forms than it once was. And just this past year has undergone several revisions by the American Land Title Association which is called ALTA for our purposes, the ALTA, all capital letters, has referred to a group that establishes essentially a standardized form or set of them actually, 5 different policies, which can be found across the country. Only California and New York, I believe, have significant variations from the ALTA form. One of the interesting things about title insurance is that unlike other insurances which is insuring you against against future occurrences of some sort of hazard, title insurance is concerned with things that have already occurred, that nobody knows about and it's really dealing with either forgery in the chain of title that's in the public record or the fact that there are legal consequences in transactions which occurred in the record but not all of those consequences are understood and, therefore, may invalidate, for one reason or another, the transaction. And title insurance is really designed to protect against the unknown past rather than the unknown future.

First of all, it's not all inclusive protection. If we look at the basic parts of the title policy, the first part is really insurance provisions which describe the risk insured against. And essentially the risk insured against is that a buyer will not accept the title for what he perceives to be flaws in the title. Nobody has really defined an unmarketable title. It's one of those gray areas of the law. So what essentially triggers the insurance is a rejection of the title or refusal to go forward and close by a buyer and that has, obviously, certain consequences which either can be corrected and cured at the expense of the title insurance company, or which may be incurable and therefore, you lost the deal and now you get your money back while you're trying to figure out what to do about it. You know, now it's been determined that the Indians owned a significant part of Door County or in the classic case, of course, Manhattan was sold for $26 worth of beads and so forth, and it turns out a few years later that they were dealing with the wrong Indian group. These guys just happened to be on the island that day and happened over from Connecticut and the dumb Dutchmen, you know, paid 'em for it and it turns out they had to pay off another group of Indians in the meantime. And so those kinds of little upsets. So, essentially, the definition of unmarketable means somebody wouldn't vote to accept it and wouldn't close on the deal.

The second element of coverage are exclusions and the exclusions are the critical part of the policy. And they are custom crafted at each hedge so that having gone through the chain of title as it's available on the public record, they identified the obvious flaws. The cases in which the property was bought by John and Mary Doe and later on it's sold by John Doe and we don't know what happened to Mary. You know, did she sign off on her dollar interest? Has she died in the interim? And, you know, had her interest been closed off by some public record of that event? Or, was there a divorce and a property settlement? We just don't know. So you have this obvious flaw in the chain of title that him what owned it at one point, don't seem to have signed off on the sale at another point. Those kinds of obvious flaws in the property are simply not covered and now you have to have an attorney to decide whether the exclusions are significant. You know, did these flaws represent, you know, things that could come home to roost or were they so far in the past that they really aren't likely to cause any difficulty now. And as we mentioned one earlier in which the deed restriction said it had to be signed - the plans had to be signed by the original developer and we found him at the age of 90-umpteen years in a nursing home in Phoenix and got him to sign it because otherwise the title company was going to put a major exclusion which might have affected the marketability of the house because the plans had never been approved, etc., etc.

The third element by what we call conditions and stipulations. And these really spell out the rights and obligations of the company. And we'll talk about the benefits under that in a moment. One of the basic reasons why we buy the coverage like a good many other types of coverage is for the retainer of specialized legal help which may determine that ultimately you don't have to pay anybody or that you really don't owe anybody. But it's relatively expensive to decide whether, in fact, there is a claim. So like public liability insurance, the first benefit you get is, in effect, a retainer for specialized legal services that will decide whether - whatever the claimant may be - whether he has a legitimate claim. Then you have a further concern, obviously, if there's a trail and under the trial who's going to pay what and so forth. But a major element of the coverage is simply that specialized legal support at the time an issue arises.

The fourth element of the coverage is schedule A. Schedule A identifies who the insured is, specifies the amount of coverage - those kinds of things. And then schedule B may itemize the exceptions to coverage. In other words, which costs are not covered - that's different from which events are excluded to simply which cost items or consequential cost items are excluded. Other types of exceptions might be the loss as a result of a zoning violation. The zoning violation may, in fact, affect the marketability but they're not insuring that the property meets all the zoning requirements. They're just saying that the chain of title is acceptable etc., etc. That might be another type of exception. Today, of course, major exceptions would be to the effect that you're going to still be liable for toxic waste problems. Title insurance will not protect you against that even though it's an encumbrance that travels with the title, the title insurance companies don't feel they have to be experts in deciding whether the water table has now been contaminated and is encroaching on the adjacent properties and so forth.

Now there are basically five types of forms with each of these elements to it. The owner can insure his interest at the time of purchase. That's a critical statement because what it says is if you pay $100,000 for the property, the owner's policy will insure for $100,000 but you're paying for it at the time you acquired it and got the title insurance. If you now add $50,000 worth of improvements to it, that's your problem. You either have to update the owner's policy to now include that additional investment or you're simply covered for the original investment and that additional moneys put into the property is exposed.

The second type of policy is the lender's policy. It covers only the portion of the mortgage due and payable at the time that the title goes bad. So it's a declining type of coverage, as the mortgage is amortized, the degree of coverage is reduced. There is obviously a termination point. If it's a 20-year mortgage, the mortgage is paid off or reaches the amortized termination of the mortgage and the coverage terminates. Therefore, it's considerably cheaper than owner's policies. And it was customary in the early years to simply buy lender's title insurance because the lender was the one who was interested, it looked cheaper, therefore the closing costs of that lender were lower and it seemed that the buyer of the home was getting a good deal and he didn't know the difference - that the title insurance protected only the lender, not necessarily the owner of the property. So it can be a point of virtually misrepresentation by those that are trying to understate the closing costs of the property.

A third type of interest is a leaseholder owner's policy. You're a long-term tenant, you've got a 20-year lease on the property. You want to be assured of quiet possession and you're not quite sure whether the guy that owns the property is renting it to you, really has title to it or not and certainly his insurance doesn't cover you, the tenant. So the tenant is putting in tenant improvements, and you know, you're taking a long term position in the property and making it as cultural center or if you're building a retail store outlet etc., etc. has a good reason to protect his rights prior to possession as well against title flaws that are upsetting ultimately the landlord. It's called a leasehold owner's policy.

Then there's also a leasehold lender's policy. The lender who is financing the leasehold improvements. Obviously he's not entitled to bring title insurance on the underlying fee, he'd only entitled to title insurance on the economic value of the rights to rent land or that parcel for a certain period of time. And finally there's a construction lender's policy which would be the cheapest of all because, obviously, it's for a very short period of time and covers only that interim period when the construction loan is in place and so on. And again the construction lender is protecting himself rather than the owner over a tenant of the property and so on. So there are different degrees of ownership.

Yes? Question: In owner's policy does that just cover his equity amount? Chief: No, that would cover both - total purchase price. So it could give them funds to pay off the loan if they really wanted. Question: There might be overlaps if the owner buys a policy and the lender doesn't? Chief: If the owner buys a policy, the lender wouldn't have to. The lender would have himself named as a party of interest to the degree that it might appear at the time of loss. Question: Could that policy be written out for more than the purchase price? Chief: No, probably not. In other words, if they needed the principal of insurance called principal indemnity and the idea is to make you whole as a result of that transaction but not allow you to profit on that transaction. Now once you've invested more in the property, you can have it updated to the current investment.

OK. The first risk of course to be dealt with is that the title is of a lesser degree than indicated. The owner thought he had fee when all he had was a life estate. That would be one type of risk.

The second type of risk is that there are liens and encumbrances on the property which didn't appear. The missing heir who shows up for a fractional interest. Out in the west you have real problems with mineral interests floating around of unknown value. You can't even find the guy who's got the mineral interests in the property but at some point in the past that was pulled out from under the title and who knows whose strong box it's in and whether it's worth anything or not. Occasionally you have to run those down and you may find a company that was last assigned the mineral interests - explored and found it wasn't worth anything and they just simply forgot it. For a man to run that down and retrieve it from 'em or get a letter to the effect that there's no value there. Out in the West it gets particularly messy relative to water rights. Water rights can be detached from the property ownership and sold to others for a crop allotment or something of that sort. So in the Midwest the riparian (?) rights are such that all people bordering the creek get equal rights to the use of the water against retainment for their very own.

You may have judgment liens or tax liens which have not been filed at the time. Obviously, at the time of closing you try to get a letter stating that the seller is not aware of anybody that has a right to such a lien and so forth and so on. But that means it may not be acceptable or he may not even be aware of it since lien rights have a life of their own - they run from a particular point in time out, you know, well past the transaction date and so forth so it's quite possible that that one of those will crop up at some point in the future.

And the third risk to insure against is the unmarketability of the title all together. Most title insurance policies are not one in which there is a total collapse of marketability but there are some interests that will have to be paid off on the property.

The final risk is whether you lack the right of access to and from the land. This is really a two-way problem. Let's assume that you own 40 acres and you buy the back 20 or someone buys the back 20. Ordinarily when they acquire the back 20 under common law, they have a floating easement over the front 20 which allows them to find the best way of roads to your property. Now if somebody blocks that easement or something happens later that says there's no right of access from the road to the front 20 acres and the highway department pays the front property owner "X" dollars taking away their right of access, what happens to the poor guy that owns that back 20 and his floating easement? Well, it was implied by the law but certainly wasn't part of the public record. And from the flip side, of course, is the guy who buys the front 20 and doesn't know that the guy on the back 20 has a floating easement implied by a transaction that took place umpteen years ago and now, you know, builds his building across the road that's always been used to get to his deer hunting cabin all of these years. At that point title insurance has to step in and correct the problem. The lender's insurance extends the coverage to the unenforceability of the lender's claim on the real estate for whatever reason. Maybe he got the wrong person to sign on the mortgage. You know, who he thought was the owner, but it turns out not to have been the owner, and so forth for whatever reason.

And finally, more recent coverage for the lender only is that there may be a statutory claim against the lender for certain items related to the real estate. We've seen the Super Fund laws, for example, imposing liability on the lender if he exercises his right of ownership or control. There may be mechanic's liens which are involved on the property and when the lender takes over, he now inherits those kinds of problems and so on. And finally, the lender's insurance will protect him against an invalid assignment. For example, we saw in the tri-party agreement in which the construction lender sells the note and the mortgage to the permanent lender. So he wasn't the original party to the loan but he's taking a loan by assignment and that assignment may have been invalid or unenforceable for one reason or another. And, again, the title insurance for the lender really protects him from those additional costs. Generally today the exclusion from coverage that we talked about are anything to do with building and zoning ordinances. They're trying to, of course, pick up as much of the environmental protection law as possible. Nevertheless, as you know, once those problems are detected, typically there is a notice of violation in the public record. For example, let's say the building is nonconforming in terms of its maintenance of safety provisions and so forth. The building department files a lien on the property and the title company fails to pick that up. That would become collectable (?) then under the title insurance. That type of presumably constructive notice in the public record which for one reason or another breaks down, and later reappears. The public record itself is much more broadly defined under the new forms than once upon a time so that public record may include not only the register of deed's office and in the traditional track indexes and so forth, but may include the miscellaneous indexes and the Building department and the Engineering Department and the Environment Protection agencies that may be involved and also typically today includes the Septic Tank Administrator's office so that if he has rules that the site is unacceptable for septic tanks and so forth that becomes a significant lien on the land and a limitation on its use and so forth. So the definition of public records is significantly expanded.

Of course the exclusions do not protect the lender because he has an unenforceable mortgage due to usury or truth in lending laws - that type of thing - where it's an administrative error by the lender himself. The title insurance does nothing to protect. OK, so much for title insurance for the moment.

Obviously, in other countries it is not quite such a major event. Canada has the torrens system as an option in most of the providences. Australia and New Zealand, a number of other countries have the torrens system totally which essentially, every time there's a real estate transaction, the title goes to the judge, the judge calls for whatever claims there may be, not here, bang, anything that may have impinged on the title in the past is extinguished and the new owner goes forward with no past. And if there's any screw-up on the title it's his doing, you know, during his tenure of ownership. It's much cheaper, it's much cleaner. It doesn't have any surprises but it does put the title insurance company out of business and, as a result, they have lobbied very successfully against the torrens system in the US. I think we have it in reserves in two or three states as an option where it has terrestory (?), who had the vested interest in doing that of sufficient size that they're going to make the effort to get the judges to actually use it. Title insurance companies have been very very effective from a political standpoint so that the capital required to get into the title insurance business is minimal. It's the least of all of the different lines of insurance. They have to be single line companies and the reserves they have to maintain are relatively minimal so that many of them are carrying liabilities grossly in excess of their capital. And the fact is that there is almost no claims to any great significance. So the title insurance companies that do report - a few have gone under - largely because they were dumb or because they were part of the general disbursement (?) as one over in Milwaukee which has been renamed since it went under - it's now called the Phoenix because it's arising out of the ashes of the former company. And the president was accepting little things on the side for simply ignoring the existence of the mortgages that were already on the property, allowing people to put another mortgage on top and things like that so that it failed as a result of fraud and occasionally they get threatened by major suits. The Chicago Title Insurance Company a couple of years ago fought for its life because as you know the major development area in downtown Chicago is over the former rail yard of the Illinois Central and Prudential's corporate office building was, of course, built over the rail yard was challenged by the taxpayers of Illinois arguing that the gift of land of the Illinois Central in the 1800's was subject to a deed restriction which said it had to be used for railroad purposes and selling air rights for office buildings over the rail yard was not a railway purpose and therefore the land had reverted to the state of Illinois and the taxpayers were entitled to the ground rent that Prudential was paying for the land which wasn't a bad argument as a matter of fact, but obviously now they had a title insurance policy for who knows how many million - maybe $50 million dollars of that particular point in time on the Prudential Building and, of course, their assets were several million dollars and they had to fight for their lives and they successfully ultimately won the argument that railroads needed additional income to cover their deficit and therefore the ground rents were consistent with the subsidy of rail transportation to the benefit of the public etc., etc. And they were able to wriggle out of a financial disaster. But occasionally you get those kinds of challenges or the Indians did one in Maine and a third of the state of Maine goes under the cloud of whether it was really negotiated from the Indians or not and I remember a number of years ago we did something very interesting, an environmental impact court case. Jim Gertz (?) did a beautiful job of that. We ran it for three years running a tract of land in Door county along Potawongawee (?) Park and, you know, in that particular case we take half real estate students and half environmental art students and for a week and a half they would study the property. Ben Neiman had done the environmental impact analyses. Our firm, Landmark, had done all the market research and the object was to build a resort hotel kind of like the Abbey down in Lake Geneva with golf courses and so forth in an area that had some real environmental sensitivity to it. And the developer who was a really interesting man by the name of Madanza who was a - both he and his wife were ministers as a matter of fact - was willing to allow us to do this and would take part in the whole thing. And Canestero, a magnificent teacher from a role playing thing - and we brought in the chief environmental examiner, was a part of natural resources held court and the students were the witnesses and so forth. And we had two attorneys that were into it, and they did the cross exam and they had really reduced some of our real estate students literally to tears. A member of our alumni association will tell, she was actually devastated by the cross exam. Then Cannisarro would twist a mean theory (?) and introduce new nuances each day and the trial went on for the better part of a week and a half and various little upsets occurred during the way and so forth. But anyway, one of the real upsets that occurred that we had a Winnebago Indian girl from the course that disappeared about the second day of the course and reemerged a week later with some very good evidence that, in fact, the Indians had never been compensated for the land and that it belonged to the Winnebagos. If you don't think that didn't throw the developer/owners. Well, I don't know that it's been totally resolved as yet as to what the character of title is in a large part of Door County. Apparently there's some dispute as to whose turf it was among the Indians at the time that the people settling with the natives from the state of Wisconsin actually negotiated a contract relative to those lands. There's still some dispute as to whether all of Door County was properly identified, described in a legal definition. Throw me out of that court please. You never know when little things are going to pop up.

OK. Obviously the other two types of insurance of significance are 1) the property insurance on the improvements in the event some natural catastrophe damages are destroyed through improvement and 2) the public liability insurance relative to third party claims on the property. Insurance follows what is called the large law of principal that you try to insure the least probable but the most disastrous loss that could occur first. And you're not dealing necessarily with probabilities because the _________ becomes something that you build into your capital budget or expense statement. Traditionally, the concern was for the property, the building and the improvements and property insurance thereto. More recently, given the very rapidly expanding character of liability law and concern for third parties, that may be injured directly or indirectly as a result of the project. There's much more concern for the liability side of the coverage. And, in that area, we have some very significant limitations on the availability of coverage. First of all, as many of you may be aware, but, nevertheless needs repeating here, the traditional concern of liability was for property damage - your car is damaged etc. and has to be repaired, that would be property damage - or bodily injury if someone is physically hurt. There is no escape from a claim for bodily injury through the bankruptcy laws. Those determined to be responsible for bodily injury can be garnisheed and all of their assets attached wherever and whenever they get those ______? and that implies you too. If you're driving without automobile insurance, you have just significantly mortgaged your entire future. And if you're driving with $50,000 or $100,000 worth of automobile insurance when you should have a half million dollars worth of coverage you have probably mortgaged your future. You can not escape a (?) judgment for bodily injury damages through bankruptcy. It's one of the major exceptions and if you are a director or major officer of a corporation which is inadequately insured, you are personally accountable for that irresponsibility. Therefore, it behooves you to have adequate coverage. But the third element that is growing very rapidly in the area of liability is what is called personal injury. Personal injury has to do with civil torts. Disparagement, slander, liable, violation of somebody's civil rights, interference with their personal business relationships, interference with their personal relationships, upsetting them mentally and driving them into stress - and that is a very rapidly evolving area of the law. So your coverage must include all of those things. And, should there be a claim in the area of personal injury, again, in most states you could not avoid liability for bankruptcy. And they may attach whatever assets you may have, liquid or property. And the judge would enforce foreclosure by selling your car and your home and your income real estate etc. and having paid off the mortgage lender and should those proceeds be adequate to do so, the balance of proceeds would be applied to the judgment. In effect, they can strip you of your assets with a very limited number of exclusions relative to your homestead and a living wage so they don't kill the goose which is going to lay the egg in the future. As a result, you need the government. Now, if that wasn't serious enough, the nature of liability is changing radically. As you hopefully, probably, learned somewhere along the line, basic public liability assumes the following things can be established by a plaintiff, the injured party. One, that you as the defendant had a responsibility to use care and do what a prudent man would do. Two, that you failed to exercise what normal responsibility would have been involved and as a result there's a direct approximate cost between your failure to use care and his injury. You have to establish basically a chain of events, approximate cost. The classic one of course, is the poor man who owned a cotton warehouse and a cat. The cat was to control the mice and one of the partners came along and found the cat had a thorn in his paw and as a result he pulled the thorn, wrapped it in gauze, put a little alcohol on it in order to sterilize the wound but unfortunately was smoking a cigarette at the time, and lit the gauze which caused the cat to run and panic through the warehouse, ignite the cotton and burned down the warehouse. The issue, of course, is approximate cost. Was smoking a cigarette, per se, negligence? Was that, in fact, the cause for ignition and was that, in fact, the cause for the loss? Well, the defense is that it wasn't the paw that was on fire that caused the loss it was the three paws owned by the other partner that drove the cat through the warehouse. Now we could argue at some length, in many cases, that this approximate cause is a loss.

And finally, having established that linkage, you must have damages which are measurable in dollars. So that it is at least under that general description of approximate losses, some hope that you can defend yourself at some expense from whatever the claim may be. But there are a number of things which are changing that. The first is called “race ipsalowpitor”(?) or the thing speaks for itself. There are many kinds of situations in which they are inherently dangerous - blasting with dynamite for example, demolishing buildings and a great many other items which as the history of product liability has evolved have simply said that if it causes an accident, you are liable. For example, elevators. Elevator damages are race ipsalowpitor. There is no longer an opportunity to defend yourself as to whether the guy in the elevator was an idiot for sticking his foot in the track or whatever. If there was an injury caused by an elevator, it’s automatically presumed that the defendant is responsible and now the issue is how much. And there’s a whole series of those kinds of things related to real estate that are race ipsalowpitor. That makes the liability problems, obviously, even much more difficult and expensive.

The second element relative to real estate is the doctrine of attractive nuisance. This is not the bombshell on the bar stool. It refers to the fact that people are inherently attracted to construction of real estate - it’s a natural curiosity. So if a little child is on a construction project, no matter how many times you have shagged him off, no matter how high a fence you’ve put up to keep him off, if he’s injured on the construction site, baby, you’re it - almost no escape. There is some opportunity to rebut that assumption but it is a sticky and narrow one - the doctrine of attractive nuisance.

But perhaps the third and most serious and expanding area of liability law is what is called vicarious liability. Vicarious liability says essentially that if somebody is doing something in your interest, they will presume to be your agent and the acts of the agent are the liability of the principal. So if you have a drywall contractor and he has Fred driving the truck for him and Fred takes his own truck to go pick up some drywall and in the process has a serious accident, in which the total claims exceed the insurance on the truck - there may be no insurance on the truck - it will be presumed that the drywall would have gone to your project. That it was your interest that Fred was out there doing that and therefore since the innocent party can not be satisfied from Fred's insurance or the drywaller's insurance, that it's going to be the building owner's insurance that is going to pay. In effect, the courts will follow the line of authority - tenuous as it may be - back to where there is money to meet the claims of the innocent party. And that is an extremely dangerous area of construction - to a point where, in fact, your homeowner's insurance does not cover you for any kind of construction or renovation work on your home unless you buy a specific endorsement to your homeowner's to cover that remodeling. Yes.

Question: Do contracts stop those? somewhat of a disclaimer to stop the line of . . .?

Chief: No. The courts regard this as a matter of public policy. The injured parties will be compensated where they are innocent and the victims of this process. And to show you how far it goes. In a Wisconsin case in which a church in Superior, Wisconsin sponsored a mission church on an Indian reservation. The Indian Reservation Church had a picnic. As it would happen, it rained on the picnic and in order to get the children home, one of the cars was driven by a 15 year old who had an accident. Several children were injured and they went back and said, "Gee, the mission church doesn't have any money. The reservation doesn't have any money. The family of the children doesn't have any money." The parent church in Superior, totally unaware of 1) the picnic or 2) who was driving the cars, etc. etc. was nailed for the full cost. So it's one of those things that you have to be very sensitive to. Obviously, you're going to try to build a series of defenses against that and the real estate lender wants to be aware that those defenses are being established. The defenses are not denial of their liability - it's providing adequate insurance funding should the liability arise and insurance then, of course, is broadly defined to and anticipate the character of the claims. And the fact that liability claims as they have grown in frequency and severity have been addressed by the insurance industry with a whole series of policy reform that gets very specific as to what kinds of things they are responsible for and not responsible for. And, therefore, the fact that it says comprehensive liability policy on page one does not mean that it's anything like comprehensive. There are a whole series of boxes on the front page which require premium charges that should be covered for a whole diversity of these things and indeed there may be some major holes in that that will require additional policies and then finally require an umbrella policy over and above that which fills in the chinks between the other policies in terms of their problems of definition and so on. Both in terms of perils covered and who the insureds are and the amounts of money available for that type of plan. Now in setting up a real estate project in which you have multiple parties involved, it is first necessary that the contracts involved be very specific as to the kinds of insurance that will be required of those parties. The amounts and the character and quality of the company. Remember the Dewitt Trust Company letter was very specific as to the kinds of coverage, the quality of the company as rated by Best and the kinds of endorsements that were to be on that policy for the benefit of the lender. Now it's also important that the lender be aware that the borrower be covered because the borrower's credit character and capacity may all be drained by insurance claims and not really be there to provide the credit support for the loan in the sense that it's stated at the outset.

Now, in looking at the various contracts the first thing you will require, of course, is that those contracting with you provide what is called an insurance certificate. That insurance certificate is a letter from their carriers to you as one of their customers or clients indicating the kind of insurance, the amounts, the endorsements and the termination dates of all of those coverages and whether, in fact, they're paid currently or how far in advance they are paid for. So, 1) you will know how much coverage is between you and the vicarious liability exposure. Second of all, some of that coverage may be suitable for modification in which you, the customer, are named as one of the insureds under the contract. And you want to know, of course, what conditions have to met to be one of the insureds.

The third problem relative to his insurance - relative to those that you're dealing with - is the fact that you could be both the named insured and a defendant against his insurance company. For example, let's assume that you're a tenant in an office building and you have insurance on your leasehold improvements. You're named as an insured and the company in the landlord's policy to the degree that, you know, the building was damaged and so forth and you leave your coffee pot on and it sets the office on fire and as a result, one, your office and the contents are destroyed and your building is damaged and maybe other tenants are damaged as well. Your coverage would pay you to replace your interiors as a named insured in the building - whatever structural improvements would be paid for by the insurance companies and then the insurance company would go and sue you for that proportion of the loss which was the landlords so that, let's say, if there was

$100,000 worth of damage to the building and you were the guy that is 25% insured, they would sue you for $75,000 and they had to pay the other guy. Being named insured entitles you to the coverage regardless of fault short of arson and, nevertheless, if they have to pay the other guy, they're going to come back and sue you. Obviously, you'd like to avoid that and so one of the elements you might want to negotiate into the contracts contained by those that are working with you is a waiver of subrogation feature. A waiver of subrogation says that no matter what the interplay here is between our fault and what you pay, you don't have the right as an insurance company to come back and sue me. For one of the other elements that are paid out other than those I would do as the named insured. A waiver of subrogation feature is an extremely important one. Some insurance companies will grant it as a matter of course, in some cases, you would have to pay for it. But it considerably deepens the insurance protection that you have. And it is particularly useful in the real estate area. Once you have the insurance certificates, once you've decided whether you want to be named insured on any of those policies, once you've determined whether there's a waiver of subrogation and so forth and if, in fact, you can't get that, you may want to have specific additional insurance to cover what you conceive as gaps in the total coverage. Then, of course, you are interested in 1) what kind of liability insurance can he acquire directly for the various perils that are involved and 2) can we get an umbrella policy which goes over all of that? Umbrella policies 15 years ago were probably rather unusual, for the larger corporations, they were common but certainly for the small individual, not common at all. Today the umbrella policies are almost a necessity in order to cover between the definitional distinctions that different lines of insurance make. The difference between a boiler machinery policy that would cover liability on the boiler in your real estate relative to general liability insurance and so forth. There are nuances in the language which mean there are gaps between the policy. Umbrella policies come in and fill the gaps. They also typically raise the limits. They also typically expand on peril's cover. So personal liability under a basic policy might cover only a limited number of mistakes that you can make. But personal injury under the umbrella policy would be much more broadly defined and therefore, be a more comprehensive type of covenant. And even an individual today is positively foolish to go forward without an umbrella liability policy. And what's happening on the umbrella side, of course, is that they are raising minimum levels of basic coverage that you have to have. For example, you might notice in my own case my umbrella policies for automobiles used to kick in at $300,000 single limit policy. That has moved with no fault of my own - no acts of recommending anything else to $750,000 minimum underlying first level policy coverage and then the umbrella policy kicks in with $1 million of coverage above that and therefore, you continually have to expand your underlying coverage when your umbrella coverage should be affected. Even a small little thing calls for probably umbrella coverage is a $2 to $5 million dollars over and above their basic coverages which probably go to a million to 2 million. Once you get beyond $2 million in liability coverage for a specific accident or event you're very rapidly outrunning the capacity of local industry and you would probably have to either go into the London markets or find you couldn't get it at all. So for the lender to require, let's say, $2 million dollars worth of basic liability coverage and an umbrella policy to $5 million is pushing most borrowers to a point where they may not be able to get the coverage. OK, I hear the bell ring.

. . . both the securitization of the real estate capital markets and the realization that the appraisal of real estate is reliable base for collateralizing the loan - that loan-to-value ratios and so forth can be deceptive. The underwriters are seeking to report perhaps the liquidity of the borrower and his ability to meet timely payment as well as safety of principal in the event of a disaster by finding outside ways of enhancing the loan in order to 1) be assured of regular payment of funds and ultimate recovery of the capital. So credit enhancement covers really a multitude of devices which either provide liquidity or safety of principal and we really need to look at those and their use, where it is becoming more and more the primary source of collateral on an income property loan rather than the secondary source.

The first set of tools, if you will, is what we will call letters of credit. Letters of credit are demand instruments in which banks will issue for a certain charge and they will provide for very specific contingencies which the lender can then present to the bank for immediate payment. A letter of credit may be simply for, let's say, the first two years of payment on the loan in the event the project doesn't rent up as quickly and reach the point where net income is adequate to cover debt service. Or can be for very specific kinds of things which the lender fears he will not be able to control because they won't necessarily be obvious - for example, a letter of credit for latent defects - that the building won't be built to specification or a year after they moved in, suddenly it would be discovered that the brick wasn't done correctly or the air conditioning doesn't hold the humidity and controlled temperature or whatever the case may be. So a letter of credit for latent defects might be for 5, as much as 10 percent, of the project depending on whether it's a very highly specialized kind of building or one in which it's fairly conventional and therefore reasonably capable of inspection on the project. Letters of credit may be for other specific contingencies - cost overrun. It may be for operating deficits for 6 months following the initial occupancy period. It may be for simply, as I say, covering the debt service payments on the mortgage regardless of how the project is doing for a stated period of time after the closing of the loan. Now, the letter of credit is by far the favorite way of doing that. Banks like to issue those because of the fee income, but more recently bank regulations are tightened up so typically the bank must have somewhere an offsetting asset. You know the law of offset in banking is if I have a savings account or an escrow account at the bank, that if I have an obligation to the bank, they can simply take that account by attachment and use it to offset the claim from some other aspect of the business. Banks obviously want to know that customer to whom they have provided the letter of credit very well to know that those assets, in fact, are there should the letter of credit be cashed and the bank now has to seize the appropriate assets from the borrower. Because not all developers have that type of liquidity or have that type of asset, quite often an equity partner is brought into the project whose sole function is to bankroll the letter of credit and he may obtain a significant equity position for simply providing that dimension to the financing package. And there are equity investors who will do that, who have far more credit power than they need to use and would like the additional income that comes from attaching their credit reputation to another project. And they may get anywhere from 10 to 25 percent of the equity in the deal for having provided the letter of credit. And, of course, given the fact the letter of credit is utilized and they actually ask for the money in the project, they then become an unsecured creditor of the project for that amount of money, as well as an owner.

Another way of providing that kind of backup, a little more oblique, is that the mortgage loan is administered by a trustee and that trustee will receive additional collateral from a third party source. For example, let’s say you’re doing a $10 million loan to develop an apartment project and they are concerned that during the first year the lease-up may not go according to speed and so forth. They therefore want the debt service, let’s say, which is another $1.2 million on hand if they should need it. Savings and loans would deposit with the trustee administering the mortgage loan $1,200,000 in mortgages - single family mortgages - which they may have made at a time, let’s say interest rates were 8% or 8 1/2% or 9%. And they’ll receive a fee of 1 1/2% or 2% for leaving those mortgages as collateral or additional collateral and should the mortgage get into trouble, they got the major commercial mortgage, the trustee would start selling those residential mortgages provided by the savings and loan to generate the cash with which to make timely payments on the underlying mortgage. Now, the object for the savings and loan, of course, is to do that when it doesn’t think it’s really necessary, it’s just that the lender of the $10 million, of course, wants that extra protection because what they do, in fact, is increase the yield on that mortgage from the nominal 8 1/2% on which they made the deal years ago to, let’s say, 11% which is much more competitive with the current market rate on that loan. So it’s a way of producing extra income from a portfolio which if they were to sell it, would sell at sharp discounts because the contract rate is well below the current market rate and this way they can generate income for the savings and loan with which to pay the dividends that are required to be competitive and so in essence you’re overcollateralizing the deal because not only is the basic income property on which the $10 million mortgage is made in the pot, the trustee already has his hands on liquid assets which could be sold, if necessary, to meet the timely payments on the loan. So it accomplishes the same thing as a letter of credit but the trustee has his hands on the resources in case they need them.

Another type of credit enhancements looks to the fact that the real security on an income property deal is the lease. And the question is, of course, how good is the tenant? Is he likely to make the payments on time? One, you can have commercial lease insurance, it's much harder to get these days but it's still available in some cases. The mortgage guaranty company has a subsidiary called CLIC, Commercial Lease Insurance Corporation. And, they had taken terrible losses and as a result they're much more selective than they once were. But, nevertheless, it is available. Or the Small Business Administration will provide lease guarantees for selected businesses that accomplish their political objectives.

Two examples of that: One, of course, the Sheraton Hotel here in Madison was originally built by a local developer saw that he was going to have some cash flow problems initially so he created a second company to manage it and leased the entire hotel in broch (?) to the management company. Somehow because of his political connections he was able to get an SBA guaranty on the lease between the management company and the corporation which owned the building and then that, of course, protected him from his lender because when the hotel did, in fact, get into trouble, why the SBA was caught in the middle. The SBA was making timely payments to the mortgage lender essentially because of the assignment of the lease guaranty and, of course, adding that to the balance too eventually the developer dug such a hole that it went into receivership and so forth and then you have to cash that out. But in the mean time the lender at all times was protected and enjoyed this steady income.

In another case up in Eau Claire Mr. Barberg, of course, is representing himself as the hotel expert. With Mr. Mullins on the convention center, built a hotel next to the Eau Claire Convention Center, saw the same problem coming up, that it wasn’t going to work very well, created his own management corporation, leased the hotel from himself from the one corporation to the management corporation which he also owned, and got the mortgage guaranty insurance company through CLIC to guarantee that. And that project has never worked well and CLIC has subsidized it for years to the tune of, I don’t know, a million and a half bucks at the far end of it. But it makes the loan good, whether you particularly like whether it was a good idea or not in the first place, if you can sucker somebody into guaranteeing the lease, why it obviously assures the cash flow for the lender for the term of the lease insurance.

Obviously, the alternatives are overcollateralization by the borrower himself. Not only will I give you a mortgage on my new property, but I’ll give you a second mortgage on let’s say on two other very successful properties that I have and the overall values will be more than adequate to protect both the timely payment and ultimate principal values. One of Wisconsin’s best known apartment developers did that on a very successful project and went into a tennis club project in Palm Beach. Lost his shirt in Palm Beach. The lender, however, was wise enough to have second mortgages on his project in Wisconsin and he then sold those second mortgages to the other equity investors who were only too happy to get a larger position in these projects and wipe the developer out. One of the cardinal sins in development is to take the profits of project A and use it to collateralize project B. You really want each project to stand on its own because sooner or later you're going to plow up a snake and one's going to go down and if it takes everything you have earned in the last 15 years with it when it goes, you're a dummy. The probabilities are that everything you touch is not going to turn into gold at least for you. And therefore be very careful to provide a risk management scheme which does not jeopardize the net worths you have created justifiably and creatively in the past in order to simply go forward with the next project.

Another type of credit enhancement are what are called payments bonds. Actually payments bonds are often linked with construction guarantys as well - completion bonds as they're called. A completion bond guarantys the owner and lender on the project as the name insured that the project will be completed according to specifications and presumably on time. So that if developer or contractors or subcontractors or whoever gets themselves into difficulty the bonding company has to step in and provide the resources and the supervision necessary to finish the project. Problem number two and very much related to the lender's interest of course is that the additional contractors and additional mechanic's liens that may have been created by the upset in the project program also be paid. Because those mechanic's liens may undermine the first lien security of the lender. So often tied to a construction completion bond is what is called a payment bond. And, in effect, the bonding company guarantys that the mechanic's liens and so forth will be paid and that they then will pursue recovery against then what was responsible for the default. But at least the lender now has his first lien position on the project as, you know, as he initially contemplated. Quite often as a result of the bonding company stepping in, they also end up owning the project. Sherman Terrace, for example, out here on the east side of Madison was owned for many many years by the bonding company because the original developer/contractor went bust during the development process and they had to step in and pick up the pieces. And ended up owning the project. They do not anticipate that they are going to lose money. What they do anticipate is that they will involve themselves in the hassle of assessing liability and going after whoever was responsible and collecting. They're obviously going to make their guarantys where they feel that it's collectible. The payment on the premium paid for a payment and completion bond is really a service charge that says we'll take on the legal hassle of collecting the money if it comes to that but hopefully, of course, the developer/contractor and owners of the project will have the wherewithal. Most government projects today still require payment and completion bonds. Most FHA projects still require that and most VA even home deals where you're building, let's say, a home for disabled veterans and so forth, would require the contractor to post a completion and payment bond so that the ultimate owner of the development can take title free and clear of mechanic's liens and will not be embarrassed because the project is unfinished. The problem, of course, is that there have are terrible losses taken, premiums are very high and in many cases, not available. Only a limited number of companies today have sufficient liquid resources that they will qualify for completion and payment bonds. So that if it's required on a particular project, they either have to joint venture that project with somebody who does have that or they're going to have to give away a piece of the action to some wealthy individual or institution to secure the necessary credit power to get the required bonds. Indeed, in some cases, the bonding requirements of the government run counter to the requirements really of spreading the business around smaller firms or minority firms who do not have the liquid resources, do not have the assets to give the bonding company assurance that if they have to step in they can get their hands on their money some time later by attaching the assets of the defaulting bonded individual. A good example of that kind of mess is the elderly housing project down on Park Street, you remember about a year ago they had to strip all the brick off and replace the brick on the project. And what happened there is interestingly enough was that initially that was put out to bid with the standard payment and completion bond requirements and they couldn't get anybody to bid on it because the kind of firms that would deal with that size project didn't have the resources to satisfy the bonding company and particularly at this point in time which was a down cycle in the real estate and development industry was the bonding companies were being pounded anyway by default. So they changed the rules and said, "OK, instead of having you have a bonding power, we'll only require letters of credit." And the letters of credit were then specified for latent defects and so forth and so on. And Wisconsin Housing Economic Development Authority (SHEDA) built the project as a turnkey basis and then turned it over to the City of Madison but they turned it over to the City of Madison, none of the letters of credit were assignable and so they were simply canceled. And the original contractor ultimately did go out of business. So now it turns out to be a major latent defect, the brick is peeling off the building and about to fall on everybody's head. They don't have the credit enhancements they thought they did and the ultimately responsible party, the corporate entity, was no longer in existence so now how do you proceed? And, of course, the City had to bite the bullet and is now suing everybody including WHEDA to get their money back. The fact that it was a nonassignable letter of credit, who's fault is that, I mean?

The City closed on it, if they wanted to make the deal, they should have taken the letters of credit along with it. But in the usual fashion, sue somebody for your mistakes.

Another element of credit enhancement, of course, is using not a standard mortgage form for the loan but using a bond indenture. By setting up the deal as a mortgage bond in which a bond, even a private placement bond, is issued to the lender and then there's a trustee that administers the bond and a program that takes back a mortgage as collateral. The tradition in bond financing has always been to impose a variety of financial constraints on the borrower. You could require that he couldn't pay dividends, couldn't pay extra salaries out of his corporate entity, couldn't make disbursements for new projects etc. etc. etc., until, let's say, cash reserves of the project represented at least a year and a half of payments on the debt program. And there would be other financial constraints. Or for some reason or other the tradition financially was that bonds had no problem at all restricting control, or providing very restrictive control on the borrower, relative to the cash reserves, liquidity, debt cover ratios, disbursements - the other future things that businesses might do in order to maintain the liquidity of the borrower. Mortgages, of course, never did that. Mortgages simply took a very static position and, you know, didn't impose any constraints on the borrower as long as they heard from them every month with a timely payment and then if they didn't hear from them, then they would try to go back and negotiate through the weakness what the borrower should be doing to reorganize his life to pay the loan. Well, as a result, use of a bond indenture form with tight controls on what the borrowing entity can do and can't do with its cash until certain minimum reserve cushions are established, is a form of credit enhancement. And you have much more operating control of the borrower and quite often what you will do, of course, is create a specific corporate identify with its own accounts segregated from anything else that the borrower is doing and require that corporate entity to build up a segregated reserve. By the same token, some developers and public agencies and so forth, require that the firm have a segregated cash reserve that they will look at in lieu of performance and completion bonds or other elements. So, for example, the C.A. Hoover Company here in Madison is one of the state's largest utility contractors. Utilities specifically require either performance and completion bonds or require the contractor to have large attachable resources which guarantee that if sued by their customer for nonperformance or whatever that there will be resources available to do that. And they have to show a regular balance sheet showing that their assets exceed a certain level of their contracts. And as a result, C.A. Hoover Company is one of the larger investors in real estate around and all of those assets are accumulated simply to maintain their so called bonding power with their customer clientele. And it becomes a form of credit enhancement which gives them a very significant competitive advantage against other contractors that would be bidding to install utility lines and gas lines and things of that sort. And so many developers that have been established for a time have essentially an asset base which is segregated and simply retained as part of the overall security basis. So they can go in and get 100% financing on the deal and no mortgage at all. The bank isn't even looking to the real estate for funding of the loan in the event of disaster, they're simply looking at the other attachable assets that the borrower may have. And that can be a very very powerful tool. One of the great old men of Madison real estate law has gone to his reward was Kit Steel and Kit Steel was a delightful old gentleman. He and his wife did many of the old houses that you see in town that still have the great redwood fin in the front and maybe a redwood facade on it. And they converted those old homes to rooming houses for folks that work on the Square and students and so on. And he and mother would go around in a pink cadillac with the roof down in the summer and took a very paternal view of all of their tenants. Old Kit was no dummy however. He built the Holiday Inn #1 with some of his profits from real estate and he always had women's night on Tuesday and would make sure that all of his girl tenants got out to the saloon for free drinks because it attracted the males from 17 counties to the Holiday Inn Bar and so forth. And he stood there and supervise things with mama. Kit has done very well by accident, he has bought 160 acres which turned out to be the intersection of Nacoma Road and the Beltline in which the store tractors and threshing machines which he rented during the seasons. That worked out very well and he got out of the tractor and threshing machine business all together but Kit never had a mortgage on any of the projects. He simply went to the bank. He had an amount of money on deposit at the bank in a segregated account and, you know, that was his collateral. And many developers worked the same way. In fact, even TV Lenny finances his projects the same way. He's got a $10 million CD on deposit at the bank. Everybody looks at that asset on the balance sheet and says, "Wow he's liquid." And as a result he's got $200 million in credit or something or other. And every lender thinks that $10 million is set up for him. So at any rate, you may want to set up that kind of credit enhancement through a segregated asset on the balance sheet.

There are other types of ways to provide liquidity. One is called a standby gap loan. There are two types of gap loans. One type of gap loan covers the period in which the construction loan expires but the permanent loan won't be fully funded because you haven't reached the required occupancy levels or you haven't, you know, finished construction for one reason or other, during delay. And the gap loan comes in, pays off the construction lender and stays with you until you can close on the permanent loan - sometimes called a bridge loan by the way. It can fund either the excess costs or it can fund the total construction loan during that period of time. The price of a so-called bridge or gap loan is very high. Typically you may pay from 3 to 5 points up front when the contract is signed. Probably have to give away a piece of the equity position and if, in fact, you don't pay off in time, you know, kinda one of those no-neck fellas with a funny Italian names will probably show up to help you pay. But, nevertheless, it is the wise developer who typically has a standby or gap loan to protect him against the possibility that a project is going to be strung out, not meet the deadlines on the construction loan and particularly where he feels that the construction lender is the kind of guy that would close him out and do it willingly. There's two philosophies among lenders. One is, of course, that you're the developer/borrower's partner and that you're all good friends and you're going to go down the road together. And the other's viewpoint is we're both big boys and we're going to make you the money and you're going to live up to the terms or we're going to take the project. And if you're particularly dealing with one of those, why then you need a gap loan so that you can get yourself out of losing the project and, of course, losing out on any future equity value created for your benefit. Gap loans.

Another type of credit enhancement is simply an assessable partnership. Many, many projects are done today with syndication. Many of those syndications are general partnerships, not limited partnerships. There have general partnerships deliberately for a variety of reasons. One, a general partnership is not a security and therefore you don't have to have all your ducks in order going in. You create a checkbook. You bring in five investors. They each pledge $250,000 up front and the developer and the general partners go down the primrose path together. And if for some reason or other the project strikes out they all lose together. Where in a limited partnership, the general partner has to have virtually everything set up, has to know what his loan is, has to have his proformas done, has to make a prospectus representation in many cases which means that he has sunk a great deal of cost and time into the project before outside money comes in. And therefore it's usually a general partnership.

A general partnership in the development game will generally have an assessable feature that says, "Fine, you're all in it for $250,000 and you're going to put your $50,000 in each month for 5 months, but if things don't go right you're all in for another $250,000 and we can collect that any time after the 6 months." They generally have sanctions against the general partner that now gets cold feet and doesn't want to pay in. If, for example, he has paid in 25% or less of his principal balance, probably loses his investment. But beyond that the courts would not permit a penalty which was 100% of the investment so that instead his position changes typically from general partner to long-term unsecured creditor in which his $250,000 that he put in on the first draw, but was unwilling to back up in terms of his assessment responsibility, now becomes a 6% or 5% subordinated debenture due 15 years from now. And the courts will enforce that. They'll pay you the money, it's going to be awhile before you see it. And you'll say, "Yea, but it's at 5% and the current market rate's 11%." And the courts are saying, "Well, they didn't take it from you all together. At least not instantly you were gonna lose it gradually." And they would enforce that. Now the bank is only too happy to know that the general partners are assessable for X number of dollars should the project come into play and require it. And generally would take an assignment of the assessability income as additional security on the loan. That has become so prevalent - either that limited partners only paying in gradually over a period of time or the general partners will be assessable that a number of companies including MGIC set up provisions which would then insure that those funds would be collectible. So you really have two layers of demand. One, of course, is an assessability feature that would require a progressive pay-in by the partners in the project and then on top of that you had MGIC coming along and saying, "We'll guarantee that they pay that and we will pay that money in as demanded, on call, as it were by the lender. And then we'll go back and collect it from whoever was draggin their feet relative to payment." So again, it enhances the liquidity of the project.

Relative to the safety of principal. The first element, of course, is some sort of partial endorsement. You would like the borrower, of course, to endorse the loan but as you know most income property loans are made on a non-recourse basis. And the object is simply to be able to apply selective pain. That's wrong, I'm going to make you a $5 million loan but you've only got $500,00 net worth and you're going to protect that. On the other hand, if I can get you to assign just let's say the top five percent of the loan, is what you're going to endorse personally. $250,000 on the top side of the loan is half your net worth. I, as the lender, will have your attention. You will pour your little heart into that project before you want to get called on that $250,000. So there's no sense getting him to sign personally for the $5 million, you don't have it, you won't do it. But maybe you'll look at 5% on the top of the loan as being the critical element. And the object of the partial endorsement is not to provide really that much additional capital protection as it is to make sure that you have a real commitment to the project because the pain that will be applied for the partial endorsement is such that you really will try to avoid that.

The second type of protection in terms of safety of principal which is becoming more and more common today is an insurance company bond on the principal. A number of major insurance companies, CNA, for example, in Chicago, Traveler's, Signa and so on will guarantee the top 10-15% of the loan and issue that on an insurance bond basis with a single premium payment or, perhaps if you want to renew it for 3 years of interim loan on annual premium basis. And they will look at the project in terms of what's the salvage value here because if they have to step in an honor their endorsement of the loan, it becomes their project. You, the borrower, are out. And they want to know that there's some value cushion there between the amount of money that they're going to have to pay the lender that they had guaranteed and the ultimate equity value of the project. And a relatively recent insurance device, interestingly enough created by March McClennan who of course as you know is essentially an insurance broker and they created a special division for real estate which provides for these kinds of insurance company guarantys on major income property loans - particularly development loans, but also for the purchase of existing buildings that are in a workout stage presently, let's say that have 60% occupancy. To make it really viable you're going to have to get another 20-30% occupancy and they'll step in and insure the loan for the first three years so that you could get a sufficient loan to buy the building even though the cash flows won't provide the initial rent number ratio that's required.

Another major source of principal is to assign stock for the corporation that owns it, particularly where specific amounts of equity has been put up. And watching up in

Minneapolis, there's several projects that are on again, off again and the lenders have been baking off and putting on new requirements for equity. And requiring that the borrowers put more into their shopping center and hotel development. And what they do is they take an assignment of the stock. Now, they may also assign a general partnership position. Notice what happens and WHEDA does this (Wisconsin Housing Economic Development Authority too). Quite often the real problem is if you were to foreclose, is that you're going to do terrible things to the limited partners in terms of their tax status and what you really want to do is not get into a big fight as to whether it is Chapter 11 or this is a foreclosure and take back the asset and so on. Quite often it's a crisis in management. The general partner or the people that control the corporation aren't doing the job as you thought they could or as they represented they could and what you really need to do is take control of the property before it goes down as an asset. And so what you do is set up a series of covenants in the deal and then say, " All right, a breech of this covenant allows me now to vote the stock." And, of course, you vote the stock, put on your directors and out goes the management that's controlling the deal but now your guys are running the project. And the same would be true on a limited partnership. Now remember that the general partner can only be evicted at the will of the limited partner. That may not happen fast enough so what you do is you get the general partners to assign his general partnership position to the lender. And then if the lender feels that he has breached one of the covenants, he simply slides into position with being the general partner until he can replace it and assign it to another general partner who will run the project correctly and appropriately. And it presumably will get you a fast response to protect your principal before the project starts to really run downhill, lose its momentum and perhaps to be a significant waste of the underlying real estate. Yes. Question: Doesn't that create some problems with under liability? Chief: Sure it can and the general partner may sue if he feels he's been abused or the stockholders may feel that he's abused. But typically they'll set that up, for example, the developer may be the sole stockholder in the corporation and what you're really trying to do is saying, "Rather than going through this long involved process of getting control through foreclosure or even through Chapter 11, you've breached the covenant, bang. You lost control of the stock." Now, all you get is the right to vote the stock, you may leave the equity behind. But as long as you can put your guys in charge of the project, when you got it on its feet and the loans repaid according to its terms, that's really all you want. At that point you hand it back to him, here it's yours, bank with us.

Another method of protecting, of course, the principal is to subordinate the financing on other components of the project. Typically in a hotel, for example, you would require that all fixtures and equipment would be subordinated to the first mortgage. And they may define that fairly broadly. It's not unusual, for example, that the elevators could be financed by the elevator company and the window air conditioners to be financed by the air conditioning company and so on. And all of the chattel notes that would be on those resources would probably represent 20% of the value of the enterprise or more would be subordinated to the first mortgage. So if push came to shove and they had to sell the hotel in order to get their money back, all of those guys would be wiped out. People could come in and pay $.80 on a dollar, buy the hotel for the real estate component of it and those that had provided the equipment and so forth, even though technically it was now a fixture like an elevator, would lose out. In addition, there's generally an after acquired property clause that says either those aren't the original elevators or the original air conditioning or the original furniture or the original kitchen equipment, everything you've added since you've owned the hotel, becomes part of the subordinated collateral value backing up the first mortgage - very, very typical kind of arrangement.

Of course another way of providing safety of principal is to simply require a large downpayment that is disbursed prior to the mortgage draw. More typically found in residential but now beginning to appear income property levels. You say, "OK this is a $10 million deal, I'll give you an $8 million loan. That's going to require $2 million up front of your money. You give me, the construction lender, your $2 million and that's the first $2 million I'm going to disburse. Then after that's gone, then I'll start drawing down on the construction loan." As a result the lender knows there's money in there ahead of them particularly at the riskiest point in the project. After all, if it aborts at that point, all you've got is footings in the ground and a couple pieces of reinforcing rods sticking up above the grade. You really don't have much to sell as collateral value. It's only after the show of a project that's completed, it starts to look like a building, that somebody else might come in and buy it, if it were necessary to sell it, in order to pay off the loan. So as a result, they would require your money go up front and go in first and it would be under the control of the construction lender disbursing agent to make sure that it went out first.

Finally, of course principal endorsements are available from government sharing guaranty. The first type of government guaranty, of course, is FHA multifamily insurance. The FHA has made a practice for years of making non-recourse loans. All FHA deals, in fact, are non-recourse loans. If the project goes bad, they have no recourse against the borrower, which is one of the reasons borrowers are willing to put up with the FHA.

Nobody else would make them a non-recourse loan, but the government will. Secondly, the FHA, once they have committed on the permanent loan, once they have set their standards and they're willing to issue the guaranty on the permanent loan, they will extend the guaranty coverage to the construction loan. So now, not only do you have permanent finance enhancement but you have construction loan enhancement. Now that's relatively unique. There are very few project kinds of guarantees where you can get that type of insurance on the construction process. Again, another reason for young developers doing FHA projects, because they can get a type of credit enhancement that would not be available otherwise in the private market. The trick, of course, is learning to live with the FHA and meet all their requirements and paperwork and so forth which can be a very frustrating and exhausting experience.

The second area of government guarantys are SBAs (Small Business Administration Loans). Typically the SBA will insure 85-90% of the principal and the lead bank, the original underwriter, who is looking at the deal will have to take the risk on the first part. So if the deal goes bad, 90% of the loss on principal is taken by the government, the guy that made them supervise the loan, will have to take the hit on the balance. If he's clever about structuring that in terms of the points that he gets up front and the interest that he's going to be able to charge and so forth, he will have recovered his 10% very early in the game in terms of what he might have to pay out. The result is ultimately that he might not make any payments on the loan but the clever banker will probably not lose any of his principal on that either. Obviously, by being a coinsurer with the Small Business Administration, the premise is that of course the pain will cause them to be a more careful underwriter and a tight administrator of the deal. That remains to be seen whether in fact that's true. FHA is also trying a coinsurer arrangement and will abdicate its underwriting responsibilities to selected mortgage lenders who will package the loan deal and so forth and keep 10% of the risk on the personal side. Probably getting enough points so that on every two loans, it probably has its 10% exposure back and it doesn't expect, of course, after the deals it makes to go bad.

There are further economic development guaranty loans in areas that have qualified for special government assistance and these economic development loans, again, typically take the small business formula of perhaps guaranteeing 90% of the principal and requiring that the lender of record who initiates and administers the loan swallow the other 10% of the loss.

Now, let's talk about any form of guaranty for a moment. Financial guaranty and, by the way, that's always spelled with a "y", g-u-a-r-a-n-t-y as opposed to a double "ee". A double "ee" says it will work or do what it's supposed to do. A guaranty with a "y" is a financial promise. It's usually a conditional promise to repay the debt of another if the debtor fails to do so. A financial guaranty is a conditional promise to repay the debt of another if the debtor fails to do so. There's a legal maximum that the guarantor is a favored person in the eyes of the law so that the terms to the guaranty will be always strictly construed by the courts in favor of the guarantor, not the lender. Typically the guarantor can come up with a variety of ambiguities and so the lender must be very careful to be clear in his own mind, as well as in the language of the agreement, as to what the coverage and conditions of the guaranty really are. So that it's impartial. It's a very tricky piece of the law. Guarantors usually limit their guaranty, particularly those who are not involved with the investment directly but are doing that as part of their business or investment philosophy. And the limits can be one or the amount (?). You have to be very careful about reading the language. Typically the amount they guarantee is less than the original balance of the loan. For example, given an amortized loan, the guarantor is released when the payments have been made, equal to the guaranteed amount. So if you have a $10 million loan and the guarantor provides a million dollar guaranty and his language is right, as soon as the borrower has repaid $1 million on the loan, the guarantor is off the deal. He guaranteed the top million, that isn't there anymore, not his problem anymore. Obviously, the lender would rather lock the guarantor into the last payment. Second of all, if it becomes necessary for the lender to advance additional funds to increase the loan and that changes the risk of default therefore by the individual, does that invalidate the guaranty? Probably so. If the guarantor comes in an says, "OK I'll take the top million on a $10 million loan. The project has a cross-over loan with the lender - provides $11 1/2 million and now the debtor can't make the payment on the $11 1/2 million deal, the guarantor can come back in and say, "Wait a minute, you changed the risk on the deal, I'm off the hook. I was looking at his ability to repay a $10 million loan, I thought that was a safe bet. I would have never made the guarantee if I knew it was going to be $11 1/2 million loan." Furthermore, if there are several loans and only one of which has been guaranteed, what's the priority and sequence of collection if the asset is sold? You got two loans, one of which is guaranteed, one of which isn't, both first mortgage loans. Now you sell the asset. The guarantor is going to have to say, "Wait a minute, there were enough proceeds to pay off the loan that I guaranteed. You didn't choose to do it that way, that's your problem but I have priority."

Another control on the guaranty may be the date. The date might be conditional. For example, I'm reaching a certain level occupancy. I'll cover the timely payments on the mortgage until the building reaches 80% occupancy. It reaches 80% occupancy, the guarantor is off the hook.

Guarantys may be limited to certain kinds of losses. Quite common today, for example, to have a guaranty on losses caused by environmental legislation. If nothing happens environmentally to the property, the guarantor isn't responsible. They may be limited to problems of fraud or fidelity matters. I guarantee that the representations made and the closing arrangement and so forth are so and indeed I'll fund the difference. Not unlike what a title insurance company does, of course, relative to the title clause. That's really a form of guaranty - a much more formalized one. But today more and more, you make representations in the closing agreement relative to the environmental status of the property or relative, let's say, to whether a certain tenant, as in the case we just had, I think as I recall Prudential provided a guaranty of one year's rent on the presumption that it would take that long to release the property. OK? That would be a conditional guaranty with a time dimension. Guaranty is your last recourse. After you have exhausted all of the other assets of the borrower and so forth, we'll issue a collection guaranty that says you took the borrower to court and got a judgment, you attached all of the assets that he had, and now you still have a balance due, now call the guarantor. A payment guaranty, by the way, allows the lender to proceed directly against the guarantor without having to go through the judgment process. So a collection guaranty is the last resort protection for the lender. A payment guaranty, obviously, is a high priority, go directly against the guarantor without having to attach the other property. Other types of guarantys would be a traditional guaranty which would only come into play let's say if the appraisal falls below a certain number. Now you promise that I might have an asset that would be, you know, a 75% loan to value. I make an $7 1/2 million loan against a $10 million asset. The appraisal came in at $9 million. The guarantor would step in and say, "Fine, I'll give you another $2 million worth of value until the amortized loan falls to a point where it's 75% of value." So because the preferred status of the guarantor and the ambiguities, it's typical for guarantors to go into court and try to avoid payment. They can say, "I just didn't understand what I signed. You didn't understand what I signed. I signed off only because you promised to do something and you didn't do it so all bets are off. You did something with respect to the borrower without consulting me to change the risk and was discriminatory against me and my guaranty so "Phooey on you, I'm not going to pay." You know, "I didn't realize what I was signing, so therefore it was a defraud." A classic case is the Olympia Resort in Flint. Olympia Resort, you know, is in Oconozucwoc and I can remember being called on that first of all by the developer. The developer's all excited. He's got a letter of commitment from a New York Bank that said that they would give him $50 million to build the resort if I would approve the feasibility of the report. Well I knew the site, I knew the pieces and I knew the developer, which was even worse, and I said, "Gee Charlie, that's really wonderful but I think at this point I have no time available to do that, it'll be three or four years before my schedule will permit me to do that and so when I called the bank, "I said what are you idiots doing out there?" And he said, "Well we'll worry about it. We've got 18 doctors that are the limited partners and they are all going to sign personally on the construction loan, so what do we care if it doesn't work." I said, "One, that's immoral and two, that's stupid and count me out." So I sent a friend of mine out to look at it from New York - a good appraisal firm - he looked at it and charged them $1500 for coming out for the day and said, "Forget it." I don't like the developer, I don't like the site and I don't like the project." Well, he said, "Kiss off, we'll go get a big name firm to go in and appraise it, which they did, came out to appraised value and they went ahead and funded the project. Well, the developer left for South America long before it was finished and they had come in and spend another $10 million to finish it. . . .

Administrative Announcements: 1. Some of you, I know, will be attending the morning sessions of the alumni back on Friday at the Concourse. If you still want to attend the first section, the 105 quiz section in Room 113 will be available to you as you may miss the morning session of this section. I think they're going to be in the Concourse, instead then you can attend the 105 session in Room 113. If not too many attend why there'll be enough seats, otherwise they'll run out of seats, but at least it will give you a chance to do both things. Second of all, a couple of you have signed up to assist on the registration relative to the alumni affairs and Elaine has posted on the bulletin board right outside my office the times during either the Thursday evening or Friday that she would like, you know, specific individuals to be there to assist so if you would look at that board, you can amend your schedule. And finally, Elaine needs help at 5:30 or 5 o'clock actually to assemble the ring binders and so if some of you are available in Room 120, there'll be a short assembly party while those packets are put together for the alumni. We have over 350 alumni coming. We had 100 and some students that are attending to that and so we'll be pushing the capacity of the Concourse as well. So if you have elected or selected certain sections that you are going to, be sure you attend those sessions that you said you were going to, because we've had to allocate the room space by the estimated attendance in each session, so please observe those selections, if you will. Tomorrow night is the welcome buffet for the alumni. As you know, all day Friday is a seminar afterward at the Concourse. And we have some really exciting speakers and program elements there. OK. So much for Friday.

And now we want to move on into one of the major areas of risk management for Wednesday which is essentially the interest risk. The interest risk takes several forms, some of which are relatively easy to deal with mechanically and others which are more elusive and for which there are no adequate solutions at this point in time. The first interest risk faced by the lender essentially is call protection. When he makes the loan at the top of the interest rate market, there is obviously a built-in bias of the borrower to refinance when interest rates fall, leaving the lender, of course, left in the lurch to reinvest the funds. And to protect the lender then against the loss of investment opportunity when he, in fact, incurred a high risk because he opened the project and now is not entitled to the benefit of that debt, as it were on your talents and your budget is obviously unfair. We want to look at the call risk and the ability to reinvest the funds at an appropriate rate.

The second type of risk, of course, is that interest rates will rise after he has made the loan and he, therefore, has a significant opportunity cost being locked into a long-term commitment at a below-market deal which, depending on the type of investor, may or may not be a significant problem. If you're a savings and loan association required to maintain current dividends that are competitive with cost of capital, to be locked into a portfolio of low interest paying loans means that you are unable to compete for capital and that capital will gradually evaporate out from under you and you face eventually a liquidity problem and an insolvency problem because you can't sell the loan for the obligations that you have incurred as a result of it. Other lenders, of course, can match the interest rates on their project to their commitments more effectively like the life insurance company and so on. It's not as significant of a problem, other than it may affect their competitive effective cost of insurance over a long period of time. But, at any event, we need to look at the fact that interest markets are volatile and that if interest rates rise after the contract has been made that the liquidity value of the loan declines and, obviously, the portfolio gradually establishes an average rate of return that is less than competitive.

The third major interest rate risk is that the inherent business risks underlying the project which will be financed, are higher than that contemplated by a mortgage rate. That there is a mismatch between the presumption of fully collateralized well-protected capital underlying the loan and then, in fact, the risk payoff matrix is inappropriate to the lender. We will look at each of those elements.

The first being the call protection or preservation of the investment once it's made. We've seen a number of features already during the semester that direct themselves to that problem. The first, of course, is that you walk in and say there are no prepayment privileges - that for the term of this loan for ten years is 12% and that's tough luck Charlie. If the rate falls to 9%, you're going to continue to pay 12%. This is by far the preferred method, of course, of lenders. They are assured of an investment of a given duration and a return on investment that is not going to cause the borrower to refinance and escape that element. The problem from the borrower's standpoint is that that very significantly depresses the market value of his equity. It may, in fact, wipe out the equity and make the real estate illiquid. If, for example, you have a 12 percent loan with no prepayment privilege and the market rate falls to 9%, the property equity is devalued by the present value of the interest payments between 9 and 12 percent for whatever remaining duration there may be on the loan. And that could be pretty heavy going. In our portfolio up at the First Bank we have a little office building which at fair market value is worth $2.4 million. We thought we made a real clever 12 percent loan a few years ago when the rate was 13% and now we can't sell the property subject to the prepayment non-provisions for probably less than $1.8 million. So we've taken a dip of $600,000 on our equity when we only had probably $800,000 worth of equity in the property in the first place and so you lose three-quarters of your equity as a result of the non-prepayment privilege. The alternative is to sit on the property and wait it out. Obviously, the owner would like a little more flexibility than that and so you have seen the DeWitt Letter of Commitment a clause in which, if it were prepaid you would have a yield maintenance agreement - that the cost of prepayment will be purchasing sufficient treasuries for the lender that the difference between what he can reinvest the money at at the time you prepay and the contract rate for the duration remaining on the loan will, in fact, be paid for by an escrow account of additional bonds yielding whatever the spread may be. Now as you begin to approach the point at which the loan is going to mature anyway, the yield maintenance element may not be that expensive and you may be able to go forward and refinance or sell the property or at least get out from under the existing loan. But that yield maintenance agreement can be a very expensive proposition if rates have fallen significantly from the time in which you financed the deal. And all that does it does allow you a way out but it's an expensive way out.

A third alternative with a little softer consequences again for the borrower may be a staged prepayment in which you're allowed to perhaps prepay 20% of the remaining balance each year without penalty. But beyond that you would be subject to a yield maintenance or a fairly stiff - anywhere from 5% to 10% of principal would be paid to the lender for prepayment in excess of that minimum annual allowance.

Other ways of handling that same rate risk, of course, would be to go to a variable rate mortgage. After all, the old American way is "them what takes the risk, takes the profit." So if the borrower is willing to take the risk that interest rates will sail and rise, the lender may, by the same token, not feel that he has to have an average rate of return. Over the life of the loan, that he can take the current rate as his point of departure and move it up and down on some index. Maybe it's indexed to treasuries, maybe it's indexed to cost of funds at the federal home owned bank. There are a number of ways of indexing a variable rate loan, but obviously that makes the cash flow planning of the borrower a little sticky. Now, if he has a relatively small loan and adequate cushion in the net income of the property, or he has other net income from other properties that are not encumbered by debt, he may be able to take that risk and, in effect have a variable rate versus a fixed rate loan and the lender, therefore will not have to load his interest rate for a premium that reflects the possible risk of rising rates. The largest application to that, of course, has been in the residential area and in the commercial area they are typically more likely to go to what is a called a Canadian (?) roll-over concept in which the loan has a relatively short maturity. Every three years or every five years, the loan technically comes due, guaranteed renewable, but at whatever the market rate is for that type of loan at that particular point in time. So you again have a sharing of the risk that over short periods of time 3 to 5 years, the lender takes the risk that the rates may bob up and down and over the longer term the borrower takes the risk that the rates may shift upward on him. The initial deals that were cut, essentially calls the loan to come due and the lender to take another look at it, and the borrowers are going to take another look at it. But that could leave the borrower hanging out there in which the lender didn't want to refinance him and nobody else did either and, as a result, he lost the advantage of the long-term loan getting him through business cycles and changing attitudes by lenders as to what kinds of properties they wanted to lend on and so on. So essentially you may have a 25-year term loan and every five years, it comes up for renegotiation on the interest rate. If the borrower doesn't like the deal he got, he can cut and run without prepayment. Otherwise he has no options, he has to take whatever rate the lender provides. If you'll recall again on the DeWitt commitment, they were locked in for seven years. They probably negotiated that up from five and the cost of that was essentially that there was a 250 basis point move upward and then they capped it again, so that for the last three years of the loan the interest rate does not exceed an increase of 250 basis points, if that was justified by the market. Now if the lender gets too aggressive, too greedy, at some point the borrower says, you know, "See you around, I can get it financed by so-and-so at this rate." Obviously, there's a little thread there because if he has to go to another lender and pay another point to get another loan and go through the loan closing costs and all of the costs of closing the loan, then it isn't going to be dollar for dollar. The first lender has the advantage of being able to push that, let's say, 25 basis points or more beyond the market rate before it becomes cheaper for the borrower to negotiate a new deal and pay all the costs that would be involved with the new lender. True, there are no prepayment penalties relative to the old lender, but there could be significant loan origination fees relative to the new lender and, obviously, the first lender can compute what that's likely to be and come up with a basis point increment over the market rate which virtually extracts all of that change over cost out of the borrower and it's still just easier to go along rather than go through a whole new process, declaring that you're going to prepay the loan (?). In any event, that initial interest rate risk has been, I think, effectively handled by commercial lenders and certainly the yield maintenance type of agreement goes a long way in stabilizing them against the call of the loan when interest rates fall.

The second problem is what do we do when interest rates rise. As you'll see, in general there's some negotiation between the borrower and the lender, as we mentioned, the Canadian role over plan and so forth, sort of takes the short term risk is the lenders, the long term risk is the borrower's and now how do the borrowers pass that risk through to their tenants. There are any number of leases today in which one element of the escalator clause in the lease is a pass-through of increasing interest cost at some point down stream. So if somebody, let's say, is in a 20 year leaseback of a single tenant industrial building and all you can get is five year protection on the interest rate on the loan, the wise developer will try to negotiate an adjustment in the rents that will pass through the increment in interest rates to the tenant since essentially a tenant that has a bill-to-suit a leaseback situation is really receiving the use of capital. That's what the transaction is all about. It's just a way of financing the capital requirements of that particular tenant. And, therefore, his lease reflects the fact that the cost of capital has to be variable over a stated period of time and so on. But that's not always possible. Sometimes you can simply hope that you can roll the leases, let's say, at the end of their five-year term on a shopping center and increase the rent roll adequately to cover whatever increase in interest rates there may be. The alternative is to establish some sort of cap as we point out in the DeWitt.

The other alternative, which is the major subject for today is to create some sort of participating loan. The participating loan recognizes really both of our last two issues. One, the fact that interest rates need to vary with time relative to the capacity of the project and relative to inflationary pressures on the economy (?) may cause it's decline (?). And second of all that the financier, the mortgage lender on the project, in many cases is more likely to be in the venture capital business than he is making really a straight secured, you know, blue-chip investment suitable for widows and orphans. And, therefore, we are looking for a device by which the interest cost as a cash drain on the enterprise early on can be deferred and yet the lender has protection against, one, rising interest rates and, two, compensation for the additional risk that they took at the time the project was relatively new.

The very first participating loan was made by a life insurance company called Tennessee Volunteer Life. And it was made to finance an industrial facility for the Dow Chemical Company in the late 1930's. They made essentially a mortgage loan subject to an industrial bond indenture - so they used an industrial bond format in which the bond is collateralized by mortgaging the facility and attached warrants to the bond that would allow them to buy Dow Chemical stock at a very nominal price. So when the plant, of course, was very fortuitously built at the low costs of the late 30's, late depression, it hit World War II, the thing just took off and so did Dow's stock. And Tennessee Volunteer Life made a fortune for having taken the risk on that particular plant. And that was not lost on a lot of folks. In fact, it's still a rather bitter pill that Northwestern Mutual had prided themselves on being the low-cost company. Tennessee Volunteer Life for years, which nobody had every heard of, because they didn't have the same skill in marketing that they had in finance, had a lower cost per dollar of insurance than Northwestern Mutual, simply because of the huge surplus they had created for themselves by the profits on the Dow Chemical deal. Now, the insurance company said, "Gee, where is that going to play best? Where is the best up side against rising interest rates due to inflation? And they said retail property, in other words, shopping centers." And in shopping centers where you have rents typical with a base rent plus an overage tied to sales. That if retail prices really run amuck because of inflation obviously the sales values will increase and the overage rents will increase and they will be capable of paying higher returns on the mortgage. Because of the early days of regional shopping centers, very few lenders were capable of providing the kind of money that they needed. They were able to create participating loans. And, in effect, tell the developer, "OK, I'll put up your $60 million bucks but you're going to create, one, a special corporation to own the shopping center and we're going to loan you the money on a mortgage bond format and you're going to give us warrants to 20-30-40, sometimes 50% of the stock in the shopping center corporation. And when the mortgage is repaid, we can exercise our warrant at whatever the net worth of that shopping center corporation may be, you know, as appraised at fair market value etc. etc., at that particular time. So they're really following the best format of the Dow Chemical deal. Obviously that worked exquisitely well because if you had financed a $60 million shopping center and now 20 years later they have paid off the loan and you now own 20% of that and let's say it has doubled in price because of inflation, you got $120 million shopping center and you're entitled to something in the neighborhood of $24 million of it as a little kicker at the end of the loan, it significantly alters the rate-of-return. And the very early-on folks began to perceive that. The first deals were cut in the late 40's on that participation basis. There weren't a great number of them, but certainly Teacher's, New England Life, Mass. Life, Connecticut General proved that Met was always slow on its feet, in those days, but and, Northwestern, benefited greatly from that kind of deal cut in the late 40's, early 50's and they watched them come home to roost in the early 70's. In many cases they came home to roost earlier because now the developer wants to refinance his deal or wants to expand the shopping center and he's got to come back to them and buy his way out. Now in almost no case does the lender retain the ownership position. The idea was that the developer, typically very jealous of his ownership position, would simply come back in and buy them out to get rid of them. I'm not going to be a partner with XYZ insurance company, what's it going to take to get rid of you based on the terms of our agreement and they would arrive at a value of the shopping center and allocate accordingly to the book value of the shares of the corporate entity and then the developer would refinance his shopping center, take part of the proceeds of the refinancing and buy out his previous lender. That was the game until the mid-70's and by that time inflation was starting to push hard at it and they were saying, "Gee, that worked so well. Look at the money those guys made in the mean time. Why can't I participate, not in the net worth of the corporation 15-20 years after making the deal. Why can't I participate each year in the net income which is moving up that very nice curve of increase as a result of either better marketing in the shopping center or inflation?" So the second level of participating loan was cut in which they would share in the increase in gross rents, excuse me, called the increase in rental income, and the retail price of the center. As interest rates were rising, the developer really didn't have a lot of choice. First of all the developer wanted to finance out on a shopping center so a major life insurance company would go to them and say, "All right I'll tell you what I'm going to do. I'll lend you 70% of your center on a conventional deal at 10.5%." And then the developers screamed bloody murder, it can't work and so forth, where am I going to find 30% equity in the deal. So they say, "All right, tell you what we'll do. We'll give you 85% of what you need and you give us 15% of the action and we'll make the deal at 9.25%." The cost at 9.25% essentially in terms of total dollars of income taken from the project was probably the same on an 85% loan as it was at 10.25% on a 70% loan. And the developer is still moaning and groaning, "What do you mean, I've got to use my own money. It's unheard of." And so he says, "All right, tell you what we're going to do. We'll give you 100% of the money you need, but at that point we're going to take 50% of the resale net profit and we're going to let you have the money for 8.5%. OK? You look like a good guy. And then we'll also take 50% of the cash throw-off." So you can take your choice. You can put up your own money and we won't be quite so greedy, but if you want us to take the venture capital risk and give you 100% of the money and so forth, then in return we're going to cover ourselves on our interest cost by taking 50% of the cash throw-off as to debt service. Our bond indenture will control how much debt there's going to be. It's only going to be our loan, thank you, and on our terms and we'll take 50% of the refinancing profit you get when you get rid of us or 50% of the net profit over and above your cost on resale. And the developer said, "Gee that's not really a bad deal." And, of course, one of the problems that the lender hadn't anticipated was that the bookkeeping got to be done by the developer. And so, again, there was almost never any cash throw-off. So the guy says, "Wait a minute, time out, we've got to take a little kick. What we're going to do is we're going to define the net income in which we're going to participate. We're going to set up very stringent rules in the colonial (?) arrangement that defines what is, first of all, gross rent and then what vacancy will be permitted as normal. And we'll then subtract those expenses which are beyond the demands required (?)." There's not much you can do about insurance payments or real estate taxes and so forth and so on. But there are a lot of discretionary items. You know, you can spend more money on uncle Louie's janitorial services than they're really worth and vacancy allowance and we don't see why you get to spend our money advertising to fill the space etc. with your advertising agency and so on. We're not sure what we're getting for that money. So for all those items which are discretionary, they should be 15% of gross. Now if you do it and make this thing work on less than 15% of gross, wonderful, you're efficient, you keep it. But if you spend more than 15% of gross, all we're going to do is subtract 15% of gross as an allowance for those expenses. And we're going to come up with a defined net income. And then from that defined net income we are going to subtract the basic contract interest and principal payments that you have with us and now we're down to cash throw-off and now that cash throw-off is what we're going to split according to our agreement - 50%-50%, 30%-40%, or 30%-70% or whatever it happens to be. So imposed on the developer a set of accounting principles that allow them to be reasonably confident that at the end of the year the auditor's statement pretty well defined what net income there was to divide. Shopping centers were a great place to start because basically shopping centers created significant value increments over and above cost. After all, if you had created a shopping center that was worth $50 a square foot and it cost you $30 a square foot to do it, your leasing capabilities and your ability to generate income well in excess of that which justified capital cost, meant you had created $20 of value there. And therefore, the developer in sharing that, created value because the lender was willing to make the loan, really wasn't losing any hard dollars at all. He was losing a soft dollar. The synergy of capital and his ability to market the center was creating value well in excess of the dollars and therefore it was possible to share those paper dollars created as a result of the appraisal process, the market perception of what shopping centers were worth etc. etc. So the model for participation worked well on the kind of real estate where you did create that significant increment in paper value simply by your ability of expertise to create that kind of project. It was the ideal blend of the capital available from the institution and the entrepreneurial abilities of the developer. And hence there was a good negotiation base to do that. And, in fact, it did succeed in providing a variable, ever-increasing interest yield to the developer and, in fact, a yield appropriate for the venture capital risk that he took up front at the time they built the center. There were certain limits which they had to place on. One, of course, was the usury limit. It was quite possible that the returns would be so attractive from the participation that in many states you would very quickly reach the point in which the issue of usury would come into play and the lender, therefore, had to put a cap on how much he collected and, in effect, in any given physical payment period, the amount due from the project would not exceed that which was a non-usurious interest charge for the money. That was problem number one.

Problem number two was to shape that share in such a way that it didn't adversely affect the appraised value of the property because the appraised value had to exceed the amount of the loan which was technically going to be 100% of the cost. So, for example, if you had set the deal up as if 5% of gross rents went to the lender, the appraiser would start right out with a rent rule that was 95% of what they were collecting. And the result would be net income would fall. When you capped the net income, you get a lower value, therefore, you would have to be able to make the loan on less money and so on. By in fact, taking your cut at the bottom when the appraiser was dealing with net income and gross rent multipliers and so forth, you weren't adversely affecting your appraisal results and therefore as a lender, you could make larger loans than statutory rules thought by loan valuations might have otherwise permitted. So it was important to structure it and keep your eye on that aspect.

A third aspect, of course, was the degree to which you wanted to control the developer's degree of discretion. Obviously, the one was the 15% clause. The bond indenture often created other constraints on the developer. He was unable to put on second mortgages on the project and would not be permitted to disperse all the cash collected from the corporation. And instead would have to create a reserve to cover one or two years debt service payments on the mortgage before he would start making dividend distributions to his investors or himself, etc.

The next problem, however, with participation loans was that they had worked so well on shopping centers that other lenders, less sophisticated, thought they would work well on everything. They really didn't understand, for example, on apartment buildings that it typically cost you as much to build it, as it was worth when it was finished. That you were really gambling on a long term appreciation in rents to cause any significant capital appreciation. So when you started asking the developer now to share 50% of the, you know, resale price, proceeds or the refinancing proceeds, you were starting to dip into some of the hard dollars the developer had to put in to make the project go. It simply wasn't that paper profit increase for having created the project. There was almost a dollar for dollar element, what you could borrow was about what it cost to do the project. In addition, typically on apartment buildings, sometimes on office buildings, it was not unusual for the developer to have to come in under the market on his rents in order to get people to move. So if the pro forma might show that ultimately it's a $500 a month apartment, but he might have to lease 'em for the first two years at $450 so that people's perceived bargain could motivate them to pick up and move and relocate and do all of those things. And so now if you've got a deal in which the lender is getting a percent of gross, you know, first the guy is below market and taking a loss and now to make the loss worse, $450, 5% of that is supposed to go to the lender. He says, "Wait a minute, hold everything here." Them what's taking the risk, takes the profits initially. So what we're going to do is. We'll give you a participation loan, but first of all there's going to be a floor and you don't participate until the rents reach a certain level. So, until rents get to $525 a month on these babies, you don't get a participation, you get just your interest rate. What's more, is if, you know, the whole accounting goes to hell in a basket and inflation takes over and so forth, if rents go over $650 a month for these things, it's got nothing to do with the capital that you advanced on this or whatever and therefore we're going to put a cap on it and if the rents go higher than that due to reckless management or the fact that the economy collapsed and the dollar is going to devalue, then in any event, you know. (?) So they began to structure a floor below which the lender wouldn't participate and a cap, above which the lender wouldn't participate.

The savings and loans didn't want to get involved with all the fancy accounting necessary to define a certain net income and therefore the less sophisticated tended to go with a gross rent or effective gross rent - rent after vacancy. And the sophisticated borrowers would always set that floor a little above where they thought it was going to get to in the near term anyway. And so many of the lenders that came in on a participating loan, on apartment buildings, on industrial sale tenant net leases, and so forth, were very much disappointed in that the rents never reached the level that were anticipated for them and as a result their participations were minimal or nonexistent. Instead the landlord found other ways to make a profit. He defined it based on the apartment unfurnished and then marketed the units furnished and loaded the furniture cost in there or he rented the furniture from his own rental agency which wasn't part of the deal. Or he put in user charges for parking or a variety of other things and in some cases and still in some markets they have what they call T-money. When you signed the lease you have to pay the manage company $240 for setting up the deal rather than spend $20 a month more rent. So as a result the books never show what the real rents are and unless you were really a capable, knowledgeable lender the chances of your making the participation loan work dwindled. So today I would say that most of the unsophisticated lenders on apartment buildings would much rather have interest rate that was higher initially and not dependent on future performance of the real estate and have relatively short fuses - anywhere from 5 to 10 year term, at which point they got to renegotiate the interest rate and knew the borrowers could go elsewhere if that's what suited you to do. So development participating loan was a very hot item when it was hoped that the interest rate was tied to rents that would inflate either as the project gained stronger market positions or because of devaluation of the dollar. Today, of course, the typical lenders no longer takes his participation that way. The majors become owners of the property and we call it a joint venture. But at this point in time - late 70's, early 80's - they wanted to be strictly a creditor so that they had all of the creditors powers on the down side, but enjoyed some interest risk protection and some profit participation on the up side.

Today the participation loan is used primarily by pension funds because again, they don't necessarily want to be the owner of the real estate with the liabilities and so forth that that carries. They would rather be a creditor on the down side with profit participation on the up side and instead of negotiating the loan themselves, there are several firms around the country which do nothing but manage and create participating loans for the benefit of the institutional investor. One of the best of those out in California is Piedmont which is run by two former professors, by the way, from Ohio State, Bob Jerks and Dan Koab and all they do is represent pension funds and savings loans that want to go into participating loans. They structure the deal, they negotiate the deal, they monitor the deals. The only thing they never do is take the money. Having set it up, the title company in Chicago takes the funds from the client, distributes them and disperses them under the terms of the agreement, all interest payments taken are sent directly back to the title company and therefore all the bookkeeping functions, all the fiduciary functions which are relatively expensive but relatively low paying, meaning that you have to have a large staff to handle all of that stuff is simply sidetracked. And Piedmont are a very very small firm - I don't think they have 20 employees, is handling well over a billion dollars in participating loan arrangements. They know what kind of deals create that paper profit that can be shared between the developer and the lender so that the value created by that synergy of capital and management makes a participating loan a logical and suitable arrangement and the lenders with the exception of the big lenders which go out for joint ventures, simply don't cut these deals themselves very much any more at all.

OK. Any questions on partcipating loan? As I said, the participating loan initially was designed one, to give them some interest rate protection against rising rates due to inflation. Secondly, it was designed to provide additional compensation for being venture capitalists where the lender, in fact, was providing most or all of the money for the real estate deal.

From the experience that they had doing participating loans, the major lenders, the sophisticated lenders, learned that even if you had a participating loan, you were still essentially a creditor who, while you had some influence on the project management, design, implementation - nevertheless, were expected to sit on the sidelines and shut up if it wasn't, in fact, in default and you had that extra leverage on the developer. Many lenders began to perceive that if they were going to be the venture capitalists and take the risks of the new project, that they wanted to be able to intercede immediately in the management in order to advance the interests of the project and, therefore, changed the character or form of participation from that simply of a loan in which there were future ups participation to a joint venture agreement in which they had an immediate say in the management of the project. So, in effect, they would have set up one, a seed company organization, a corporation typically, sometimes a partnership in which they were 50/50 owners and then their loan department would make a conventional loan to the partnership for the financing that was required. The conventional loan would carry the current market rate which in some ways simplified portfolio issues and so forth. In many cases the loan might be made with a lender who they felt were less sufficient than they were. It would not be unusual for Prudential with a joint venture project saying, "Gee, this is kind of risky for us. We'll take the joint venture position, but we'll get 100% financing from Metropolitan, cuz they don't know any better." So you have that initially in the game as very sophisticated, efficient institutional lender borrowing from their cousins who weren't quite that swift or if they were that swift, simply didn't want to participate on the equity side of the project - they wanted a straight conventional mortgage loan. So the joint venture arrangement gave them a mix and match results, as it were, in terms of how much of the deal they financed themselves, how much they got from other people and, you know, when it was that they participated and what it was they participated in.

The joint venture arrangement then spelled out very specific control procedures for the borrower. And the joint venture agreement ultimately had what was called a disenchantment clause in it which at some point if an institution didn't like what their developer partner was doing allowed them to call his position. Disenchantment clauses are much like what you had with your brother or your sister when it came to cutting a slice of cake. You get to cut the slice, I get to chose the piece or visa versa. So if the lender decided he wanted out and he looked at the project and decided at that point he had a $4 million equity value and he wanted to buy the developer out, he might say, "OK. Tell you what, I'll give you $2 million for your 50% interest." Now if Charlie thought it was worth less than $4 million, he would take the $2 million and run. If he thought that his insurance company was giving him a bad deal, that it was really worth $6 million, he would say, "Fine, I will buy you out at $2 million." It was his choice. So if the insurance company made the presentation and said, "We'll take you out for $2 million," it was his right to either put up or shut up. He could take the $2 million and run and be out of the project or say, "Fine, I'll buy your 50% at $2 million and good-bye." And the joint venture arrangement then would go a little further so that both sides had equal buying power at that point because otherwise why would the developer have brought in this venture partner, I mean he didn't have as much money as his institutional friend and therefore the institutional investor could freeze him out by calling him at an awkward time in which he could not respond by buying that equity position. So typically the disenchantment clause is a provision that if the lender and fundamentally the financier's partner in the deal called the equity partner out, the equity partner could borrow whatever money he needed from his financial partner to make the buy. So if it took $2 million to buy him out, the lender had to let him buy him out at $2 million on terms that the developer could afford. So, in effect, at that point in time they had equal buying power, equal purchasing power, and it was a fair deal.

Now the joint venture gave the insurance company some other things that they did not get as a lender. Insurance companies in particular are in a peculiar tax situation in which they are allowed to deduct from their interest income or investment income, that part of the income which is already committed under the interest assumptions of their policy. So if they had computed their premiums based on a 5% interest assumption and making their actuarial calculations as to what rate money would come out and at what rate the cash value would decrease and so forth, they're allowed to deduct that 5% from the interest income and they're taxed as a corporation only on the income over and above the interest assumption amount. So far so good?

Secondly, of course, they're allowed to take deductions for depreciation and interest expense like anybody else. So let's assume that they're building a project in which they lend the project in one hand $10 million at 10% interest, so they'd have a million dollars worth of income coming in. So far so good? Automatically if they have a 5% interest assumption, only $500,000 of the million dollars worth of interest they collect on their mortgage to their project is, in fact, taxable. So far so good? So we get a tax exemption on $500,000 right off the bat. But because they're also 50% owner in the $10 million project, they get to take half of the depreciation. So the $10 million project on an accelerated basis in the old days, under the old law is throwing off a million dollars worth of depreciation. They got $500,000 worth of shelter to cover the other $500,000. So far so good? But in addition, insurance companies are taxed on the reported value of their assets - they're taxed on both income and asset positions. If they can hide an asset, in other words, apparently the project's worth $10 million but we don't know. If, in fact, because of good management and so on, it goes up to $15 million, there's no recognition of that on the insurance company's balance sheet. They continue to carry the stock of the joint venture corporation, which they own, at book value which may have been $2. And now they have a submerged asset of $2, $3, $4 million, whatever 50% of the equity value is, that they don't have to pay taxes on. So as a result, the equivalent after-tax yield on a joint venture in which they make themselves a conventional loan was higher than they would have made on a participating loan where it was carried on the books as a straight mortgage and they didn't get the benefit of the depreciation etc. Now they still the advantage of a submerged asset because warrants aren't worth anything until they're realized but, nevertheless, it was not escapable. So the participating loan that gradually evolved into joint ventures participation by the major institutions in commercial property and the only ones that aren't willing to do that currently are pension funds because of liability issues, financial problems and so forth. So the major market today for participating loans is essentially in the pension area where they tend to feel more secure as creditors than they would as an owner. OK. We'll pick up on this again on . . .

The field trip, as you know, is on Friday, November 13th. We need to get our sign-up sheets going on that. We have arranged for 2 buses so we can handle up to 94 people, I guess. You can not drive your own cars, University rules, risk management require that you go on a common carrier which provides adequate liability insurance. If you live in Milwaukee you can stay home. You can go, but you must go by yourself, you can not take another student along. The total cost of the day is $11 and maybe you could give your check and so forth well before you go so we know how many buses to commit and the tour will be the Black's conversion of their magnificent old (?) house to a mixed use project which was financed primarily residential also but contains retail and office use - very exciting project by two of our alumni, Dave (?) and Jack Safer and Yankee Hill. We're going to take 2 buses because with that size group we'll overwhelm the capacity of either one. We'll fire one bus into Yankee Hill, the other one into the Black's and then switch midway through the morning so that we'll have, in effect, two presentations for each of the two projects and then we will proceed to Northwestern Mutual who will be our hosts for lunch and provide the meal and they will then provide also an auditorium classroom unit in which one, they will, with Pizans (?) make a presentation on joint venture to build the new office building on the corner of the Milwaukee River and Wisconsin Avenue which is currently is a canvas of (?) reinforced holes so there's really not a lot to see on that. And we will do that there. And then we will have Tramel/Crow & Company make a presentation on the theater project which is quite a tour de force (?). And we'll also do it there as that is currently a hard hat area in which the insurance companies would go bananas if we showed up with 90 people walking off the end of scaffolding and so forth and so on. And we will also have a presentation there initially of the Grand Avenue Mall which some of you that are from Milwaukee I'm sure have seen before but then ultimately was financed by Northwestern Mutual and is managed by one of our grads, John Seifert. And all the projects we'll look at will be our grads. And then having completed our presentation at Northwestern Mutual we'll take the tour of the Grand Avenue Mall and we'll allow you to one, filter through it, find something to eat or drink along the way and pick you up on the other end with the bus at about 6:30 and have you back in Madison by 8 o'clock. So it would be a pretty intensive day of real estate. And we were rather pleased in the Monday, when the Urban Land Institute began in what is essentially a 2-day hike of downtown Milwaukee, every project that was under review or was being analyzed in terms of future developments were headed up by one of our alumni or two of our alumni. So that where Northwestern Mutual was a joint venture partner, we had people on both sides of the project, which was pretty impressive. So I think you'll find it a very intensive, rich day of real estate with quite a variety of different kinds of projects and different kinds of problems - and particularly unique financing in all of them as all of them feature an interplay between public and private agencies with the City of Milwaukee providing what's called soft capital with a loan to have highly strategic repayment schedules and so forth which are sculptured to fit the anticipated cash flow of the project when it initially starts up at a deficit and eventually builds to a point where the rent structure is capable of carrying the debt structure - and also capable of, in effect, putting a downtown high-rise apartment project in a competitive posture to the suburbs so that the rent structures can be comparable on the upscale end which is very hard to do otherwise. So Dave Byerton and Tom Cline and about three from Pisans (or Pizans) and John Pfeiffer from Northwestern Mutual and Franz Bryzinski from Trammel Crow will all make presentations relative to their saga. So that's Friday, November 13th and we'll have a sign-up sheet and we need to have the bookkeeping done by the Monday of that week so that we know that one, we can afford two buses, otherwise we'll have to peel it back to one. OK, that takes care of social announcements.

On November 6th, for those of you who are in the 795 course, Ed Kelley will be our guest for the day. OK.

One of the major risks of the commercial lender, as well as the commercial borrower, is the volatility of the interest rate risk character which has only recently emerged as a significant exposure - recently, being over the last 5 years where capital markets become more and more tied to international capital markets and where lenders are more and more prone to lock themselves into long-term commitments. Obviously, both parties face an interest risk. The lender faces the problem of locking into a long-term commitment at a rate of return that may not cover his cost of capital which could be a varying cost of capital. The savings and loan may have to pay dividends on its savings accounts which allows it to hold its track capital. The bank, more often than not, is funding its real estate in the commercial paper market which may be relatively volatile and some of those that have done that - again, the late 70's - generated tremendous negative leverage. I think that at one point GIC was experiencing negative leverage to the tune of about $75 million dollars a year in terms of the commitments which they had made at fixed rates and the cost of capital as they rolled short-term commercial paper to fund those obligations. So the lender is concerned with what his cost of capital is going to be over the term of the loan commitment that he has made to the borrower. By the same token, the borrower typically is dealing with a futures interest in the property. He's concerned not easily not only with the construction loans per se but with his permanent loan rate once he has completed the project and is concerned that the rents that he has been able to achieve are going to be adequate to cover his operating expenses at the debt service on the mortgage. And many of them saw a point in which interest rates moved quickly during the development span or even during the closing span of the loan and suddenly he had reverse leverage and the project which was otherwise a success, obviously, failed. So we need to look at both sides of it.

First let's look at the lender's side. What are his options? One option, of course, is to have a relatively short duration on the loan which allows them then to renegotiate the interest rate periodically. Three to five years technically is called an interim loan or typically is called a bullet loan as you are putting the gun to the head of the borrower and pulling the trigger while interest rates rise and forcing him to refinance at the higher rate. Because of that character and because of the fact that it may take a year or two of rental experience and the opportunity to move rents to the market after filling the building, quite often the construction loan has become the interim bullet loan during the early year of a project. So the construction lender who expected to get bailed out by the permanent lender, in effect, stays with the project through the building construction period, into the initial rent up phase, maybe to the end of the first rollover of the leases and will be with the project three to five years and then has a chance either to bump the interest rate or extricate itself at that point in time.

The second type of protection, of course, is a variable rate mortgage. Construction loans lend themselves to this best, but there are variable rate mortgages on the longer term. And generally they would state the rate as so many basis points over the U.S. Treasury rate at a particular point in time or the prime rate. The prime rate is a little mooshier as it tends to be somewhat more artificial. Some banks no longer quote prime rates because they are more of a, what shall we say, a statement of policy than they are in a fact of operating market driven number. As you can see by the last week, as soon as the stock market went down the banks dropped their prime rate - not that they would lend to anybody at that rate but they used it for publicity which presumably made it provide confidence to the investor in the stock market that money would be available at a reasonable cost to its corporate share interest. But, as a result, typically perhaps more tied to the Treasury rate - sometimes tied to the commercial paper rate. That spread would be anywhere from three to five hundred basis points. Each month they would compute the appropriate base rate as of the monthly anniversary date and then balances outstanding up to that point would pay monthly interest on that base. On construction loans, typically sets up what is called the interest reserve. It’s part of the money you’re borrowing. So if you have a budget on the front end of $50 million and they decide that 15% of that is going to be an interest cost during the development span, you have built into that $50 million loan, four and one half million dollar interest reserve and the monthly rate is charged against that reserve. So it doesn’t necessarily impact on the cash flow of the developer immediately but it may eat up the reserve faster or slower depending on whether the interest rates bumps up or bumps down and how many dollars have already been drawn down on the loan. Obviously, if the interest rates rise - catching you right at the end of the project, when most of the dollars are already lent out, that's a very substantial increase in interest cost and you very quickly eat up the reserve and suddenly you're forced to put up more capital to meet your interest payments. On the other hand, if there's a little aberration in the interest rate and the early, let's say, first month of the construction project, the developer just goes slow on making his payments to his subcontractors until they really start to scream and, you know, try to decide, step the bullet through the short run, if it looks like a brief spike in the base rate on which his interest rate is located. So there's some ability for him to postpone the impact in the early years end of the deal.

A third way for the lender to cover himself, is to establish one, a very strict "to draw" date on the loan and then promising the contractor a fixed rate of interest on the construction loan, the lender takes positions in the futures market which is always, you know, offsetting position. He has promised to lend the contractor, let's say, money at 10%. He's scheduled to write that first draw, it's going to come, let's say, 90 days into the project. He has a specific date in which the contractor has to come in with his draw and he isn't quite sure what the money is going to be worth at that particular point in time, so he goes short in the market if he wants to protect himself against an interest rise and goes long in the market if he's trying to protect himself against an interest rate fall and therefore takes a loss on what he lends to the contractor under that rate offsets it with a gain on the short position or visa versa. Using commercial paper that hatches the duration of the first draw, then the second draw, and the third draw and so on. The contractor is under obligation to one, run his project on schedule and two, take that money down at that particular point in time and even if he's not ready to, that money would be drawn down, put into escrow, until such time as the developer qualified to actually have the money. But he would be paying interest on it from the time that they put the money in the escrow.

An alternative way in which a lot of insurance companies during high interest rate periods were afraid the interest rates were going to come down and that the loan would look quite competitive then, would make you take the entire loan as of the date of closing and then they would put it into escrow and the escrow agent would actually pay the money out according to whatever draw schedule was involved in the project. But you would be paying interest on 100% of the loan from day one, even through the project was proceeding to be finished and, you know, successive increments and you took the risk that interest rates would fall and, in effect, they've locked you into a non-prepayment loan from day one. Now, that backfired in many cases where the interest rates continue to rise and the short-term reinvestment rate was higher than the long-term mortgage rate that they had committed to and as a result the developer actually made money on his escrow because of the spread. And so lender decided, gee, there's got to be, you know, a better way to do that where I can take the benefit of the possible up-side without getting trapped on the downside. The developer, on the other hand, has both a short and a long-term concern for the interest rate. And we should distinguish between the home building developer who has a relatively short time line, perhaps a year during which he plans his production, builds his housing and sells his unit; and the commercial developer who obviously has a much longer term of concern one, if the project fails, and two, of course, his holding period after it is built. Talking about the home builder who is probably in a better position at this point to hedge. A home builder much be able to guarantee that a buyer of a home or condominium in his project will enjoy let's say 9% interest for the next year. The effective demand for his house on a subdivision lot or condominium unit is really a bunch of monthly payments. He wants to lock in a monthly payment that's affordable and be able to offer any qualified buyer that monthly payment. He can go to his friendly savings and loan who will then, in effect, commit to give him that rate and he has two ways of assuring that. The simplest is simply a buy-down which says that now that you've guaranteed me 9% we will pay you in points a sufficient amount of money at the time of the closing of any one of our home loans, enough to change the contract rate at 9% to whatever the market rate is at the time we close. So the market rate moves up to 10%, he has to pay a certain number of points to the savings and loan and that buy-down factor is simply built into his capital budget. As you know, particularly in the case of condominiums, in the case of a high interest rate, they would often buy that rate down for as many as five years and it would be expensive as anywhere from 9 to 12 points on the mortgage. So that the nominal price of the home was grossly overstated relative to the real estate guide, and appraisers were taking those nominal prices as the appraised value and really concealing the fact that the guy whose buying a home for $90,000 and financing for $10,000 and it's easier to sell the home the next year for $90,000 which is what it's worth, you know he could kiss the $10,000 good-bye. There's no tax deduction for that, it was hidden in the price of the home and all he would take is a capital loss which for the usual tax payer is kind of a slow recovery, I think, under the tax laws. So it was a reasonably unfair, you know, kind of position. The alternative is for the savings and loan to lock in at 9% rate and then go into the commodity market, the money market, and offset that with a hedge. The initial hedging was done in the Chicago commodities market which made a market in Ginnie Mae certificates. A Ginnie Mae certificate is essentially a $100,000 face amount collateralized with mortgages in the Ginnie Mae portfolio. And has a coupon rate of, I think, the initial issues were at 9%, more recent GNMA issues are slightly higher than that, I can't remember the exactly fractional rate it comes out at 9 and 5/8% or something like that. And so if interest rates were at 9%, Ginnie Mae's sell at par. If interest rates fall, Ginnie Mae, obviously, sells at a premium over and above the face amount just like a bond would. If interest rates rise, they sell at a discount against their face value. It gets a little sloppy since Ginnie Mae's are essentially pass throughs and so after a couple of years it's less than $100,000 from the pool and so it moves up and down proportionately but let's ignore that for the moment. As a result, the savings and loan having made a commitment to lend at 9%, would then take a short position against future delivery for let's say at 10% or 10.5%. So as the mortgage rates rose, it could cover it's short position by borrowing Ginnie Mae's at less than par, recoverance commitment, and making a profit on the short sale and covering his losses on the fact that now I have to make a loan at 9% and, in effect, take the profits as being equivalent to the points the builder would have paid if the builder had bought down the rate. So the loss it takes on making this commitment to the builder at 9% is offset by the profits for having gone short against the rise in the interest rate in the commodity market. That is only good for as long as a year. And, obviously, the small home builder probably isn't making plans for longer than a year and it works fine for that type of situation.

Relative to the commercial builder - Yes, question. Question: Does the builder pay a premium to the S&L? Chief: Yes, he would pay a service charge for that. But at least his costs are fixed as opposed to the situation in which he's not sure what the buydown is going to cost him in the future. So it stabilizes his position that way. On the other hand, if he doesn't sell any houses at all, he doesn't get his money back either. OK. And if interest rates fall, he's going to take the more favorable position and he doesn't get his premium back. So here he depends on, you know, how much the builder wants to stabilize his operations, period. And if he thinks interest rates are going to rise, he's willing to pay that premium and lock that rate in. If he's not sure which way they're going to go and thinks there's a possibility that they'll fall, he's likely maybe to take that chance. And so for the next (?) The builder is obviously is in a position to build that cost into his capital budget and take something out of the house. If he knows what his financing is going to cost him, then something else may have to go, maybe fewer amenities in the property or he makes the lot smaller or, you know, there's different ways of recovering that cost and a variety of ways which the buyer may not necessarily see at the time. The buyer's going to buy that monthly payment and take what they can get at that time.

When you're a commercial developer, his problem is longer term - let's say he has a two or three year construction date - and he may even want to cover his project into a couple of years of the rent up in which he has to provide concessions and maybe get no rent initially at all and is therefore very vulnerable to a variable rate contract. He has a number of ways of doing that. One will be hedging in the international money markets, another would be swaps in which there are investors, particularly in eurodollars who would rather have a variable rate income and he can swap his variable rate mortgage for a fixed rate debt obligation, stabilize his cost at a rate slightly higher than the market and avoid the risk of a much higher rate, as a result of an interest rate, rise. We'll come back to that in a moment.

International money markets depend on essentially three basic contracts. One is the treasury bills from the U.S. Another are bank certificates of deposit - particularly the London Inter Bank bank rate - LIBOR. And the other are eurodollars. Because that's a relatively sophisticated market, the commercial developer will generally hire a futures specialist and many of the major banks like First Chicago have a department which, in effect, figures out what your problem is, what's the duration of your interest rate exposure and then designs a commodity position in your international money market that will offset at least a significant portion of your interest rate risk. There are no perfect matches in this area. And what you're really going to do is mitigate dampen, the impact of an interest rate shift during the project. And the basic contract that they look at, all three of them that we're talking about, the Treasury bill, the LIBOR, the Eurodollar, are all stated in terms of expiration dates that are quarterly - March, June, September and December. So that provides a common denominator which allows to structure a schedule of commitments both short and long. At some point on any specific month during what is called the delivery month, the time in which you can get your money back, the instrument is always price at par and this fact that at some point it comes back to par is a critical starting point for trading and hedging in these unit because you can buy in at that particular point at the face value and then measure the anticipated premium or discount that will occur as the rates move. And the price increment in each contract, one basis point equals $25 essentially in a $250,000 contract. And 180 basis points is equal to the one percent of the face of the contract. So let's assume that the developer of an office building faces a floating rate construction loan which makes it a little nervous during the initial planning stage and the solution for them would be taking an offsetting position in the futures market that pays him money if interest rates rise. Now that position, of course, is a short position in one of those three major international money market contracts. If the rates rise, he'll be able to cover his position to deliver those bonds at a particular price at a lower cost than he can currently. And make (?) a profit which will cover the interest loss he takes on his floating rate which is going to be tied to one of those three elements. A primary cost for him is the difference between the current rate, at what's called the spot market, and the rate at which you short sell the futures. So if the current rate on a CD currently is at 9% and the futures market in that rate is at 10%, the cost of insuring a fixed borrowing cost is 1%. You can go short and cover that potential rise. Question: What accompanies a major crunch? Chief: Why not check at the copy center, we have an example of this worked out for you. So the problem solution and cost - let's say the contract (?) matures as of February 28th and the principal amount you want to cover is $1 million and let's assume further that the current rate is 9.15% for a CD. These CDs will be repriced quarterly to reflect fluctuations in the overall market and we want to hedge the current rate for one year from the first (?) year pricing on March 15th through March 15th on 1986 covering our construction loan period. We'll hand out a set of numbers. OK. before we get to the output just handed out, there are two steps that are involved initially. One, of course, is to set what is called the hedge ratio. And the hedge ratio is a function of two items. One, of course, how much money are you going to borrow compared to, let's say, a $1 million unit. And in the example it's talking about you're talking about $1 million. The example we're about to look at is a $5 million construction loan with draws at 5 different quarters. And the pricing period, which is going to be some function of 90 days. Now we don't know how long the first one may be, but let's assume that they're all 90 day periods. As a result, what we need to do is have a hedge structure for each 90-day period in the year and that means we really have to sell a short position one position in March, one position in June, one position in September and one position in December and we will have been able to extend our coverage over the 360 day financial year. Obviously, we can extend it further in the example we'll look at in a moment (?). The second thing is to calculate the effective hedge rate and we need to know in terms of the bank's CD's minus $1 million, how many points we're going to have to have to come up with the effective rate and calculate, therefore, the amount of money necessary that we have to sell or buy short or long to cover the total dollars of interest that we're going to need for our particular transaction. So now on this first case that you have in front of you, for example, in looking at the way that was weighted average rate, it appeared that the weighted average rates that we anticipated for the four quarters was, let's say, 10.28% and our initial rate going in was 9.2%. We mentioned earlier on $1 million that represents a 1.13% spread over the year and then in that case we would need $11,300 profit on our hedge position to cover the incremental cost to our $1 million loan as the result of the move in the interest rate. So it is this dollar amount of profit that we need to cover in whatever we buy in the market. The interest rate in this case that we anticipate - interest rate A is 10.28%. The interest rate going in on the certificate is 9% so we have a difference of 128 basis points and the discount rate is at 10%. So if we were to have a construction loan and we drew $1 million in the first quarter, the interest for that quarter would be $25,700 initially, if the interest rates went up to our anticipated 10.28%. If the interest rates stayed at 9% it would be $22,500 so our total interest exposure in the first period is $3,200 and to cover that we need a short futures position essentially of $146,000 in order to cover that $3,200 exposure in the first quarter. If we look then at the second draw, now we're going to have $2,025,000 exposed and he made the second draw on the loan, if interest rates do go to 10.28% it's going to cost us $52,060 during the second quarter on that cumulative balance and, on the other hand, if the interest rate had stayed lower at 9% which is where we were going in when we started, we'd only have $2,022,000 outstanding and we would have only had a $45,506 exposure and that means then the longer we have the higher interest rates, the higher incremental interest cost we're going to have at $6,584 and now to cover that in the second quarter, a total short position for a total of 15.96% or another $1,396,000. By the time we make our third draw, if interest rates are sailing to get not only, you know, additional interest from that third draw, but on the first two draws as well. We're carrying that forward at 10.28% and now our interest costs are up to $79,000 as opposed to what they would have been at 9% at $69,000, so we now have a $10,000 exposure for that quarter and so on cumulatively for a total exposure that is a $51,171 cost over the 5 quarters of our construction phase. Obviously, if you're talking about higher interest rate costs, as it was at one point in time, the treasury rate was, let's say, 10% and then you had a 4 point loading on that so that you were really at 14.28%, those dollars of interest cost really start to soar. So the comparison here 9% to 10.28% doesn't seem to produce very big values or cost discrepancies, but typically we're looking at, in this case, the base rate of Treasury and if you loaded a 400 or 500 basis point load for construction loan on top of that, why pretty soon you're talking about some very significant swings in your total budget for interest in the project. But what they then try to do is hedge that same situation as they give you a comparison here. If the rate was at 12% initially, and then began to drop to 10.28%, what would it look like? They begin to look at the loan - the cumulative draw, the interest expense factor that you've got to cover in excess of the original lock-in rate that you wanted to achieve, and the interest expense, the additional present value factor and the number of contracts that you would have to purchase in order to generate a short profit equal to the additional interest costs and so you see the number of contracts and the total short position in terms of what you're trying to earn on those short contracts necessary to cover the $5 million, the increment in interest expense that will occur during that period of time and the fact that you're trying to stabilize that 10% rate of interest. Now one thing that isn't calculated in here, obviously, is the fee that's being charged by the bank to handle the transaction for you. The result is over the short run, the builder can convert what essentially was a variable rate construction loan to a fixed rate cost which is higher than the nominal rate at which he started but certainly is significantly lower than might have been had the rates sailed during the construction period and, his interest reserve would have been inadequate for the loan. The complexity in dealing with the European market is not what most builders deal with and so the bank and a number of investment banking houses like Goldman Sachs and Solomon Brothers have specific departments which will structure any kind of commodity speculation in money necessary to stabilize the rate. One of the mysteries of that international market is the fact that there are European lenders who would rather have a variable rate loan, variable rate interest rather than a fixed rate that it is possible to make swaps of loans between investors that prefer, let's say, a variable rate for a long period of time and another wanted a fixed rate for a short period of time and the exact legal transaction that they place, I still don't understand but, nevertheless, for the major players like Gerald Hines or somebody like that who came dealing in $100 million at a crack will go directly to the European market and work out an interest rate swap on their construction loan. A good many developers for a long period felt that that really wasn't something that they had to do and got wiped out in the last real estate crisis because the construction loan rates really sailed - some of them going as high as 20% during the later part of their project. We were at Chemical Bank talking to one of their Harvard people who said, "Gee, there's really no interest rate risk for the bank - we have all of our construction loans with a 450 basis point loading on the treasury rate and so we keep up with the market that way." And we looked at one of those $100 million projects which had something like a $16 million interest reserve or a period of essentially of a year half of construction and development. And we asked, "Well, what happens if the rate goes to 12.5% or whatever it was that you calculated that on to, say, 17.5% halfway through the project. And very quickly carried a total interest cost of $37 million on the loan?" And we said, "Fine, if you fund it, you know, let's say, $15 or $17 million on the loan deal, you're only $20 million dollars short. Doesn't the contractor/developer have $20 million to cover the shortfall in the interest rate?" "Well, no he didn't." And so what you really did was to build into your loan a guaranteed default if, in fact, interest rates moved during the construction period. So it really wasn't a hedge at all unless there was, you know, some way of offsetting that increment in costs downstream, which there won't be. So developers have to be willing now to pay a premium now both for the servicing of the hedge position and for interest rate swap which will allow them to have a fixed rate during the construction/development phase, even though the fixed rate is higher than the current market rate. Certainty in terms of their budget is more important than coming up with the cheapest rate in the short term. Since a loan developer is not capable of structuring that for them themselves, there are institutions which will do that for them.

The last element on interest rate risk is really related to the devaluation of the dollar element in the long run particularly for the long-term lender. And there are no suitable hedging mechanisms which carry out much beyond 18 months. Therefore, the participation loan that we talked about earlier, together with the joint venture has become their hedge against devaluation of the currency. One of the most aggressive positions in terms of devaluation of currency aside from a participation loan is called a convertible loan. Convertible loan works something like this. Let’s assume that a shopping center developer has now completed his community strip centers. He anticipated that it was going to cost him, let’s say, $9 million to finish it and that he could borrow $8 million in the process. Unfortunately, between construction costs and a slow rent-up, by the time he has achieved 90% occupancy he’s got $10 million in it. He still would otherwise get a conventional loan at $8. He only has $1 million worth of equity. He has a gap of $1 million he can’t fund. So along comes the pension fund and says, “All right, tell you what I’m going to do. I’ll make you a $10 million loan and maybe I’ll even lend you $10.5 million and we’ll create a constant on that loan or an interest rate on that loan that is interest only equal to what the net income would be at 90% occupancy. So we’ll take all the net income that we’ve got and we’ll call that the base interest rate on the loan.” And so he lends him $10.5 million. $500,000 is the development fee to the developer who was about to lose his tail feathers - was about to lose the whole center after his magnificent effort because there was going to be a gap between what he could borrow, what he had in equity and the money that he had in it. The lender says, "OK. Tell you what, at the end of ten years, I have the option of either owning it and I'll take a written note that says, OK I call and we will turn it over to me - in proportionment - that will produce a 16% rate of return to me as the lender. Now if you're able to raise the rents in the mean time and therefore the net operating income and the value of that center goes from $10 million, let's say, to $14 million as a result of your astute asset management, and the fact that you've rented the other, you know, 10% of the center and so forth. Wonderful. I'll probably only need 80% of the value of your $15 million center and I'll let you be a 20% partner and you'll sell this $3 million interest in your project. On the other hand, if it doesn't go anywhere, and it's only worth $12 million and that's what it takes to give me a guaranteed internal rate of return of 16% after I've accounted for the cash distributions you've made to me in the mean time, why then it's all mine and you have nothing." And the developer says, "Gee, that's not a bad deal because during the first 10 years, one, I have a fighting chance to maintain some equitable interest, two, because I am a borrower and not simply a property manager, I just take the depreciation on the shopping center, three, I get to be in control as the manager - take the leasing commissions and so forth, and to the degree that the leases roll, let's say in the fifth and the tenth year and I'm able to aggressively improve my rent role, why I have a fighting chance of realizing the ultimate equity that I created here by being the developer." On the other hand, the lender is assured a minimum yield of 16% on their money. It's just that maybe 7% or 8% is now in terms of the cash dividends from the project and the balance will come at the end of the term. They may, in turn, also create an arrangement whereby the lender gets 50% of the cash throwoff and in excess of debt service. So if the developer succeeds in renting the balance of the 10% of his center, half the net income from that will go to the lender, half will go to the developer and therefore they may, in fact, enjoy a slightly higher cash yield than they expected before. But notice they have their choice of either saying, "Pay me off at the end of 10 years because one, I don't like your center and two, I don't want to be in real estate and three, the only thing that I can do with my money etc." And you have to pay me off to give me a minimum yield of 16% or I see the asset is worth more than the money, I will simply exercise my right to convert to equity and now I will own anywhere from 80% to 100% of the asset and be hedged against further devaluation of the dollar because I have converted my monetary allocations to an asset ownership position and the ultimate hedge for the capital if that occurs in terms of devaluation of the dollar. OK, we'll pick up again on this tomorrow.

OK. First of all, a reminder, the real estate club field trip - Friday. Buses leave the Memorial Union promptly at quarter of seven so we'll have you at the respective destinations at 8:45 on Friday morning. And coffee and donuts will be provided on board. Is this note current? No? That was in there - OK. That's a museum - right on schedule. This is last year's note saying there will be a turkey party at Thanksgiving for the real estate club. It's in the 316 South Brook Street so why don't you show up and give it a try. There's probably not much left over from last year, but I'm sure they'll be happy to see you. OK.

The subject is, obviously, the capital pools that are available for commercial lending. And we began with our discussion of shifts which are occurring both institutionally and in terms of the transaction preferences of the institutions that we name.

And as I recall we moved through the traditional sources of the savings and loans, the banks and the life insurance companies and had begun to take a look at what we will call the private internally regulated pools of capital such as real estate investment trusts (REITs) and investment banks and the pension fund areas which are more internally regulated, rather than regulated as securities. Now the shift in investment philosophy that has occurred in each of these institutions with an, in effect, shift toward the internally regulated pool as opposed to traditional intermediary institution, reflects several elements. One, is that institutions has moved toward an emphasis on yield even if it comes at the expense of greater risk. We're looking at the savings and loan association, they lost the protection of regulation Q relative to their arch competitors, the banks and are pushing hard for higher rates of return which will support, in turn, higher payments to the savings deposit within their organizations.

Life insurance companies have found that to compete for life insurance sales, particularly on the term insurance, they need higher dividends to reduce their net cost of life insurance and therefore they are pushing to offset the inroads of inflation on fixed dollar commitments of life insurance by making it possible for you to buy more life insurance on a continuous basis in order to protect the purchasing power of your life insurance program. So the most typically used feature of life insurance today is the so-called automatic purchase option in which the dividend feature applied to buying additional units of paid-up insurance and as a result the purchasing power of your life insurance keeps pace with devaluation of the dollar. Well in order to make those dividends significant, now that they've sweated out the actuarial batten and so forth, they really got to go to a higher yield. And higher yields which are sensitive to inflation so that their portfolio returns move with the rate of inflation and therefore their dividends can move at the rate of inflation and therefore people will buy more insurance with the automatic paid-up feature.

By the same token, we're talking about banks. Banks, of course, need higher yields for two reasons. One is to cover their tremendous losses in international banking as well as in their real estate portfolio and two to cover the fact that to attract additional capital into the holding company structure which ultimately controls the bank, they obviously have to be able to pay better dividends and also be able to carry large amounts of bonds through the holding company.

Pension funds, of course, also want to go for higher yield because to the degree that their assets will increase as they compound their yield, the payments required of the sponsors of those pension programs will decline. The sooner that the program can be fully vested, fully funded, the sooner the pension sponsor/employer can stop payments annually out of earnings and therefore have more money to either reinvest in the business or paying dividends and obviously improving the stock market price of that particular firm. So all of those institutions are under great competitive pressure to emphasize yield at the expense of safety. And it is not working out well.

The savings and loans, the real estate investment trusts/mortgage trusts were the first, you know, misadventures in that area with disastrous results. The savings and loan association had an incredible bundle of national disaster proportions. At this point the FSLDIC has measured $30 billion dollars of losses of capital to the savings and loan industry and currently have $1.5 billion in the FSLDIC fund to cover the losses and as a result they can't even close the ones that are bleeding. And it's just an incredible disaster.

And you're going to see some more of that showing up in the bank side and on the pension side. The life insurance industries are able to cover their tracks a little better because they're not nationally regulated and therefore there is no national repository of statistics and what's more is - they require the lowest level of liquidity and so their mistakes lie there for years and gradually just sort of mature out of trouble. Every one of the life insurance companies has some major disasters. Well, what's a $500 million estate to Prudential, you know, big deal. They're really, you know, it isn't a big deal, you know, why worry. Sooner or later it'll be worth something. And so, you know, when we get around to it, we'll get around to it. In the mean time, we don't have to worry about having a mortgage on it. We just put $500 million of equity in it and, you know, the rest of our investment will carry it along. So, as a result, the life insurance industry really doesn't show it's mistakes very well. It's very hard to find those. Unless, of course, you happen to be working in one of their offices in which every office has a few jokes of their own. We had a new master's student from Wisconsin, let's put him in charge of, you know, HO-Ho-Ho. I think we've had three of our master's students cut their teeth at General Electric Corporation now on a project called the Chase Plaza in St. Louis. Which has been an unmitigated disaster. It was a hotel which they partially converted to condominium on the one side. The good part of the hotel we would call the Plaza got converted to condominiums which didn't sell and so that's sort of on the rental market at the moment. And then they had to completely rebuild the hotel to make it competitive with the downtown hotels and, unfortunately, the location was a little out of kilter relative to the action is in St. Louis so that's bleeding quietly. But these two buildings couldn't be separated because the utility system was so incredibly complex that nobody knew where to cut the pipe. You know, there was one boiler that turned both of them and the air conditioning compressors were all, you know, cobbled up and, in fact, they have managed to disentangle them to some degree. Because running a condominium where you don't know how to allocate the cost of the heating and cooling is a fairly sensitive issue with those that are expected to buy the condominium unit and pay a monthly assessment for heating and cooling. And so they weren't able to solve that problem very well so, as a result, attorneys didn't recommend that people buy there. But anyway, those kinds of mistakes get lost where you don't have the high silhouette of a savings and loan or a bank. The pension funds, of course, are also those that really don't know they've been hurt for a while. So that, you know, they can go into a commingled fund and it's a while before the commingled fund falters and it's all equity inside and they say, "gee Charlie we're getting 4% cash on cash on that," and the assets manager says, "yea, but look at the up side. It could be along any decade now." And so yield instead of risk and it is that move toward yield without a clear perception of what the risk payoff matrix is, that has accounted for a significant institutional shift toward real estate and real estate equities in particular.

Second of all, of course, is the recognition by all of these institutions that we can put more emphasis on portfolio theory, that we can hopefully stabilize our results through a scale of operations if we're not too selective. And so, as a result, we have a second defense against poor performance which allows us to pursue yield at the expense of folly.

The third major recognition of these institutions is that because they're no longer general account investments, because almost all of the big pools represent segregated accounts, specific investors or a group of investors in a commingled or open-end fund, that again, the institution itself is not at risk. The institution's risk is now collecting the fee that it will receive for managing the asset and being able to continually attract new capital which it will also earn a fee on. You know, it's kind of interesting, five years ago when Mike Miles was here with us, we started to work with NCREIF, the National Council of Real Estate Investment Fiduciaries, how's that for a title. Which represented the 15 heavy hitters at that time in pension fund management. I think they have 45 members now, plus or minus, and we got the bright idea - Miles and I said, "Gee you really want to measure performance, we oughtta measure the quality of the appraisal because you're reporting two numbers - the cash return on last year's appraised value and then the appreciation measured by comparing this year's appraised value to last year's appraised value. And therefore the investor would certainly feel much more confident if he knew those appraisals were being done correctly." You wouldn't have believed the reaction. You know, the institution says, you know, can't tell you that. The appraisals are obviously being done well, we would never do anything that wasn't being done well by definition, and so forth. And, you know, the rules of the fund and so forth. And we got squashed, just absolutely squashed. Not only did they stop meeting the research committee at Madison, Miles and I were off in a shot, you know, don't ask about the appraisals. The reason was that, gee, if you found anything wrong with the appraisals, those that invest in our open-end funds might want to withdraw. They might perceive that the returns aren't as high and therefore we wouldn't be competitive with stocks and bond advisors and they'd start pulling their money out. The problem was investors perceived that anyway, and starting pulling their money out just so one got themselves into real liquidity problems and so forth and finally the Rosenburg fund had to step up and say, "Our appraisers were just a little off in Denver with the real estate and so we're marking all those equities down by 50%." And that's why you really have to with the trust us because we're honest, especially their public relations ploy there. You know, these funds simply were so sensitive to the possibility of withdrawal of their funds. Notice their ability to compete for funds, which is function number 1, would be adversely affected by having too precise a measurement of how well they were doing. And now it's completely changed. They realized that investors are ahead of them - that the state and the private pension fund sponsors are truly concerned about the reliability of appraisals and the reliability of accounting statements and whether the accounting statements, in fact, measure what they purport to measure. Until suddenly there's an about face and Prudential is saying, "gee, we gotta change our portfolio theory, you know, we found out that diversification doesn't have to do with geographic dispersion at all, it has to do with the kind of tenants we have and what aspects of the economic cycle affect which sector of our tenants and so forth and so on - being much more sophisticated and suddenly you've got Professor Ribsbach in charge of their portfolio and a former professor DeLyle is charge of their research and they're saying, "gee, Graskamp you were right, those appraisals are pathetic, but we won't let you read 'em yet." Now, they're still concerned about other things (?). For example, we had a major tax case where one of the other asset managers owning the property Rouse is the manager and Rouse wants to pursue an argument that was always made, the shopping center's values are largely a product of the operating agreement that determines how the shopping center will be managed, how long the major will be there, you know, the rules of the game as to the major and the minor tenants and so forth. And that represents a franchising agreement which is personal property and not subject to real estate tax. So if you look at the price of the shopping center, you're going to have to allocate the land, building and the value created by the operating agreement. If everybody agrees it's correct, except now those that manage pension funds say, "My God, our financial statements, therefore, are misleading. We've indicated the real estate is worth "X" dollars. But it's really not true. The real estate is worth "Y" dollars and the operating agreements are worth "W" dollars. Maybe we better not pursue that argument. True it would reduce our real estate taxes by a buck a square foot but, on the other hand, what will that do to our liabilities relative to our pension fund investors who now see that we're now keeping totally differently a different set of books and maybe they'll perceive the risk of those assets differently if they suddenly realize that heh, that isn't land and buildings and something that you can go kick and sniff and stomp on but it's some kind of a fragile operating agreement that somebody might break and therefore maybe a different discount rate ought to apply to the income attributable to that portion of the asset and so on." So, as a result, in the process of becoming a segregated account which is attempting to market its services for fees to various capital sources, these funds have become extremely sensitive to perception of their security rather than the reality of their security. And that, of course, has become significant impact on those that would borrow from them and the emphasis is being placed on credit enhancement or the emphasis being placed on the feasibility studies and appraisals and other justifications for that.

The next element, of course, is the expansion of fiduciary role that's very much related to segregated account. Initially started by ERISA, the Employee Retirement Insurance Securities Act, it puts a high level of fiduciary responsibility on those that manage pension funds and anyone who works for a pension fund who has discretionary decision authority, that's a critical element. If you're an appraiser and you're simply directed - go appraise this property, and so forth - you are not regarded as a fiduciary at that point. Yet, on the other hand, you who hired the appraiser have the discretion to choose which one and when you accept that appraisal as being appropriate and so forth, you are a fiduciary and should it be determined at some point in the future that you have not done what you should have done or you've done something you shouldn't have done, you become personally accountable and you can be pursued both from civil and criminal standpoints in the case of ERISA by the federal attorney generals office and in the case of state fiduciary responsibilities by the attorney general. And that changes significantly again the kind of capital procedures - you know procedures for advancing capital that would be characteristic of that sort of money.

Finally, in the process of the segregated account management or capital pools, we now have two very different routes. We have those that are institutionally regulated internally for safety and liquidity, and those which are externally regulated by the securities management apparatus. Traditionally our intermediaries were always regulated by the FSLDIC or the FDIC or the state insurance regulator or recently by ERISA. But it was an internal process of audit and administrative rule and adjustment of those administrative rules. Now that we're moving into capital pools which are not from these intermediaries they are recognized clearly as securities. A security is any group of two or more investors who give their money to a third person for management in the expectation of profit. There is no question that any form of group investment in real estate is a security. The question is simply the level of security regulations that will be applied to that security. And there are a series of regulatory exemptions which soften the impact of that on the real estate industry currently in order that they are not totally swamped by applications for review and approval. Nevertheless, the security regulations in general represent a very real exposure to those who manage pools of capital raised through the public. But it is not so tightly regulated that one can't have a great deal more flexibility in the securitization of real estate than you could have had through the traditional fiduciary realm of real estate. As a result if you want to look at it from a market efficiency standpoint, as the major intermediary institutions become more efficient because they have to, given their liabilities for the alternatives, the most inefficient areas currently to raise your capital is in the Wall Street area, in securitization. The guy who buys into a real estate investment trust or guy that buys into a collateralized mortgage instrument of one form or another, really doesn't have any idea of what he bought into at all. And the appraisal standards and the even more vague - say, well it's OK. - if any. That may change. There's a number of major suits going on presently in which the Wall Street sponsor of a securities issue is now being sued because they did not investigate the quality of your present worth at the time and it's being alleged as a violation of due diligence - that you can't accept it simply because it says MAI on it and so forth - that you really have to do some sort of quality spot check to find out whether the MAI knew what he was doing. As in the case of the ethics mortgage company, he didn't. Well, he did as a matter of fact, he knew what he was hiding. And he knew he was employed to hide it (?). So he was very high. And the other company as you know failed with colossal losses to the investors and now Solomon Brothers and a number of the other investment bankers that initially marketed that security are being sued for not having done any check at all on the appraisal process. It remains to be seen whether the courts will decide if they are, in fact, responsible. But in the mean time it's simply evidence that the least efficient market is currently Wall Street. If you have a deal that wouldn't sell locally, probably it will sell nationally simply because people don't know any better. In fact I have a basic rule, if somebody tries to sell me a piece of real estate that's more than 100 miles away, there's obviously something wrong with it because there's an awfully lot of money between me and 100 miles from here who would have jumped at the chance to buy it, if it was any good. And I can remember a client being very excited a couple years ago because somebody had thoughtfully thought of him for an apartment project in Galveston, Texas. Why anybody in Green Bay is investing in Galveston, Texas, when at that time there was a lot of money in Texas looking to invest in something, you know, tells you right away, oh oohh. Well what's wrong with that particular project was that it was a gas heat and cooling job and in Texas intrastate gas prices aren't regulated - only interstate gas prices are regulated. So as a result the total heating and cooling processes are going right off the wall and that was all included in the rent and they had no way of metering it independently of the apartments so what you needed was somebody from Green Bay as an investor.

Now, the result of this shift is first of all a transformation of the traditional real estate funding device - the mortgage or the traditional real estate equity device of one individual being the owner into formats which are suitable for institutional investment without the necessity of maintaining the traditional debt servicing or equity servicing arrangements. Mortgages are a penny-anty kind of business which most people want nothing to do with. So as a result, the format is to convert the character of a mortgage loan into a security which permits more manageable, shall we say warehousing, by the ultimate investor. So we're really doing hybrids. Whether we're doing a single industrial mortgage and convert it to industrial bonds to be attractive either as a tax exempt or interest rate loan, or whether we're doing more elaborate pools of mortgages which then get transformed into CMOs of one form or another, the fact is that we're disguising the fact that we've made a real estate loan. And the irony of that in a number of Ph.D. students have proven it, that as we change the format, as we disguise the fact that it's really a mortgage loan and make it look like a security, investors change their risk perception of the investment. The industrial bond sells at a lower interest rate than would have been paid on the industrial mortgage on the same property. People no longer perceive that they're making a real estate loan because it doesn't look like a real estate loan.

The second major element is that as a result of this change in format, significant change in the legal cost and the time period necessary to close the instrument.

The third major change as a result of the first two is that we have a good deal of tandem financing in order to achieve the lowest possible constant to be carried from the net income of the property. Tandem financing takes several levels. One, public/private. On Friday in Milwaukee you will see a good deal of that kind of tandem financing. A conventional mortgage up front or whatever can be carried by net income of the project, backed up by what is called a soft second provided by the city. The soft second essentially is an advance of funds for either no constant or a relatively low contingent constant if, as and when the cash flow is available to be paid. Tandem financing. The Japanese are doing a great deal of tandem financing, say through General Electric Acceptance Corporation. The Japanese want a lot of money if somebody else is ahead of theirs. So let's say you're doing a $100 million office building, they're going to lay on an $85 million mortgage. In the old days, $85 million loan to value ratio, there 85%, probably would have been acceptable for a single lender but the debt service was getting out beyond the reach of the net income of the project. So the Japanese come in and say I'll tell you what we're gonna do, we'll make an $85 million first but we'll put in $60 million and General Electric Corporation will put in $25 million and the constant on the whole deal is, let's say, is 10% or whatever you say may be, but we'll take 9.5% because the $60 million will be coming in first. In other words, we're both partners in a first mortgage, but if it goes bad, we get paid off first. So they have a preferential position within the first mortgage giving General Electric then a little higher yield for being one, second in line in a first mortgage, and two, for having structured and managed the deal so now they're picking up another half percent of $60 million relative to let's say the $20 million they're putting in an $80 million deal so what is that, that's actually 1.5% more than is relative to their $20 million and so they're picking up 11.5% on their $20 million, borrowing it in the commercial paper market at let's say 8.5% and picking up a 3 point spread on their $20 million bucks. Now a classic tandem financing in which the Japanese institutions get the preferred first mortgage security essentially with a 60% mortgage ratio for the total value of the project. And the packager, General Electric, coming along and picking up an increment spread for putting together, managing the deal and so on. Tandem loan.

Another type of tandem loan is to really recognize the first mortgage on the property now being sold let's say to a new investment group, then has a wrap-around second provided by the seller. The wrap-around second being totally dependent, really, on the favorable terms of the underlying first mortgage which let's say, was made in a happier era in which interest rates were 8.5% and as a result they get a lower average constant between the dollars advanced by the second lender and the original dollars remaining on the balance of your loan. Tandem lending. Tandem lending alters the security position, rates of return are constant for the borrower and the saver.

Other types of tandem structures in the good ole days and to a lesser degree today represented the tax differential between the parties. Obviously money provided by a limited partnership in the form of equity, the nominal ownership of the limited partners gave them all of the tax shelter whereas the first mortgage position got the benefit of the cash flow. For example, for a time there during high interest rates Lansing was offering an arrangement in which the limited partnership put up a certain number of dollars equity and then borrowed everything from an REIT which was also run by the Lansing group. The REIT got a first mortgage convertible to an equity position at some point in the future and the interest rate on the first mortgage was simply all the net income there was in the project. Now notice the same entity in terms of control of both sides. The entity that controlled the partnership that put in the equity money, the entity that controlled the real estate investment trust that made the loan to the partnership and made the loan at a constant which the partnership could afford to pay for they simply took all of the net income. And realizing the net income was less than they should base on the mortgage, therefore they also had a false constant because they have a convertible feature that says ten years from now or fifteen years from now, the mortgage people can take over the ownership of the property to the degree necessary to provide an overall internal rate of return of 14% or something of that sort. Now that’s a tandem investment - playing off the fact that different capital pools had different emphasis placed on current income versus tax shelter or appreciation versus current income and so on. And so you being to involve more than one institution in the financing plan in order to arbitrage among the different institutional characteristics. Tandem financing. The ultimate in tandem financing of course is Ginnie Mae project. Let's say you were doing a housing project to be financed by Fannie Mae and you got an FHA insured mortgage for 90% of the deal at 7.5% interest but unfortunately 7.5% was significantly, let's say, 300 basis points below the market. So at the same time that you applied for FHA insurance and you applied to Fannie Mae to buy the loan at a certain discount. You can also apply to Ginnie Mae and Ginnie Mae would take its allocation of funds from Congress and buy your loan at par so that you effectively have a 7.5% interest rate and then sell the loan to Fannie Mae at a discount which gave Fannie Mae a market rate. The gap between the value of the mortgage at that par or as it was funded by the US Congress with an allowance on the US Treasury call under the tandem plan. So in effect you have two institutions as well as FHA insuring the mortgage providing the financial structure for subsidized housing. Each of the various institutions really have not only a different source of capital or capital cost, they have a different level of expertise and also have a different tax status. And those are to be mixed and matched in order to provide a highest yield to each of them relative to their abilities and relative to their emphasis on yield at the expense of risk. OK.

The securitized side has taken several different formats and these formats are subject, I think, to rapid evolution. First and foremost is the real estate investment trust, REIT. REITs come in two types or maybe three types if you want. One is what's called an equity trust - one that invests in the ownership position of the real estate with a limited degree of leverage. The second is a mortgage trust. It is a trust which makes mortgage loans typically with a participation feature so there's some up side on the income and then combined equity money from the REIT shareowner with some source of outside credit. The amount and source of outside credit, of course, is a critical factor. Most of the mortgage trusts went belly up during the 60's because they were borrowing in the commercial paper market short-term and lending in the construction loan side long term. And they had fixed rates on the construction loan side and of course the commercial paper rates just exploded and very quickly they had negative leverage and the negative leverage destroyed them. And so the real estate mortgage trust is working uphill against a very decidedly negative public image. The third type of trust is called a hybrid trust. One which has a strong equity position, owns many properties out right but uses some of its cash to make participating loans.

The real estate investment trust came into being about 1961 with its special tax status that it could be a conduit - that it could pass through earnings and as long as 90% of the taxable income was distributed to shareholders that it could therefore avoid income tax on attorneys. It was created or permitted by the internal revenue service at a time when limited partnerships had gotten themselves into some difficulty because of the misapplication of funds. What had happened in the late 50's, early 60's was that once the new tax law with accelerated depreciation had come into play, obviously a number of very successful real estate entrepreneurs realized that - people like Cradder and Wein and a number of others. And Cradder in particular - I forget who the other syndicator was - began producing for national syndication and sales a series of individual real estate investments. And they very quickly used up the existing product that was available. Started building new buildings and at a time of inflation the budgets on the new buildings didn't work out and so the cash flow that was available on project by projects at that point was highly erratic even though perhaps the overall cash flow of their existing buildings and the new buildings they were building was relatively even. But because each project was isolated in its own little partnership structure, there was no portfolio effect which allowed them to move the funds from one partnership to another, which they did anyway and they went to jail. Now, the real estate investment trust therefore was really allowed, was created with the idea of one, providing some tax shelter but allowing the portfolio effect of integrating a number of properties both existing and perhaps under development into a single portfolio so the cash flow could be applied from one to another and the relative tax characteristics of these properties could also be used to insulate it from one to another. There were several significant structural flaws in the original real estate investment trust format. The first was, of course, that you had to pay out 90% of your earnings and therefore if you didn't have significant tax shelter, you had to pay out virtually all of your income and therefore there was no internal financing of either expansion or new projects. You had to raise additional funds by selling more shares. This is what's known and is characteristic of all real estate securities as contra dilution. If you sold the first set of shares at $10 a share, you had to sell the second set at at least $11 so that the average value of a share was $10.50 and the original guys in got some benefit - $.50 on a share benefit from the new shares coming in and the new shares paid a premium of $.50 to get into a deal that was already established and had a track record. The third sale of stock then had to be - that's assuming an equal amount of stock - that had to be at $12 a share or something greater, $12.50, so that again, each of the first two sets of owners would each get another $.50 of book value relative to their yield from the new issue. And the third power would be willing to pay $1.00 premium in effect to get in because the book value of his share would be $1 less than what he paid for it. The premise was, of course, that if you could increase the earnings and the stock sold at a price earnings ratio that was relatively constant, the market value of the real estate investment trust share would continue to advance. But they found that in order to do that, you had to have continually new investments. But you couldn't have new investments because you couldn't reinvest your earnings - you had to pay them out. And most of the early real estate investment trusts had been around for a long time as Massachusetts Investment Trust and then operated simply as corporations paying out their earnings. And they had pretty well depreciated their assets so they had no shelter. Not only did they have no shelter, they couldn't borrow money. Because if you borrowed money, you had principal payments to make on the loan. Principal payments aren't deductible for income tax purposes and therefore you had to have after tax income available to make the principal payments but you were required to pay 90% of your after tax income out to the investors. So unless you could get an interest-only loan, the real estate investment trust sure didn't work. You had to be able to sell more shares in the marketplace and you couldn't sell more shares in the marketplace because if earnings weren't going up because you couldn't reinvest, etc. So there was no internal growth. What was worse is, people began to perceive the real estate investment trust not as a growth vehicle but as an income vehicle. They certainly looked at the number of dollars of dividends that were being paid. At the same time the reported book value of the share was continually going down. The faster they tried to depreciate their assets to shelter some of the income to keep the in-house regular reinvestment and expand internally, the faster their book values came down. And the faster their book value came down, everybody would say, "gee there's no appreciation there." Now the real asset might be worth twice as much as the book value simply as a result of inflation or because they've invested in the improvement of the asset, and so forth, but people didn't perceive it that way. It wasn't being reported that way and the security analysts and investors simply didn't understand the trust and as a result they sold at a discount from book value. Incredible opportunities there if you understood what was going on but most real estate investment trusts sold at a discount from book value and book value itself is a discount from market value. But there was one little clincher there with a (?) structural problem. The advising corporation had no intention to sell any assets and realize the profit that was there for two reasons. One, they had paid as a percentage of assets managed and if they sold it and took a profit they had to distribute it which meant their fee went down. And the second problem was Uncle Sam that said they could not take a capital gain that exceeded 25% of their income in any one year. But they were not to be a trading vehicle - that it was a long-term investment vehicle and therefore there was to be no churning of their assets. If you bought an asset, you had to hold it for at least three years and when you sold it you had to phase the sale over an installment basis so that at no time were the capital gain dollars more than 25% of the income dollars and in any event the taxable capital gain dollars were also earnings which had to be distributed and so virtually the only way you could realize the equity build-up as a result of this gradual appreciation was trading. You could trade the equity in your shopping center which had appreciated for, you know, a new equity position and a more highly-leveraged new project but that wasn't always that easily done. Two $50 dogs for a $100 cat is not necessarily a step forward. So the real estate investment trust has some very significant structural problems with it aside from just a complicated accounting of meeting all of the various ratios of how your assets were invested and so on. That characteristic of real estate investment or those characteristics have been significantly modified through a series of revisions in the tax law so that it is a much more flexible realistic instrument and the IRS is doing that and permitting that deliberately to make the REIT a more attractive vehicle to investors because of its liquidity, because of its long-term stability relative to a limited partnership. And the REIT after you look at it seriously today as a major vehicle for financing real estate in the future both from an equity standpoint and a mortgage standpoint. Remember an REIT that, let's say, has 40% equity and 60% mortgage, blanket mortgage over all of its property or a bond issue outstanding which is essentially a blanket mortgage collateral-like bond issue is a very attractive loan for an institution that says I don't want to own equity and I want mortgages - but now I can have a mortgage over 17 shopping centers, 3 office buildings and the condominium and that's a much better deal and as a result probably a little lower rate on that mortgage given the fact that there are that many assets behind that particular loan and that if, in fact you were to foreclose, one, you would put the real estate investment trust out of business and two you would put that advisor out of business and that would really hurt.

Now a real estate investment trust still has several major flaws. One, is that it must be a passive investment vehicle. It is now allowed to take development profits, it's not allowed to take a participation into businesses of the tenants in a property. It can only do those things which a passive investor can do. All of the aggressive functions like leasing and construction and so forth, must be subcontracted out. And they do that through an advisory corporation. So the real control and the real profit for a real estate investment trust depends on who owns the advisory corporation. It may take anywhere from 75 to

125 basis points on the asset value of the firm or some combination of asset value and net income. And in addition it gets the leasing commissions. It could control, the general contracting for remodeling and new construction. It can be very lucrative and yet virtually all of the money is in the trust. One of the most significant operations for a long long time was a little operation in Des Moines, Iowa called General Growth. General Growth is a developer of shopping centers in third and fourth tier cities. Super tacky sort of thing. They've been extremely successful at it and it had a real estate investment trust which essentially became the buyer for all of its products. Now it made the business of, you know, finding land, building centers, getting them leased and so forth and then selling the centers based on what was the current market cap rate to the real estate investment trust. So they had a guaranteed captive consumer for everything it produced. One, General Growth was extremely profitable but too so was its trust. Its real estate trust of shopping centers was the most successful real estate investment trust in terms of the price earnings ratio of any trust in the country. It was selling somewhere around 25 to 1. And eventually somebody tried to raid General Growth and to solve that problem in that it owns some of the trust and so forth. It sold many of its shopping centers off to Equitable and Eetna and used that as a way of avoiding a leveraged buyout by unfriendly forces. But nevertheless, the real estate investment trust became a captive customer for the product of the development company. The hotel industry has some, Hilton, for example, has its own real estate investment trust to sell hotels to. A number of the shopping centers developers have their own real estate investment trusts to sell their product to and it's a wonderful way to be able to retain control and all the profit centers of the development process without having to put any equity in the deal at all.

The real estate investment trust can also be used as a way of gaining a specific mortgage. For example, Lawrence Wein is probably the best known, but the recent Rockefeller Center deal created a real estate investment trust with "X" number of dollars of equity and then in essence a financing above that and then all of the money was used to make a single mortgage to the partnership which bought the Rockefeller Center. In effect, the real estate investment trust had virtually all of the cash income from Rockefeller Center on an amortized mortgage basis which represents a very good cash flow to the investors in the trust and they've created a pool of capital that owns only one mortgage. The very first major syndication and use of a trust in that way was to financing the Empire State Building by Lawrence Wein who also did the same thing. He set up a real estate investment trust, raised, let's say, $.50 on a dollar of what he needed to lend to his Empire Building associates and then borrowed the other 50% on a general debenture secured by the underlying trust equity and then took all of the money and made one loan to the group that bought the Empire State Building. So the real estate investment trust is a great way of creating your own captive institution for financing your commercial development. Now of course you can have a real estate investment trust which is not aligned with any particular developer but simply, you know, buys and invests properties individually. But, by in large, both real estate investment trusts traditionally and historically have been captive tools of capital for the advisory corporation and the advisory corporation is protected from charges of inefficiency by the fact that the IRS says that the trust can not be actively involved in the business of real estate. That they are simply to provide capital for real estate and they can take their return either as interest on a mortgage or as equity dividends from a corporation or building unit which they may own but they can not be

involved in the traditional profit centers that are involved in real estate. And that is still true today. But it nevertheless makes the REIT a relatively attractive vehicle even for smaller things. For example, we're working with a group of doctors that has about 200 doctors in the group. They own a lot of real estate and very convenient to put all of that into an REIT because they can buy and sell their units once a year at some specified price based on appraisal of the property. And they can come and go. I mean the 200 doctors represent a relatively fluid group of folks that die and move on and either chose to practice with that particular HMO or not and so on, you can put the real estate into a real estate investment trust - one that has a least 100 shareholders and no three of them control 50% of the deal - you've met that ownership requirement and it becomes a very useful vehicle for passing through the income with a single tax to the ultimate investment. OK.
We'll come back . . .

(TA talking intially) . . . same room . . . is 12:55, try it at that time on November 23rd, thats' a week from today. You'll miss our class period. And then from there I'm trying to get a feel for how many people in this class plan to take Business 552. And if you're thinking about it, I'll ask once, you know, how many are thinking about it and how many people plan to take it? Question: What is it? TA: Oh, you don't know. It was formerly called Residential Real Estate Finance, it is now getting more into the securitization of real estate, dealing with the secondary market and things like that. It will be taught by Rod Mathews and I don't think it will be real early. I think it's an 8:50 class. It is a pretty good one dealing mainly with the securitization of real estate. How many people in this class are thinking about taking that course? Raise your hands high. About 18. How many actually plan to take it? OK. Thanks that will be helpful in the way we're going to schedule the course itself. Jack wanted me to run through the effects of the 1986 tax law changes and wanted to cover everything on this outline. That'll mean we'll move pretty quickly. TA continues. Didn't transcribe.

Just to keep you current on where current rates and spreads may be and the impact of obtaining your rates on the amount of money that you can borrow or may borrow as a result of the volatility of the market. So, simply to keep you in touch with current rates and as it says on the bottom, as always rates may change by the time you receive this and that's always true here too by some 25 basis points one way or another.

The subject is land loans and land loan development financing. And there's really three components to financing of the land development process. One is financing the land itself, the raw land, the acquisition of the original land. The second, of course, is financing the infrastructure that makes it approved as opposed to a corn field in terms of sewer, water, streets and related elements. And finally as the financing of the marketing and operating costs, soft costs, of the carry during the marketing process. And each of these are quite different in character and generally obtained from different sources although conceivably you might get a participating lender to provide some money for all three.

Financing of the land, the basic common form, are one, financing by the seller itself. The seller has the greatest to gain from providing financing for the developer and still maintaining a passive role. The second may be certain types of institutions which will make land loans. The third is what we would call a syndication but the syndication, very broadly defined, is an association of wealthy people who have got themselves in land banking. Very interesting thought on that is that is one time land banking was thought to be highly speculative and certainly not suitable for fiduciaries and PCW has just floated a

$175 million closed-end fund whose sole purpose is to invest in undeveloped or predevelopment land for what would be called a planned community type of development and doing this in multiple markets based on a recent study which indicated that, in fact, it was one of the better capital gain plays around and that real yields were higher currently in land. A person has in fact a participation type of investment, risks were considerably less if you chose the land with care and then pursued predevelopment plans with some (?). So it's moving out of the area and with a number of local wealthy people, land bank the local developer to a point where it's becoming institutional and as a systematic search and diversification process and which can operate on a fairly large scale.

And finally there have been and sort of comes and goes various programs which are involved in land development financing. And depending on where HUD is and political favor and where the mind set of folks in power may be, the HUD programs may be more or less aggressive, interestingly enough, virtually all of them have failed. As typically they are the programs with last resort for those developers who were not able to find capital based on the merits of the case, economic merits of the case and have pleaded their case based on the social significance of their programs, the Title 10 and other related HUD programs would step in. Virtually all of them have lost their shirt. And so it is the least likely but the one in which there is still a considerable amount of publicity. Between the seller financing, institutional financing and the land banking, the provisions of the loan contract are quite similar. And therefore we'll take a look at the basic character of the arrangement for those types of loans.

The first thing that distinguishes a land loan from the traditional real estate mortgage and so forth is the recognition that the collateral will gradually evaporate - that you take a large tract of land, you subdivide it into lots in a series of some form or other and then you begin to sell it off and you need to pull it out from under that first mortgage and be able to deliver title to whoever is going to buy the lot or the shopping center site or whatever. And so a great deal of negotiation is spent on the process of releasing land from the mortgage.

First of all one aspect of that is what we'll call the partial release clause. The partial release clause recognizes that you will need to take out portions of the site from time to time. The first question is how much must you take at each release date? Because obviously there's a whole process of closing to go through here. Ordinarily if you bought a piece of land the seller would have one closing. You went to the closing and you all signed the papers etc. and you had a schedule, he handed you the title, you gave him the money, and you parted company. But now we're really talking about the fact that the sale is going to be progressive - that you're going to have multiple closing. And one, that increases the cost, two that increases the inconvenience and more than that it increases the possibility that the deal will be intercepted because one of the parties died or now changes his mind - the farmer sells the land for $2,000 an acre which seemed like a terrific sum when the price of corn was down and now three years later, the first draw comes along, corn land has gone to $3,000 an acre, the kids are ready to get their hands on the money and they're saying Dad you blew it, you know, let's sabotage the deal. Well, they sabotaged the deal, sent mom and dad to Europe for six months so they're not around when the time comes for closing and you go into a stall and many a deal is renegotiated at the closing rather than at the purchase. You promise them anything in an offer to purchase and then when you get down to the closing you start to chip away at them. And that goes both ways. Buyers do that too. For example, I had a meeting with Jay Shidler night before last, and he's classic at renegotiating that. You go into buying the land and now you find the toxic waste and now you find gee, there were 2 gasoline tanks buried there and they leak and we're going to have to clean that up and over here, the old flooring, you filled that up with all kinds of debris and it's not useable and so what's useable acreage falls out and our price of so much per acre was for useable acres not for gross acres and gee, now the road encroaches on your land by 33 feet all the way around the perimeter and that drops out of useable. And so a lot of times you start renegotiating the deal at the closing. And depending on how bad the seller wants to get this property back or how bad the buyer wants to get it kind of determines the whole process. You've got a very tight set of rules as to how this partial release is going to take place and who's going to administer it.

First thing we need to know is, of course, how are we measuring units? Are we going to release per lot or per acre or per square foot? The second thing we need to know is what is the sequence of the units we're going to release? And the third thing we need to know is how do we measure a unit? Sounds pretty elementary, but this is where all of the misunderstandings begin. So let's say for the moment that we're buying a 240 acre farm and on that 240 acre farm we've got 40 acres of woodlot that's on high ground, beautiful trees etc., we've got a 40 acre pond and so forth, we also along with the pond we've got 20 acres of swamp and the rest of the land - half of it is on the highway and the other half is in a back piece of ground that's pretty difficult to get at and will require rather expensive road building and so forth to be accessible. First thing the buyer and seller really have to do is sit down, kind of work out a gross master plan for the site and allocate to these different areas, which may produce anywhere from let's say, one to five categories of tillable ponds, woodlot, swamp, you know, etc. - useable or unusable as the case may be. And then you will set up a sequence that says, first of all you're going to start at this point and you'll have to take a minimum of 20 acres on each draw. We don't want to go through this whole closing process and pay all the attorneys and so forth and so on for less than 20 acres. Second thing we're going to do is we're going to talk about gross acres and for every twenty acres you take of dryland, you will also be taking 20% of that amount in pond. Remember we had a 40-acre pond on a 200 acre property so that 20% of the property is technically under water. So a really savvy buyer would very cleverly nibble the cheese all the way around and never pay for the pond, right? It's not going anywhere, you know, people get the view and nobody's going to have to own it. If I want to be really tricky about it and leave the seller sitting there with 40 acres of bottom on this pond so that the seller's got to be sure that when you pick the good stuff, you're also getting a share of the stuff that, by itself is not marketable or useable or whatever because his ultimate objective is at some point to have sold all 200 acres and not be left with a pond that isn't marketable or would have very minimal value. So you set up the sequence and you say, all right for every 20 acres I get that's dry, I'm automatically going to get 20% of that number on the bottom of the pond and in addition, I'm going to get another 20% of swamp land and so forth - you know the unusable road beds that are underneath the county trunk road and so forth and so on. Second of all I'm going to price these acreages differently. You know, if I were you I'd, you know, as a developer, I'd say gee the average price is say $1,500 an acre and then I'd really take the high ground in the woods and forget the rest and I've got a terrific spiel because woodland is worth $5,000 an acre and the swamp land is worth $250. So I don't want my buyer buying just on average price. So each of these zones that I identify is going to have a different release price per acre. So now I have a map that indicates which land is which, the price per unit for each of those zones and what I call the sequencing or congruity (?) clause which says how do I start nibbling at the cheese? I will start at this corner and each 20 acres that I take, one, must be contiguous with the last 20 acres that I took and two, can't leave me with any parcels that the seller can't market or reach from the public road. So that if at any point along the way the buyer drops out, the seller isn't left with a piece of land that so cobbled up that he can't sell it, that it doesn't have any real economic use. So both the buyer and seller are going to be working on some kind of master plan and set up release price, the schedule of units to be taken, and the congruity of the take down so that each time he comes in for 20 acres, it cumulatively adds up to a master plan that makes sense for both the buyer and the seller and the seller's residual is always protected. Now all of these things are under the release provisions. Now that may take some time obviously and then the question then becomes, gee do I want to compensate myself in terms of the price or do I simply want him to pay interest on the balance of the purchase price that we haven't paid off as yet? If you use a straight mortgage back to the seller, typically it would be interest. All of the interest is taxable as income for the seller. Instead he might prefer to have a minimal interest required by the IRS also called imputed interest rate. And for taking the risk for going along and, in effect, financing the land for the developer, he would get a stepped up basis so that for the first two years the release price was so many dollars per acre adjusted for the different loans and then there would be a bump that for the next two years the price would now be 15% higher reflecting the fact that one, by allowing the developer to get his entitlements, to get his infrastructure up to the site, do his master plan, begin his marketing program and so forth, he's created a certain amount of value to the site that wasn't there before and that they ought to share that value that's been created by the seller's patience and the buyer's political know-how and him getting the appropriate zoning and master plan approved and so on. So if the saddened seller perceives that gee, having waited three years, the land will now be worth 30% more than the nominal withdrawal farmland price, I ought to get at least half of that for having been so good as to finance him and carry it through. So the release price may be moving up in steps at the same time that the interest rate on the unrecovered purchase price continues to move forward as well. So the release then is concerned with the zone, the sequencing, the size of the unit that has to be taken down and the price that will have to be paid at each point in time when the release is exercised.

Now, if we move from simply a mortgage format to, let's say, a land contract format, there is more opportunity for the seller to buzz off if the developer doesn't live up to his promises. But, on the other hand the seller has more control under a land contract than if you gave him just an option. One of the things you have to do is be able to abort the deal and wind it down quickly without getting embroiled in a long lawsuit trying to push the developer out of the picture if he didn't perform or he encumbered your property unnecessarily with construction liens and so on. So quite often the same arrangement, instead of taking the form of a mortgage or a land contract, takes the form of a series of options. You still have the same sequencing, the same pricing, the same release elements, but it takes the form of what is called a rolling block option in that if you buy the first 20 acres, that renews your option to buy the next 20 acres and you do what you said you were going to do in the first 20 - certain conditions are met - why then you're entitled to take out the next 20 and by a certain time, of course. And if you fail to do it by a certain time, the whole deal is off. Now notice the option does not transfer anything to the buyer in the way of an equitable or legal title. It simply is a right to indicate that he wants to acquire the title, you know, at some point in the future, certain conditions being met. So the seller has maximum protection against default by the buyer under a rolling block option. The provisions, the pricing and the planning are the same as a straight mortgage with a release clause, the same as a land contract, but in this case failure to exercise to purchase the next 20 acres or do what you were supposed to with the first 20 acres, means the deal is off, you've broken the train and the options die for failure to renew them by the consideration of your actions.

The rolling block option as well as the release clauses are often tied to what is called pace clause - at what pace will you develop and take down land? You do a 360 acre industrial park, the seller wants to know how long is it going to be before I get my money back? I got to do some financial planning too and I want to be assured that while waiting some 76 months or a year, absorption rates will differ with the economic cycle. At the end of ten years we're all done, I've got all my money, you've got all the land and we part company and be on our way. The pace clause is typically a minimum/maximum kind of thing. The minimum is to assure, obviously, a steady pressure on the developer to go forward with his plans and complete it according to some schedule that is a least a little pessimistic in terms of how long it will take him to do that but the maximum is related to the tax status of the seller. Remember the seller, particularly prior to current tax law was much better off to get a capital gain than he was to get an ordinary income kind of deal, and second of all he was much better off to spread it on an installment basis over time because it was a progressive income tax, you wanted to stay in the lower rates of the progressive scale and therefore you wanted to kind of smooth out the proceeds and from a tax planning and estate planning standpoint have a pretty good idea of how many dollars you're going to get each period. So the maximum would put a lid on how many acres you could buy all of a sudden from the seller under the rolling block option.

The alternatives to that, to protect the seller from a surprise tax burden in a time period in which it might be inconvenient or expensive under the progressive system is to use what is called a substitute collateral clause. Substitute collateral clauses are drafted in such a way that the seller would put the money with an escrow agent along with the purchase all of the land at a particular point in time or half the land more than he would ordinarily be allowed under the minimum pace provision. But he would put it with a trustee that would take no direction at all from the seller and would continue to make payments to the seller on some predetermined schedule so that the seller would receive his receipts according to whatever financial plan he and he his tax attorney had worked out. That way the seller gets the financial planning and the benefit of whatever level of progressive tax rate he wanted to take, but the buyer can get his hands on the title of the property suddenly and perhaps well ahead of schedule because there's an opportunity for him to sell it to somebody for one thing or another or because, you know, his financial plans indicate that would be a good thing to do.

The substitute collateral clause, has to be very carefully drafted. Typically the tax attorneys that are using it has tested one or more of these with the IRS, they come up with boiler plate language that meets the current district office requirements and they tend to defeat them. The IRS, of course, is looking for anything in the world to upset an installment sale and get their little hands on the tax revenues sooner and so they kind of get a little persnickety about the language. The critical element in a substitute collateral clause is what is called “constructive receipt”. Is there any way in which the seller can viewed to have an influence over the use of the money. You can’t name, you know, the old lady’s son as the trustee of this escrow and you can’t name her banker or lawyer as the trustee because there’s a presumption that he is representing his client’s interest or his relative’s interest and therefore there is some element constructive receipt and the IRS says, “ OOPS, this installment sale is over, you owe us taxes on the whole nut as of this particular point in time.” So it has to be very carefully designed or crafted to be totally independent of influence from the seller in order to make the substitute collateral clause work. Now, the same is true if you’re an institutional lender. The institutional lender may want to have an enclosed loan for a period of time and yet you need to hold some of that land out and be able to convey clear title to somebody. Again, you may use a substitute collateral clause and, in effect, it’s a form of a credit enhancement because you’re substituting a new asset which is the cash, against which there is not a lien, i.e. the mortgage, as opposed to the land which used to have the lien on it. So if those of you that were on the field trip the other day in Milwaukee, the FHA lends more on the development project than was justified by the real estate because they put $2.4 million in a second trust account and that was part of the total property value pledged. So the mortgage can span not only the lien on the land but can also have a lien on a specified trust of assets and go from there.

The next problem is administration of this rather complex arrangements relative to the release. As we mentioned earlier, people tend to me mortal, people tend to change their minds, get irascible. There's something about land that causes people to get emotional and fight about it anyways and therefore you really want to neutralize the parties. So invariably land deals there is an escrow agent who's given a specific set of instructions by the seller. He has a specific set of conditions that the seller must meet relative to the buyer and the escrow agent presumably executes the arrangement over the years with rationality and impartiality within the scope of the power of the escrow arrangement. As a result, you don't have to deal with the farmer once he's sold property, or his heirs which is even worse, and by the same token the buyer is going to be held in check by someone who is essentially representing the seller equally well and the closing process will be greatly facilitated typically by a title company who then goes forward and updates the title insurance, delivers the necessary papers and so on at the closing. So almost invariably in a long-term land deal there's a third party escrow agent who is administering the contract and keeping the parties at best informed over time.

Now one of the problems that developers always have is money. They never seem to have any which is the cash type money. And the problem with a land purchase arrangement is that the interest meter is running, the real estate taxes come due on a regular basis and obviously there are other carrying charges. And so it may be possible that the seller, if he gets into it, may say, "All right, tell you what I'm going to do. You don't have to pay me the interest in cash each period. I realize you don't have that. Instead we'll add the interest as a balance on the loan and we'll carry that forward during let's say the first five years of the project in order that you can, you know, get through the planning phase, start a cash flow from lot sales and so on." Exactly what Rouse did in the development of Columbia. Connecticut General was perfectly OK to say, "All right, I'll tell you what I'll do. The interest, let's say, is 8% or 9% plus adjustment every two years for critical interest rate and we'll just simply add that to the balance." As a result, cash needs of the buyer are initially reduced. What does the seller of course want in return - some sort of equity participation. Them that takes the risk, an old American tradition, also takes the profits. Seems a reasonable proposition. It's a good thing more people don't know that but . . . So then the question is how do you allow the financier to get the profits without becoming one, a partner with the seller which changes his liability position and changes also his right to foreclose or right to impede the execution of options and so on. How do we get that participation back to the seller? Well, one way of course is to set up some sort of conditional sales price that says well, what I'm going to get is a minimum of say, $5,000 an acre for the raw land plus I will get 10% of the total retail sales prices of the lots you sell. So if you're very skilled and you produce fewer lots but they are more exclusive and they get higher prices, the seller benefits. If you chop it all up into little tiny pieces and you sell a lot of lots for a lower price, but never the less the aggregate sales prices achieved are higher, great, the seller gets plenty. He doesn't have to guess beforehand, neither does the buyer, you know, what kind of lot or what price they're going to sell it for. He simply gets a percentage of gross sales. This is, for example, what the Irvine Company has done for years. They lay out the large major traffic arteries, the major utility zone, and then they'll sell a 200 acre parcel to a developer that actually puts in the collector streets and the cul-de-sacs and the sewer and water and so on and he gets a base price going in plus he owes them a percentage of sales coming out. If you're really good, you tie that percentage not to the lot, but to the lot and the house. And there's been quite a few deals in the Madison area, in fact it came under the scrutiny of the attorney general, because it was really kind of a tie-in contract. The builder who bought a lot from the subdivider generally would give a credit, - you know, nickel down, dollar when you catch me, or three years from now whichever comes first, sort of thing - if he sold a house on that lot in that subdivision, then owed the subdivider 6% on the total house and lot on the argument that if you haven't had the lot in this particular subdivision it wouldn't have made the home set. And a lot of buyers got a little upset by that - finding out that, you know, first they bought their lot from their builder and then they planned a dream home and now they get the cost of their dream home and it turns out to be 94% of what the builder is going to charge them because now they're paying the 6% commission on the whole schmeer to a broker they never saw - who happened to be the subdivider and that was the deal that was cut with the builder. So it's a way to get your participation back to the seller which avoids him getting categorized as a partner or general partner, in particular, with all of the liabilities that might attach as a result and all the limitations on his actions on the downside that could result. Another way of doing it, of course, is simply to have the corporation which is doing the development issue warrants to their stock every time that they acquire land and allow the seller of the land to eventually be bought off the warrant so that the subdivider doesn't have to share the stock with somebody else. There may be other ways in which to do it but as you get moved closer and closer to the partnership the liability exposure of the seller changes significantly and you may simply not want to do that. He's much better off to be a mortgage holder on the parcel and the public liability and the environmental liability that goes with the development process that stays with the developer and not travel home to the seller.

The next administrative problem early on in the deal is, of course, the degree to which the seller will cooperate with the buyer in one, obtaining information about the site and two, participating in the public planning and entitlement process. The first release of land that's going to occur is going to be the land dedicated to the street right-of-way and perhaps to park lands or school sites or other conveniences that pass through. Can you get the seller to do that? Well, ideally what you want to do is to get the seller to agree to dedicate the streets and the school sites and the storm water runways and so forth free of charge. Saying, "Gee I really didn't want to have to pay for land that I really wasn't going to get and so forth." And the seller is saying, "well obviously I'm not planning to do that all for nothing for you guys", and so as a result there's impact on what is the unit that you are going to release? Is it a neck acre after the road is dedicated or a gross acre before the roads have been dedicated and what will you pay the seller for dedicating roads, park lands and so on. A compromise often is that the downpayment, let's say, you have a $200,000 land purchase and you're putting down $20,000 or $30,000 up front, that the downpayment includes the seller's cooperation in dedication of street right-of-ways and public green space. The premise of the seller is that by going along on this even if the deal died at that point, his land is now worth more than it was before as the master planning is completed, the public entitlements are in place as are the improvements. And therefore his parcels will be worth more by his cooperation either if the project fails, than if, in fact, he blocks any such participation.

Prior to the dedication, are what are called right of entry. Every good land purchase of land arrangement will give the so called buyer/developer the right of entry to all of the land, whether he has taken down his option rights and so forth or not to allow you drill and to do bounce soil tests, foundation tests, environmental toxic waste reviews and so on. That's extremely important that there be a right of entry to the buyer to get on the property and do the proper tests relative to the suitability of the site for whatever it is he has in mind. Will it support the foundations under the heat log etc. You don't have to buy a pig in a poke, you can inspect the premises thoroughly and have that as part of the purchase arrangement.

The other element of right of entry, of course, is damages for the crews that are on it. Particular true of farm land. You back one of these great big rigs for doing borings and testing over the corn field, well you're going to have to pay the landowner for whatever damage you've done to his crops and his livestock and so on. In some areas one of the interesting aspects of that damage is compression. In many farm areas such as California, certain parts of Wisconsin, the fact that the soil is loose, sandy and very much aerated is a critical element of its productivity. Driving a big truck over that thing and compacting the soils may, in fact, squash the timing of your need - certainly squashes the clay into a virtually impervious base for agricultural purposes and that becomes part of the damage. In fact, it may even be one of the constraints. You may say all right you can't do anything on the site that doesn't come on floatation tires that exercises no more than so many pounds per square inch and that the buyer will be responsible for correcting for any compression that may have occurred and so on. Right of entry, damages for that project.

We've already talked about cooperation in terms of dedications and so on. Also would be required are the signatures of those in charge of the interests for the seller relative to zoning application, relative to platting application. As you know there's a fairly elaborate pre-platting, planning process and the owner of the land technically has a right in that or it won't go forward. Again, you want to have an escrow agent that's presumably less emotional and irrational to the land seller as being identified as being the agent who is empowered to sign the platting applications and so on. Without any of these things, the land will never be worth what was the basis for the buyer's price offer and you'll never be able to get to a point where the entitlements are in place and you can go forward.

The last element to financing of the raw land that we need to look at is the indexing of the various components of price. One, of course may be the capital cost of the land. One may be the interest charges on the balance due. And three may be any bonuses that would represent a change in use for the site or I infected generosity by the entitlement forces and so on. If the seller has decided to hold out certain pieces of land, the buyer often feels that whatever he does is on the initial phase is going to make wealth for the individual that owns the encasing property and therefore he may want to negotiate a first right of refusal so that he starts with, you know, 80 acres and has the right to acquire the additional 80 acres and see if the project work thereby controlling the environment of construction and making it possible that he doesn't simply create tremendous wealth for somebody else. Disney, of course, learned that lesson very well. If you're going to Disneyland initially buying just enough land for Disneyland and everybody around made a fortune because it became very attractive hotel sites and supported ancillary businesses so he went to Disney World he made sure he got enough. You know, he got 100,000 acres, surrounded himself with walls of money and grass so that all of the people on the outside can't benefit and then to the degree that they can benefit, he created the village of Buena Vista to have a tourist support subdivision that was not within the park itself but was able to compete to the Park with the private sector and put the private sector out of business. And the only big hotel that's going is the Sheraton outside of Buena Vista is literally just over the line that defines the town of Buena Vista. It's the biggest hotel down there, has the biggest convention facility of all the hotels down there but isn't part of the Disney complex nor did it buy land from Disney. As a result, Disney won't let its buses go there, you know, won't allow any of the roads to tie up to Buena Vista so you can be sitting there across the road from the shopping center but you can't get there without walking across land which has been very carefully landscaped to discourage you from doing that. And it was just simply an example of a piece of land that he wasn't able to control soon enough and he's still mad about it. Not that Walter, of course, was ever mad at anybody but. . . current management. In fact, when the ULI had their 50th anniversary at Disney World, they got taken to the cleaners by Disney, but one of the problems was they wanted to use the big auditorium at the Sheraton and Disney said absolutely nothing doing - that they couldn't stay at Disney World and use the Sheraton's auditorium and what's more, the Disney buses couldn't go there and so forth and so on and so on. And so Disney, instead built a - I don't know I think it was something like - 30,000 square foot circus tent on top of that heliport at Disney World and moved everybody by bus down there which ultimately turned out to be a disaster but it was fine with Disney, it just didn't work out very well for ULI.

The next element is obviously not all land is suitable for immediate development than an alternative to financing the raw land of an active developer is to involved with an investment called land banking. Land banking is essentially the ownership of land over a relatively longer term anticipating that ultimately the community will grow up and need you to convert the land to urban purposes. Land banking, therefore, requires capital that does not require any current interest return that will await for capital appreciation as a result of their other efforts and where the resulting payments on the real estate taxes, liability insurance research on what you're going to do with the sites, legal consequences of development can all be expensed through to the investor and at the same time in the future the capital gain will be just that. Two of the favorite ways of doing that presently are subchapter or S-corporations and two, limited partnerships. A subchapter-S corporation as you may know or may not know, can have 35 investors - that can be mom and pop so 70 persons all together possible. And it has the limit of liability of a corporation with a full pass through of taxable losses to the investors up to the maximum out of their contributions. So if they each put $10,000 in the pot, they can each take up to $10,000 of losses during the predevelopment stage and apply that against their income tax. What did you call that? Passive income generators, something like that? Now the next thing about a subchapter-S corporation is while you're in the predevelopment stage, before you have any product for sale, you can pass through the expenses to the investors who then can deduct those for what they're worth on their income taxes. Once you're in a productive state, you then opt or elect to go off the subchapter-S status and become a normal corporation. At that point the corporation takes the profits and as you know the first $100,000 are taxed at a considerably lower rate than the balance of the income.

What's more is the corporation can do several things. One, of course it could trade some of the lots for taxable investment real estate on an exchange basis and pay no taxes at all. Two, it could build its own depreciable assets in the form of a shopping center on the key site or a small office building on the key site and again the taxable losses on that particular property would offset the taxable gain on the land. The corporation can go into a leasing operation and lease from the apartment developers and the shopping developers and so on and therefore not have to pay an immediate income tax hit on the property. The subchapter-S corporation or partnership then sets up a redevelopment plan, a master planned community and gets the appropriate entitlements to extend the infrastructure and so on and then starts to sell off the land from these new sites that have been created relative to the development. Currently the rate of return on that is anywhere from 8 to 20% a year in real terms and the name of the game essentially is to buy the land low enough that once you've sold that first shopping center site or apartment site or 50 acres of single family developer at the new price that represents urban land as opposed to corn land, that your payback is virtually at 100% within a year or two of your initial marketing program. The balance of the site, 70-80% of it essentially has no costs effective with it and, you know, if you never sell half of it that's fine too. You've already recovered your money and made an adequate rate of return. And there's quite a few of those that are buying by the ranch and then selling by the acre or square foot and doing very well. The syndicator, of course, has the same advantage of the subchapter-S, a full pass through of the carrying costs and operating costs back to the taxpayer. The IRS laws are starting to tighten up. Of course you have to capitalize looking at the expense but nevertheless, still favorable to land development.

Seems like we still have half a semester of work to go and 2 weeks in which to do it so I think I'll have to talk faster. The other bad news of the morning is that there will be an assessment for mimeographs. We have long ago used up our allotted 50 pages per student and the assessment is $XX per head. So we have a mortgage on your grade - sort of a Xerox lease. And you can fire a check made payable to the real estate club poke account or whatever they call it and hand it in to Mark here and at discussion, at your leisure unless, of course, you don't want an incomplete. So I guess they're due by the end of the semester.

A further reminder is the that the last of the 795 sessions is this Friday. It will be at the Edgewater Hotel on the first floor ballroom. Our guest is John Robert White who is really the dean of real estate counseling chairman of the board and president emeritus, of Landauer and one of the really smooth people in the background of the real estate industry and he's going to be talking about a number of different things. One, you know, where is appraisal going as a career but more about real estate counseling and a number of the different types of things that Landauer does. They're very famous for their Pan American building transaction which really kind of revolutionized the way large buildings are marketed. They're really what they would call a buyer's broker in that they go out and negotiate and acquire properties for other folks - sometimes setting up a strategy for them initially as to what it is there looking for and how it is that it ties into their operations. They're also into corporate real estate policy and assisting corporations in maximizing the returns on their real estate base even though it may not be directly related to real estate investment in its corporate manufacturing and resource company and so forth. Very schooled individual, complete total contrast to Ed Kelley who is a delightful, you know, high energy projectile and so forth. And John Roberts is smooth - that's the best way to describe it. He's very low key and I think you'll really enjoy him - he's a super instructor. Anyway, that is this Friday and at the Edgewater. And what we like to do so that Mark can sit on part of it is: those of you that are in the 9:40 quiz section, we would ask you to go either to the Wednesday session which is at what time? Wednesday is at 1:05 in Room 113. We may move the room in order to get a little more capacity but there should be a sign on the door if we're able to do that. Or the 12:05 session which is in Room 113 also on Friday. So you can enjoy the morning session with John Roberts. So program that in and let your associates know if they're not here and are in the Friday night session.

Now, you have what, a case study to hand out. Mark: The case study was handed out on Wednesday so those of you who didn't get it when I come up to your row, please raise your hand and I'll pass that along. Graaskamp: I'm taking your name down for not being here on Wednesday.

The very least laws of common medicine topic. (?) OK while Mark is handing out your last problem of the season let's go back and talk about tax exempt financing initially and then we'll start securitization of the commercial mortgage side.

Obviously there have been a number of different types of government programs to provide some financing for various types of commercial real estate. And prior to the 1986 tax law one of the favorite devices was the use of the so-called industrial revenue bond or just tax exempt financing of one form or another. State and local governments could issue bonds which in turn were secured by mortgages on properties which were thought to advance the public purpose. What was thought to advance the public purpose was initially pretty much a blank check - you do everything but a Wee-Willy Waterslide to counterfeit plants and there were some really incredible examples of small towns being incorporated in Tennessee with 50 residents who then voted Yea to provide a $350 million industrial revenue bond to finance a chemical plant, let's say, for Dow or DuPont or somebody of that sort and the tax base for, you know, back then, put everybody in that town on easy street. They never had to pay real estate taxes because the relatively modest real estate tax on $350 million industrial plant covered all of their needs and those of their children and, you know, future generations and this type of abuse of the tax exempt element, obviously, was one factor in contributing to its demise as a major loop hole for corporations trying to reduce the overall constant on their debt base.

The other factor, of course, it was with the tax reform and the reduction in income tax rates from 70% early on to then 50%, more recent years and now it's at 28% - the spread between a taxable bond yield after tax and a tax-exempt bond with no tax narrowed significantly and as a result, the degree of advantage in using an industrial revenue bond or a tax exempt financing has been significantly reduced and therefore doesn't have as much impact on rent structure and so forth as it once did. The tax reform act also began to distinguish those things that were generally the traditional activities of government like building schools and roads and so forth which remained tax exempt from what they called private business activities. And private business activities are what are called IUPs, were either one, were more than 10% or $15 million in the case of financing an industrial facility would be used in a trade or business carried on by persons other than the state or local government and 10% or more of the principal or interest on the bonds would be secured by or would derived from money or property used in such a trade or business. So for example, the hotel project in downtown Madison in which they are proposing to put a city built parking ramp underneath the hotel which would be leased one, to the hotel and two, to the redevelopers of the Tenney building and so forth, would not qualify any longer as a tax-exempt bond issue of a parking utility because more than 10% of its spaces would, in fact, be leased to a private entity that would be the beneficiary of that resource. So tax exempt financing which was a major way of reducing the constant on your overall debt burden for various types of commercial development has really been spiked by that kind of control on its use. Previous to that there were some further constraints that was 25% per trade or business and so forth but, it nevertheless was not applied as tightly as it is now. Therefore in order to make an industrial bond useful to a real estate project you will have to mix the bond proceeds with a larger public purpose and conceal the fact that the bond issue was really issued to advance the particular redevelopment project or housing project and so forth. The one area where you can still use qualified tax exempt financing is for a number of specially exempt activities and for the real estate financier it's useful to know what those are.

The primary one is multifamily residential rental housing where a certain percentage of the residents fall into what is called low income housing standards. Low income housing standards mean that they are below 80% of the median income for the area in which they live and what's more are endorsed by a public housing authority that will, in fact, review and administer those eligibility requirements relative to those who live there. So if you want to develop an elderly housing project with tax exempt financing which would provide a shallow subsidy at any rate to the residents in the project, you would have to get the housing authority in that community to indicate that the project had their approval. They would, in fact, issue the bonds for the tax exempt benefit and they would then make a mortgage with those bonds to the developer who was building that particular project. The developer, in turn, would have to indicate that at least 20% of his unit were priced at a point which would fit the 80% of the median income standards of the project. If you'll recall the Yankee Hill when we visited was financed with a tax-exempt bond authorized by the City of Milwaukee Housing Authority and that $600 rent on the base unit met that standard. $600 times 12 is $7,200 and $7,200 was 80% or represented about 30% of a number which in turn was 80% of the median income of the community. At the time that those projects were done, the allowable median income was for a family of four. And which doesn't make any sense at all because the rent of $600 was on a one bedroom apartment but nevertheless it was a way of the government very slyly in effect, subverting the tax law to provide financing for housing. And a number of projects, lots of projects, were done as a result of that bid. Now under the new tax law, if it is the income of the residents - if the one-bedroom unit can house two people at the maximum then you're looking at the presumed median income for a family of two and take 80% of that, then take 30% of that and that's the maximum rent you can charge on those units. That typically is lower than what it takes to build the project so you end up with two classes of tenants - those that are paying just the ceiling rent that they are permitted to pay and then the others have to pay a little more to subsidize the presence of the first 20% in order to qualify for tax-exempt financing. It gets very messy and as a result there's less and less of that type of thing going on because the current rule tends to discourage that.

The other reason is that not only is the interest rate under the new tax law higher because the tax advantage of tax-exempt interest is less, but the bankruptcy laws as we mentioned earlier have suggested that payments to a mortgage bond holder are preferred payments and therefore may be curtailed by a bankruptcy trustee while they sort through the claims. So it is conceivable that if the project went into a Chapter 11 receivership and so forth, that you would have a broken stream of payments to the trustee of the tax exempt bond. As a result, public sales of the tax exempt bonds required some form of credit enhancement and the cost of that credit enhancement probably eats up a large part of the difference in terms of the interest advantage that tax exempts would provide. Indeed the advantage today is probably not so much in the interest rate, but in the way of amortization. If you get an FHA approval of the loan, suddenly you can have 40 year amortization and in addition the FHA will provide insurance for the construction lender as well as the permanent lender. And the saving may come on the interest rate on the construction loan which is now, you know, full faith and credit of FHA rather than necessarily in the interest rate on the long term loan itself. So that by the time you add the cost of the credit enhancement you're getting pretty close to the market rate for that kind of money. The other alternative of course is you buy credit enhancements from somebody like - what's the insurance company in Chicago? - Continental Insurance and a number of others and again you'd probably pay 100 basis points a year for that credit enhancement to make it possible to sell the bonds in the open market and that, in turn, also pretty much eliminates the advantage of tax exempts. The alternative, of course, is to prearrange a private placement of the tax exempt financing with a local bank so that if you have a situation in which you can use tax exempt financing and as part of the county development plan of the community, the local bank with a private placement will take it without the credit enhancement particularly if it's a relatively small issue $1 million or $1.5 million and they'll simply stick it in their portfolio and at that point there is still some small interest advantage to using the tax exempt financing.

The second type of tax exempt for tax exempt financee's (?) are for Airports and dock and wharf facilities. One of the things you want to do then of course is perhaps color the project to look like a dock and wharf project. So I'm currently scheduled to be on a planning charette in Seattle in which one of the docks below Pike's Market is going to be going to be redeveloped and it's critical that they keep the harbor authority office in the building that they will be converted to housing on the wharf so that it falls in that status and the city can do tax exempt financing one of the incentives to the developers coming to do the project. Sewage, solid waste disposal facilities and toxic waste disposal facilities are another one that is exempt. Interestingly enough however they have a specifically exempted alcohol and steam generation facilities from tax exemption. As you know, during the energy crisis one of the ideas was to take corn and other agricultural products and produce some sort of benzole or whatever it was called, some sort of a pseudo gasoline and so forth and they made a couple of loans on that which turned bad, real bad and as a result both are exempt from IDB. Facilities for the furnishing of water including irrigation systems can still be done with tax exempt financing. Classic case of the agricultural lobby being able to protect particularly development in the Southwest. And so that qualified. Facilities for the local furnishing of electrical energy or gas are still enjoying tax exempt because again there's that constituency that believes that electrical, and gas systems should be all owned by the public. Local heating and cooling systems are still exempt. If you want to build a centralized heating plant, and then pipe hot and cold water to your downtown district, you can do that. Hazardous waste disposal facilities and mass commuting facilities are the other exempt activities which still permit the issuance of tax-exempt IBDs even though the facility is privately owned. On the other hand, they put the spike to a number of things of interest here - sports facilities, convention and trade show facilities, parking and air and water pollution control. Notice how things fall out of political favor by air pollution control have now declared the problem solved and so they are no longer entitled to tax-exempt money. Qualified redevelopment bonds have also enjoyed a tax-exempt status. They generally qualify if 95% of the proceeds are used to finance redevelopment in a designated blighted area where increases in the real estate property tax revenues due to redevelopment are reserved to debt service on the issue i.e. a TIF District. So you can have a TIF district, and once in the TIF district you could have a tax-exempt bond issue to go forward with the project. In addition there has always been and still remains on the tax laws a kicker if you can combine the TIF district with a U-DAG so the maximum usage of a tax-exempt is $10 million per project even in a redevelopment district unless you get a DAG grant in which case you can do $20 million. And the classic demonstration of that operating is the River Place project in Minneapolis where they needed $30 million of tax-exempt financing to make the project work so first they got a relatively small U-DAG grant, really nominal but it managed to kick them in for at least part of the project from $10 to $20 million. So now the second trouble was that they were still only entitled to a maximum of $40 million per company and $30 million of the project so what they had to do was literally build a brick wall right through the middle of the project so with a couple of fire doors that you could go through, but they literally divided the project vertically in value so that on one side of the brick wall it's worth $10 million and on the other side of the brick wall they have $20 million in place and they have two different bond issues because it's nominally two different projects. It's a classic case where the bond indentures designed to the project and where that $10 million break was wasn't very convenient. If you ever get into the River Place project you'll find this mysterious divider kind of meandering through the project and it has no architectural function at all other than to put $10 million of cost on one side and $20 million of cost on the other side of the project in order to meet those constraints. The other type of IDB, Industrial Development Bonds, that enjoy exempt status is something called the small issue bond. And small issue bonds really cover very minimal projects like $1 million for a manufacturing facility and a lifetime of $250,000 on farming facilities. So it's conceivable that a group of farmers could get together, form a water coop decide to create some sort of irrigation trench of one form or another and each farmer would be entitled to a single lifetime $250,000 tax exempt loan to facilitate creating that water facility or in some cases a shipping coop that needed to be able to sort the grapefruit into various sizes and that type of thing. It covers primarily agriculture and manufacturing and, interestingly enough has a special section in which the local economic development authority can make loans on tax exempt interest rates to insolvent farmers and insolvent agribusiness. So if it decides to provide debt from an essentially nonmarket source for those, and one other group that's covered are first time farmers. So if you had a local development bank that wanted to re-populate the farm district and you're concerned about young farmers being able to finance their equipment and so forth, the first time farmers would get a $250,000 tax exempt loan from a local agricultural coop or development bank area in finance his adventure that way - very strange set of rules. But in effect tax exempt financing has been greatly reduced with the exception of some multi-family housing and a few types of specialized facilities - it really isn't as significant a role in the real estate commercial property game as it was prior to the 1986 tax reform act - where there was a significant gain and there were real advantages in terms of the debt service constant to be realized by going to tax exempt interests.

The other reason for bringing up tax exempt financing at this time is that it's a very excellent bridge from the traditional mortgage lending sources that we've been talking about to a securitization of the commercial lending promise. It certainly was the first stage of securitizing the mortgage process and operated primarily as a way of taking advantage of federal IRS regulations relative to tax-exempt finance. What do we mean by securitizing?

The securitization of a mortgage really - somebody have an answer, what am I missing - a rhetorical question. Securitizing of commercial mortgage lending really means that the capital sources for funding that mortgage are the result of the sale of fractional interests directly to individual investors. So remember your basic language. One, of course is disintermediation and disintramediation. Disintermediation is where you shift from one traditional institution to another - from savings and loans to banks and so forth. Disintramediation means that the borrowers are bypassing the traditional institutions and going directly to the sources of capital. So securitization represents one, disintramediation and two, fragmentation of the interests in order to pool capital to finance the mortgage. The initial securitization took the form of really private placements as we mentioned earlier with life insurance companies using the bond medium as a way of making the loan because bonds traditionally allowed tighter control of the borrower than the mortgage forum. The bond indenture could establish a series of constraints on the borrower both in terms of his operations, his ability to pay dividends, pay salaries and so forth - could require the gradual funding of a sinking fund or a securities fund could require creation of a repair/replacement fund to protect the collateral values and so on. And so the initial private placements in the mortgage finance area found that the formats of bond financing provided tighter control. Eventually they found that it also provided greater liquidity and that they could sell a portion of the financing to other lenders, so it was a facilitator of participation among institutions but still on a private placement basis rather than on a public basis. As the various financial institution began to withdraw from certain types of lending, the residential area as you know began to develop new forms of pooling capital that did not depend on traditional intermediaries. One form, of course, was the so-called collateral mortgage trust in which a group of residential mortgages was placed with a local bank trustee and certificates of beneficial and interest were issued to large investors - people who could buy $100,000 or more at a crack, sometimes $500,000 at a crack. So the first form of securitization was simply to create a new fractual interest which was a beneficial interest in a trust. Trust spelled with a small “t”. The trust was literally managed by a corporate trustee, typically at the local level and units of investment were custom tailored to what whatever the budget of the investor was and you could have anywhere from five investors to maybe a dozen that essentially owned the whole issue. The second step in that process was to formalize these pools as you recall recognize them as a legitimate alternative to traditional institutions and Ginnie Mae was given the power to insure residential mortgage pools for the timely payment of interest and principal. And these pools had 2 features that made them a little clumsy. If you’ll remember that vague part about the IRS law that says an association of two or more folks that have certain characteristics were a corporation. The IRS ruled that essentially a trust owning a series of mortgages and having a series of investments which they passed through their interest and principal payments to, was a corporation and therefore subject to the double tax unless the issuer of the debt continued to be liable on the debt and two, unless the debt had only one class of investor. So if you were a commercial developer and you were going to go into the bond market for one or the other pool forms, in effect the debt remained on your books and you, the borrower, were primarily liable as a general creditor to the trust and the mortgage characteristics which would allow the trustee to foreclose on your real estate if you got into trouble were really a backup. You no longer had the nonrecourse mortgage characteristics that had characterized the traditional commercial loan kind of financing which made it rather discouraging for large developers of commercial property to really use that collateralized mortgage bond, you know, mechanism because it didn't really help their balance sheet any. They had a significant liability which remained on their balance sheet to offset their asset. The alternative to using the collateralized mortgage bond in commercial development was to use something called the real estate investment trust. There government had institutionalized a format which allowed the developer, let's say General Growth, a development company in Des Moines, having built the shopping center to sell it to their own real estate investment trust and the real estate investment trust would then have a mix of equity and mortgage money to finance the property. And it could accomplish a number of things, one it could book the profit on the development immediately in the development company, retain the management control of it and to the degree that they owned some portion of the real estate investment trust shares of less than 50%, they could enjoy whatever asset enhancement occurred over the long period as a result of their management of the trust. The real estate investment trust had two problems however. The first problem was, of course, they had to pay out 95% of their taxable income so that it was difficult to grow internal by reinvesting the earnings of the trust. The second problem was that the federal government in setting up the single tax conduit status of the trust had always been paranoid about the possibility that the trust wouldn't have losses in excess of its income and be able to pass through that tax shelter to its investors. And so as a result the trust is always limited. It may have no taxable income but on the other hand it can not pass through tax losses to the investor. By the way an interesting thing about a real estate trust, however, it can continue to pay dividends out of earnings that were sheltered by depreciation in the trust and the receipt of the dividend is a recovery of your capital and not taxable until you've exhausted your basis. So if you had paid $10 for a real estate trust share and it chooses to pay dividends on its tax-exempt earnings, the first $10 in dividends are tax-exempt, but at that point you have zero basis in the share and if you sell it, why you pay a capital gain on the whole schmeer sort of thing. So that there's still a little bit of a tax payment but not a significant one particularly now that capital gains rates are the same as income tax rates.

Now, the real estate investment trust, the captive trust, allows you to sell one, equity shares which fragmentize the financing and often the income expectations on the equity share were less than the constant on the mortgage. People expected like say a cash dividend of 8% on their real estate investment trust share which made them perfectly happy to do that. Whereas a constant, let's say, might have been in the interest rate area. By the time you put amortization on top of the interest rate, averages 10 or 11% if you'd used a straight mortgage. As a result a number of major deals in recent years have been structured in which the borrower, in effect, creates its own real estate investment trust, and the real estate investment trust sells shares and then makes a single mortgage to the Rockefeller Center deal, the Bank of America deal and so forth are all financed by principal of a real estate equity investment trust which sells shares expecting an equity dividend of a certain number of dollars or pennies per share - let's say at 8 or 9% equity dividend which is pretty good if you compare that to the equity dividends you get from other stocks and then it turns around and has a single mortgage to the purchaser of the equity position in Rockefeller Center or Bank of America or a variety of other projects. Oxford Homes has worked the same thing to finance, in effect, mortgages on subsidized elderly housing projects where they wanted to keep the title with investors in a syndication who could use the tax shelter. So they wanted to be able to control the mortgage source of money so they paid a real estate equity investment trust that makes the loan on a blanket set of package apartment projects spanned all over the south seas and the real estate investment trust people because their tax exempt, get the income condoing right through from the apartment house to them as being the mortgage lender and the syndication limited partnership people get 100% financing and get the tax shelter from the subsidized housing projects which Oxford is into. So here is a way of securitizing the deal without having to retain direct liability on the loan. It's a nonrecourse loan to the trust that makes the thing go in trouble. The trust takes over the property and so forth. But on the developer's books he's clean. He has no further responsibility for the project and it is not a double tax entity.

Now to clean that whole mess up, the 1986 tax law came up with something called a REMIC, real estate mortgage investment conduit. A REMIC is not a structural entity like a REIT or a corporation. It is any kind of entity that you choose, whether it be a partnership or whether it be a trust or whether it be a straight corporation, doesn't matter as long as it meets certain characteristics defined by the IRS. It falls into essentially a single tax pass through entity without requiring liability of the issuer of the mortgage or partial ownership of the entity by the borrower. Simply to facilitate what people had been doing obliquely in the collateralized mortgage trusts or the REIT in pre-1986 time.

So the first step in securitization was to change the source of capital and perhaps arbitrage because now you could deal with multiple small investors who were willing to pay a premium for a reduction in risk, smaller scale of investment, diversification, more accessibility, if you will, to real estate than they would have had otherwise.

The second step in securitization was to shift the base which established the interest rates factor all together. Traditionally mortgage finance had always related to the long term bond rates particularly the BAA rates where you have a rate that anticipates some loss of principal on the portfolio. Mortgage rates maybe were loaded 50/100 basis points over the BAA rate to represent the fact they were a little more awkward, a little more management, a little more risky but nevertheless they pretty well paralleled the long-term medium quality bond. The fact that you could pool a set of mortgages suggested that, gee, maybe you could also pool the payments of the mortgage collection in such a way that some investors could be short term and some investors medium term and some investors long term and you could shift from tying mortgage rates to the long term bond rate to tying mortgage rates to the curve of treasury rates. If you could tie those back to the treasury rates, you could get a weighted average interest cost that reflected the fact that short-term payments were confined to a relatively low-rate of interest and that longer-term payments would move up the curve however the long-term rates worked out and as long as you had a normal interest curve and didn't have any inverted curve, that makes a lot of sense. As a result, first in the residential area and by the way, first developed by the federal government, Ginnie Mae and Freddie Mac really been their innovators in developing these pools secured by these mortgages. Wall Street really had nothing much to do with it. It was only until Freddie Mac and Ginnie Mae showed that it would work, because they were doing it with federally insured funds so that you really had nothing to lose by trying it, sort of thing. That Wall Street jumped in and copied the idea and of course has made an impressive market out of it and moved the buy into the trillion dollar class in just a couple of years. So nevertheless, the real innovations came from federal government and came from the insured mortgage side of the residential portfolio. As you know the modification of the classic mortgage pool and the source of funds, are called CMOs, collateralized mortgage obligations and sometimes called cash management obligations. And the object of the CMO was to one, structure the repayment of the mortgage principal and interest so that certain investors got paid off first and other investors didn't get paid off at all until the first ones were satisfied. Many investors did not invest in mortgages up to that time because of the uncertain call feature. You were never sure when somebody was going to repay the mortgage and you now had the money back to reinvest and what's worse is that repayment process rose very quickly as interest rates fell, and as a result your portfolio loss rate of return very quickly as the mortgages were called and you now had to replace it with new investments at the lower interest rates.

So they really wanted some sort of interest investment which locked in the higher rates during the high points of the volatile market and provided for less call characteristics than the mortgage. So the uncertain call characteristics had discouraged many investors. By going to a collateralized mortgage obligation and creating several different levels of investment with different call features you could attract a broader range of investors. Not only could you create a broader range of investors but you could give some elements of those investors a preferred credit status so that their risk premium would be minimal or nonexistent. In effect, the CMO divides the issue into several tranches or levels. The first tranch, and there's generally four plus a residual tranch, says that all income interest and principal payments either scheduled or prepayments will be focused on the repayment of tranch one. Tranch two, three and four will get nothing until tranch one is paid off. As a result it is a highly liquid investment and notice if it represents let's say 15% of the total issue, then in fact it is credit enhanced by the other 85%. All of the income from the other 85% of the portfolio is dedicated to repayment of the first 15%. You couldn't get a higher level of credit enhancement - talk about overcollateralization - you're talking about 6 and 2/3rds to 1 overcollateralization of that first string. As a result, it goes for a pure short term treasury no-risk rate. It may be paid off in a period of two years. It'll vary a little bit depending on the rate of prepayment. Tranch number two then starts getting paid off when tranch number one has been resolved. Since it might have to wait 2 to 5 years to get its money, it will be operating a little higher up on the interest square, paralleling again federal treasury rates because, again, it's still overcollateralized. If it represents 20% of the total issue and 15% has now been paid off, you know, 20 over 85% is still a pretty 4 to 1 overcollateralization and as a result the risk factor again is regarded as minimal since until they're paid off, there's no payment available for anybody else. Now the term of payment, notice has been stabilized. They know they are not going to get their money until tranch number one is paid off so they can be confident their investment won't be called until let's say at least 2 years, it may be 2 years to 26 months. Now their investment continues to be paid off at a certain rate and again they may be confident that their investment won't be paid off at somewhere between 26 and 40 months. So they have a fair amount of call protection, at least, such that they can plan a little better in terms of when they're going to have to reinvest their money. The third tranch doesn't start getting paid until the second tranch is over so they have a much longer call period before they have to be worried about reinvesting the money - and the fourth tranch and so forth. The fifth tranch is called a residual tranch. Under IRS law there can be only one residual tranch. And what it really says is, you know, the funds are not going to be flowing exactly on schedule because repayment will vary and there will be delinquencies and hassles and so forth and what's more we, let's say, make quarterly payments to our investors rather than monthly payments to our investors is going to be reinvestment opportunity. We may make a little money on the reinvestment side particularly if the short-term treasury rate is five and we're able to reinvest at seven, there's a reinvestment gain that's occurring while we're waiting to make our payment on the next quarter distribution and so forth. So the residual interest as the prepayments slow down, then the residual interest will be less. If the prepayments come in sooner than they need the, they'll have a reinvestment kicker and the residual will go up. Anyway, the residual is a very interesting speculative possibility which will be bigger or less depending on how the interest rates move in the marketplace, depending on the delinquency record of the parent mortgages and depending on what the reinvestment rate is during the span of the collateralized mortgage bond. Disability then of securitization not only to bypass the intermediaries but now shift the unit of comparison for interest rates from long-term bonds to short-term treasuries, obviously stands to create significant drop in the constant required to amortize a commercial mortgage. We'll look at the third phase of that on Wednesday.

I have a reminder 9 o'clock Friday quiz section will not be held so that Mark and anybody else in it going down the pike - so attend either immediately after this class today or the 12:05 quiz session on Friday. Second of all for your social calendars - the real estate club is planning to have its last bond spiel deal on Friday, December 11th. Location will be announced, but be as comfortable where alcoholic beverages can be served and the speaker will be Lisa Graham on the Canary Wharf project in London followed by Christmas refreshments, etc. So that'll be on the 11th. That takes care of social announcements for the moment.

The subject is continuing on the securitization of real estate and the move of Wall Street into the real estate investment market. One element that that introduces into real estate finance, of course, is the fact that any course of investments by two or more persons in an enterprise being managed by a third for their mutual profit is not only an investment, it is a security. And that security is regulated unless the regulators say otherwise. So that the presumption is that once you become a partial ownership interest of some form, that you are subject to securities regulations. Now there are significant exemptions to make the problem administratively feasible but nevertheless, once we start talking about any form of investment in which management is centralized and in which there are two or more investors for profit, we are talking about a security. And security regulations are rather detailed and explicit - both at state level which are often called blue sky laws, and at the federal level which is SEC. So that as we move from general partnership in which all persons have equal managerial potential and therefore it doesn't represent centralized management, to a limited partnership, we're now in the securities business and that changes, of course, the character and degree of regulation or potential regulation very significantly. Steve Roulak felt that at one point virtually all investment real estate, whether we were talking about mortgages or whether we were talking about equity investment, would, in fact, eventually be regulated by the securities market and that has only been delayed by a very small lobbying effort on the part of the real estate industry to create fairly large exemptions to detailed regulation and registration. Nevertheless, the real estate investment group has to file with at least the state, if it's an intrastate organization or the federal government if it is a multiple state operation to get an express statement that they are exempt and that they can go forward with an enterprise as planned subject to the conditions of that example. This introduces a whole new level of regulation to real estate in terms of what you can do, represent and the sequence within which you can do it. Now, for example, if we were talking about a limited partnership syndication type of thing, if you are to create a prospectus to be reviewed by the securities folks, you pretty well have to have one, the land under control, a fairly detailed plan, a capital budget for that plan, some fairly detailed legal documents on how it's going to be owned and managed, and who it is they think they're going to market it and have the mortgage in place so that, at least a commitment, so that you can tell your investors from about the capital structure and how the cash flows will be allocated and so forth and so on. In effect, the project is pretty well in place by the time that the general partner can now file his prospectus, gain approval for the project and market it to the investors. That means that a relatively high sunk cost on the part of that general partner before he can get participation. So the element of securitization means a very significant front-end load on the project. If he were to go to a general partnership, he would avoid all of that. They would simply get a couple of guys together and each add, $100,000 or $500,000 or a million bucks or whatever, and they'd say, "today we're going to be general partners and we'll create a bank account and here's the checkbook and so and so has the power to sign the checkbook and this is the way we're going to communicate among the general partners and participate in the major decisions and that's it. There's no front end costs in terms of registrations and there's no danger says the managing partner that at some point in the future someone is going to blow the whistle and say you didn't follow the securities regs on that and therefore not only am I entitled to my money back, but, in fact, the interest on the money for your failing to follow the proper regulations and indeed if you deviated significantly you could go to jail as the security people seem to be kind of up tight about violation of their regulations. You've got to have a real noodle for it, to punish you significantly for failing to observe their procedures and protocols and reporting requirements. And many of those offenses are criminal and result in jail sentences. So as a result the traditional, you know, single proprietorship, general partnership, those kinds of things that did not fall under the securities rules, are for many investors a preferred mode of operation, simply to sidestep the costs and pitfalls of the securitization process. Now, once we've moved into that second phase, the security area, not very much can be taken for granted in terms of what we represent to our investors and the nature of their risks and their legal position and their risk position and their priorities relative to claims on the assets and so on. As a result, the securitization process immediately adds a minimum of $50,000 and on up to the legal costs involved in structuring the enterprise.

As we suggested there are essentially three major levels of market areas. One is a small group of not friends, but at least associates, people who are aware of each other and generally sharing or a part of a codexy of a real estate developer and broker and they operate at a very local level to buy and finance real estate. The second level is that a state level, still intrastate, but where the developer actually goes out and solicits strangers for investment in the property but they have to have certain minimum standards of qualifications, typically under the law, in terms of their net worth, their income, some evidence of their participation in business matters and so on to be an eligible investor or they have to have much more stringent filing and monitoring rules by the local intrastate mark. The entire deal must be intrastate. You can’t have one investor who buys in Wisconsin and moves to Michigan a day later. It will have very tight control on the fact that if you change your domicile within, let’s say, 2 years of the time that you buy your stocks here or your limited partnership share or whatever other kind of unit it was that you bought, that you have to give it back to the partnership. The fact that it’s intrastate have to be clearly intrastate. They have to be developed by somebody who is in the state of Wisconsin, invested in by residents of the state of Wisconsin for a project that’s located in Wisconsin. If any one of those three things are violated, it is not intrastate and you now fall under the national SEC rules and regulations which, of course, gets to be very expensive. So we have the public offerings at the national level, which may seek hundreds of millions of dollars from major underwriting houses, marketing it through sales persons who are largely uninformed on the project but need to be able to offer their investors a series of choices in terms of stocks in the regular market and real estate interests and investments interests - gold bars and silver bars and whatever else the portfolio folks are pushing at a particular point in time. Now, once you move into that national market, the investor obviously knows very little about one, the property, he knows the guy selling it to him doesn't know for a hill of beans that yesterday he was a stock salesman who, you know, didn't even notice what happened in that (?) and so forth. And so that's no help - that's no real sense of security. Almost none of the investors want a prospectus and find out that a law firm of with 47 names on it says that it looks good to them and it looks like it meets the tax standards and probably qualifies for this that and the other thing and the leases look legitimate and so forth. That's not a great deal of assurance particularly when they end up buying bonds on national companies and they have been able to buy very detailed securities analyses of an industry and a firm and perhaps dates back 10 to 15 years as support for their investment in a stock. So some way needs to be discovered to provide a good housekeeping seal of approval on the group issue. And the device that the real estate industry has hoped would do that are the rating houses - Standard and Poors, Moody's, and Duff and Phelps, which by the way is the best of the three, at least according to those that are into the business. These rating agencies are expected for a relatively small fee to one, analyze the real estate, analyze the people that are putting the real estate program together and will manage it and the economic base context in which the real estate is located and is expected to operate and prosper. They have put these packages together relatively recently and there is still some debate as to whether the process is appropriate but essentially what it is is a doomsday type of approach that says, "OK. Under the worst scenario for the economic environment, and assuming these klutzes have to be replaced because they can't manage it very well, how far down is down before the project breaks - before the investors won't even get their money back. And, in effect, set up a cash flow scenario that suggests rents are below the pro forma expectations, that expenses are above that, that this condition lasts for some specified period of time and now what does that do to the cash break-even point of the project given the financing structure and giving the credit enhancements that are available for the project. And having pushed this project through this worst case scenario, how long can it survive and does that keep the minimum survival period for the cycle that could be forecast. Each of the three rating agencies have somewhat different specifications as to how bad does presumed downturn begin but the downturn is presumed to begin immediately upon your investment - Murphy's law sort of thing - the day after you've bought the property, it goes into a tailspin and the tailspin is a gradual decline in revenue over two or three year span and then requires several years again to right itself and they look at the enterprise from a cash flow standpoint, how will it survive? Then relate that scenario to the context in which the property is located and to the capacities of the investors. Obviously, one of the things that softens the impact of that scenario is a series of credit enhancements that may be available to protect the capital base of the investor and presumably postpone the necessity of foreclosure or takeover in the re-organization of the project. So the early ones were quite easy to do. They simply were a portfolio of multifamily apartments all done with FHA insurance. The FHA insurance covered the construction period and, in addition, the FHA people required letters of credit for various elements of the deal and so the rating process was fairly simple in looking at that credit enhancement, the backups that were inherent in the FHA insurance, and the project obviously was scanned in a fairly protracted doomsday scenario and what's more FHA had a long history in not being too quick on the trigger to foreclose the property because one, the FHA had too many properties to manage at once and two, it might be essentially counter productive relative to the social function that the FHA project was supposed to be fulfilling. And so as a result those projects defeat the rating test relatively quickly.

The next step was to loosen a little further and get them to look at more conventional kinds of nonresidential projects. And here the rating people have been very very reluctant to endorse the commercial properties area very effusively. As a result, securitization ironically in the area of commercial real estate has gone very very slowly because the rating companies are balking and saying "Gee, you expect to give me a fee of $30,000 to go analyze the project when you guys have already paid, you know, who knows how many hundred thousands of dollars to come up with a package of appraisals and feasibility studies, and so forth, on the project, none of which we trust because they're all designed to advocate for your position anyway and if you expect us to go back and review all of that, validate all of that, and then, you know, test the project under our scenario for a crummy $30,000 and risk the name of Standard & Poors or Moody's on it because it gets plowed under a year later and we gave it an "A" rating, phooey on that. You expect us to approve your project, market your project for you, and do it for a fee while on the stock market or the bond area for $25,000 or $30,000 is more than adequate." In terms of a real estate investigation, it barely scratches the surface. And so as a result the rating agencies have been going very slowly in establishing their standards for commercial real estate. And this has meant that commercial real estate has had considerable difficulty in achieving this securitization particularly in terms of mortgages that has been enjoyed on the residential sector. We simply don't have the willingness of the rating agencies, nor do we have the universality of mortgage insurance to provide that assurance that the rating agency is looking for. This is kind of ironic when you think about it in that millions of dollars of Wall Street fees and legal fees and all of the other spin offs that go to the benefit of the investment banking industry are all blocked by one little group of rating agencies that says, you know, if the name of Moody's or Standard Poors is sacred and we're not going to be conned into going along with this conspiracy just because that's what happens in other areas of real estate. Very hard for the real estate industry to pick it up, because in the past they've always been able to buy their appraiser, buy the feasibility study. Investment bankers have always fallen out of their chairs trying to make the deal, whether it was a good one or not and so forth and not being very judgmental about the project. That comes back and said, "Come on guys, you know, clean this up and this isn't going to work," and if your assumption is off by 2% and the project is going to crash and so forth, the industry really doesn't know how to deal with it. People that are really saying, "Hey, I really don't need the fees from you guys in the real estate business and I'm not going to give you my good name for a crummy $30,000 because it's going to cost me more to do the mortgage investigation? So as a result securitization on the commercial side is being severely constricted by the fact that a broad market requires some sort of rating and the traditional rating agencies are not really enamored of sticking their neck out in an area which is very volatile, very dependent on management and, of course, very visible if they make a mistake and say, "Gee we're sorry about that but the management people didn't work out after all." There's obviously going to be a lot of name calling if you get them all to invest in Rockefeller Center and it all blows up, as the Rockefeller Center deal had blown up. A whole series of suits involving that presentation. It was not reported in the prospectus that NBC which is a major tenant was considering moving out into the new Trump/TV City project and somehow nobody thought that was a significant fact that you should mention in the prospectus and some sore-head investor felt, you know, that that should have been brought to his attention relative to his investment, but in any event, that was problem number 1. Problem number 2 was, of course, that the appraisal in that case was done in the very modern method of having the investment banker do the initial pro forma income projections who obviously has a vested interest in getting the highest price paid from the highest possible income and from the project. The accounting firm did a very careful audit of operating expenses and arrived at a statement of expenses and they gave those two reports to the appraiser and said if the income is what the investment banker says and the operating expenses are what the accountant says, what's the value? And the appraisal firm said, "Well, in that case here is how we would discount that and here's the number," and so forth and then on that basis they justified the quotations. Well there's a great tendency to say, "Hey, wait a minute, what happened to the idea of the independent appraisal?" Well, they said it was independent because he could have raised his voice and said, "I don't like the income approach, or I don't like the expense approach," and canned 'em, but he didn't. But he could have, and therefore he's independent. And the appraiser is saying, "Hey, wait a minute, I don't remember it being presented to me that way. And if I had raised my voice they probably would have probably found another appraiser and I would have not gotten any more work from those folks, so as a result, he said I bid it as I was told and my limiting conditions explained very explicitly where I got my revenues and my expenses and the nature of my assignment on the property." Well, anyway, you can imagine that the Wall Street attorneys were having a wonderful time with the whole process. And now you have a really visible project - the Rockefeller Center project. About 50% of the investors were foreign because they could relate to the Rockefeller Center. They knew the building, they'd seen it when they went by on the tour bus and hundred of Japanese families have a picture of, you know, the Roky Theater there and "Ah So!, you know!" Put a couple hundred thousand yen to that, and know exactly what was bought. So as a result, the rating agencies are standing back and say, "Hey wait a minute, I'm not sure whether what we're doing is something that we can afford to do and take the rap, when we can't afford to do the due diligence that's required of everybody else." So the securitization of real estate to the public side is present on commercial properties but proceeding much more slowly than Wall Street would have hoped at this point in time. The flip side, however, is that part of the industry which is not subject to security regulations and son-of-a-gun those are the pension funds and related kinds of entities. Once you start marketing to large sophisticated investors, the regulatory structure that is there to protect the little guy, the little sheep from being fleeced by the big lion, is no longer relevant. And therefore we can begin to securitize real estate and market it to the tax exempts, the pension funds, the endowment funds and so forth and that's slightly different legal environment which we'll see in a moment, and not have to deal with the SEC. So that big expansion in securitization has occurred on the pension side rather than in the private capital market side relative to commercial real estate.

Now, there are essentially four major vehicles that can be used. The first is called a commingled fund and there are 2 categories, one an open-end fund and two, a closed-end fund. An open-end fund sells units to qualified pension investors and public employee funds, I should say, with a promise that each quarter, every three months, they will publish a valuation dollar amount for each unit and anybody who owned the piece can sell it back to the fund and anybody else who would like to get on can buy in at the same price. It is a no-load fund. So it's the end of the quarter and they decide that each share is now worth $10.50 by dividing the total number of shares into the appraised value of the real estate. If you want out, you turn your shares back in, you get your $10.50. If you want in, you pay $10.50 and go along. In effect a mutual fund for real estate for qualified tax exempt pension plans, and public employee funds. There are several major problems with that. One is the fact that everything hinged on the quarterly appraisal. The funds were sold initially on the expectation of inflation and that in addition to reinvesting the cash dividend that would be generated by these properties, the investor would be able to report not only an increment in his unit value as a result of reinvesting cash earnings but also an increment due to the appreciation of the underlying real estate. So he gets two kinds of return. Both of which are on paper. One, a cash dividend that has been put into the pool and now used by additional property and two the reported increase in value of the pool. And initially this was begun by Prudential Insurance Company in a fund called PRISA One which was the first model and the two guiding lights to that were Claude Ballard, and an actuary at Pru whose name is Wendall. At any rate, tremendously successful in terms of marketing the concept of buying a unit of a pool of real estate so that you got instant diversification, presumably you got professional management, and you got a reporting system that allowed you to book the earnings at the appreciation in your pocket. The timing was perfect. They had tremendous of run-up in real estate values as a result of inflation and they began reporting returns of 16%, 17%. I think the highest they got to was 23% annualized rate-of-return on the fund. Now why was that important? - in terms of the ability to pass through the appreciation. As you know, pension funds must be financed by their employer's sponsor for the difference between the present value of the vested benefits which they have promised to pay and the future value of the assets they already have in hand - essentially a licensure concept for establishing cash reserves to always meet that picture (?). In other words they're expecting the cash on hand to compound up to the point at which you make the distribution to the pensioner and, at the same time, most of constant payments you made to pension at some time in the future and therefore, are discounted back temporarily as well as financially so that you end up with two elements, the asset and the money you've compounded and the liability in terms of how you can discount it back to match that asset fund. Now, if for any reason their portfolio goes down in value, then it no longer beats the present value of future benefits and the sponsor has to step in and cover the difference. Now notice what happens when the stock market falls 500 basis points, funds that have surpluses in terms of their present value of assets relative to the future values of their claims now has deficits. And there will be many major corporations having a significant reduction in earnings this year because for the first time in several years, they've had to step in and put money into the pension fund to make sure that the assets cover their vested liabilities. Now vested liabilities are those which, as you know, have in effect become contractual obligations, liabilities to the company. You may have to serve 10 years before your pension fund vests but then there's a certain number of dollars required to make good on that once you reach 65 or whatever age the retirement age is. Now that's problem number one. Can we trust the value? Now when values are becoming to run a little ahead of what we think real estate's really worth, some sponsors are delighted with that because obviously then that overstates their asset position and means they don't have to contribute as much out of earnings of the employer's sponsor. But at some point they say "gee, that's not a really hard dollar unless I cash out first." So you tend to get runs on open-ended funds in which if it's perceived that the appraisals are running a little ahead, or people doubted the real estate's worth what it said it was worth on the quarter, they tendered their share. Because it was only worth $10 and their saying it was worth $10.50, you've got a $.50 advantage of getting out now. And PRISA One found that out. They had hundreds of millions of dollars put to them saying "I want my money out. Appreciate what you guys have done for me, but I want to see it in cash instead of on a quarterly report which I can't spend." That means that from the management standpoint the assets that they're managing and the fees which they are making are somewhat volatile and they have a liquidity problem. Some of the properties they're going to have to sell in order to refund the cash unless they can sell additional units to other folks with cash and then run it through. The same as being on call at a savings and loan association in which the fact that you can't meet the request for payment immediately doesn't mean you're technically insolvent. It just simply means your name is on the list and when we get the money we'll give it to you. And many of the funds such as PRISSA, such as Aetna, such as Traveler's and so forth were a little aggressive in their appraisals and the investors began to perceive that on open-end funds and started to ask for their moneys and the boys went into a swoon and a stall and said, "Gee, we're sorry about that. You know, it's going to be a while before we sell the property." So they didn't want their fees to shrink.

The alternative is a closed-end fund. A closed-end fund says we're going to raise $200 million, we're going to invest it all in real estate and somewhere between the tenth and the twelfth year we're going to sell all the real estate and give everybody their money back. So we don't need to do appraisals every year. We can do some appraisals to tell you how you're doing and so forth, but gee if you want to invest more in real estate, you think it's appreciating, fine, buy our closed-end fund number 2 in the second year and buy our closed-end fund number 3 in the third year and you'll get dollar averaging but you'll be assured that at the end of the 10th year, at somewhere between the 10th and 12th year, there's going to be a window, we're going to sell the real estate, liquidate and give everybody their pro rata share back. In the mean time, we will push through to you all of the cash income we get from the project because after the 2nd year, we're not going to be buying anything anyway. The closed-end is a finite trust. For the major investors that's pretty attractive and many of these pension funds, invest in these things at $20 million, $30 million, $50 million at a crack. And they own 10 or 12 open and closed-end funds, each with $20 or $30 or $40 million in at a time. After all the state of Wisconsin investment board which is not the biggest in the country by far, they're putting $300 million a year into real estate with a staff of about 3 or 4 people if you really analyze it, have to make the call and therefore it's very efficient to analyze it and say this is what we're going to do for $30 million here and $20 million there and you know, in doing $30 million we now have an interest in 20 properties across the country that, you know, are relatively divided between industrial, commercial and retail and as a result we have instant diversification, we have professional management and we've only had to make three or four decisions. Very efficient way to get in and put your money at work and be able to represent your portfolio as being diversified which is one of the things the federal government requires under ERISA. So the closed-end fund is a very popular vehicle for those who are skeptical about the appraisal process. They don't need to know about the appraisal process for ten years at a time and then they know that at that point it will liquidate. The first several of the closed-end fund which were done by Coldwell-Banker have now liquidated and the returns were phenomenal. The timing was terrific. They got in just before the inflationary run up and, you know, they can demonstrate that the cumulative compound rate of return was 16% to 18% which runs circles around the stock market during the same ten or twelve year span and it's a terrific marketing nook. To be successful as an open or closed-end fund, however, requires that you market fairly large units. It's not something you're going to retail away at $100,000 a crack or even $1 million at a crack. You really have to go to the heavy hitters. And it doesn't work very well if you start getting, you know, very small fractional interests in the fund.

Several new device which provides some of those same characteristics but, nevertheless, perhaps a smaller unit investor. That happens to be the real estate equity investment trust - the REIT. The REIT has several advantages. One, you can sell to several different groups. The legal requirements of a qualified pension plan or public employee plan, are somewhat different than what would be characteristic of a non-profit endowment fund, say a university endowment fund. Both of them can invest in an REIT because the tax position is that of the investor not of the entity. But they both can not invest in a commingled fund because a commingled fund has its own tax characteristics dependent on the fact that all of its investors are qualified pension plans. So the REIT has a broader market and, of course, can have a smaller unit participant because there is a market made for those shares, weekly, whatever, and what you get and what the pension fund like about it is that you get a market statement about price. Remember they have been used to all of these years investing in the stock market and been able to look in the paper every day and find out what their portfolio is worth. "How are we doing?, you know. Does, in fact our portfolio value cover our vested liability on any given day? The REIT provides that market determined, rather than appraisal determined, unit value which they feel is more independent and a more reliable, less self serving in terms of management. So many REITs are being developed specifically for the non-profit investor as opposed to the public investor, although they could market to them.

The fourth type of vehicle is an interesting hybrid, is called a side-by-side. The most typical side-by-side but not exclusively - there are several ways to do this - says that every property we buy is going to be owned 50/50 by two different funds. So the pension fund investor or the public employee - we will make him a beneficial interest in a trust - now this is not a real estate trust, mind you, this is a fiduciary trust, you know, a financial type of trust and you are the beneficial interest in it. So if you give us $5 million we'll give you a certificate of beneficial interest for $5 million in our corporate trust account and that will entitle you to a pro-rata share of all the returns that that trust makes. So if you're one of 20 $5 million owners, why you will, obviously, 5% of all of the cash returns and so forth from your end of the building. (?) building is a 50% common ownership in each investment. On the other side they will do a limited partnership and each investor will be a limited partner - endowment funds, university endowment funds or other types of non-profits - and in some cases even taxable entities can buy those limited partnership units. The limited partnership unit is not vulnerable to what is called unrelated business income, it does not fall into the pitfalls of the tax law which is a problem for endowments but not for pension funds. Pension funds were exempted from the unrelated business required. And essentially unrelated business refers to income from an asset which exceeds the net basis of the asset.

Another type of side-by-side would be a real estate investment trust on one side making a loan to a limited partnership on the other side. The REIT would have a participating loan that would take all of the cash flow from the property and a large portion of the resale price. The limited partnership would be wholly owned by tax sheltered investors who would then get primarily virtually all the tax shelter from the deal and some of the equity buildup that might occur as a result of repayment on the mortgage and appreciation of the property - that's also called a side-by-side. The second unit obviously reaches a different type of investor than the in the first case. Now all of those vehicles become suitable for the securitization of real estate because with the exception of the limited partnership which is being sold to taxable investor for tax shelter, they're all exempt from the security rules. As long as the investor is a public employee fund or a registered pension sponsor, the fact that it's not registered is not a germane element to it. So most of the securitization of real estate in terms of group financing has occurred in this market of selling to the pension funds who in the recent years have had several major incentives for going to real estate. One is the federal requirements under ERISA that they diversify their portfolio and that stocks and bonds are not adequate diversification. Two, there is some evidence but certainly not conclusive that real estate equities are covariant to the stock market and the bond market. Certainly if you were going to build that case entirely on October 1987, it is a real good case. Real estate went sailing along relatively serenely partly because of the fact that the leases go on for some time and that while the economy may be running down and going into recession, that has to occur over a long period of time before the tenants start to default and move out of the building and therefore the decline in real estate is a little more gradual and as long as the property is owned by a pension fund with no mortgage, there's really no reason to sell it, it's just ownership may be sniffling and sulking a little bit, but there's certainly no public visibility to the fact that it's declining. You can go down to Dallas, Texas and the Galleria and all of the properties around it look glorious and, you know, you've got the great pile on there by Mr. Hine's other than the fact that three out of four of the projects are now bankrupt is not readily apparent because there's no billboards out there saying, you know, this price crashed yesterday down by 50% of the assessed value, and so forth. So as a result real estate is a little more comforting to the pension fund investor because he's not being second guessed by all of his pensioners and by the employer whom is concerned with how much money they got to put into the fund this year as to whether real estate has undermined the pension fund or not. So the diversity is one, required theoretically and two, there seems to be some evidence that real estate is much more stable than stocks and bonds and is, in effect a covariant element which tends to stabilize the value of their portfolio as the real estate's going down about the time the bonds are going down because interest rates are rising or because the stock market is falling. The third reason for going into real estate is that it really represents a very efficient way of investing, nominally. It's certainly efficient at the state levels to be able to have two guys investing $300 million a year and, you know, the total cost per dollar invested is relatively low. What is concealed, of course, from that is the significant fee to be cycled off by the people that are managing the assets. Now real estate may be hurting the cash dividend let's say at 8% which is twice as good as the stock portfolio is doing, but they guy who is managing that real estate portfolio for you is probably taking anywhere from 80 to 125 basis points for managing your money for you which is considerably different than the five to ten basis points that would characterize an asset manager on the stock side. So whether it's efficient or not depends on whose set of books you're really looking at. Nevertheless, the securitization of real estate has proceeded with a great deal of sophistication into the pension area. We're at about the third generation of participation. PRISSA and a number of its counterparts began with the presumption that if you were going to have a stable investment value, that you needed properties of all types, industrial, retail, office and so on, scattered about the landscape in all regions, in all urban areas so that you would enjoy the stabilization that occurred in a county which has its regional up and downs rather than major national cycles in one form or another. So the first definition of diversification was simply different properties at different locations, with the presumption being that offsetting cycles in various areas, in various buildings would stabilize the overall portfolio. That's what we'll call the first generation. Investors looked at that as though it were a so-called bond proxy. PRISSA originally came out at a time when interest rates were rising rapidly and bond prices were falling. Because they had profits in other areas, they sold their bonds and bought the real estate open-end funds, looking at them as really a crudely indexed bond that if inflation was going to keep causing assets to increase in price, because of the cost of replacement, and bonds were going to continue to depreciation because interest rates were high and tied to the inflation rate over the real rate, that they were better off to go into the open-end fund where the price being reported essentially, represented one, price trend in real estate tied to inflation and two, it really gave them a crudely indexed principal amount. After all the asset was inflating because the cost to replace the asset was increasing. And so they really looked at them as an indexed bond and that was really the first generation philosophy of going into that type of an investment.

The next thing that came out was, "Gee what do we really mean by diversification? And do we really want a cross-section of all of American real estate?" And, of course, the bright money said, "No, what we really want is to put our real estate where the appreciation will be the greatest and that must be where economic activity seems to be the greatest and therefore we really ought to go into the really exciting hubs like Denver or Houston, the growth areas of the country." And so funds moved away from the idea of a cross-section of all types of commercial real estate to what they perceived as value creation funds. This is quite a step from the "Let's avoid the risk kind of philosophy of the first types of investors." And they began investing in selective funds which could be regarded as special situation funds in which, you know, they specialized. They did suburban office buildings or they did strip shopping centers or they did industrial lease backs or whatever they purported to do and then the fund managers, the pension investors, could create what was called naive diversification. They could decide whether they wanted to put more emphasis on industrial buildings by just buying primarily funds that did industrial buildings. Or they could chose funds that did primarily retailing because they saw the retailing shopping center as being the best inflation hedge since the rents were tied to retail sales and retail sales were reflected very quickly of what the price level was and so on. And so the second generation of sophistication really was to go into special situation funds which presumably represented a strategy on the part of the investor to get better than average rates of return by positioning themselves in some type of property that they thought would benefit from the long-term economic cycle better than other types of property would have. And for a time being it was thought that the office buildings and currently it's thought to be industrial buildings and the fads change and are heavily marketed.

The third generation is now a sadder and wiser group that has some realization that real estate cannot be bought purely because you're going to move with the system. They now remember that, "Oh yea, the stock guys used to talk about systematic and unsystematic risks." And PRISSAs and, if you will, the specialty situations were essentially gambling on a systematic risk. That certain classes of property or investments were going to perform or out perform the business cycle. Now what we really want to manage is the unsystematic risks. There's more real estate to be purchased wisely if we take advantage of the inefficiency of the market than if we presume the efficiency of the market. Why have appraisers calling the value of the property when appraisers don't know the system anyway? And why go into one class or another of property just because it's industrial. Why buy twenty industrial buildings at a crack and hope that, you know, eight of them work out and the others do so-so. So the sophisticated pension funds are now moving away from group fractional interest kinds of positions to buying the whole property and employing asset management which will exploit the optimum potential investment possibility in that property. And interestingly enough the reason they're doing that is because it's a very counter point of securitization. Securitization creates a level of impenetrable management input. After all, the fact that you own 100 shares of US Steel doesn't give you the right to call up the president and tell him how to run the company or change the product mix or whatever. But if you own a piece of real estate and you bring in a manager that says, "Gee what I'm going to do is this and this to the shopping center. Get rid of this anchor which isn't selling anything and bring this one in and reposition this whole thing to reach the upper end yuppie group or the lower end blue-collar group or whomever and create value for the center. Suddenly as a pension fund I can have the best of both possible in the world, I'm protected against the faddish swings of a public market, in which the flow to decisions to a few idiots in pricing my investment for me without any input on my part at all and second of all, I can suddenly be in business without being in business. As a pension fund, I'm not allowed to have control of the business. I can't go and buy 51% of US steel and tell them how to run their damn business. But I am permitted to buy a piece of real estate and tell them how to run their damn business. Real estate is not perceived as a business enterprise. It's perceived as a passive investment even though I hire the property manager and even though I tell the property manager how it is I'm going to strategize and run that property. So suddenly pension funds can create value by combining their capital with management synergy provided by outsiders. And that's something they can not do with any of the other security markets. They have been trained not to interfere. Many pension funds do not hold their stock at all, the way they vote is to simply sell the stock, hawking(?) at a fallen price which embarrasses management. But in real estate they can interject their own manager and systems, and we'll come back to that theme . . .

. . . The trust could buy and sell its own units. It could expand the number of units that are sold or offered and so forth. And a number of them that were formed in the mid-1900's are still around. Real Estate Investment Trust of America, REITA, The North

American Real Estate Investment Trust and so forth date well back to just after the civil war and neither of them have missed a quarterly dividend since that time. The problem was that when the income tax law came in in 1913, they were simply overlooked. Apparently they didn’t lobby and they didn’t have anybody to speak for them and as a result they became treated as a corporation with a double tax and it was a situation which prevailed until 1960 with the Real Estate Investment Trust Act of 1960 was passed that allowed them to be a conduit so long as they passed through, at that time, 90% of their taxable income to the investor. The willingness of the Internal Revenue Service to create this tax conduit was prompted by the rise of the limited partnership between 1954 and 1960. As you’ll remember 1954 was the passage of the first tax act which provided for accelerated depreciation, privilege tax treatment for capital gains and so on. So that it was really the birth of the tax shelter industry. And suddenly the IRS saw a whole slew of limited partnerships being spawned not at the local level where it had been sort of tolerated but on a national scale in which the investment banking outlets were starting to use the limited partnership as a way of educating the middle class to the tax shelter game. And a number of those went bad in 1959. They went bad primarily because they were creating limited partnerships for each building as they ran out of existing buildings as products the general partners began creating new buildings and at that point inflation hit and you know one of the first gushes of a real run up in prices and their budgets fell short and they began to borrow money from other limited partnerships which had positive cash flows to finish construction of their new buildings. Now that’s a diversion of funds which is punishable by not only by fines but by going to jail which a number of them did and therefore the limited partnership was under some pressure from a public image standpoint in 1959 sufficiently to get Congress to take the opportunity to pass the Trust Act with the idea that the real estate investment trust would, in fact, supplant the partnership. And the reason the IRS was willing to let it supplant the partnership was twofold and in concept which has hurt the REIT ever since.

One, was that you can not pass tax losses through to the investor so if the losses exceed income you can only carry them forward within the trust accounting system until such time that they would otherwise have taxable income and then the depreciable losses and so forth that could be applied to income. So at best the investor is going to get a dividend of capital but no tax shelter.

Second of all the real estate trust was to be a passive investment vehicle. It could not create profit from doing things like building projects and so forth with its own construction crew and so forth. They wanted to be sure that it was clearly an investment vehicle that was designed to finance projects but it was not going to be a shelter for developers who remember were taxed on an ordinary income basis for creating single family lots and for profits created by the development of a shopping center and so forth. They didn't want it to become a shelter for that kind of profit center. And as you know one of the basic themes here is that one of the reasons to create real estate is to bring a whole series of profit centers for other kinds of enterprises which it may control, mortgage banking, your general contracting, your leasing, your property management, etc. etc. etc. With the exception of managing their own owned properties, the real estate investment trust could not engage for profit in any of those other elements. So it became a classic setup for those that do provide those services to create a captive financing vehicle that would then buy out, if you will, the shopping center once created. So one of the most successful real estate investment trusts of all time was created by General Growth out of Des Moines, Iowa. General Growth is a shopping center developer who specializes in community shopping centers in 4th, 5th and 6th tier cities in the hinterland the US. And they would create the center - you know, buy the land, create the site, get the entitlements, do the leasing and so forth. And then sell it at capitalized income value, of course, to their own real estate trust. And then, of course, with the management fees they continued to operate it, lease it and so forth and did so very successfully so that the real estate trust was selling in multiples of 25-30 times earnings. And it gave them a guaranteed market for all of their product. And once, of course, you get that multiple times earnings way up there, it's cheaper to raise your money selling more stock, than when you're selling your earnings to 25 times earnings which essentially is what, about 4% return on your money, than it is to borrow the money at 8% or 9%. So as a result they were able to finance and retain control of their product by, in effect, distinguishing between the profits of creative asset management and services from the passive returns of the capital put into the property.

Now because of the requirement of the full payout, the real estate trust, initially structured, failed to achieve much investor interest. The basic concept of an equity trust was something called contra dilution. It was simply a very basic investment concept that you could sell so many shares of stock, let's say 100,000 shares of stock at $10 a share initially, would produce a million dollar capital base. And that million dollars would then be invested in real estate and let's assume the folks wanted a 10% return on their money and, in fact, instead of making $100,000 a year, they made $120,000 a year, so they made 12% on their money. So they're getting some leverage value and as a result the stock would move from $10 a share to $12 a share. So far so good? Therefore let's say $12.50 a share because people now have a little more sense of the fact that, "Gee there's a captive (?) money and therefore the risk is less so I'll settle for a slightly less return." so the next time around you can sell 80,000 shares for $12.50 and raise another million bucks. So far so good? As a result you would now have $2 million dollars in equity but you would have slightly less than the 10,000 times 2 shares or 20,000 shares - you'd have about 18,000 shares. So the book value of the original investor would go up. The buyer of the new share would have a book value slightly less than his purchase price, but he would expect that in the third round of selling off stocks, that again he would be the beneficiary of people paying a premium over and above his purchase price. So, in effect, to expand and grow the real estate trust, it was important that earnings grow and that the price earnings ratio in the market also grow so that you can sell successively smaller and smaller numbers of shares to raise equal amounts of money or more. With the result being that the book value of the original investor or the second tier of investor would grow as the third, fourth and fifth tier investor paid premiums to come in. In effect, it was perceived as a growth stock. With very few exceptions such as General Growth, the investors did not see real estate trusts as a growth stock. They saw it purely as an income stock. At a time of inflation, one of the problems of real estate trusts was they were using standard bookkeeping that showed their book value going down as they depreciated their property in order to shelter their income and have some cash available to make new investments, the apparent book value of the share was going down, as you wrote down the fixed assets as quickly as possible. So if the investor looked only at the accounting record and looked at traditional definitions of earnings, not only were their earnings low because they were understated deliberately to shelter the earnings from having to be paid out through accelerated depreciation, but the book values were declining. And the average stock broker investment council looked at that and said phooey. And in the 60's and early 70's people were not accustomed to looking at cash flow as being a measure of the performance of the entity. They were traditionally conditioned by the typical type of pro forma and income statement to look at income after taxes. And that wasn't very good for the trust, deliberately so, that was their charm but most investors didn't appreciate that. So the contradilutions didn't work, in fact prices fell. You paid $10 for it, somebody would look at it and say that's crazy, the book value's only $7.50 and therefore why am I paying $10 for a $7.50 book value when I outta pay $6 an issue for a $7.50 book value and then I would have a real deal. So, as a result, prices fell and the real estate investment trusts were not able to grow. Remember any taxable dollars had to be paid out in the form of dividends or they were confiscated under the tax law with 100% income tax. So it was important that they pay those out. Then there were a couple of unfortunate experiences in which the IRS and the real estate trust management differed on accounting and, of course, there's really no differing with the IRS, they're going to prevail ultimately. And they said, "Hey, you didn't pay out all of your income when you said you did because we defined your income this way and you only paid out 80% of that." And so, bang, they took 100% of that or they fined them or they actually took away their real estate investment trust status at which point they became a double, you know, taxation corporation under the association rules and really got hammered. And so some investors got a little nervous as to whether the tax status was really supportable over the long run. But sooner or later you'd think an accounting mistake and the IRS would clobber you.

And so with all of those elements of misunderstanding the real estate investment trust as an equity vehicle never got off the ground as a really popular investment medium. Now, in addition to those problems, of course, there were some pretty fancy accounting problems. One, of course, you had to pay out 90% of all taxable income so now you had to agree on what taxable income was. Second of all, if you paid out dividends of depreciable depreciation cover earnings, you were paying out capital. So let's say you had a good cash flow but it was all sheltered. So you made a dollar dividend out to the buy with the $10 share. The dollar dividend wasn't taxable but its basis on the share dropped from $10 to $9. So they could pay out tax shelter dollars until they'd used up the basis on the stock. Anyway, it was a negative basis and that was even messier. So, you know, the average investor was faced with an accounting problem which otherwise he didn't have in other securities and so that wasn't a very popular feature.

Next there was the problem of ownership. They had to have no less than 100 unrelated persons investing and no 5 persons could control more than 50% of the ownership. So every year you had to do a census of your shareholders and find out who was related to who because under the rules of the IRS if mom and dad both owned it, they were considered as one person and then if you have the kids, the presumption was, the kids responded to whatever their father told them to do which was pretty laughable presumption but, you know, the IRS will make any assumption according to what serves their purpose. And so you had to use this continuous census and if you had a relatively small local trust it was possible for the control gradually to gravitate to a point where five person as defined by the IRS under attrition rules, controlled a significant portion of the deal. Seventy-five percent of the assets had to be in real estate assets which included mortgages and no more than 30% of your income could be from short term trading. In other words, you couldn't buy a property, fix it up, and sell it a couple of years later. You had to hold it for at least 3 years and then when you sold it the capital gains could not be more than 30% of your total earnings. Well that gets pretty messy. Let's say you only own three properties, your shopping center does marvelously well and you're chugging along with a couple hundred thousand dollars to your net operating income, and now you sell your shopping center for a $500,000 capital gain, you're in big trouble because you can't do that. You know, because now more than 30% of your earnings in that year - so you had to sell under an installment basis to distribute your capital gains over a relatively long period of time, or you had to trade the new equity in the shopping center for some other property in which you now got more leverage and so forth. So, again, your hands were kind of tied without playing with one arms behind your back and one foot nailed to the floor in terms of what maneuvers you could do to make money and book it and let your investors know. Because now if you sell on an installment basis, your investor simply see this year's installment payment in booking the gain and you've really submerged the fact that there are now five more, you know, installment payments of similar size coming in in future years etc., etc. and the result is that while the book value may be enhanced, people really didn't see that as income. For all of those reasons the REITs didn't do very well as equity trusts. That was blow number 1.

Blow number 2 was the fact that a bunch of folks down in Miami that ran the First Mortgage Company got a really bright idea. They said, "Why don't we have something in which there is no depreciation and no capital gain. That our gain is basically income and we arbitrage between the income on mortgages and the cost of borrowing short." And they created something called the mortgage real estate trust. And it was really the first effort at a secondary mortgage market for mortgages and they bought only government insured mortgages, VA and FHA home mortgages that let's say could be bought in the market yielding at that time 88.5%. They would then go out and sell a real estate investment trust block for let's say $10 million and with the $10 million they would now have sufficient credit enhancement that they could borrow another $90 million in the commercial paper market. So now you've got $100 million. So $100 million costing them overall let's say 6% interest similar to the short term commercial paper rate and the fact that they didn't have to pay anything at all guaranteed on the dividend for the $10 million of equity shares. They now go out and buy $100 million of mortgages yielding 8%. Gangbusters! you know a spread of 2% on $100 million portfolio was $2 million. OK, and it all fell to the $10 million worth of equity at the bottom which meant 20% return on the equity and they had to pay 90% of that out, so the equity guy at the bottom, you know, got a dividend of 18% of his money. Wow, contradilution finally worked! People were perfectly happy to get 9% of their share. The next round of shares could sell for $20 instead of $10 a share. And you could go back in the commercial paper market and do it again. And they said, "How could you go wrong because all of the mortgages were insured by the federal government." So what they were really doing is arbitraging between the commercial paper market and the long-term paper rate. It was a precursor, if you will, of the CMO. You were moving from a long-term mortgage rate curve on the government guaranteed mortgages to a short-term interest rate position on the commercial paper. And as long as you could run before the wind and do that, because the commercial paper rate was less than the mortgage rate, it was a terrific idea. And it was highly touted as being a really secure thing. You know, how can you go wrong with an entire portfolio of government insured mortgages? You could always sell the mortgages, you know, for, you know, something close to the original purchase price and if you had to bail out, because commercial paper rates started to rise and therefore you shouldn't get trapped in reverse leverage and so on. So that began something called the mortgage real estate investment trust. And it became a really hot idea, leave it to Wall Street to jump on the band wagon - not really understanding the game particularly well, but it looked something that would sell well and for which they could be in and out and have their fees and not really be responsible for the result. Now the next couple guys come along - they're a little greedier. They didn't want to play just the spread on government insured mortgages. They said, "Gee, if you could do that with 8% residential mortgages, think what you could do with 13% construction loans?" And so the mortgage trusts moved out into construction loans, commercial short-term bullets, that type of thing and again played the commercial red paper rate game of using the equity money provided by the real estate trust shareholders as credit enhancement sufficient to get commercial paper deals and then using the whole bunch to make construction loans. The problem was there weren't a whole lot of folks that were making construction loans and selling them. After all if you could buy VA and FHA mortgages in the market, that was no big problem. You didn't have to be in the loan making business, you only had to be in the loan purchasing business. But with construction loans, you had to be in the business. So they held themselves up as being experts on making construction loans. And they had that book earning relatively fast one of the nice things about construction loans, in addition to high interest rates, you could get fees up front. And, wow, when somebody has money from Wall Street and under the rules of Wall Street at that time, if you didn't get the money invested within six months of recouping it, you fell under another section of the securities law which was much more stringent than the initial flotation law was because now you were essentially in the non-banking business. And so there was great pressure to get the money out as soon as you raised it. And every charlatan and crook in town knew exactly where to go for the loan. And they flooded in and now you've got the poor real estate trust officer on the one side seeing all of these applications come in, and on the other side his investment banking officer screaming at him to get the money out before a certain date because otherwise all these terrible things are going to happen under the SEC law which would be very expensive and his employer would be very unhappy. So they said, where are we going to get these construction loans? Well, one group said, "Gee, we're banks and we're turning those things down all the time. Why don't we have our own real estate mortgage trust and we can dump all of this stuff we wouldn't do in the bank into the trust and charge advisor fees to the trust which means that our mortgage banking department within the bank doesn't cost us anything because it now becomes a profit center rather than a servicing center and what's more is now we can accommodate a lot more customers without violating the banking laws because a lot of this stuff wouldn't look too good if they have it in a bank. Really dump it in the trust - they're a risk taking entrepreneurial organization. So that's what they did. Then we had inflation. Suddenly the commercial paper rate takes off and they're locked into 3 year construction loans at fixed rates that looked pretty good when they did them. If they didn't have fixed rates, they had a floating rate and you can imagine where the flating rate went as interest rates in the commercial paper market went up 13%, 14%, 15% to the 5 point, you know, 500 basis point load -

suddenly the interest rate on the construction loans is 20%. It has absolutely no relevance to the reserves that they had set up for interest costs at all and it's a debacle, I mean this is a disaster. The First Wisconsin Mortgage Trust lost $195 million out of $200 million. You know, conceptualize it - you couldn't do that on a random walk basis. Construction loans don't go bad to the tune of 97.5% of your portfolio, ever! You really have to work at it. Chase Manhattan, (?) just an absolutely disaster. Most of the banks had real estate investment trusts that were giving and mortgages trying to arbitrage off commercial paper rate. They had reverse leverage in many cases of 4% and 5% on their total portfolio. Not only that, they were concerned with all (?), you know, the shareholders here are going to be kind of mad about this. Maybe they're going to sue us for malfeasance - ridiculous idea. And so in some cases like the First Wisconsin bought back $25 million of the worst loans. They were embarrased to even have it out in the public as to what it had gone wrong with it. They had a deal down in Palm Springs, CA in which they built a condominium for about $10 million loan on land that the developer/borrower didn't even own. And they hadn't checked that out, of course the whole thing evaporated, the owner didn't see any reason to call Milwaukee and say, "Hey, guys," you know, "you're building your $10 million building on my land." They eventually did find that out soon enough. And he got to keep the building, I mean, you know his loss, $10 million right there. No recovery whatsoever. They lent to Casuba (someone's name - maybe that Judge Casuba?) just cleaned them out. It was just great. At this point, the entire banking system was falling out and then blame it on externalities. It wasn't out fault if the commercial paper markets hadn't gone up, this would have never happened. Baloney! Whenever the banks are really being stupid, it's always external events beyond our control caused us to look stupid. All it did was turn the spot light on what they were doing in the dark otherwise, you know, so. At any rate, the mortgage trust came on and it was a total debacle and people identified the mortgage trust with the equity trust. And as a result, the prices of the equity trusts just plummeted. Real estate investment trusts became a joke in the investment market. People didn't distinguish between the equity trust that was pluggin along with some good old basic properties and the mortgage trust that was playing this high form of finance with a bunch of Harvard MBAs. As a result, you could buy real estate investment trusts for $.25 on a book value dollar when the book value dollars were probably half of the real value of the underlying real estate. People finally started to figure that out in the early 80's and made a killing on real estate investment trusts. As they began to stagger back and people began to figure out that "Gee, I don't look at the earnings, I look at the cash flow per unit." And what are we doing with the cash flow? What are buying with it now? Why kinds of property is it going into. In some instances people began to look at the book values and say, "Gee, if I buy that for $.25, $.30 on a book value dollar and then take control and liquidate the portfolio, I'll make a killing." Now that's what John Albert Wade is talking about relative to Turner Equity. You know, at $4.50 a share or whatever it's supposed to be, he would deny it of course, if he has to under the SEC rules, but the book value is somewhere around $8 or $9 minimum on the real estate portfolio they have. You know, if somebody goes in and just buys controlling interest, gets their board of directors on and says, liquidate. You know, you've got $8 a share, you know, on a relatively short holding period and a number of people did that play as well.

Now along came the pension funds. Some institutions did not want to be identified with a real estate investment trust movement any longer and decided to sell out some of their portfolios. Connecticut General, for example, in reorganizing SIGNA on a leveraged buyout, found out one of the significant assets they had was their real estate investment trusts and they simply sold the whole thing to one of the pension funds because they were able to buy up their own shares quietly for a time and then sell out in the market value of the real estate and the pension funds, asset managers found that a very attractive kind of purchase because when you consider how long it would have taken to search and acquire each one of those properties individually, they would be probably willing to pay at least a 5% premium to get all of those properties at one time. The same was true of Northwestern Mutual which sold its real estate investment trusts to somebody whom I can't remember, and so forth. So the smaller trust were simply raided, local control acquired and then liquidated. A few others, of course, were able to fight off takeovers. General Growth is one that faced a very heavy takeover bid and was able to sell off large chunks of their shopping center portfolio now fully depreciated and so forth to folks like Eetna and others and, as a result, create capital gains for their shareholders and at the same time, significant capital gains for general growths primary corporation, the asset manager and again, used that money to avoid a takeover in a public that was a fairly bloody little fight over it in the morning.

Now, we're back to the real estate investment trust as of today. A number of things have happened as a result of that. Two stage body blow to the image of the trust. First of all, the income tax laws have been tidied up considerably so that you are less volatile or susceptible to an accounting error that costs you either 100% confiscation of income because you were not paying back as you should have, or costs you your real estate tax status. There've been a whole series of little accounting matters under the thing that made a much more stable vehicle one that makes a little more sense without quite so much tensing of the IRS.

The second advantage to the real estate investment trust is that it does allow different types of investors to invest. There's no reason why you can't have a pension fund as a shareholder and a private investor who's taxable as a shareholder. So as a result there have been a significant number of relatively recent offers in which the real estate investment trust share is marketed in a two tier market. One tier is for the large investor who comes in, buys, you know, $5 million, $10 million at a crack and gets a discount. Maybe he pays $9.50 a share. And then another 20% of the trust is marketed to the general public at maybe a slight premium $.50 or $1 a share to represent the marketing cost of retailing investment shares. And the result is that you end up meeting the minimum of 100 persons by a long shot and yet at the same time the dominant investor may be 5 or 6 major pension funds or institutional investors. Now why is this useful to them? Because the problem if you'll recall with the open-end fund and the closed-end fund is you never know what the market value of your unit is and that drives pension people nutty. Now if you'll look at the Russell Index or you'll look at the open-end appraised value, they've been pretty much manipulated. And yet they need to know at the end of the quarter, what's the market price on the day that we have to establish our portfolio value and establish what our pension funds needs to contribute for the next quarter to keep our benefits vested. And they can look up a real estate investment trust share and get a market based price, which they can't do with any of the other collective mediums. The second thing is they can partially liquidate that without any problem. If they own 500,000 shares and they want to slightly reposition their portfolio. Maybe the shares have appreciated and they want to do some profit taking. It's very hard to do in an open-end fund in which the trading unit's $2.5 million or $5 million at a shot and you go on call, and they say, " Well, great, you want your money, we don't have any money at the moment. As soon as we sell something, we'll, you know, send you a check." This way, if they want to reposition, they can sell through the market, it's not a secondary offering, they're not at anybody's beck and call, they can just do it. So there's liquidity in a real estate investment trust share for which there's a regular market which is not present in many of the other collective kinds of devices.

The third advantage to the real estate investment trust unit is the fact that you can and, in fact, do keep separate "them what does and them what invests". Under the pension rules there is a great deal of concern about conflict of interest - who you can deal with. For example, a bank making a construction loan to a particular type of developer could not later invest its pension funds in that same development through its trust department. That would be a conflict of interest because it would appear that it was trying to create liquidity on the construction loan by buying an equity position in the property. OK? Not only that, the network of interrelationships can very quickly lead to a conflict of interest and therefore nonpermissible transaction gpme to (?) the pension fund. Real estate investment trusts by being very focused on just the investment of capital and having nothing to do with the management -- the advisory corporation is a whole separate deal and the advisory corporation makes the decisions on who's going to build and who's going to lease, and who's going to manage and who's gonna sell the insurance and all that sort of thing - is separate from that. So you can't have a conflict of interest in that way. So the REIT is much cleaner in terms of potential violations of ERISA rules and so forth than some of the other kinds of relationships.

Now the real estate investment trust has moved from being purely an equity vehicle or a mortgage vehicle to being a mixed vehicle. It perceives that investment, for example, can participate in mortgages. Gives it a creditors position on the down side with some up side protection if in fact the shopping center does well or the developer creates value for the project because of the spread between the actual cost of construction and so forth and the market value of the property based on capitalization rates and so on. They may own some mortgages in terms of participation and some equities. They may even go side-by-side as we mentioned earlier, with a real estate investment trust raising the mortgage money which it lends on a participation basis to the limited partnership, if you will, so the tax shelter investments can buy on one side, the investor for income can buy on the other side and yet they're involved in the same basically good property of which there's a limited supply. So the REIT is coming back and it's coming back very strongly despite its previous image problem and beside its previous mechanical problem. Because it's solving its marketing problem by going to a double tier marketing system, of going to both pensions and to private investors it can now operate in a scale which is much more efficient than the old days and therefore buy better quality properties. Madison, for example, has something called the Madison Real Estate Investment Trust and on a good year it sold $500,000 in stocks and at a ridiculously artificial price/earnings ratio but what can you do with $500,000 in real estate today? Not much. You were left investing in industrial tin buildings and small local shopping centers and playing the local games but you really didn't have enough logging around money to get involved in any major projects. And yet at a local level it's hard to sell much more than $500,000 a year. And if you wanted to get into one of these Wisconsin real estate investment trust of which there was one once upon a time, it too had difficulty finding enough spread in Wisconsin investment to do very well. And yet if it moved out of its own turf and began looking down in Arizona or Florida or something of that sort, one it didn't internally have the skill level and two, the cost of operating at remote distances from its corporate headquarters was relatively high. Yes. Question: I wondered, is there still the limitation of a given that you can't invest more than 5% in the trust. Chief: Basically, yes. I think that figure has increased by the recent tax laws to maybe 7 and a half or something like that but there is a limitation as to how much one can invest and then the further limitation that no 5 of those can not control more than 50% of the deal, you know, as defined under the attrition rule with the IRS.

The scale of real estate investment trusts permits them one, to go into a major office or commercial or retail structures or two, to raise significantly large number of dollars for securitized mortgages. So, for example, the Bank of America's deal and the Rockefeller Center deal both involved the creation of a real estate investment trust which in turn made the mortgage to those properties gives it a creditor's claim on the down side, some participation on the up side but provides the basic funding for that element in a way in which you would in essence securitized a single commercial mortgage without having to go through the asset enhancement and all of the other things that would otherwise be required, the rating service and so on. The real estate investment trust advisory vehicle has therefore become also a very interesting profit center for the real estate professional.

It creates a captive customer for their services in terms of leasing, management, construction, financing and by the nature of that agreement between the board of directors of the trust and the advisory corporation which are generally overlapping and the real estate investment trust is in the control of friends of the advisory corporation if not the actual executives of it, creates a captive market for services which is what the real estate game was all about anyway. More recently there are a number of specialists in real estate investment trusts that are creating funds of funds. So Alex Brown of Baltimore represented by Bill Morrill (?), has created really an advisory function for state pension programs and particularly the smaller public employment program in which you buy a cross section of perhaps twenty different equity real estate trusts which are carefully matched so that you have regional diversification, you have property type diversification. You may even have one or two of the trusts that are more in the development business as opposed to some which are in older more passive types of property and the local pension fund can than tippy toe into real estate without having to buy a building or without having to go into closed or open-end funds which makes their management very nervous about the value today and so forth and so the real estate investment trust is not only getting first of all primary marketing from Wall Street as a very convenient securitization device but it's getting secondary marketing from those that provide advisory services to major institutional accounts. College endowments and pension funds and other types of nonprofits are not taxable investors and with that kind of support, large blocks being sold to relatively passive investors who do not trade in them, you are stabilizing the share values of those trusts by removing most of the shares from both. Most of them are now buried in accounts which aren't going to go very far very fast and the result is a more stable real estate equity trust shareholder than you had before. They are now into a knowledgeable investors who understand what kind of cash flow earnings, he doesn't care about the tax shelter and what's more he feels confident that his investment has adequate diversification and what's more has been bought as a long-term participation in the real estate rather than a short-term trading ploy. Nonetheless, real estate equity trusts did slide with the market but probably not as far as the market did in October and it probably can come back much more quickly than many of the others because behind that investment is a fixed asset. It is not a paper asset dependent on services or dependent on constant retailing of the product. It's basically a fixed asset with long-term pieces in place that will carry that cash flow forward. Interestingly enough it is a favorite target also of the European and the Japanese investor who get nervous every time he gets outside of San Francisco, New York, Chicago or Washington DC. He wants to tippy toe into the promises, the way to do that is buy a selective number of equity trusts and many of them are regional and are highly successful. Denver has a very fine real estate trust. Washington DC has two very fine real estate investment trusts operated almost entirely in the Washington DC district. You have a number of them that are tied very closely to developers like Rouse and to like General Growth and so forth where they become repositories for the final product using more equity money and less mortgage money to produce a more stable financial structure. So take a look at the real estate investment trusts - it may be the wave of the future now that the . . .

. . . the exam. Real Estate club meets this evening at 7 o'clock Room 220 is that right? Maybe here. Oh, right here with Lisa Graham talking about the Canary Wharf and the London connection and perhaps some suggestions for those of you who would like to be employed in London for the summer or forever. And there's also, I believe, election for VP and Social Secretary shots that are involved. So that's this evening at 7 o'clock probably right in this very room. And remind me immediately after this to make arrangements so that we can bring out the huge television screen. OK.

The subject today is essentially government roles and sources of commercial property finance. And we can look at it across both longitudinal and vertical lines. Obviously, one, the federal, state and the community municipalities now are in many ways in the banking business to support commercial development. And commercial development may take place under essentially three broad categories which by their very nature tend to overlap. So one, we'll talk about real estate developments and redevelopments. Two, we'll talk about economic base development and three we would talk about business development. The difference between economic development and business development is essentially the same difference as between economic base and ancillary activities. We can finance a small venture on Williamson Street through the business development program, one the other hand, Semitec, if they were attracted to Madison would be regarded as economic development kind of finance. Straight real estate and redevelopment (?) real estate, obviously, is a stand alone type of area. The additional efforts at so-called real estate and economic development were really the result of the Roosevelt administration who wanted to focus capital into various areas in order to offset unemployment and what they perceived as an uneven distribution of income and wealth as a result of very uneven distribution of jobs within the country.

Now you're all familiar with FHA and that's the more of the residential aside, which represented the initial efforts of the federal government to create credit enhancement to divert capital into the residential area. But Fannie Mae and ultimately Ginnie Mae really brought the government into direct lending as opposed to simply credit enhancement. And that type of thing, obviously, demonstrated their ability to channel capital at non-market rates by washing that capital through a government agency. Ginnie Mae might get money from the US Treasury, let's say, 50% of its needs from the US Treasury which essentially has a zero interest cost or very nominal one. They would borrow additional money selling Ginnie Mae bonds and then using a very low average cost of capital be able to make non-market loans, in the case of Ginnie Mae, primarily for residential development, although FHA is capable of insuring projects that have up to 10% of their revenues from commercial purposes, particularly ancillary to the development such as grocery stores and barber shops and laundromats and things of that sort. But at any event that began in the 1930's.

The second elements was what was called the Reconstruction Finance Corporation which had multiple functions of channeling moneys to business. One of their early jobs was to funnel money to the banks and the savings and loans buying out the illiquid mortgages which they had and preventing the savings and loans and banks to re-open and distribute money to their depositors.

The second function of reconstruction finance as an experiment was to lend money directly to innovative businesses and they did much to stimulate development of the aluminum industry, the chemical industry and, indeed, a reconstruction finance corporation was involved in a number of prefab housing ventures as well. National Homes gaining significant benefit from them in the early years of the ill fated (?) must run home with almost all RFC money. But they regarded housing as a critical issue long before HUD had its, you know, special splash in trying to accelerate construction techniques in housing. That evolved into two other agencies. One, the small business administration and two, the Farm and Home Administration, the FMHA. Each of them have specific real estate and mortgage lending programs in which they lend directly from the agency for commercial purposes. Now Farm Home Administration has a housing vector as well but I'm talking about their commercial vector. So if you were in a community that is eligible for Farm Home lending and I forget what the size of that is but relatively small, 25,000 population or something like that, and you want to start a cheese factory or you want to start some sort of industrial plant and so forth, you can get substantial help in the terms of non-market interest term funds from the Farm Home Administration which isn't necessarily where you would look. It creates obviously, some economic base and some ancillary business support as well. The Small Business Administration will either loan money directly for eligible projects or and on what are relatively high-risk projects at that, or will provide lease guarantees as a form of credit enhancement so the private sector will do it. The Sheraton Hotel, for example, when it got into money troubles it needed more money than it had planned, the developers set up a subsidiary to run it, made a lease between the management corporation and the corporation owning the actual real estate, SBA insured the lease, guaranteed payment to the lender at which point then Bowery Savings and Loan was happy to come in and advance the money on a first mortgage which was not directly guaranteed by SBA but because of the assignment of the guaranteed lease, was in effect guaranteed by the SBA. And our very typical arrangement which in a small town would been often the plan offered by the Farm Home Administration. Many of them chose not to lend all of the funds on a particular project but would lend in essence a portion of the funds as the lead lender and then have the local banks or financiers participate. So as an alternative to a full direct loan they would, in fact, have the local bank make a commercial mortgage to the project and then require that the initiator/originator of the loan take the first 10% of the risk and everything after that would be insured by Farm Home or the Small Business Administration. So one of the ways you got a direct loan from them was to go to the bank and get turned down and you needed a couple of letters that said, you know, this thing is too risky for, you know, a fiduciary institution to put its money in. It certainly has community merit however and with the letter of turn down, you would then go to the Farm Home folks or the Small Business folks depending on which category was most appropriate and they would then set up either a guarantee or a loan participation in which they advanced some of the money, the bank put in the rest of the money and, in effect, the bank was protected by the front end moneys put in by the federal government. So there were several different combinations for doing that. The propensity of each of those groups to lend all of their own money or to participate with the local lender, really depended on how generous Congress was in appropriating money for their program in any particular period. They could have more political outreach as it were, and so forth, if they only to put up 20% of the money, let conventional sources put up the other 80%, but their 20% obviously would take the hit in terms of some writedown of the asset. One of our alums runs that program in Wisconsin and the record of the Small Business Administration and the Farm Home has been horrible in terms of the losses taken while many, many communities have been the beneficiary of projects they would have never enjoyed otherwise and ranging from motels, cheese factories, a farm implement dealership and a whole variety of other types of business enterprises, particularly in the smaller community.

A developer who's knowledgeable of those channels and politically astute could get a considerable amount of money which was virtually non-recourse as far as the developer was concerned because, of course, it's the very best kind of money to be found for real estate development.

In addition to those two agencies the economic development agency is interested in creating and funding major regional projects. Certainly TVA is one of the best known of those efforts to finance major capital impacts which will change the economic base of a significant region. The TVA primarily federal funds initially, to some degree more utility participation in later years and now the TVA is into financing the development of industry that will utilize their ability to provide electric power and full generator power as well. For example, in Louisville there's a major industrial park with a coal fired electric plant which is based right at the river so that you could bring the coal in by barge from the coal areas of Pennsylvania down the Ohio and that electric plant then just sells the steam to the industrial plants in the industrial park as well and all of it paid by essentially the federal government as an experiment to show that industry would go where one, there was a total energy system available and that it wasn't vulnerable to changing prices for international oil or whatever and it wasn't even part essentially of the utilities rate system of the state because it was a totally self contained private industrial park in which the only people eligible for power from the power plant are those that are in the industrial park. It was an unregulated utility that could deliver electricity at a subsidized price and, in addition, deliver the surplus heat product in the form of steam and hot water to the industrial people located there. Here would be a classic form of economic base support by a federal agency to attract industry and job to the area presumably underemployed or in a labor force that could be reached. And the TVA is now moved into a variety of those kinds of projects to build off the energy and road system which they implemented in the first place. In addition, of course, the Corps of Engineers is into the subsidy of development along its projects. So, Mike Robins' group, Real Estate Dynamics, recently did a major feasibility study along the canal that has been dug all the way from the Gulf of Mexico to I think the Tennesse River, it's one of the typical pork barrel projects, but up in Mississippi there's an area which is relatively undeveloped, a large level of unemployment, they want to develop a major resort complex alongside one of the man-made lakes as part of the deep water channels of the sea. And, again, the Corps of Engineers subsidizes the infrastructure and the site planning and so forth and eventually puts the project with all those elements in place up for bids and will provide subsidized credit to build a resort hotel and all together complimentary facilities necessary to make it work. Where you find those kinds of opportunities there's considerable non-market financing available as generally on a non-recourse basis for the development.

At the state level, many states parallel the federal effort although you may not call it by the same name. Most states have economic development agencies - sometimes subdivided into certain subcategories where the state will issue tax exempt financing to support the developer. Currently Wisconsin Housing Economic Development Authority is essentially a bank which is in the business of converting moneys from the tax-exempt area into loans available for businesses which will build economic base or businesses which will simply build businesses from existing operations. Just as they did on housing, they can be used to provide outright subsidies to cover the, what you would call the gap, between the capital budget required for certain projects and that which would be justified if we were using our old front-door, back-door approach to determine how much capital would be required. Common to all of these programs is something called a "butt-for" clause in which the borrower needs to demonstrate that "but for" the availability of the money on these these terms, this publicly worthwhile enterprise would not take place. And that "but for" determination may be done with a great deal of earnestness and seriousness or it may be obviously a political decision in which people are responding to various and subtle pressures. After the re-election of President Reagan, the UDAG program came under considerable fire - Stockton wanted to do away with it and HUD conducted an investigation in which they set up a committee of seven of us to look at some 50 projects selected at random with the UDAG thing and analyze whether in looking at them after the fact, whether in fact the project would have gone forward because the UDAG covered the gap between that which was justified by the revenues of the project and that which was justified by the public benefits from the project. And, by in large, every one of them did. We were quite surprised to find that there were a few that would have been built in any event in which the community had been muscled. For example, a plant that made large oil transmission line pipe in Chicago wanted to expand and they had a great deal of land adjacent to their existing facility - made a great deal of noise about the fact that they were going to relocate their plant closer to Texas where all of their customers were and so forth. And they needed a UDAG grant to, in effect, correct for the fill problems. Their plant was adjacent to what had been a very unattractive city dump at one point in time and the soils weren't very good for building this kind of facility and they needed the infrastructure in terms of the water channeling system and they also needed to bring some bumpers between them and a relatively low-income Hispanic area adjacent to them. You know, after they had made enough noises that they were going to move away which didn't make a great deal of sense as you looked at it, why they got the UDAG grant to, in effect, prepare their whole site and virtually build their plant for them. The payoff, however, was that it created about 450 jobs for people of relatively low skills in a pipe and foundry operation in the middle of what was a relatively low income area. And so, granted, the company could have done it in terms of their profit margins without the UDAG grant, the fact that you guarantee that the facility would go in a place where it was needed and having created jobs and all the other good things that go with it and it cleaned up an old dump and quarry and had a whole series of public benefits, people kind of glossed over the 'but for' thing and the letter that justified the project was written in a rather grand and generalized style. But, again, the developer with political skills can obviously obtain the 'but for' letter with somewhat more assurance than one who has found someone and hosed them along the way.

States in addition to their economic development agencies may also have specialized agencies. Let's say one designed to do nothing but create port facilities or airports and ports and related water facilities. Well you say that doesn't really effect development very much but if you go all the way down to the county level, a number working for Mr. Mandanza up in the Potowatawan Park area, in which there's a little bay called Idelwilde Bay and by setting up a county port commission, about three people, all of whom were very friendly to Mr. Mandanza, there was money for dredging and that money would be advanced by the state to the local township port authority and, in effect, was financing the developer's preparation of his shoreline and so forth for a resort hotel. So that if you're aware of how all those little specialties work and you read the statutes carefully, you will find many avenues for tapping either the grants that are available from the state program or loans that are available from the state program. In some cases the state program is oblique. In Wisconsin, for example, there are significant loan programs available from the public utilities which are approved by the public utility board. And so I don't know if you've noticed recently but the sanitary fill site proposal for the east side of Madison would be 100% financed by the, I think it's the Wisconsin Power and Light Company, who will also will finance low income housing and so forth. And, in addition, the power companies like Madison Gas and Electric have a grant program to come in and rehabilitate your commercial building relative to energy loss so that we arranged a financial grant for the YWCA to become energy efficient that's paid by the utility company as part of the energy conservation program. And it amounts to a substantial number of dollars too, I think it's like $2500 per apartment that is available and, depending on who you are, it's either a grant, a partial grant or a very low interest rate amortized loan on the properties which for an individual is a function of what income level they're at and what age level they're in and so forth and their organization or enterprise, whether they're profit or nonprofit and, you know, if so, why so. There are other programs like that available, for example, banks in Milwaukee and Madison and I'm sure probably other communities as well have what they call development funds. And these development funds are available again to provide seed money for whatever is considered desirable business development or economic development loans in their community at non-market rates. And, again a number of projects in downtown Madison have had the benefit of second mortgages from a consortium of lenders under this program. The limit may be $500,000 or $250,000 or something of that sort in which each of them then puts in

$25,000 or $50,000 generally proportionate to the total deposits of each organization and the thing given their ability in proportion to pay. But notice it's relatively oblique. It's encouraged and authorized by the federal government and the FSLDIC and the FDIC and many of those are monitored. For example, both savings and loans and banks are required to put a certain amount of their lending money back into the neighborhoods in which their deposits were collected. And they have to report the sectors from which they generate their deposits and the number of dollars alone made in that sector. That's very useful for a developer to know because if there's a major sector which has had recent deposits and they haven't done much down there lately, they may be very anxious to support a commercial development, let's say, just within the boundaries or adjacent to the boundaries of that area and so that they can report that, in fact, they have a half million dollars invested in this neighborhood relative to the million dollars worth of deposits that they generated from that neighborhood in the previous year. So one needs to know how those are defined and to what degree lenders are falling short of their requirement.

The life insurance industry has similar requirements and generally managed to avoid taking any high risk positions by getting major credits to create plants and offices and warehouses in these critical zones that they were expected to provide financing in and getting credit essentially for meeting social redevelopment objectives while making a loan to a triple A national credit which, you know, gives them the opportunity to accomplish two things at one time. And again, the developer needs to be aware of those kinds of incentives within the federal rules for favored financing.

The local city level typically have loan programs under a variety of different elements. Community block grant programs own invariably allocate some of their funds to redevelopment or business loans. If you were a merchant on Williamson Street I'm sure you would be able to find some moneys available in the City of Madison through their economic development or block grant group that would assist you in putting on a new store front, remodeling the building, upgrading the parking adjacent to it, a variety of physical improvements that would be characteristic of a real estate loan, in this case for redevelopment and rehab, and again you could get it from the city. Quite often they would like to make the second mortgage on, you know the first mortgages is that which would be justified by the local banker presuming it's not quite enough money to do the job, they would cover the gap with a second mortgage using community block and (?) funds which can be relatively valuable. A couple of years ago having put a great deal of emphasis on the railway corridor, they made a large amount of money available - I think there was $750,000 - to anybody that wanted to develop in the railway corridor. And at that point Jean and I were attempting to market the railway station and that was a very significant incentive. Anyone that will come in and redevelop the railway station over on West Washington Avenue would not only have been able to buy the station at a reasonable price because of its physical condition, but would have qualified for a major city loan for the redevelopment of that at non-market interest rates. But it was very much point specific. You had to be one, in the rail corridor and two, you got an extra bonus if you did the railway station rather than building something new somewhere else in the rail corridor. And every community has those kinds of opportunities available and some of them are point specific and some of them are neighborhood specific and some of them are just some sort of project-specific thing like income for transient men or housing for transient men or some sort of energy conservation program or housing for, let's say, halfway facilities for your disabled people coming out of prison or whatever. All have some rather favored programs and some of them have very interesting kickers to them. For example, one of the things that we explored for the Y is that if you employ people out of the halfway house, you can get a grant of significant amount from, of all things, the state prison system program. So one of the things we looked at is that, you know, Stan Flauker (?) out here in Wannakee builds motels with what is called a stacked bond. He uses an epoxy cement and an epoxy stucco and he build a two-story motel cheaper than anybody by just stacking these things up - very unskilled labor required. In fact, the first couple of motels they built were built by their kids. And it's really designed to be very inexpensive and require virtually no skill at all and therefore no union workers and in addition he had a knack for having the rest of the family in the winter make the linens for the hotel so that the bedspreads and the curtains and those kinds of things were manufactured by the younger children at home and that's how he started his economy hotel chains. No mortgage on the property at all. And after he got the first few going, why he had enough cash flow that every year he could build one more out of the cash flow from the first two and he made his kids all stockholders in the corporation so that they had a long-term interest in watching this continuing. It's really a great story. But anyway the building technique is something that uses unskilled people so he said, "Gee, we wanted to finance low income housing and the state prison system is going to give us about $3,000 per housing unit for employing people that are coming out of prison. Here's a building system that we could teach to just about anybody and we could, in fact, create housing at a very low price per unit and we propose doing that off the square for the YW and therefore happened to decide that they wanted to stay on the Square for a variety of other reasons. But nevertheless, an unexpected source of financing available for a specific type of project qualification and if you can match the nature of the lever product of your project to the conditions of the prison grant moneys suddenly your financing residential apartments out of a very unexpected kind of source. The same is true of Operation Breakthrough here in town which is a program for training boys and girls that have gotten into trouble and teaching them how to be carpenters and drywallers and painters and so forth. And in the process of developing that skill and that work habit and so forth they renovate houses and as a result they get special financing from the Wisconsin Housing and Economic Development Authority and special financing from the local banks through development fund to go about development of those kinds of projects which they then resell to the residents and so forth in the neighborhood. Again, at the state level there may be special programs that are tied to economic development particularly in northern Wisconsin, for example, and every state has its own economic development agency that is stressing regional development. You get very very little financing for the acquisition of resorts and restaurants and the other kinds of things that are very hard to finance in terms of the traditional banking institutional sources because of the high rate of failure and the states have been delighted to insulate themselves reasonably well from criticism of the press that they make loans on terms that have almost virtually no hope of repayment. All of these governmental sources become interesting tradeoffs for the would-be developer or real estate investor. On the one side the money prices are cheap and in many cases outright grants. On the other side is the relatively high political silhouette and frustration with dealing with the political process during the negotiation phase. Once the project has been financed and is underway it generally fades from the public conscience but during the period of time that you're applying for it, why you're extremely vulnerable to both political extortion on the state side or the local government side and to criticism by those that feel that for one reason or another you, as the borrower, are not entitled to it which is really not the issue for federal financing of real estate development. The question is, who is going to be housed by it - what kinds of businesses are going to be closed by it and who's going to be the secondary beneficiary of having created this enterprise? And that's a very soft abstract concept which the public has difficulty dealing with. Those that do the best in that area are those that become more specifically adroit at anticipating the nature of business and then educating the community to that. For example, the Baltimore Inner Harbor Corporation financed much of their public input into that redevelopment in Baltimore using general obligation bonds. Every general obligation bond requires a referendum and they had 11 major referendums in Baltimore and never lost one simply because they were sufficiently politically atuned to tell their story and tell it convincingly enough that the voters saw that even those who were rather remote from their particular benefit, it wasn't going to hit their neighborhood, wasn't going to improve their school or whatever, that it was in the public interest to support that referendum. There aren't very many developers that have those kinds of skills that can sustain that type of public awareness and support in order to be the beneficiary of those sources of public funding. So that's the price you pay for a lower constant that makes a project work that might not otherwise be feasible at the market rents and capital costs that prevail.

The whole area, of course, of public participation has become more sophisticated so that instead of just tax exempt funds or instead of just a loan or rent program, the federal government and local government as well is moving into participations which take the form of leases. They will lease through the land - remember Fanieul Hall which is certainly a classic case of commercial finance, the City of Boston leased that entire facility after they had preserved the exterior from further deterioration and so forth to Rouse for a percentage of sales. And, as a result, if the project didn't succeed and the rents were relatively low, the City of Boston got less. If the rents were relatively high because it became a desirable retail area, the City of Boston got more and they were perfectly willing to, in effect, subordinate that percentage lease to first mortgage financing required by Rouse to complete the interiors and to otherwise upgrade the area into what it has become. That's pretty advanced risk taking by a community on behalf of business development and economic development. In other areas, of course, the city actually builds the space frame. Many of you remember 550 the Galleria in Philadelphia in which the entire structure of the Galleria is owned and built by the city and Rouse simply leases from it those spaces which are appropriate for retail presentation. Everything else, in other words, if you begin with everything in the public sector and that which is appropriate to the private sector, you lease back to the private sector. And as a result the walkways, the subway stations, all of the communal collective areas in that project are still in the public ownership and then are managed by Rouse under a separate management deal. The Milwaukee Grand Hall project the same way. The City owns most of the real estate and leases back to Rouse those portions which are suitable for commercial development exploitation. That's really a loan. That's really capitalizing, if you will, the equity portion of the business. In corporate finance you learned that there was first debt obligations and then you have subordinated obligations and then you had preferred stock and then you had common stock. Well, we don't call it that in real estate, it doesn't have the name, but the structuring of our capitalization is very much the same and the municipalities in the state are becoming more and more willing to take the common stock position. Now, there's a last to which the earnings will filter down to and the equity position of the developer quite often is that of management skimming the top before anybody else gets theirs and then perhaps having a preferred stock position as well so that they get paid their fees up front for management and development and then you have the first mortgage position and you may have general obligations to a development corporation in the community and so forth and then you get the developer's cut which is really kind of a preferred stock position and then after he gets some minimum stated return on whatever capital he's put in, what falls through that whole set of sifting and wheeling goes to the equity position which is the public. And the public owns that position in the real estate.

The second element whether or not leasing back is to contribute what can be broadly defined as infrastructure. In the old days infrastructure was sewer and water and curb and gutter and, you know, fire and police stations and so forth. Today it can be one, parking ramps, and the parking ramp can be directly integrated into the project. That essentially is a capital contribution of the community. Two, it could be land write-downs in which the land is purchased at market price, cleared, prepared for the private development and then sold at a much lower price to the development and needs to be ammortized out of fifth bonds or perhaps should be made paid for by the city. In effect, putting capital in the form of land into the project rather than in the form of cash. And by putting land into the project they secure much more direct participation and effectively in the land use controls that they want to apply to the development. Ownership of the land in which you now sell it subject to a very elaborate agreement as to what will be built there gives you much tighter control of the development process and the management process than does, let's say, a straight loan. The characteristics of a mortgage loan simply don't provide for direct interference from the debtor's operation. Now, in some cases there will be multiple tiers of that and they can be incorporated by reference. For example, in lending from the Wisconsin Housing Economic Development Authority, first of all you have the enabling legislation which states the purposes for which these funds can be used and to breech that restraint is interpreted by the loan agreement as a default so the enabling legislation becomes the controlling element of the project and to fail to keep that in mind automatically represents a default under which the agency can take over control. Second of all, in the case of housing there is a housing assistance program called HAP which also defines who's eligible to be there and how you will monitor their ongoing eligibility as their income changes and so forth and so on. The third level is that the HAP agreement calls for a property management agreement between the housing finance agency and the developer of the housing and that housing management agreement can be extremely detailed and lead to quarterly inspections of the property, review of the books, etc. and that inspection team may represent a social worker and an engineer to see if the mechanic's (?) are being maintained and so forth and maybe a construction person to look at the balance of the project. And so it's a fairly intensive management review or audit of the project and all of these elements are then incorporated into the loan agreement and, in the case of the housing thing into the partnership agreement. And if any of those, the enabling legislation, the stated governmental plan or the negotiated management agreement are breached by the borrower, two things happen. One, you could foreclose on the project but in the case of the Wisconsin team, it was set up so that the general partner could simply be replaced by the state finance agency. That would not disturb the tax status of the underlying limited partners at all. By definition you are incompetent, by definition incompetent general partners can be removed and replaced and the state has that right to do so and we did. Boom and you're gone. And now we'll find another general partner who would like to pay us for the opportunity to move in and take over operations of the project. Notice the critical element there is immediate and sensitive public control. We don't care who's got the title, that's not the important thing, we don't care who gets the tax shelter, the point is to control it so that it is directed toward the government purpose. And to that degree, government as a financial partner can be a lot rougher and a lot faster than a traditional lender. A traditional lender that had that feature in his loan, might in fact lose his portfolio rights from something called inactive equity which says he took advantage of your financial position relative to the borrower to exact harsh and socially unapproved terms and therefore you have lost your right to foreclose on the property. But in the public sector you can move quickly and fiercely to protect the public interest and it would be very hard for a court to rule that you were out of bounds simply because you were concerned about the revenue and who didn't have heat or didn't have, you know, dry and sufficient and appropriate housing. So again one of the prices paid for using public money is the fact that retribution can be somewhat more slick and somewhat more harsh and the good politicians will probably make use of that as well to hang you in effigy as well as the project. They distance themselves as much as possible from whatever failures occurred.

OK. I think that covers the public sector for the moment and there will be one more lecture on Monday and we'll try to bring the whole thing together . . .