



CPAs & Business Advisors

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Closing the deal with seller financing

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

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

Why seller financing?

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

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

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

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

What should the seller consider?

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

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



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

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

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

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

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

What tax issues come into play?

Seller-financed transactions have several potentially vexing tax implications. If, for example, the seller is a real estate investment trust (REIT), it must determine whether the loan constitutes a "qualifying asset" that generates "qualifying income." A seller-financed loan could jeopardize the seller's status as a REIT under the Internal Revenue Code (IRC) if the loan isn't properly structured.

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

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

Is it right for you?

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

Sidebar: Document, document, document

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

To that end, sellers should obtain:



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

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