

Balancing the Interests of Sellers and Developers in Purchase Money Transactions for Developable Real Property

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Real estate developers can avoid being “ground” down when taking back seller financing

Most real estate developers will agree that the acquisition of unimproved land for future development can rank very high on the risk scale. Although many of the risks inherent in the acquisition of developable land, such as market decline, permit moratoriums, changes in the capital markets and the like, are due to the possible occurrence of conditions and events beyond the control of the developer, the developer may, through the use of purchase money financing, remove or at least cushion some of the risks related to its acquisition of raw land for the purpose of future development. While the use of purchase money financing in the acquisition of undeveloped land is certainly not a new financing technique, this article seeks to summarize for both the land-owning seller and the purchasing developer many of the variations to purchase money financing that can be used to assist the developer in its acquisition structuring, as well as to help the seller understand the developer's concerns, so that by anticipating some of the pitfalls inherent in a transaction involving purchase money financing, the seller, in its role as a lender, may balance the maximization of sale price with the retention of an appropriate level of risk.

The requirement for a seller to provide purchase money financing to a developer as part of the purchase of the seller's land should be addressed at the earliest practical point in the transaction, if not at the letter-of-intent stage, then certainly in the contract of sale. So as to help avoid disagreements about such matters at the time of closing the contract of sale might very well include the forms of the purchase money financing documents. The following issues should be considered in connection with every purchase money financing transaction involving the acquisition of developable property.

Amount of Financing

The developer may very well seek to bridge the gap between the equity requirements imposed by its institutional or other third-party lender and the developer's equity contribution to the project by the use of purchase money financing. The seller should consider how much debt the property could support, taking into consideration obligations and development requirements that will need to be incurred by the developer before it is able to start generating revenues from sales. A large project with significant up-front infrastructure obligations should be analyzed differently from the purchase of fully engineered and developed lots. While it should not unrealistically restrict the amount of financing provided, the seller should make sure that it is not the only party at risk and that the developer, through either its own investment or that of a third-party lender or equity partner, has a meaningful stake in the success of the project. A seller taking back purchase money financing often lacks the experience to evaluate many of the aspects of the development process required to make a project a success and may be tempted to provide purchase money financing in an inappropriately large amount as a trade-off to getting the requested sales price. Though such an approach may yield

the sales price requested by the seller, its benefits may be illusory if the seller ends up taking back the project at foreclosure.

The developer may very well ask the seller to subordinate its purchase money financing to the lien and effect of an acquisition and/or development loan provided by a third-party lender. The seller's analysis of the developer's request should take into consideration the fact that if such subordination is granted, the seller's lien may be wiped out before the repayment of the debt owed to the seller. More is discussed about this issue later in this article.

Debt Instruments

As with any borrower/lender relationship, purchase money financing should be evidenced by a note or other debt instrument and secured by a mortgage or deed of trust. The seller, like any lender, should perfect its security interest in the property sold, subject, in some cases, to the right of the developer to receive, at closing, a release from the lien of the mortgage or deed of trust (which terms are used interchangeably in this article) of a portion of the property conveyed; which release would be granted by the seller in consideration of the payment of the cash portion of the purchase price paid at closing by the developer. It is not unusual for a developer to defer the designation of the land that is not to be encumbered by the purchase money financing by virtue of the developer's payment of the cash portion of the purchase price, in which event the deed of trust should provide that the developer is entitled to future release credits arising out of such cash payment.

As with any note, the deferred purchase money note may very well bear interest and provide for periodic payments of principal and interest over the term of the note. As they are required in order to effect partial releases, prepayment rights are obviously very important to the developer, and the developer should have the right to make such prepayments (if not in any amount, than at least in increments no smaller than required to release the minimum size releasable parcel). If made, prepayments should not only be without penalty, but should also generate either the release of portions of the encumbered property or create release credits entitling the developer to future releases. Unlike conventional financing transactions where prepayments of a note might not defer regularly scheduled payments of principal and are applied to the "back end" of the payment schedule, as the principal amortization schedule for a purchase money transaction might be structured to reflect the anticipated development schedule for the property, it is not unusual for prepayments of principal to be credited against scheduled payments of principal in their regular, rather than inverse, order of maturity.

Defaults and Remedies

Customary provisions relating to grace periods and rights to cure should also be included within the debt instruments, and the parties should consider the applicability of non-recourse provisions that limit the seller's ability to pursue remedies against the developer as a result of a default under the purchase money loan documents. A number of factors will have a bearing upon the seller's decision to grant a developer's request for a nonrecourse loan, including the amount of property released for the initial down payment, the release rate for all releases, and whether or not the seller's purchase money financing is subordinated to other third-party acquisition or development financing obtained by the developer.

Relief from Moratoria

Of the variety of events that have the potential for causing disaster in the developer's plans, some of the most important include the possible imposition of moratoria on the connection to and provision of public services such as water and sewer service, building permit moratoriums and similar events that are beyond the contemplation or reasonable control of the parties at the time they agree to enter into the purchase money financing transaction. Predicated upon the assumption that during such periods the developer is unable to prosecute its development plans in the manner anticipated at the time the parties entered into the contract, the developer might seek to negotiate a

provision in the loan documents providing that during any period of such moratorium, the regularly scheduled payments of principal are deferred.

Whether or not regularly scheduled payments of interest are also deferred, or if interest ceases to accrue at all during such periods, can be the subject of vigorous negotiations between the parties. If deferrals on principal payments (or the deferral or possibly cessation of the accrual of interest) are granted, the seller will, quite naturally, wish to impose time limits on such relief, notwithstanding the fact that the moratorium may be continuing after the expiration of the period established for relief under the loan documents.

Estoppels

The seller should remember to include in the purchase money financing documents the requirement that the developer provide estoppel certificates to the seller (and its designees) as may periodically be requested by the seller. If the seller wishes to pledge the developer's note as collateral for a loan or use it for any other similar purpose, confirmation that the seller is not in default under any of its obligations under the loan (however minimal they may be) and confirmation of the principal balance of the note and the date through which interest has been paid will all provide additional comfort to a third party.

In the context of pledges, the seller should be wary about any provisions in the loan documents that could adversely affect the hypothecation or sale of the purchase money note, such as limitations on transferability or provisions (such as those requiring the construction of a road by the seller) that require meaningful actions by the seller as part of the note's terms. On the other hand, the developer may wish to limit the seller's transferability of the purchase money note, as the developer may feel that while it is comfortable dealing with the seller (who may have some continuing interest in remaining portions of the land or who may otherwise be generally familiar with the development challenges relating to the property encumbered as collateral), the third party may look at the transaction simply as a financing transaction and may not be quite so accommodating to the developer in the event times get difficult.

Condemnation

Condemnation proceeds should, as a general matter, be thought of in the same manner as partial release payments. The seller should be entitled to all condemnation proceeds to the extent such proceeds equal the amount needed to be paid for the release of the property condemned from the purchase money deed of trust. The developer will typically seek to retain any amounts by which condemnation proceeds exceed the amount required to effect the release of the condemned land.

Partial Releases

The inclusion in the loan documents of provisions allowing partial releases is key to most purchase money financing transactions of developable land, especially land in a nonurban setting. Partial releases permit the developer to deliver title to portions of the originally encumbered land to third-party purchasers or lenders, free and clear of the lien of the original purchase money financing, all without having to pay off the entire debt. While the developer will wish to provide that the parcels, lots, or even condominium units it has developed are released from the lien and effect of the purchase money financing so as to coincide with the developer's sale of such properties to third parties, the seller will wish to make sure that such releases are accomplished in an orderly (and possibly to some extent, predetermined) fashion, as well as in a manner that at all times leaves the remaining indebtedness owed to the seller appropriately collateralized.

In any discussion of collateralization, the subject of release rates is appropriate. At its most basic, release rates are the dollar amounts payable by the developer to the seller for which portions of the property encumbered by the purchase money deed of trust may be released from such lien. For example, if a 130-acre parcel of land is encumbered by an \$11,000,000 deed of trust, then releases at "par" would provide for a release rate of \$84,615.39 per acre (\$11,000,000 divided by 130). It will

certainly be of no surprise to the reader that a concept so simple is usually not the way that release rates actually work in real life. The following are some of the permutations of the way releases may be effected:

Accelerated Release Rates

In order to help assure that the seller is appropriately collateralized during the term of the purchase money loan, many sellers will insist upon accelerated release rates, the application of which will, in theory, cause the payoff of the deferred purchase money debt prior to the release of all the parcels that serve as collateral for such repayment, thereby leaving the seller a cushion against the developer's default. In the earlier example, if the seller sought an accelerated release rate, the deed of trust might have provided that the total deferred indebtedness would be divided by the number of acres originally encumbered and such number would be multiplied by 110 percent, which computation would yield a per-acre release rate of \$93,076.92 (\$11,000,000 divided by 130 times 1.1).

Free Releases

Not unexpectedly, the developer will have some "suggestions" when it comes to establishing a formula for partial releases. For example, the developer might logically take the position that the real value of the property is contained within the salable portions of the property, such as individual subdivided lots, and not within areas that, as part of the subdivision process, the developer is obligated to dedicate and transfer without consideration from third parties. Such areas might include streets, park sites and other recreational areas, storm water detention facilities, homeowner association common areas, and other areas that while comprising the property originally encumbered, do not generate sales income from which release prices may be obtained. For that reason, developers will often ask that the party secured by the purchase money financing documents release, without the payment of any principal or interest, areas required for public and common use. If such requests by the developer are accommodated by the seller, a very different release structure could result. For example, what was, in the prior example, a per-acre release rate of \$93,076.92 per acre based upon 110 - percent accelerated releases would become, assuming that one third of the 130 acres is required for public (i.e., nonsalable) purposes, a much lower effective release rate. While it may be true that the value to the purchaser does not lie in the publicly dedicated areas, likewise such areas are not a viable source of collateral for the seller. For that reason, the financing documents should provide that where the property is subdivided, a per-lot release rate will be established. One way to compute a per-lot release rate is by dividing the total debt by the number of lots encumbered without regard to dedicated areas. Condominium unit release rates may be handled in much the same manner. Such a computation would again provide for releases at "par" and could be subjected to a formula providing for an accelerated release rate.

Accelerated Payment Date for Interest

At the time of any partial release, the developer usually is obligated not only to pay the principal amount of the purchase money indebtedness required to effect the release, but also accrued interest on such release amount, as to provide otherwise would leave the interest portion of the debt payable after the collateral had been released.

Orderly Plan of Releases

While the developer seeks to gain whatever leverage it might in the establishment of release rates and the release, without additional consideration, of areas to be dedicated to the public, the seller will want to assure that all releases are accomplished in a manner that will not impair the remaining collateral. For example, the seller may want to provide that all releases are made in accordance with good land development practices, in an orderly manner such that no land would be released in a way that would result in unreleased land not having access to adjoining publicly dedicated streets and roads, utilities and drainage lines, and facilities by way of access to public

rights-of-way or through unencumbered easements or other similar agreements. Also, if the project is divided into sections, the seller may not want the developer to seek the release of parcels in one section until the developer has caused the release of all the parcels in a prior section. The seller's concern about being left with scattered sites upon foreclosure will drive this discussion.

Recordation and Transfer Taxes

In those jurisdictions that impose recordation and/or transfer taxes in connection with the recordation of deeds of trust, the parties should allocate, at the contract stage, the obligation for such taxes. While such taxes may be allocated by statute or custom, there is a good argument that because the developer is gaining the benefit of the deferred purchase money financing, the obligation to pay any transfer or recordation taxes imposed upon the filing of the collateral documents should be imposed on the developer.

Equity Kickers

In reviewing the totality of the circumstances, the seller may find that it is really more of a partner than a lender by virtue of facts, including the fact that the seller has subordinated the lien of its purchase money financing to other financing (especially if such subordination is to other acquisition financing), or that the collateral provided to the seller does not approximate what an institutional or third-party investor or lender would require in similar circumstances. In that event, the seller may wish to consider keeping an equity participation interest in the development of the project.

Cooperation in Development

Whether or not such parcels are released from the lien and effect of the deed of trust, the purchase money financing documents (subject to a variety of protections created to assure that the developer does not adversely affect the seller's remaining collateral), should provide that the seller, as the party secured by the deed of trust, will join in and consent to, to the extent legally required, all subdivision plats, easement agreements, condominium documents and other similar development agreements. The seller will want to make certain that such consent is solely for the purpose of subjecting the lien and effect of the purchase money financing documents to such development-related agreements and, importantly, does not impose independent obligations upon the seller.

Subordination of Purchase Money Financing

In some instances the seller may agree to subordinate the lien of its purchase money financing to the lien of a third-party lender, but only if such lender is a bona fide lender (possibly an institutional lender) and if such subordination is only for new funds provided by the third-party lender for construction and development of only the property encumbered. While being in a subordinate position may present a significant impairment of the seller's collateral, the developer's argument for such subordination is that the proceeds of the loan will be used exclusively for the purpose of enhancing the value of the collateral encumbered by the seller's purchase money loan. When a portion of the third-party loan to which a seller is requested to subordinate is used for acquisition monies, a different result could occur.

Some Bells and Whistles

In those instances where the developer intends to resell individual parcels or lots, it may seek to require that the purchase money indebtedness be capable of being treated as being "divisible," such that the developer may split the encumbered property into sections (lots, condominium units, parcels of acreage, etc.) and, upon request by the developer, the seller would permit the modification of the debt instruments evidencing and securing the purchase money financing so as to create individual purchase money notes and deeds of trust covering the portions of the property not released. These individual notes and deeds of trust would constitute separate and independent notes and deeds of trust, which are not cross-defaulted or cross-collateralized and secure unaccelerated release prices at "par."

This approach would permit the developer to sell off individual portions of the encumbered property to third-party purchasers who could take title “subject to” the divided indebtedness that becomes a lien on their land only. This approach passes on to third-party purchasers the benefit of the original purchase money financing. As a third-party purchaser taking the benefit of the original purchase money financing will not want its individual parcel to be subject to an accelerated release rate, the seller may require the developer to separately collateralize the accelerated portion of the original release amount. Care should also be taken by the seller to make sure that the process does not jeopardize the priority of the original deed of trust.

Conclusion

While there is a certain level of predictability in any negotiation involving purchase money financing for developable land, an understanding of the goals and concerns of each of the participants in the transaction will help maximize the benefits to both and will avoid unpleasant and possibly unnecessary surprises.

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