These are markets that demonstrate a capacity to support growth, where the lease contracts have an upside potential, and where existing financing can be acquired.

Being income-oriented, a REIT must look not only at long-term appreciation potential but at positive cash flow as well. By establishing a minimum cash flow return, a REIT can assure its investors of the value of the investment simply because the greater the cash flow, the tighter the purchase price must be.

Once the property is purchased, a REIT functions again like a limited partnership. It manages the property and makes the improvements necessary to meet both occupancy and tenant retention requirements.

Tax-Advantaged Benefits

A REIT also offers the benefits of a tax-advantaged investment, sheltering substantially all of the income it produces. In terms of tax equivalents, an investor in the 40 percent tax bracket earning a 10 percent sheltered income from the REIT winds up with a 16 percent taxable equivalent yield.

In addition to sheltering the trust's income, a REIT may also sell off a few of its properties during the holding period to provide some capital gains early on. And there are more capital gains at the end when the entire trust is liquidated.

Not all investors are suited for REITs. They are most attractive to investors who need a consistent income stream sheltered from taxes while at the same time seeking capital appreciation.

Look, for example, at the results of $10,000 invested into a REIT in today's market.

We'll assume our investor stays with the trust through its five-year lifetime. And we'll further assume the property held by the trust appreciated 15 percent per year and that the annual cash flow from that trust averaged 10 percent during the period.

The investor would realize a return of $5,000 in fully sheltered income that would be actually worth $9,000 to someone in the 40 percent bracket.

At time of liquidation, the investor would get the original $10,000 back plus another $6,000 (pretax capital gain).

This, of course, is a hypothetical example based on some market assumptions that may or may not be valid.

There are a number of options open to an investor wishing to add real estate to his or her portfolio. By choosing a REIT, the investor will get the combined benefits of a sheltered real estate investment and the flexibility of a stock. WG&L

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Enforcing the Mortgage: Strategies for Preserving the Investment

by Bruce J. Bergman

With mortgage interest rates apparently creeping upwards, the pressure upon sellers of real property to take back purchase money mortgages is increasing. At the same time, of course, the regular institutional lenders are in the mortgage market. Ultimately, some percentage of these loans go into default, and the lender, whether a novice or veteran, must assess the action to be taken to preserve the investment.

While mortgage foreclosures tend to be a technical and obscure area of the law best left to specialists in the legal profession, the astute lender who knowledgeably participates in the case can measurably aid his own case.

The Importance of an Initial Policy

It is well understood that lenders do not enjoy foreclosing mortgages. More-

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over, for a variety of reasons, they wish to appear, and in actuality be, compassionate. That does not mean, however, that delinquencies may be treated casually. In fact, that is one of the worst ways to preserve cash flow and investment.

Rather, there must be a meticulous approach to dealing with payment arrears because all the time lost before a foreclosure file is turned over to counsel is time lost forever. Most likely there won't be a remedy for the time lost—even with the most vigorous attorneys.

The only effective way to deal with defaults, whether a handful or a huge portfolio, is to have a system that keeps track of dates and triggers appropriate action. Without such a system, control is liable to be lost.

Every mortgage payment has a due date, followed by a grace period of the number of days the particular mortgage form states. Many people have a variety of problems and some percentage of payments will always be outstanding. A default can be ignored for a certain number of days before or even after the grace period. But there must come a set time when a prearranged system triggers collection procedures—be they phone calls or letters—or preferably both.

Obviously, there are some special situations that will require deviation from the system's mandates. But these must be kept to a minimum lest *every* situation become a "special" case. When that happens, the portfolio becomes unmanageable and the ability to protect the investment is seriously hampered. The key is consistency.

There must be a time when collection efforts are recognized as a failure, triggering the next step—acceleration of the principal balance.

The Critical Concept of Acceleration

The keys to pursuing a foreclosure is having leverage and dealing from a position of strength. This is obtained by acceleration—declaring the *entire* mortgage balance immediately due and payable.

Authority for this is found in the typical "acceleration clause" in the mortgage, providing in essence that upon the happening of certain events, one of which is failure to make a payment when due, the mortgagee has the option to declare the *entire* loan balance due.

The precise wording of these clauses may vary from state to state, but the thrust is basically uniform. Although reliance is placed primarily upon the most common default of failure to pay principal and interest, acceleration is available for defaults of other types, but these may be treated differently by the courts.

For example, failure to pay taxes (obviously where the lender is not taking an escrow) is generally viewed by case law as less severe than neglect to submit a monthly payment. Consequently, although suppositions about the power of acceleration are accurate, they may not be applicable to every breach of the mortgage contract.

Assuming the existence of an acceleration clause in the mortgage and an act violating the clause, acceleration is accomplished by an *unequivocal* election by the lender to declare the total principal due. This can be expressed either in a letter to the mortgagor or by the act of actually starting the foreclosure.

The recommended practice is to accelerate with a letter so that time is not lost in transmitting the file to counsel and waiting for him to formulate and serve pleadings.

The letter must be sent in accordance with the specific terms of the mortgage. While regular mail is usually the mode of communication, some mortgages may specify certified or registered mail, in which event there must be compliance. However, even if regular mail is all that is technically required, the better practice is to send the communication *both* by certified mail return receipt requested *and* by regular mail. A return receipt will defeat any argument by the mortgagor that he never received the letter. Adding regular mail covers the situation of the sharp defaulter who declines to accept a certified letter.

As to the text of the letter, the key is an *unequivocal* demand to pay the entire principal balance, *not* a mere request for the arrears to be satisfied. Once the letter is sent, the lender has attained a position of strength.

Why Acceleration Is Vital

Acceleration is so critical because once the lender makes its election, it need not accept arrears but, if it chooses to do so, it will be upon *its* terms.

This concept may be viewed in two ways. First, assume the situation of the

chronic defaulter. Time after time he is in collection and you or your staff are constantly calling and writing to keep the account current, using time and money for these efforts. Without acceleration, the problem made by this mortgagor will continue since he is always free to tender his arrears with the lender facing the same default next month. However, once the balance has been accelerated, the lender need *not* accept arrears and may insist upon full satisfaction of the mortgage.

Second, suppose this particular loan is at an interest rate well below the current market. No matter how tardy the mortgagor has been, or is, until the entire balance is validly accelerated, arrears *must* be accepted. But *after* acceleration, the lender is free to foreclose or, in the alternative, validly insist that the mortgagor enter into a mortgage modification or extension agreement at a *higher* rate of interest.

Another benefit of acceleration is that the lender can demand that any legal fees it has incurred be paid as a condition of reinstating the loan. The mortgagor may deem this unfair—even outrageous—but the lender is simply not obligated to reinstate after acceleration. Clearly, this factor becomes increasingly important as the amount of legal fees charged the lender increase.

The Tender Trap

Having validly accelerated the mortgage, the lender's efforts can be thwarted if it subsequently accepts any payments. Hence, your staff must be alerted to reject any payments after acceleration and your files should be so flagged.

Even after acceleration, on a case-by-case basis the lender *might* be willing to accept payments of all arrears. What must be understood, though, is that there must be an actual tender. A promise or suggestion that payment will be forthcoming is not in the eyes of the law the equivalent of *delivering* payment.

What is perhaps more vexatious is the partial tender after acceleration. For example, suppose a residential mortgage is in arrears for three months at $1,000 per month. There is now $3,000 due together with late charges of 2 percent per month (as permitted in New York), totaling arrears of $3,060. The mortgagor strolls into the lender's office with a payment of $3,000. Should it be accepted? Of course, it is a policy decision, but you need not accept. If you do, the acceleration is waived. But if this is a mortgage you wish to be rid of, or if you desire to increase the interest rate, reject the tender with a letter saying forth that since the entire indebtedness has been declared due, the lender need not and shall not accept anything less than total payment.

Maintaining the Pressure

Most of us have either experienced or heard about the foreclosure action which dragged on for months or years while settlement was contemplated. Although this could be the result of a defaulting mortgagor having the wherewithal to take advantage of legal process by rearguing and appealing every phase of the action, it is more often a consequence of laxity or bad strategy on the lender's part.

The error made by some lenders in approaching settlements is holding the action in abeyance pending the contemplated resolution. Rather, the foreclosure should proceed as if no settlement is expected, until the very moment that a conclusion *actually* occurs. Only in that way can the defaulter be constrained to capitulate.

While most foreclosures *are* settled, experience dictates that defaulting mortgagors either cannot or will not honor their obligations until their position is about to become irretrievable. It may be that they are trying to buy time to sell the property. Perhaps they hesitate to obtain a loan from family or friends or are loath to encumber some other valuable property. But whatever the reason, they usually won't move until they absolutely have to. Hence, continuous pressure is essential to a favorable and expeditious conclusion.

To appreciate the point, it should be noted that foreclosure actions in most

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states typically proceed in steps, each one of which is a prerequisite to the next. If an acceptable settlement is offered—be it full payment, tender or arrears over time, recasting the mortgage, etc.—the temptation is for the lender to halt the action while awaiting resolution. After all, "the mortgagor promised to pay."

But what if the promised conclusion doesn't arrive in the promised 10 or 30 days? (Again, experience tells us it usually will not.) The obvious answer is that the lender is sitting in the place wondering when or whether payment will be made. Meanwhile, lost interest mounts, and the case is no closer to conclusion.

To avoid that, each step should be vigorously pursued, which can be done *without* causing the lender to incur additional legal fees.

Example. The summons and complaint have been served, no answer has been filed, and foreclosure counsel is entitled to say $750 plus disbursements. A settlement is discussed and the defendant says he will pay within 20 days. Should the lender wait the 20 days or direct counsel to proceed with the next step—appointment of a referee? The latter is recommended.

While it is correct that the attorney will now have to be paid perhaps $1,000 rather than $750, this fee is to be borne by the mortgagor as part of any settlement. He should be advised unequivocally that the action goes forward until the day that money is *in hand* and until that time, whatever legal expenses emerge are *his* responsibility. Approaching the case with this stance insures faster settlements upon terms most favorable to the lender.

Receivership Device

One of the very best methods both to maintain leverage and to preserve the property during the course of a foreclosure action is the appointment of a receiver—something which should always at least be considered. While it sounds like a grandiose concept, it is not.

If the lender believes the property may decline in value during the action, or that the defaulting mortgagor may destroy or allow the premises to run down, a receivership is definitely in order. Although most often obtained for income-producing commercial properties and apartment houses, receiverships are available for one- and two-family homes, particularly if the action is expected to be protracted.

The mechanics of appointing the receiver are not at all difficult in many jurisdictions. In New York, for example, a receiver can be appointed without notice of the other party. Indeed, once the foreclosure search is received by lender's counsel, it is possible to have a receiver appointed in one day. When the mortgagor realizes that during the course of the foreclosure litigation the net income of the property will inure to the benefit of the lender, and will not line *his* pockets, his interest in delaying or contesting the action is greatly diminished. Many favorable settlements have been reached

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view of this, arguing that only land was purchased and as everyone knew, land was not depreciable.

The Tax Court agreed with Sexton and decided that space in a pit is "a property right separate and apart from the land." It also found that the dumping gradually reduced the value of the property to Sexton. When Sexton proved the cost of space, the amount consumed annually and the remaining property value after it was filled in, the court allowed depreciation deductions.

In a more recent case, besides operating a landfill business, the owner hoped that the land would be rezoned for townhouses. The IRS contended that since there was another motive, depreciation should not be allowed. The Tax Court allowed the depreciation, finding nothing wrong with the owner wanting to develop the property after it was useless as a dump site. (*Sanders v. Comm'r*, 75 T.C. 157 (1980).)

WG&L Note: Buying land for future development? Why not consider whether you can have dumping operations first which will make part of the purchase price deductible. WG&L