



## **MARKS PANETH REAL ESTATE ADVISOR OCTOBER 2013: STRATEGIES AND SOLUTIONS FOR CONTINUING TO GROW YOUR REAL ESTATE BUSINESS**

### **CAVEAT EMPTOR: YOU MIGHT JUST GET WHAT YOU PAY FOR**

In today's real estate market, you can still pick up investment properties at bargain basement prices. But what may seem like a good deal could cost you much more than you expect. Several factors should be considered besides the purchase price.

#### **Tenants**

The demand for certain kinds of rental space, including office and retail, hasn't recovered to precrash rates in most markets, so a bargain property may come with a high vacancy rate. Finding new tenants can be time-consuming and costly, especially if you need to first renovate the vacant space.

And don't take too much comfort if the property has a decent vacancy rate. You'll need to examine existing leases for any troublesome terms and evaluate the financial standing of every tenant.

Before purchasing a multitenant property, review existing leases and compile a current rent roll that includes such lease terms as:

- Tenant names,
- Move-in dates,
- Expiration dates,
- Security deposits,
- Escalation clauses,
- Options to extend or purchase,
- Outstanding rent balances,
- Subletting and landlord approvals, and
- Landlord work obligations.

Watch for tenants who are behind on their payments, leases nearing expiration and rent rolls that differ greatly from the seller's income statement that could indicate undisclosed concession agreements.

You might want to consider hiring professionals who have expertise in reviewing underwriting projections to ensure that your bid is based on realistic assumptions and in-place leasing data.

#### **Zoning and code compliance**

Most lenders won't extend a property loan unless it's zoned for your intended use — you can't make assumptions about zoning based on current use. Do zoning authority records suggest any plans to change the property's permitted uses? Are existing approvals and permits transferable? If not, it could be difficult to obtain any required variances or permits.

Property located in special public financing or redevelopment zoning areas may be subject to land use restrictions. On the upside, properties in designated areas may be eligible for property tax abatements and income tax credits for rehabilitation that the new owner might undertake.

Bargain deals often involve distressed properties, and owners of distressed properties might not have kept up on their compliance with building and other codes. You may find it's impossible to bring the property up to code, and, if it *is* possible, the costs could be substantial.

### **Maintenance and carrying costs**

If the property is distressed, it's likely that routine maintenance and repairs have been neglected. In that case, you'll need sufficient capital to bring the property up to speed and make it attractive to tenants. Depending on the property's condition, you might be unable to market vacancies for some time.

Regardless of the property's vacancy rate, you must pay its carrying costs — property taxes, mortgage payments, insurance and so forth. If a building is off the market because it needs maintenance or code compliance work, you could shoulder carrying costs without offsetting rental income for a while.

To minimize hidden costs, hire an architect and/or engineer to review wear and tear of the physical structures. Also evaluate the adequacy of parking, signage and drainage before you buy.

### **Judgments, claims and liens**

The seller of a bargain-priced property may have fallen behind on obligations to contractors and other third parties. In such cases, you may incur costs to locate lien holders and obtain releases. Code enforcement fines could also come into play.

You'll need to verify certain contractual obligations of third parties, too. Are the warranties, guarantees, indemnities and rights under the original construction contracts assignable? Would the contractor's additional insured endorsements apply to you as a successor buyer?

### **Environmental issues**

Cleanup costs and liability for lurking environmental issues can pile up quickly. Often *anyone* who's owned the property may be jointly or severally liable for cleanup. In this case, determine the applicable federal, state and local environmental regulations, including those that could limit future uses. Review any environmental reports, notices of violations and pending litigation.

Lenders typically require a Phase I Environmental Site Assessment, which requires an analysis of a property's past and current uses, looking for environmental conditions that could create liability for the buyer. The assessment generally covers underlying land and any physical improvements to property.

### **Platting and neighborhood**

Unplatted commercial property must be platted before it can be developed. So you may need to deal with right-of-way dedications, utilities installation, impact fees, and restrictions on access and levels of development.

The nature of the neighborhood will significantly affect its current and future value. Check the crime rate, median income of tenants, rental rates of comparable properties and unemployment rate for the past few years to help estimate the neighborhood's future property values.

### **Look before you leap**

Before you snap up a bargain-priced property, take the time to consider all the issues. You may feel as if you need to move fast, but failing to take the time to perform thorough due diligence could put you on the hook for far greater costs than you originally anticipated, while reducing your expected operating income.

## **APPELLATE COURT RULES ON LEASE OBLIGATIONS**

One of the most vexing concerns investors have when buying real estate is whether they'll end up being saddled with unexpected liabilities or obligations related to the property. When it comes to commercial lease obligations, though, there's very little a real estate investor can do without the tenant's consent, and the resulting costs can prove significant — as a case out of Massachusetts demonstrates.

### **Lessee seeks reimbursement from new lessor**

In August 2004, Bright Horizons Children’s Centers entered a lease with 400 Longwater Realty. The lease included covenants dealing with the construction of a new building.

Longwater, as lessor, agreed to construct a base building and substantially complete its construction work by Oct. 15, 2005. Bright Horizons, as lessee, would do the fit-out work to make the building suitable for its intended use as a child care facility. From the beginning, however, the building project was marred by delays.

On Sept. 23, 2005, with the base building far from being substantially complete, Longwater conveyed its interest in the property to Sturtevant, making Sturtevant the successor lessor.

After further construction delays, Bright Horizons performed part of the base building work, in addition to the fit-out work. It subsequently made a written demand on Sturtevant for reimbursement of the costs incurred in performing the base building work. It also requested payment of its “improvement allowance,” as specified in the lease, and rental credit for delays attributable to late delivery of the base building. Sturtevant refused, and the parties went to court.

Sturtevant argued that a side agreement it had entered into with Longwater — the assignment and assumption agreement — absolved it of any and all construction-related lease obligations owed Bright Horizons. The jury ruled in Sturtevant’s favor on the lease claim.

### **Appellate court rules for lessee**

On review, the Massachusetts Appeals Court cited the “ancient rule” that “a successor lessor, who takes real property by deed subject to a pre-existing valid lease, stands in the shoes of ... its predecessor.” In other words, it has the same rights and duties under the lease as its predecessor. Moreover, the lease at issue in this case expressly provided that the “covenants, agreements and conditions” set forth in it — whether to be performed by lessor or lessee — “shall be binding” on each other’s “successors and assigns.”

According to the court, Sturtevant’s assignment agreement with Longwater threw aside the “black-letter law” that one party to a contract can’t alter or modify the rights or duties of another party to the contract by unilateral action. Such changes require the parties’ mutual consent. In fact, the lease at issue in this case states that it “could not be modified or amended in any manner except by an instrument in writing executed by the parties hereto.”

The assignment agreement attempted to unilaterally alter and modify the lease terms, to the detriment of Bright Horizons, without Bright Horizons’ consent. It couldn’t, therefore, be used to carve out the covenants in question from the obligations Sturtevant “accepted” as a result of its purchase of the property.

The court of appeals vacated the trial court’s judgment and entered a new judgment for Bright Horizons. It sent the case back to the lower court for determination of Bright Horizons’ damages.

### **No picking allowed**

The appellate court stressed that real property buyers can’t lawfully cherry-pick the lease obligations they’ll assume. When buying a property that may come with lease obligations, the best protection is to perform thorough due diligence into existing or potential liabilities. Your advisor can help you perform due diligence, including review of landlord lease obligations and other lease terms, to determine whether the potential costs are worth the upfront investment.

## HOW TO ENSURE YOUR QI IS ON THE UP AND UP

Qualified intermediaries (QIs), which are similar to escrow companies, play an important role in Section 1031 or like-kind exchanges. Unfortunately, however, many states simply don't pay much attention to the QI industry. That's why it's crucial that you thoroughly vet the QI before signing on the dotted line.

### Understand how a QI works

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

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

Unfortunately, QIs aren't required to be bonded or insured or to maintain even a minimum level of capital. *Anyone* can start up a QI and start administering Sec. 1031 exchanges.

Years ago, after several high-profile incidents involving QIs that declared bankruptcy or otherwise were unable to fulfill their contractual obligations, the IRS warned real estate professionals and investors to exercise caution when selecting QIs. Problems with QIs can end up disqualifying the transaction for gain deferral.

### Do your research

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

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

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

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

Last, make sure you fully understand the QI's fee schedule from the beginning. It could include transaction fees, hourly exchange consulting fees and interest sharing arrangements.

### Don't become a casualty

Perform your due diligence when deciding on a QI. Going with a larger QI doesn't necessarily guarantee that you won't be left holding an empty bag. But if you complete the due diligence suggested above, you have a better chance of signing up with a QI that's rock solid and ready to help you through the process. Also, be sure to include your real estate and tax advisors in the mix. They can help you make the best decisions.

## **SPOTLIGHT ON MARKS PANETH**

### **BE A PART OF OUR THIRD GOTHAM COMMERCIAL REAL ESTATE MONITOR**

The *Gotham Commercial Real Estate Monitor* from Marks Paneth LLP represents the findings of a survey of top commercial real estate professionals in the New York City market. They include owners and managers of commercial property as well as commercial real estate brokers, agents, attorneys and accountants specializing in this sector.

We will shortly launch our Fall 2013 survey. You will receive an email invitation to participate from William H. Jennings, Partner-in-Charge, Real Estate Group. You will also be able to take our survey at the Crain's Real Estate Conference on Thursday, November 7. (Please see below for more details on the conference.)

If there is anyone that you would like added to the list of survey participants, please email [marketing@markspaneth.com](mailto:marketing@markspaneth.com). All responses are confidential and anonymous.

All participants receive a copy of the findings, which will give you insight into the sentiments of other top New York commercial real estate professionals. We look forward to your participation in our third *Gotham Commercial Real Estate Monitor*.

### **MARKS PANETH TO SPONSOR CRAIN'S REAL ESTATE CONFERENCE: RESHAPING NEW YORK**

Marks Paneth is a sponsor of the *Crain's Real Estate Conference: Reshaping New York*. The conference will take place on Thursday, November 7 from 8 a.m. to 12 p.m. at the Essex House in Manhattan at, 160 Central Park South. Please feel free to stop by our table and take our real estate survey. We look forward to seeing you there. More information can be found on the [Crain's website](#).

### **MARKS PANETH NAMED A TOP 3 FORENSIC ACCOUNTING FIRM FOR THE 4TH STRAIGHT YEAR**

Readers of the *New York Law Journal (NYLJ)* have again ranked Marks Paneth as one of the top three forensic accounting providers serving the New York legal community in the publication's Annual Reader Ranking Survey. This is the fourth year in a row that we have received this honor and the first year we have been ranked #2.

More than 8,200 readers of the *NYLJ* ranked over 350 firms in 80 categories including technology, research, accounting, insurance, financial services, litigation support, real estate, education recruiting and staffing.

Ours is the only major regional firm to be selected as one of the top three firms in the category of forensic accounting for all four years of the survey – 2010, 2011, 2012 and 2013. Please [click here](#) to read more.

### **DOING BUSINESS IN NIGERIA**

Doing business around the world presents a variety of challenges. Morison International (MI), the association of independent accounting and consulting firms of which we are a member, has added [Nigeria](#) to its series of *Doing Business Guides*.

This guide can be found in the Library on the Marks Paneth website. Each guide is written by the MI member firm in the country that is being profiled and provides an introduction to foreign investors on the various aspects of doing business.

## FOR FURTHER INFORMATION

If you have any questions, please contact **William Jennings**, Partner-in-Charge of the **Real Estate Services Group** at 212.503.8958 or [wjennings@markspaneth.com](mailto:wjennings@markspaneth.com) or any of the other partners in the Marks Paneth Real Estate Services Group:

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Additional information on the Marks Paneth Real Estate Services Group can be found at [www.markspaneth.com](http://www.markspaneth.com).

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