

COPY

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MEMORANDUM

TO: Honorable Mayor Jack Geraghty
Members of the Spokane City Council

FROM: James C. Sloane, City Attorney
Stanley M. Schwartz, Assistant City Attorney

RE: HUD Section 108 Loan Documents

DATE: November 20, 1997

I. Introduction. This memorandum is intended to summarize the loan transaction, areas of risk and legal remedies available to the City in the event of a default. This memorandum contains material which is deemed to be proprietary and confidential to the developer as well as our thoughts and impressions communicated to you through our attorney client privilege. This privilege, recognized in state law, allows us to keep this communication private and exempt from public disclosure.

II. Summary of the Transaction. The HUD Section 108 Loan from the City to the developer, Citizens Realty Company and Lincoln Investment Company of Spokane is for the principal amount of \$22,650,000. The principal sources of repayment are the Nordstrom Lease (containing fixed and percentage rents), a partial assignment of the rent from the PDA Ground Lease for the parking garage and connection fees evidenced by promissory notes from surrounding business and property owners. As recourse for non-payment the City will receive a lien on the Nordstrom building and an assignment of the Nordstrom Lease. The Nordstrom Lease provides that Nordstrom, assuming all operating covenants are fulfilled, will operate a Nordstrom store for 20 years with the option for 16 successive five year options. The following documents will be used to establish the loan relationship between the City and the developer.

1. Promissory Note - Principal amount of \$22,650,000.
2. Loan Agreement
3. Deed of Trust
4. Assignment of Lease and Cash Collateral
5. Assignment of Rents
6. Promissory Note and Connection Agreements
7. Intercreditor Agreement

A summary of the above documents follows.

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1. Promissory Note. This document evidences the debt between the borrower (Citizens Realty Company and Lincoln Investment Company of Spokane) in the principal amount of \$22,650,000. From the date the Note is executed to the year 2002, Borrower is only required to pay interest at the approximate rate of 4 ½ %. Thereafter, the Note bears interest at the approximate rate of 7% for a 15 year term. If the borrower defaults in the performance of any of the covenants or agreements contained in the Loan Agreement or Deed of Trust the City may declare a default and accelerate all sums due. The recourse for non-payment of the Note are the funds available from the Assignment of Lease, Partial Assignment of Rents, Property Owner payments and Deed of Trust.

2. Loan Agreement. The purpose of the Loan Agreement is to set forth the understanding of the parties, the use of the 108 Loan and developer's obligations concerning the Loan. The Agreement begins by stating that the City is induced to make the 108 Loan as a result of the developers representations concerning the project and its tenants. The loan is secured by a Deed of Trust with first priority on the Nordstrom building. Further, there is the assignment of the above identified revenue stream. Deducted from the principal amount of the loan are the City costs which include issuance charges, the cost of both the Coopers & Lybrand study and the Barnes, Hickman and Bozman study, outside counsel fees and any additional appraisal fees.

In the Agreement borrower has represented that all of its financial statements and proformas are true and correct and have been prepared in accordance with generally accepted accounting principles. Borrower will exercise best efforts to keep and maintain the Nordstrom Lease in full force and effect.

Prior to receiving any money the borrower must prove to the City that it has satisfactory funds to develop the project, has received City approval of the cost breakdown for the project and all plans have been approved by all regulatory authorities. Before the borrower may draw upon subsequent advances borrower may not be in default of any provision in the Note or loan documents.

The Loan Agreement also contains covenants which require the borrower to promptly pay principal and interest, maintain and preserve the property, obtain and maintain insurance, make no changes to the project and comply with all laws.

An Event of Default, is a failure to pay within 10 days of written notice any principal, interest or penalty, a breach of any covenant or condition in the loan document including representations, a material deviation in development of the

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project or file a petition of bankruptcy. Where there is an Event of Default the City may terminate further advances of loan funds, immediately declare the Note due and payable, seek judicial appointment of a receiver or foreclose under the Deed of Trust.

Finally, the developer agrees to pay wages according to federal law, monitor the job site for various federal requirements and create 676 jobs.

3. Deed of Trust. The Deed of Trust is for the purpose of placing a lien upon the Nordstrom building, but not the underlying realty. The City will have the privilege of occupying the building in the event of a default through an assignment of the Nordstrom Lease. The Deed of Trust sets forth the obligation secured and requires the borrower to keep the building in good condition and repair, and insure the same against any loss. The borrower again represents it will pay all sums due, that it has good and marketable title to the property, that it will pay all taxes and encumbrances, will not allow any liens to have priority to the City lien and will maintain the property and do nothing to impair the collateral. Further, the developer is again required to comply with all terms of the Nordstrom Lease in order to prevent a default. The City receives the right to collect all rents off of the property and in the event of a default may sell the property for the purpose of obtaining money owed under the Note.

4. Assignment of Lease and Cash Collateral. This assignment delivers to the City all rents paid under the Nordstrom Lease. Further, this assignment allows the City to enter and use the property where there is a default.

5. Partial Assignment of Rents. This document is somewhat similar to the previous document except that it is a partial assignment of the PDA rent to the City.

6. Promissory Notes and Connection Agreement. These documents are intended to be executed by adjoining business and properties for the purpose of paying money to the City as a result of the HUD 108 Loan and development of the project. Developer's analogy is similar to a Connection Fee Agreement. The Promissory Note is unsecured and is only as strong as the individual or entity promise to pay. A promissory note recites a debt, thus where there is a failure to pay the City could sue and obtain a judgment on the note. However, the note is not backed up by any collateral.

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III. Issue Identification/Areas of Risk. The independent credit analysis performed by Barnes, Hickman and Bozman contains two key assumptions for the success of the project. First, the project is fully or substantially leased so as to conform to the tenant operating covenant in the Nordstrom Lease and second, the Nordstrom building is equal in value to the principal amount of the Loan. If either one of these assumptions fails the City could find itself in a situation where there are inadequate funds to repay the debt. This would result in CDBG funds being paid to HUD.

Nordstrom Lease. The Lease requires the developer to keep approximately 70% of the project leased. If the developer fails to perform this obligation the Nordstrom Minimum Rent is reduced from 1.3 Million Dollars to \$520,000. There is still the obligation to pay percentage rent. With this reduction the City will exhaust its Debt Service Reserve Account and may find in a given year there is inadequate revenue to service the debt. Further, as you may recall, given this possibility we attempted to negotiate with the developer a provision that would not allow the developer to deduct the taxes, a parking fee and management fee if the minimum rent was reduced because of project occupancy. We were unsuccessful in this endeavor thus this risk squarely falls to the City. We are unaware of any study or opinion that quantifies this risk of project failure. There has not been a feasibility study conducted which would attempt to measure the risk associated with project vacancy. The developer, however, does expect for there to be some project turnover, but believes it can maintain this project occupancy. It is important to note that project occupancy is very important to the private lenders as this appears to be one of their principal sources for repayment. With a reduction in the minimum rent and the reserve account exhausted CDBG funds will have to be used to repay the Loan. As identified in the CLEAN case, federal funds are the sole source for repayment of the Loan.

With regard to the developer's deduction of taxes, this amount has not been limited. The parking and management fees have been limited according to the proformas which are attached to the Barnes, Hickman and Bozman report. If the developer's property substantially increases in value (as hopefully expected) then the developer's tax estimate will not be accurate and the revenue stream will be called upon in a manner that is not contemplated in the submitted proformas. The obvious result is that this will strain the ability to repay the Note (or Loan).

A second issue relates to the value of the Nordstrom building. The City will proceed to commission an appraisal of this property in order to determine its fair market value. Should the appraisal come back below the principal amount of the loan then we will have to re-evaluate our collateral position.

Additional PDA Rent. The developer has recognized that the City may find itself having to use funds outside of the pledged revenue stream in order to service the debt. To this end, the developer has pledged an additional five years of rent from the PDA. While this money will not solve the default it will allow the City to recover any Loan payments it makes. This can be done in the future through the receipt of rental payments or by selling the present value of this revenue stream to an investor when appropriate.

Connection fees. The developer has shifted the obligation to collect connection fees to the City. This annual half million dollar obligation is not a direct obligation of the developer. Therefore, if a connecting property owner fails to pay, it will be up to the City to sue and attempt to enforce payment. The developer has, although there is not yet a written agreement, stated it will guarantee payment of up to \$400,000. This is a guarantee which will flow from the developer.

The developer has also retained the unqualified right to sell the project. This is a matter which does not have definite legal consequences but may have certain political or practical implications.

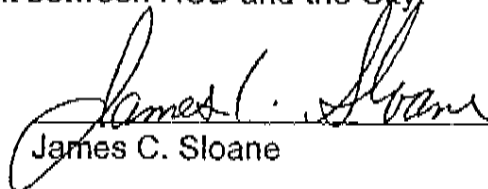
Finally, it is important to note that the project co-tenants all appear to have kickout clauses based upon gross sales in various amounts. This means that if, generally by year four or five certain sales thresholds are not achieved tenants may terminate their leases. It is difficult, and we make no attempt to forecast, the likelihood of these tenant terminations.

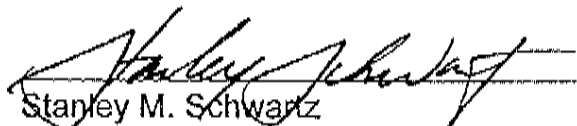
IV. Remedies. Where there is an Event of Default on the HUD Promissory Note the City can foreclose on the Deed of Trust. This would, technically, allow the City to obtain ownership of the Nordstrom building and recover the outstanding Loan balance. The City has been assigned the Nordstrom Lease which while an asset is also an encumbrance on the lien property. Essentially, this means that if the City tries to sell the building after a foreclosure the potential purchaser will take subject to the Nordstrom Lease. If we are in a situation where minimum rent in the amount of \$520,000 plus some amount of percentage rent is being paid this will devalue the value of the building from its cost basis. We can sell the asset based upon its present value. As a practical matter, the City may find itself simply waiting and restructuring the Note so as to receive payment in the future in lieu of a foreclosure proceeding. This means that the City, for example, in years 21 through 26 would take additional Nordstrom rent in order to repay any CDBG expenditures. It is, however, impossible to anticipate exactly what would occur in any given year where the City is faced with an Event of Default. The City remedies will depend upon the amount of the Loan outstanding, amount in arrears, the performance of Nordstrom and the overall project.

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V. Conclusion. We believe that this loan could be structured in such a fashion to provide the City with greater security, through for example, a letter of credit or certain restructuring in the Loan Documents. However, this has been resisted and represented as impossible by the developer. Thus we are presented with a loan that has a revenue stream which given the current performance of the Spokane market should be adequate to service the debt coupled with a pledge of collateral that should make the City whole in the event of a default. We must rely upon the developer to faithfully discharge its duties under the Nordstrom Lease and keep the project fully occupied. Certainly, the developer is motivated in this regard because it offers the developer the greatest return on its investment.

The next step in the loan approval is to submit the Independent Credit Analysis and the Loan Documents to HUD for their review and approval. HUD will probably want an assignment of the Loan Documents and perhaps may seek changes which will lead to a renegotiation of certain terms and conditions. To conclude this transaction the City Council will have to approve the above identified Loan Documents plus various Loan Documents which will establish the agreement between HUD and the City.


James C. Sloane


Stanley M. Schwartz

- c. Bill Pupo, City Manager
Pete Fortin, Deputy City Manager
Mike Adolfae, Director of Community Development