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DEBT MARKETS – DEAD, DELAYED OR DYNAMIC

CURRENT FACTORS INFLUENCING REAL ESTATE FINANCE

Thomas A. Hauser
Ballard Spahr LLP

For the first six months of 2016, the real estate finance market has been described by some as dead, others as delayed and yet for others as dynamic. The market has been directly impacted by the overwhelming volume of pending loan maturities, a slowdown of economic activity, turbulence in the global economic and political markets, and the pending implementation of new governmental regulations, such as "HVCRE" and new partnership tax accounting rules. While such conditions have resulted in changes in lending metrics, the tightening of underwriting standards, reductions in loan proceeds, and asset class dislocation, they have also resulted in greater opportunities and additional capital investment.

I. Pending Maturities, Changes in Lending Metrics and Financial Covenants

A. The Great Wall of Maturities

1. Storm Clouds on the Horizon

Real estate finance has been a longtime driver of the US economy. Over the past seven years, the commercial real estate debt market has grown to approximately $1.7 trillion dollars. Of the $1.7 trillion dollars, approximately $183 billion dollars, or roughly eleven percent (11%) of the debt market, will mature in 2016, and $208 billion dollars, or roughly thirteen percent (13%) of the debt market, will mature in 2017. The pending maturities are commonly referred to as the "Wall of Maturities". Those maturing loans which were originated back in 2006 and 2007 when underwriting standards were at their lowest point face the greatest risk of maturity default. CMBS loan originations between 2005 through 2007 totaled over $600 billion dollars, which is more than two times the amount of CMBS originations today. All-time high rental rates and heated competition among lenders led to higher leveraged loans with little to no amortization and minimal reserve requirements. Early refinancings and defeasances have reduced the pending maturities by more than seventeen percent (17%), but as for the remaining 2006 and 2007 vintage loans with lower credit quality, many borrowers will have difficulty refinancing such loans.

As of 2015, commercial real estate debt was allocated among the following lending classes, with the banking sector and CMBS sector accounting for close to seventy percent (70%) of the debt: national, regional and local banks – almost fifty percent (50%); the CMBS market – eighteen percent (18%); Fannie, Freddie or HUD – twelve percent (12%); life companies – eleven percent (11%); other lending sources – nine percent (9%), and foreign banks – one percent (1%).[1] Bank debt constitutes the highest concentration of maturities, but since the maturing bank loans were originated post 2008 under heightened underwriting standards, it is

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[1] Situs RERC, Deloitte Development, LLC, National Association of Realtors, Expectations & Market Realities in Real Estate 2016 - Navigating Through the Crosscurrents, at 23.

anticipated that most, if not all, of the bank maturity exposure will be addressed through refinancings.[2] The concern remains that demand for new commercial loans will far exceed supply. Over one-half of the existing CMBS loans will mature between the years 2016 and 2019. A conservative estimate is that approximately $183.3 billion dollars of 2016 CMBS maturities (or eighteen percent (18%) of all CMBS maturities) will encounter some form of refinance risk. In 2017, the number of at risk CMBS loans increases to approximately $208 billion dollars, or twenty nine percent (29%) of all CMBS loan maturities.

The 2016 CMBS loan maturities are more than double the 2015 CMBS loan maturities, and that number will continue to climb in 2017, all because of the overwhelming demand for 10-year term loans in 2006 and 2007. The maturing CMBS loans are secured by assets in all of the major asset classes, with the office sector constituting the largest percentage with close to thirty-four percent (34%) of the maturing loans, followed by the retail sector with just over twenty-seven percent (27%), multifamily, with just over sixteen percent (16%), lodging with close to eight percent (8%) and industrial with just over five percent (5%) of the maturing loans. Those CMBS loans secured by office and retail properties have the highest risk of maturity default, unless a loosening of underwriting criteria or some type of borrower recapitalization occurs.

2. It's Been a Good Run

The United States economy has experienced seven consecutive years of economic growth, which is the longest period of expansion in the post-World War II Era. Real property fundamentals have improved dramatically since 2009. Multifamily rents have increased over twenty percent (20%), construction activity is back to historical averages, capitalization rates are at record lows and asset values are at record highs. Transactional volume peaked in 2015 at just shy of $500 billion dollars, which is the most since the 2007 peak at $574 billion dollars. In 2015, the total outstanding for all commercial loans was measured at $2.8 trillion dollars total, which exceeded the 2007 record setting amount of $2.5 trillion dollars. More than 11.5 million new jobs have been created since 2011, and the unemployment rate has fallen below five percent (5%). The great unknown, however, is that during the post-World War II era, the United States economy has not gone more than eight consecutive years without a recession.

3. Rays of Sunshine

There is some good news, however, when comparing today's lending metrics against those from 2007. In 2007, the average debt yield ratios (DYR) for office, retail, industrial and hotel loans were as low as eight and seven tenths percent (8.7%), but in 2015, the average DYR was almost eleven percent (11%). In 2007, the average loan to value ratios (LTV) for office, retail, industrial and hotel loans was roughly seventy-one percent (71%), as opposed to just over sixty-six percent (66%) in 2015. Lastly, in 2007, the average debt service coverage ratio (DSCR) for office, retail, industrial and hotel loans was at 1.30, and in 2015, the average DSCR was at 1.70. Also, there is a healthy refinance market supported by historically low interest rates and strong capital flow into the debt and equity markets. Increased demand and competitive pressures have led to historically low capitalization rates and rising property values.

[2] Commercial Loan Maturities: So Far, So Good, Capital Watch, April 18, 2016, http://cbrecapitalwatch.com

With quality real estate assets located in large metropolitan areas, there are few signs of weakness. Vacancy rates continue to decrease and absorption rates continue to be favorable. Rent for suburban and central business district office rents have continued to increase, as have multifamily rents and hotel revenue per available room. There are also greater opportunities for alternative, non-CMBS lenders who are looking to enter into the debt markets by offering bridge financing, floating interest rate loans, mezzanine debt and direct equity participations. This opportunity is greatest for the secondary or tertiary markets.

4. Asset Class Issues

Real estate prices are up over ninety percent (90%) from their 2010 lows, and more than sixteen percent (16%) more than the previous record highs of 2007. Growth however has begun to show signs of strain which points to an end of a traditional cycle. A closer examination of the current debt levels have revealed an easing of commercial real estate underwriting which has resulted in loans with less restrictive covenants, extended maturities, longer interest-only periods and limited guarantor requirements.

5. Apartments.

The apartment sector has seen the most rapid growth, with values more than doubling since their 2009 lows and reaching a valuation point that is thirty four percent (34%) higher than the 2007 values. Such growth, however, is unsustainable based on two percent (2%) wage growth. Affordable housing is a burgeoning crisis where year-over-year rent increases have far exceeded wage growth. Almost half of all apartment renters pay more than thirty percent (30%) of their income in rent.

6. Hotels.

The hotel sector showed real revenue per room increases of over six percent (6%) in 2015, which was the sixth straight year of positive gains. Occupancy was at an historic level, achieving an all-time high occupancy rate of over sixty-five percent (65%). Although hotels outperformed most asset classes, they are also showing signs of strain. Increased construction, especially with lower-end hotels, has resulted in more competition as new hotels come online and the additional competition will result in reduced occupancy rates and reduced room rates.

7. Industrial.

Industrial remains a solid asset class with overall continued growth and increased rental rates. Warehouse rents have grown at a rate of over six percent (6%) on a year-over-year basis. Technological advances and changes in demographics, however, have significantly altered the traditional warehouse market. Changes in consumer spending habits, including an increase in on-line retail, has resulted in strong demand for warehouse space located near population centers. This strong demand in large metropolitan areas has offset a softening of demand for warehouse space in secondary or tertiary markets.

8. Office and Retail.

Office and retail continues to be a story of contrasts. Suburban and central business district office markets in larger metropolitan markets continue to show signs of bullish growth and increased rents. Office buildings located in other areas are showing signs of negative growth with increased vacancy rates and decreased rents. Retail continues to show the greatest dichotomy of any asset class. Well-located, high-end shopping malls and retail centers that cater to essential needs, such as grocery-anchored centers, are prospering. Malls and shopping centers with weak locations or anchored by dying retail chains continue to struggle.

Retail properties secure over $47.5 billion in debt set to mature over the next 18 months. The pending maturities coincide with the tightening of the CMBS market and the increased cost of capital of the banking sector. Commercial retail has experienced a paradigm shift, with many consumers engaging in on-line shopping rather than relying on big box retailers. Heightened competition has reduced margins and profitability, which has resulted in stagnant rent growth. The uncertain future of shopping centers has created concern among lenders, and this concern has only been exacerbated by recent loan defaults. Earlier in 2016, General Growth defaulted on its $144 million dollar loan secured by the Lakeside Mall located in suburban Detroit, after failing to obtain new financing.[3] Older or lower tier malls have become obsolete, and with a shallow pool of investors, it is estimated that several hundred of such malls will be shuttered over the next ten (10) years. Retail has fallen out of favor with banks and life companies, so shopping center owners have had to turn to the more expensive CMBS market, which in turn has increased owner's costs of capital and operating costs.

B. Current Lending Environment

The commercial real estate market continues to be frothy, with record low interest rates and record high real estate values. With strong fundamentals, real estate located in prime areas continues to be an attractive investment for both debt and equity, buoyed by the increase in net operating income over the past seven years. The returns on investment still exceed average returns on stocks and bonds. Global demand for US real estate has helped drive the current economic cycle. Almost $150 billion in foreign capital has been invested in US real estate. Although capitalization rates have fallen to a current average rate of six and one half percent (6.5%), they are still four hundred (400) basis points over the 10-year US treasuries. In 2007, the spread between capitalization rates and 10-year US treasuries fell to one hundred eighty (180) basis points. The capital stack today is also very different than in 2007, and is not premised on steady rent growth or anticipated appreciation. More stringent underwriting standards as compared to previous years have resulted in more simplistic borrowing structures, with at most two layers of mezzanine debt.

The current interest rate environment, however, is unsustainable, and interest rates are expected to rise in response to more restrictive government policies and increased capital costs. The Federal Reserve has publically stated that it will continue to increase rates, and banks are facing a tightened regulatory environment under Basel III and Dodd Frank. The CMBS market is also facing greater uncertainty as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and Securities and Exchange Commission Regulation

[3] Sarah Mulholland, America's Dying Shopping Malls Have Billions in Debt Coming Due, June 16, 2016, http://www.bloomberg.com/news/articles/2016-06-16

AB ("Reg. AB") , which has resulted in wider interest rate spreads. Many believe that US real property values have peaked and that they will fall as much as five percent (5%) in the next twelve months amid the pending "Wall of Maturities" and the influx of assets for sale in the market place. A number of large, publically traded real estate funds have reached the end of their fund lives, and will need to begin liquidating their real estate assets. Market dislocations (such as the sharp sell-off triggered by the Brexit vote), the slowdown in China's economic growth and lower oil prices have all threatened the continued expansion of the US real estate market. Underwriting parameters are also facing increased scrutiny with heightened attention directed towards debt yield ratios, which are less susceptible to market manipulation. Historically, lenders focused on loan-to-value and debt service coverage ratios, but with the historically low interest rates and record high property values, those methodologies do not adequately measure the associated lending risk.

1. Debt Yield Ratio

The debt yield ratio ("DYR") is a static measurement that reflects the cash-on-cash return on investment, and is considered a more accurate measurement of risk then loan-to-value and debt service coverage ratios. Average DYR is around ten percent (10%), and is inversely proportionate to the level of risk; which means the lower the DYR, the higher the investment risk. Lenders use the DYR as a check and balance to assure that the loan amount is not inflated due to low market cap rates, low interest rates or long amortization periods. DYR is calculated by dividing net operating income by the first mortgage loan amount, and does not take interest rates, valuations or loan amortization into consideration. Of the pending maturities, close to eighteen percent (18%) of the loans maturing in 2016 have DYRs of eight percent (8%) or less, and close to thirty percent (30%) of the loans maturing in 2017 have DYRs of eight percent (8%) or less.

2. Debt Service Coverage Ratio

Debt service coverage ratios ("DSCR") are still a standard underwriting tool and are measured by dividing net operating income by annual debt service. DSCR is subject to manipulation due to interest rate fluxuation and extended amortization periods. Lenders are able to adjust annual debt service by providing interest only periods or amortizing principal payments over longer periods, which results in artificially inflating DSCRs and greater risk, but without any change in property value. An uptick in interest rates will drive principal amounts down in order to meet DSCR constraints. Based on the current interest rate environment, approximately $31 billion dollars of outstanding debt cannot be refinanced at a 1.30 DSCR.

3. Loan to Value Ratio

The steady rise in real estate values over the current economic cycle has made the loan to value ratio ("LTV") the least valuable underwriting metric. LTV measures the ratio of the principal loan amount to the value of the real property. With property values reaching new levels, as evidenced by the historically low capitalization rates, the traditional LTV metric would support all time high loan amounts. Capitalization rates are measured by dividing net operating income by the value of the real property and represent the percentage return and investor would receive on an all cash investment. The low capitalization rates are inversely proportionate to the

higher real estate values. Rising interest rates and increased costs of capital, however, make such low capitalization rates unsustainable. As capitalization rates begin to increase and values flatten or decrease, the properties will no longer support the same LTV levels and loans originated based on current values will face greater refinancing risks. While increased property values somewhat mitigate the pending Wall of Maturities risk, approximately $93 billion in loans will require the investment of additional capital in order for the loans to be refinanced

C. Lending Trends

With the increased demand for debt, many lender segments anticipate increasing their loan volumes over the next eighteen (18) months, but strong demand will still outpace the available capital. Lenders are looking to hold DYR, LTV and DSCR constraints to more traditional levels, and be paid for the associated risk.

1. National, Regional, Community Banks.

Bank lending activity has increased over the past seven years due to rising real estate values and lower interest rates. Banks remain very competitive on interest rates, and lead the sector in value-added and construction financing. Banks tout their ease of closing but still have relatively low LTV requirements (55% - 60%) and limited loan terms (average maturity of 3-5 years). Interest rates are generally at floating rates based off of a spread over LIBOR. Spreads may vary between 175 to 500 basis points depending on the strength of the borrower, quality of asset, and perceived loan risk. Banks also still require guarantor recourse or partial recourse, but have demonstrated more structural flexibility in allowing borrowers to buy down credit risk by increasing interest rate spreads by 100-200 basis points. Banks have been warned, however, to tighten credit underwriting because of competitive pressures in the lending environment and rising commercial real estate concentrations.[4] More specifically, concern have been raised about the number of existing bank loans that have less restrictive financial covenants, longer interest-only periods, extended maturities, and limited guarantor requirements. Also, new regulations imposed under Dodd-Frank and Basel III have imposed greater bank reserve reporting requirements, which has
led banks to require additional loan documentation and increase interest rate spreads.

2. Life Insurance Companies. Life company lending has reached all-time high levels. Life companies have been able to increase their debt and equity allocations by ten to twenty percent from 2015, while maintaining their traditionally conservative underwriting standards. They still look to strong, experienced borrowers and pay close attention to the underlying real estate attributes, such as real estate location, tenant mix and lease quality. They still require non-recourse carve out guarantees and look for institutional quality assets, with a preference of asset classes in the following order: (i) industrial and distribution warehouse, (ii) multifamily apartments, (iii) grocery anchored retail, (iv) central business district office, (v) unanchored inline urban retail, (vi) suburban office, (vii) flex space and (viii) flagged hotels. Life companies are competing on interest rate and prepayment flexibility, rather than loan proceeds and interest-only terms. They also traditionally make lower leveraged loans with terms of seven (7) to ten (10) years, with below sixty-five percent (65%) LTVs (trending more towards sixty percent (60%) LTVs), spreads of 175-200 basis points over the 10-year U.S. treasuries, and

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[4] Statement on Prudent Risk Management for Commercial Real Estate Lending, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency

minimum DSCRs of 1.50x assuming a twenty-five (25) year amortization period. The loan amounts range from $5,000,000 to $25,000,000. Among the lending classes, life companies have been more competitive on interest rates than Fannie Mae and Freddie Mac.

3. CMBS. In 2015, over $100 billion of mortgage loans were securitized through the CMBS market, but such volume is predicted to steadily decrease over 2016 and 2017 while the market absorbs the uncertainty caused by the new regulatory requirements. Interest rate spreads are anticipated to widen due to market uncertainties triggered by Reg. AB reporting requirements and the risk retention rules under Dodd-Frank. There generally is a six month lag between the date of loan origination and securitization, and the uncertainty has created a market slowdown. Smaller conduit shops have pulled back or left the market entirely, and larger lenders have become hesitant to price new loans given the volatile spread environment and the inherent risks in warehousing loans prior to securitization in an unsettled interest rate environment. The number of CMBS issuers has decreased from 40 to 28 through the first quarter of 2016, and CMBS investors are pulling back and reducing their CMBS exposure. CMBS loans generally have 10 year terms with some periods of amortization calculated based on a 25 year or 30 year amortization period. Interest rates range between 4.8% and 5.5%, or spreads of 300 to 350 basis points. LTVs are seventy percent (70%) or less, and full leasing and replacement reserves will be required. There is no flexibility regarding prepayment, with set lock-out periods followed by yield maintenance or defeasance. Servicing issues remain with CMBS servicers regarding timely lease approvals and the release of capital reserves.

II. High Volatility Commercial Real Estate Regulations

A. Basel III

By 2013, with an eye towards increasing earnings, banks had turned to newer, higher profit margin lending products, such as construction lending. These new products added a higher level of risk to the banks.[5] Over the course of 2014, banks added nearly $15 billion in construction and development loans to their balance sheets.[6] In July, 2013, the United States banking regulators issued the Final Basel III Regulatory Capital and Market Risk Rule (the "Final Rule"), which became effective on January 1, 2014, but not fully implemented until January 1, 2015.[7] The Final Rule categorized all acquisition, development and construction ("ADC") commercial real estate loans as "High Volatility Commercial Real Estate" ("HVCRE"), and imposed additional capital requirements for all HVCRE loans. Traditionally, ADC loans were risk-rated at one hundred percent (100%) but under the Final Rule, all loans that met the HVCRE definition were assigned a new one hundred fifty percent (150%) risk-rating.[8]

The Final Rule applies retroactively to all commercial loans held in the banks' portfolios regardless of the date of origination. Banks were required to re-examine their entire loan portfolio and by March 31, 2015, identify all HVCRE loans and set aside the capital reserves necessary based on the one hundred fifty percent (150%) risk rating.[9] The net effect of the Final Rule is a substantial increase in the capital reserves required for ADC lending, and increased capital costs for ADC borrowers.

B. HVCRE Definitions.

An HVCRE loan is defined as a loan that is not a "permanent" loan and which finances ADC property. The definition is qualified and excludes those loans used to finance:

1. one to four family residential projects,

2. property that would qualify as an investment in a community development project,

3. agricultural land, or

4. ADC that satisfies all of the following conditions:

a. the project's LTV is less than or equal to the applicable maximum supervisory LTV limits (which are generally 80% LTV for commercial, 75% LTV for land development and 65% LTV for raw land),

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[5] Viewpoint: Spotlight: High-Volatility CRE, hhttps://wwwfbratlanta.org/banking/publications/financial-updated/2015

[6] Id.

[7] Basel III Implementation | Mortgage Bankers Association, https://www.mba.org/issues/commercial-issues/basel-iii-implementation

[8] Id.

[9] Real Estate Finance in the Era of Basel III, https://crefc.worldpress.com/2016/01/10/real-setate-finance-in-the-era-for-basil-iii

b. the borrower has contributed capital to the project prior to the advancement of any loan proceeds, in the form of cash or unencumbered readily marketable assets, land to be contributed to the project purchased with cash, or certain out-of-pocket development expenses, where the aggregate of such capital contribution is at least fifteen percent (15%) of the real estate project's "as completed" appraised value, and

c. the borrower's contributed capital is contractually required to remain in the project throughout the life of the project (or until the loan is converted to permanent financing or repaid).[10]

C. HVCRE Exception.

Although the Final Rule created the foregoing exceptions to the HVCRE definition, the Final Rule provided very little interpretive guidance as to the Final Rule's application. In response to such uncertainties, the Board of Governors issued a series of frequently asked questions (the "FAQ").[11] Under the FAQ, the Board of Governors confirmed that the Final Rule was not only to apply retroactively to all ADC loans, regardless of when originated, but that banks were required to continually monitor their ADC loan portfolios for HCVRE compliance. To be exempt, a loan must qualify for an HVCRE exemption for the life of the loan. The exemption requirements are strict and unwavering. Once a loan fails to be exempt, it will thereafter be considered HVCRE for the remaining life of the loan.

Under the FAQ, the Board of Governors also confirmed that to be exempt from the HVCRE requirements, a borrower must contribute cash or unencumbered, readily marketable assets to the project before any loan proceeds are advanced. Such capital may include out-of-pocket development expenses paid for by the borrower. Soft costs that contribute to the completion and value of the project can count as development expenses, and such soft costs can include interest and other development costs, such as fees and related pre-development expenses. Project costs paid to related parties such as developer fees, leasing expenses, brokerage commissions and management fees may also be included in soft costs provided the costs are reasonable in comparison to the cost of similar services from third parties.[12] Contributed capital does not include borrower owned real estate from an unrelated project, condominium unit deposits, additional financing, or assets contributed after loan advances are made. The purpose of the capital contribution requirement is to ensure that the borrower maintains a sufficient economic interest in the project and to provide a margin between the loan amount and the value of the project to provide lenders with protection against potential loss due to overruns or an incomplete or otherwise failed project.

Additionally, the borrower must be contractually obligated under its loan documents to keep all contributed or internally generated capital in the project throughout the life of the project. The life of the project has been clarified to mean until such time as the ADC loan

[10] Conference of State Bank Supervisors, High Volatility Commercial Real Estate (HVCRE) Examiner Job Aid

[11] High Volatility Commercial Real Estate (HVCRE) Exposure, Frequently Asked Questions of the Regulatory Capital Rule, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, March 31, 2015.

[12] Id.

converts to a permanent loan or is repaid, or the project is sold. Conversion to a permanent loan means that the loan is converted to permanent financing in accordance with the banking organization's normal lending terms.[13]

The exemption specifically states that the capital contribution must equal at least fifteen percent (15%) of the project's "as completed" value, and not its "as stabilized" value. The "as completed" value should be the value of the project at the time all development is expected to be completed, and is generally calculated by subtracting the costs to achieve stabilized occupancy from the "as stabilized" value.

As for the requirement that the borrower contributed capital be contractually required to remain throughout the life of the project (or until the loan is converted to permanent financing or repaid), it has been interpreted by the FDIC and the OCC as meaning that all contributed capital must remain with the project and not be distributed. This condition is not limited to only the fifteen percent (15%) of capital that must be contributed before the bank funds any loan proceeds.

D. HVCRE Loan Covenants.

Borrowers should expect to see new covenants added to loan agreements in an attempt to ensure compliance with the HCVRE rules. An illustrative example of HVCRE covenants follows:

1. High Volatility Commercial Real Estate Threshold Requirements

Borrower shall comply with the following requirements relating to exceptions for high volatility commercial loans adopted by Basel III:

a. Maintain a Loan-to-Value Ratio less than or equal to eighty percent (80%);

b. Make a capital contribution to the Project in the form of cash in an amount equal to at least fifteen percent (15%) of the Property's "as completed" Appraised Value, with such capital contribution being made prior to the initial Construction Disbursement; and

c. Retain the capital contribution set forth in clause (b) above in the Project until the Loan is converted to permanent financing, sold or paid in full.

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[13] Id.

III. New Partnership Audit Rules

A. Bipartisan Budget Act of 2015

On November 2, 2015, President Obama signed into law the Bipartisan Budget Act of 2015, Pub. L. No. 114-74 (the "BPA"). In addition to funding the Federal Government, the BPA materially changed how the IRS will audit partnerships and entities that elect to be treated as partnerships for tax purposes, including limited liability companies. The BPA is intended to enhance the IRS's ability to audit partnership tax returns and enable the IRS to collect taxes, interest and penalties at the partnership level, rather than at the individual partner level. The new BPA rules take effect for tax years beginning after 2017.

Under the Tax Equality and Fiscal Responsibility Act ("TEFRA") enacted in 1982, the IRS established administrative proceedings known as the TEFRA rules to resolve partnership audit issues. If following an audit the IRS determined that adjustments were necessary, the IRS was required to recalculate the tax liability of each individual partner for the specific audit year. The BPA repealed the TEFRA rules by implementing a new streamlined set of audit rules. Under the new rules, the IRS will examine the partnership's items of income, gain, loss, deduction, credit and partners' distributive shares for a particular tax year. Any adjustments will be taken into account by the partnership, and not the individual partners, in the year the audit or administrative proceeding is completed.[14] Any adjustment will result in the partnership having to pay an imputed underpayment penalty since the audit at issue was for a prior tax year, and the liability will be for the then current tax year. The IRS will collect any taxes, interest and penalties directly from the partnership and any taxes due will be computed by netting all of the audit adjustments and applying the highest individual or corporate tax rates.[15] The BPA does allow a partnership with less than 100 partners to elect out of the new audit procedures and have the IRS determine any audit liability at the individual partner level.[16] In order to qualify, all of the partners must be individuals, corporations or otherwise Schedule K-1 eligible.

B. New Loan Risks

Since the new BPA audit rules impose potential tax liability at the partnership level, lenders will need to re-examine their underwriting requirements in order to account for such liability risk. Lender's will most likely require that borrowers address the new audit rules in their limited partnership agreements or operating agreements, and include provisions to address any indemnification between the partners for partnership tax liabilities, claw back provisions against former partners for tax liabilities relating to their time in the partnership; obligations for existing partners to submit amended tax returns resulting from any audit liability and an affirmative covenant of the individual partners to pay their share of the tax liabilities if the borrower makes a Section 6226(b) election.[17] Lenders will also need to determine whether any loss arising from a borrower's breach of the new audit rules should be covered in any non-recourse carve out guarantee and/or any other guarantee. If a borrower is eligible to make a

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14 Bloomberg BNA Analysis of the Bipartisan Budget Act, http://www.bna.com/bloomberg-bna-analysis

15 John Sheridan, "How will the new partnership audit rules change how you do business," http://worth.com/how-will-the-new-partnership-rules-change-how-you-do-business

16 See Section 6221(a) of the Internal Revenue Code, I.R.C. §6221(a).

17 I.R.C. §6226(b).

Section 6226(b) election, lenders will need to consider if they want to prohibit any future transfers of partnership interests without lender consent if such transfers would adversely impact the borrower's election eligibility. Lastly, lenders will need to take any possible tax liability into consideration when calculating a borrower's financial covenants.

C. New Loan Document Provisions

Although the implementation of the new BPA rules is still being determined, Lenders are likely to add additional representations and warranties and loan covenants in order to mitigate against the potential risk.

An illustrative set of representations and loan covenants is as follows:

1. Representations and Warranties - Borrower represents and warrants that Borrower is treated as a partnership for federal income tax purposes.

2. Borrower Covenants - Borrower hereby covenants and agrees that:

a. Borrower will not elect to cause the Partnership Audit Rules to apply earlier than its first tax year beginning after December 31, 2017,

b. if eligible to do so, on an annual basis, Borrower shall timely elect out of the Partnership Audit Rules under Section 6221(b) of the Code pursuant to and in accordance with Section 6221(b) of the Code, and

c. if Borrower is not eligible to make the election out of the Partnership Audit Rules under Section 6221(b) of the Code or Borrower fails timely and properly to make that election in any given year, Borrower shall, in each applicable year, timely and properly elect under Section 6226 of the Code to cause the partners or members of Borrower to be liable for any federal income taxes and related interest and penalties assessed by the IRS as a result of an IRS audit (the "Imputed Underpayment").

Borrower's failure to comply with the foregoing clauses (a) through (c) shall be an immediate Event of Default hereunder unless Borrower causes any Imputed Underpayment which is due and owing by Borrower as a result of such failure by Borrower to be timely and properly paid in full in accordance with the Partnership Audit Rules and/or other IRS requirements regarding such Imputed Underpayment.

d. Borrower further covenants and agrees that (a) Borrower shall notify Lender of any audit of Borrower being made by the IRS promptly upon Borrower's knowledge of the same; (b) promptly upon Lender's demand therefor, Borrower shall provide Lender with updates about such audit and copies of Borrower's correspondence with the IRS regarding such audit; and (c) promptly upon Lender's demand therefor, Borrower shall provide Lender with copies of the documents submitted by Borrower to the IRS evidencing Borrower's elections under the foregoing clauses (b) and (c).

IV. Conclusion

The remainder of 2016 will determine whether the real estate finance market is dead, delayed or dynamic. The pending "Wall of Maturities" is real and will need to be addressed. Some asset classes, such as office and retail, face the highest risk of maturity default. The economic expansion enjoyed over the last seven years is beginning to wane, as evidenced by the 2015 peak in transactional volume, but the lending metrics remain much stronger than those metrics which existed in 2007. Borrower structures will continue to be more simplified because of tighter lending standards, interest rates will increase over time and higher lending costs associated with greater governmental oversight will be passed on to borrowers. Lenders will focus more closely on DYRs rather than DSCs and LTVs, while returning to more traditional levels for each standard of measurement. Banks and life companies have continued to be active lenders, while the CMBS market has cooled notably. Construction and development costs have become more expensive as a result of Basel III and the imposition of new bank lending rules for HVCRE loans, and lenders will most likely impose greater oversight on pass-through entities to address the new BPA audit rules for partnerships.

Thomas Hauser is a member of Ballard Spahr's Real Estate Department. Mr. Hauser represents lenders, investors, borrowers, and other sources of capital in the purchase, sale, financing, and restructuring of real estate and real estate-related assets. A significant portion of Mr. Hauser's practice is devoted to traditional real estate work, including advising clients on the acquisition, disposition, and development of assets.