

UPDATED TIPS WHEN BUYING AN APARTMENT BUILDING

By Dale Alberstone, Esq.

Every few years, I suggest “tips” of a legal nature to purchasers of apartment buildings. This month’s column will update the suggestions I discussed some years ago in this column of AOA Magazine. These pointers may be used for all types of real property acquisitions, but will be of particular interest to those purchasing multi-unit dwelling structures.

NON-RECOURSE FINANCING

The most important tip that I can impart is to use your best efforts to negotiate a “non-recourse” loan with the bank. A non-recourse loan is a loan for which the borrower has no personal liability. In the event that the borrower defaults, the bank is only permitted to foreclose on the property under the deed of trust. It cannot thereafter sue the buyer for a deficiency judgment or hold the borrower personally liable.

The benefit of non-recourse financing is immediately obvious. If, for example, the building is destroyed by ground movement and the borrower does not have earthquake insurance (as most do not), the borrower, in absence of non-recourse loan, will be individually liable for the repayment of the entire outstanding indebtedness. Unless the loan documents specifically say that the loan is non-recourse, the loan will be deemed to be “recourse” and the bank may sue the borrower in a judicial foreclosure for the amount owed on the loan, minus what the devastated property sells for at public auction.

A non-recourse provision in the loan documents would prevent such a deficiency judgment from being awarded.

Two types of financing are automatically non-recourse. Those include all loan transactions in which the seller of the apartment building carries back a promissory note and deed of trust against the property as security. If the buyer defaults, the seller may foreclose on the property, but a personal judgment may not be entered against the buyer.

The other type of automatic non-recourse financing is a loan secured by a deed of trust on a dwelling for not more than four families given to a lender to secure repayment of a loan which was in fact used to pay all or part of the purchase price of a dwelling. For this automatic non-recourse financing to be applicable, the dwelling must be occupied, entirely or in part, by the purchaser.

Bear in mind that any refinancing of a non-recourse loan will convert the new indebtedness to recourse financing, thereby exposing the owner to personal liability unless the new financing is also stated to be non-recourse.

ATTORNEY’S FEE PROVISION

Most preprinted form purchase contracts include a provision which refers to the award of attorney’s fees to the prevailing party in the event that litigation or arbitration is commenced. Under the so-called “American Rule,” neither party is entitled to reimbursement of his/her attorney’s fees unless the contract specifically contains a provision awarding such fees to the prevailing party.

Contractual provisions awarding attorney’s fees to the prevailing party usually fall within two categories. The first is narrowly written and contains words similar to the following: ***“In the event that litigation or arbitration is commenced between the buyer and seller for breach of***

this contract, the prevailing party shall recover reasonable attorney's fees from the other party."

That type of provision only awards damages if a party sues for breach of contract.

The second type of provision is broader, and is worded like the following: ***"In the event that litigation or arbitration is commenced between buyer and seller which is related to or arises in connection with this contract, the prevailing party shall recover reasonable attorney's fees from the other party."***

This broader language not only allows the prevailing party to recover attorney's fees for a breach of the contract, but also awards fees incurred in the prosecution or defense of non-contractual theories, such as fraud and emotional distress.

The most recent case discussing that concept is Cruz v. Ayromloo decided by the California Court of Appeal on October 3, 2007. There, certain tenants sued their landlord for wrongful eviction and infliction of emotional distress following the landlord's refusal to allow them to return to their newly renovated apartments after the City of Los Angeles evacuated the tenants because the building was unsafe. Because the tenants' lease contained a broad provision awarding attorney's fees to the prevailing party in a civil action arising "in connection with" the lease, the Court of Appeal upheld the Los Angeles Superior Court's award of nearly \$124,000 in fees to the tenants.

From a buyer's perspective, the broader attorney's fees clause would probably be the wiser choice as it may allow the buyer to recover damages against the seller in tort, rather than just in contract, should litigation ensue. For example, if the seller concealed adverse information about the property which was not apparent to the buyer (i.e. fraud), a broad attorney's fees clause would expose the seller to liability for the buyer's attorney's fees if the buyer filed suit and prevailed. On the other hand, it would be a relatively rare case that the seller would sue the buyer for anything other than a strict breach of contract.

Thus, a buyer might want an expansive attorney's fees clause inserted, whereas the seller would negotiate for the more narrow provision.

DOCUMENTARY TRANSFER TAX

This topic is better suited for the purchase of a single family residence or a condominium, but is also applicable to an apartment house. Some buyers who want to (apparently) increase the value of their property immediately upon the close of escrow, pay extra documentary transfer tax at the close of escrow. Generally, the transfer tax is \$1.10 for every one thousand dollars of the purchase price. In the City of Los Angeles, however, the tax is \$5.60 for every one thousand dollars.

For an extra \$110 of tax (or \$560 in Los Angeles), it will appear to everyone who obtains a copy of the grant deed from the county recorder (such as appraisers) that the purchase price of the property was \$100,000 more than the amount actually paid.

When another owner sells a different piece of property in the same neighborhood, the new lender will need an appraisal to be prepared. If the appraiser looks at the recorded deed to determine the price the first buyer paid for his property, the appraiser may conclude that the buyer bought the property for \$100,000 more than the actual sales price. Because appraisers use "comparable" properties when making their appraisals, they may value the neighbor's property higher, which, in turn, will have the snowball effect of increasing all property values in the general area, including the first buyer's property.

Employing this procedure means that the seller pays the normal cost for the documentary transfer tax based on the actual sales price, and the buyer pays any additional tax to give the appearance of a higher sales price.

For a full discussion of the documentary transfer tax and how it works, please see my column in the October 2007 issue of this magazine at www.aoausa.com.

PRORATION OF RENTS

Buyers should provide in their purchase contract (and the escrow instructions) that escrow will prorate the “scheduled” rents, rather than the rents actually collected by the seller. By prorating scheduled rents, the buyer will be given credit through escrow of the rent which should have been paid by each tenant, rather than just receiving a credit for the rents which were actually paid.

Conversely, sellers prefer that only the actual collected rents be prorated, and should so specify in the contract.

TITLE DOCUMENTS

Almost all purchase contracts give the buyer the right to approve the Preliminary Report (formally known as the “Preliminary Title Report”) within a certain number of days after receiving the report. To extend the number of days that the buyer has to approve the report, the approval period should coincide with a specified number of days after the buyer receives copies of all of the recorded documents set forth in the Preliminary Report, not a specified number of days after the buyer receives the report.

Generally, the underlying recorded documents will not be received by the buyer for several days, if not a week or more, after the Preliminary Report is issued.

LENDER APPLICATIONS

Consider applying to at least two lenders for new financing. If a buyer applies only to one lender, then he or she will have no leverage to negotiate the points, interest or other terms of the loan. Once a buyer obtains a loan commitment from two different lenders, the buyer may have the ability to negotiate more favorable provisions for the loan as the two lenders (and loan brokers) are in competition with one another.

Even though the buyer will have to pay the cost of two appraisal reports, the benefit of having two lenders available to fund the loan will often far outweigh the additional expense for the second loan application.

Also, consider applying “on-line” for a loan. “On-line” lenders may offer very favorable rates and terms.

LIQUIDATED DAMAGES

If a buyer impermissibly backs out of a contract, the general rule is that the seller is entitled to recover the difference between the purchase price under the contract minus the market value of the property upon resale. (Civil Code Sections 3307 and 3353.) If the buyer believes that the purchase price under the contract is substantially less than the market value of the property (i.e. the buyer got a good deal), he will not want to include a liquidated damages clause in the contract. That is because if no such clause is included, the seller will have no damages. If a liquidated damages clause is included, then even though the market value

is higher than the contract price, the buyer will forfeit the amount agreed upon as liquidated damages. The seller could then pocket the money and resell the property at the higher market value.

On the other hand, if the buyer believes that the contract price may be higher than the market value (such as in the case of properties which are extremely difficult to sell), then the buyer should insist that a liquidated damages clause be included so that the buyer's exposure is limited to the amount set forth in the liquidated damages provision. Sellers want just the reverse.

JUDICIAL FORECLOSURES

Let me conclude this month's column with a tip to property owners who find themselves in default of their loans secured by apartment buildings. Such an owner should almost never give a lender a current financial statement or recent tax returns even though the lender requests them under the pretext that they are necessary for a "work-out" or a "short pay." Be aware: Lenders request such current financial data for their own selfish motives. They do not request the data to help out the buyer. The real reason that the lender wants current financial information is so that if and when a deficiency judgment is rendered, the lender will be in a position to immediately levy upon other property owned by the borrower.

Different considerations might apply to owners who find themselves in default of loans secured by their own personal residences. In those cases, a lender may be willing to work with the owner if the owner provides the requested financial data.

Unlike personal residences, apartment buildings are treated as businesses. Lenders realize that a property owner might be willing to walk away from a business which loses money (i.e. the apartment building) while having ample assets in the bank to continue to make the monthly payments. Most borrowers, on the other hand, do not go into default on a loan secured by their personal residence unless they are having serious financial difficulties with very little money in their savings account.

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Mr. Alberstone has been awarded an AV rating from Martindale-Hubbell. An AV rating, registered through Reed Elsevier, reflects an attorney who has reached the heights of professional excellence and is recognized for the highest levels of skill and integrity.

The foregoing discussion is intended as a general overview of the law and may not apply to the reader's particular case. Readers are cautioned to consult an advisor of their own selection with respect to any particular situation.

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