1973

Modern Land Finance: Final Examination (May 1973)

William & Mary Law School

MODERN LAND FINANCE

Final Examination

Professor Madison

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INSTRUCTIONS: In answering the questions, you may find that additional facts are needed in order to even reach a tentative conclusion. In any such case, you should specify what additional information is needed and indicate how it would be relevant to your reasoning or argument.

[Instructions]

The following events take place in State X, a jurisdiction which has: (1) a limited partnership statute, identical in its content, to the Uniform Limited Partnership Act; (2) an insurance law - closely resembling the New York and Virginia statutes - which regulates the investment protfolio of insurance companies; (3) a usury statute which permits a maximum contract rate of interest in the amount of 8 percent with an exception only in respect to corporations; (4) a statute permitting only foreclosure by judicial sale and case-law which holds that the security for a mortgage debt is indivisible and that a foreclosure action must be of the entire security regardless of whether the default being sued for is of a portion or all of the debt, and which follows the lien theory in respect to mortgages; and, finally (5) a statute providing that subsequent encumbrances are automatically cut off at any foreclosure sale.

Sam Syndicator ("Sam") is an experienced land developer and dealer in commercial properties who lives and works in the city of Metropolis, located in State X. The population and prosperity of suburban Metropolis has been expanding steadily - especially along route "101" which has become a major commuter route between Metropolis and Sister City, located 20 miles away. Both rentals and land values in this area have doubled in the last ten years. As yet there is no community or regional-sized shopping center along route "101". Sam believes there is a great need for a small regional center, and convinced two of his wealthy acquaintances - Irving Investor ("Irving"), a doctor, and Ivan Investor ("Ivan"), a professional basketball player, to supply the additional equity capitol necessary to fund construction of the proposed shopping center ("Center"). Sam first consulted with his attorney, and fellow dealer, Al Opportunity ("Al") who agreed to become a co-promoter.

After selected the best site for the center - a vacant tract owned by Owen Owner - and obtaining an option to purchase for $250,000, Sam obtained favorable marketing, engineers, and topographical survey and marketing study. He estimated that the Center, with a store area of 75,000 square feet, will attract on a regular basis 150,000 customers and generate retail sales of 3 million dollars per year. The occupancy lease rentals should average about 5% of sales which would mean the owners would have an annual gross return of $150,000 and net return of $100,000. Sam estimates the cost of construction to be 10 dollars per square foot - which would mean a total cost of $1,000,000 ($750,000 to build and $250,000 for the land). The Center has a useful life of 25 years and $100,000 salvage value.

Based on his past experience with permanent lenders, Sam expected to obtain a permanent mortgage loan in the amount of about $750,000. Irving and Ivan each agreed to invest $100,000 - in exchange for a 30% share for each of the profits and for losses. Sam, in exchange for his promotorial- managerial talents, and a contribution of $25,000 - will receive 30% and Al, in exchange for legal services and a contribution of $25,000 - will receive the remaining 10% of profits.

Since all four principals are in a high tax bracket (50%), Al suggested they use either a Subchapter S corporation, or a partnership form to obtain a pass-thru [in accord with the profit and lose ratio] of the interest, property tax and depreciation deductions--for income tax purposes. They finally decided on using the partnership form and since Irving and Ivan were worried about personal contract and tort liability, Al suggested that the two of them be limited partners. Al pointed out that under Sec. 7 of the ULPA they must relinquish exclusive control to Sam and himself, the general partners. However, both Irving and Ivan fancy themselves as astute decision-makers, and insisted upon sharing in the management decisions. Al then--after much meditation--conceived the idea of making a "dummy" corporation (which will receive a nominal share of profits and hold no assets other than its partnership interest) the sole general partner--with each individual receiving 25% of the stock. Each would also be a limited partner and the profit-loss ratios would remain the same. This way each would have equal control (as stockholders of the general partner) and yet be shielded from debt and tort liability in their separate capacities as limited partner and stockholder of the general partner. All agreed, and Al filed the certificate of limited partnership under the name metropolis Investors Associates ("MIA"). The certificate provides that neither the death, dissolution, incompetency nor retirement of any of the partners will dissolve the partnership. The name of the corporation is "XYZ".

Al proceeded to negotiate the terms of a permanent mortgage loan with American Life Insurance Company ("American"). On January 1, 1973 American submitted a commitment letter (following the same standard form as item number 14) offering a $750,000-30 year loan at 8% per annum with annual "additional compensation" payable to American equal to 25% of the amount, if any, by which the gross income each year exceeds $150,000, or $10,000--whichever is less, and with a prepayment right after 10 loan years upon payment of 15% of the outstanding balance (three times the customary penalty rate). The commitment also contains a special condition requiring--at the time of closing, January 1, 1976--that leases be executed with three high-credit tenants: T1, T2 and T3, and that the leases be approved and assigned to American as additional collateral. The commitment also provides (in lieu of condition 18 in the standard form) the following: "Deposit as security for the making of the loan, which shall be refundable to you if and only if the loan shall close in accordance with this commitment, and shall be retained by us if for any reason the loan does not close---$3,000.

Lastly, American--over Sam's objections--refused to agree to an exculpatory (no personal liability) provision in the note--notwithstanding the Company's desire to please and do business with Sam, whose solvency and reputation they respect. The commitment letter was accepted and signed by Sam who noted after his signature that he was executing the commitment and note "solely in my capacity as officer of XYZ Corporation, general partner of MIA".

Al, on the strength of the commitment by American, went to the Building Loan Bank ("Bank") and negotiated a construction loan on terms identical to those <u>above</u> except that Bank's commitment letter omitted reference to any lease requirement. Copies of unexecuted leases with T1, T2, and T3 were submitted to American which approved the form thereof, and indicated so by noting it on the bottom of page 2 of the Buy-Sell Agreement (following the standard pre-closed form--<u>see item</u> 15). The Buy-Sell was executed on March 1, 1973 and the construction loan was closed and recorded on April 1, 1973. The note and mortgage reflect the terms of the construction loan commitment letter and the payment terms of the permanent loan--and follow the same standard forms as <u>Items 8 and 9</u>--except that the mortgage does not contain clause 13 (right to accelerate)--and contains the additional mortgagors covenants (<u>item 10</u>) numbered 1 thru 8, and 14. At the permanent loan closing American will receive an assignment of leases (item 19), tenant's estoppel letters (<u>item 24</u>), a standard form of ALTA title insurance policy, architect's certificate (item 25), borrower's certifications (<u>items 26,27</u>); and will be purchasing from Bank the note and mortgage. The annual debt service on the mortgage will be $70,000 (first year: $60,000 interest and $10,000 principal).

The date <u>now</u> is December 15, 1975--and American discovers (on the basis of an updated preliminary title report) that an outstanding mortgage (recorded April 15, 1973) and lien for unpaid federal taxes (filed December 14, 1975) exist on the property. In addition T1 refuses to execute its lease with MIA. The prevailing rate of interest in the permanent mortgage money market is 6% per annum, and American discovers on December 15 that Al's law partner, Anticipatory Breach, is negotiating, on behalf of Mia, a new permanent loan at 6% per annum with a different permanent lender.

<u>PART A.--Subpart (1)</u>: If American closes the permanent loan on the commitment

date (January 1, 1976)--will the loan be a legal investment? Discuss the issues fairly presented.

Subpart (2): Assuming the loan is legal, is the commitment binding on American and enforceable by MIA and/or Bank? Explain briefly. If so, what remedies are available to MIA and/or Bank against American?

Subpart (3): Assuming that MIA is in default under the commitment, what remedies, if any, does American have, against whom, and for what amount? Explain briefly.

PART B.--Subpart (1): Was Al Attorney's advice sound: (a) in suggesting originally that they either use a Subchapter S corporation or a partnership; (b) in suggesting they make XYZ corporation the sole general partner? Explain briefly and cite non-tax, as well as tax considerations.

Subpart (2): Assuming that the limited partnership, MIA, is treated as such under the tax law, do any of the terms of the note and/or mortgage suggest any tax problems for any of the partners. Explain briefly.

Subpart (3): Do you anticipate any special tax problems for Irving and Ivan on a later sale of the Center? Explain briefly.

Subpart (4): Assuming that the limited partnership, MIA, is treated as such under the tax law, what will Irving's after-tax cash return (yield) be (approximately)--after the first year of operation? Explain briefly--and show computation. Note that MIA paid no "additional compensation" to American in respect to the first year.

PART C.-- What are American's remedies, and against whom, in the event the following events take place on February 1, 1976 (cite the relevant loan or security document, and section number--where relevant):

(1) MIA defaults in the payment of the monthly debt service on the mortgage.

(2) Part of the Center crumbles as a consequence of defective workmanship in its original construction which was not in accord with the plans and specifications, as approved by American.

(3) MIA obtains a wrap-around mortgage from a different lender.

(4) T3 claims that MIA did a lousy job constructing a warehouse attached to the store (in violation of the lease). MIA--to mollify T3--agrees to a reduction in the rent.

(5) A street necessary for access to the Center has not yet been completed, dedicated, and accepted for maintenance by the city of Metropolis. Explain briefly in one sentence.

PART D.-- After a default in payment of the debt service on February 1, 1976, may American go into possession and start to collect rentals until the default is cured? Explain briefly.

Can American collect the rentals if it goes into possession after a foreclosure judgment (and before the foreclosure sale)? Explain briefly.

PART E.-- On February 15, 1973 as counsel for MIA you are reviewing the 20 year lease agreement between MIA and T2 and come across the following provisions: "Subordination--This lease shall be subordinate to any mortgages which are now on or which hereafter may be placed on the premises. Lessee--at the request of lessor--will execute any instrument necessary to accomplish the same"; "Condemnation and

Default by Lessor--In the event of a total or substantial taking of the premises by eminent domain, or substantial default by Lessor under the terms of this lease--Lessee may, at its option, terminate the lease by giving appropriate notice to Lessor of its intention to do so. In the event of any taking by eminent domain, all damages shall belong to Lessor; provided, however, that Lessee shall be entitled to that portion of the award equal to the value of its loss of its leasehold estate. Do you see any objections?

PART F.-- On February 1, 2001, MIA decides it needs additional working capital and must decide whether to refinance the existing mortgage--or, sell the property to Owen who offers to lease it back for 25 years. The amount of new mortgage payment and rental under the ground lease would be approximately the same. Give a brief non-mathematical explanation of which course of action will probably be most beneficial.