

## IN THIS ISSUE

- > Wind-Energy Projects
- > Section 1031 Tax Deferred Exchanges
- > Strategies to Lower Your Property Taxes

FredNEWS: Real Estate is produced by Fredrikson & Byron attorneys who provide legal advice and assistance on business issues in real estate. Articles discuss new developments in real estate, disputes, and environmental issues and are aimed at both small and large organizations, lenders, real estate developers, property managers, individual owners, and investors.

For more information and contacts within the Real Estate Group, see page 6. An electronic version of this newsletter is available on our web site at [www.fredlaw.com](http://www.fredlaw.com). FredNEWS: Real Estate is edited by Mary Ranum.

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## Subordination, Non-Disturbance and Attornment Agreements for Wind-Energy Projects

### *Recommendations for Wind-Energy Developers and Agricultural Lenders*



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A key step in establishing site control for a wind-energy project is obtaining third-party consents to the wind-energy easement (or lease) agreements. If a mortgage encumbers any of the project property, a "Subordination, Non-Disturbance and Attornment Agreement" (SNDA) must be obtained from the lender to ensure that the easement will not be terminated. This article discusses the reasons SNDAs must be obtained for wind-energy projects, their key provisions, and recommendations for wind-energy developers and agricultural lenders for the efficient review and execution of SNDAs.

### WHY IS AN SNDA NECESSARY FOR A WIND-ENERGY PROJECT?

In the event a landowner defaults on a mortgage that is recorded against a property before a wind-energy easement, a lender would be entitled to foreclose on its property interest and terminate the easement. Because hundreds of millions of dollars are invested in wind-energy projects, loss of site control on a parcel within a project footprint could result in catastrophic losses for the project (resulting from interruptions in transmission lines, or in the free flow of wind, or from the removal or relocation of wind facilities). An SNDA within a project must be obtained from lenders to eliminate this risk. It provides that the lender will not disturb the easement rights in the case of foreclosure. An SNDA may be necessary also because many mortgage documents prohibit a landowner from creating additional encumbrances against the property without lender consent.

### WHAT ARE KEY PROVISIONS OF AN SNDA?

- The **Subordination** section may benefit either developer or lender and determines whether the mortgage or the wind-energy easement has priority. This is not a critical provision from the project's perspective, so long as the SNDA includes non-disturbance language (below). Many lenders are hesitant to sign a document that subordinates their mortgage to an easement, or to sign a document with the word "subordination" in it, even if the provision

CONTINUED ON PAGE 2 >

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favors them. Thus it is often acceptable to use a “Non-Disturbance and Attornment Agreement” (NDA) form to eliminate this issue. However, the owner of the wind project may sometimes require that the mortgage be subordinate to the easement (a utility may have language in its indenture prohibiting real estate ownership in a second position).

- The **Non-Disturbance** section benefits the wind project and is the key reason for obtaining an SNDA. It provides that, upon foreclosure, the lender or the foreclosure purchaser will not terminate the wind-energy easement and will be bound by the terms of the easement.
- The **Attornment** section benefits the lender by providing that, upon foreclosure, the developer will recognize the lender or the foreclosure purchaser as the owner of the property.

### WHAT OTHER PROVISIONS MAY BE INCLUDED IN AN SNDA?

In addition to the above, the following may also be included; each are addressed from each the lender and developer perspectives:

#### • Limitations on amendments to wind-energy easement

- *Lender:* Lender may request that no easement amendments/modifications be effective/binding upon the lender without lender consent, or at least until written notice of those amendments/modifications has been given.
- *Developer:* To maintain flexibility, developer may request that amendments/modifications to the easement be effective/binding upon lender without notice or consent.

#### • Extended cure

- *Lender:* Lender may require that the

developer notify lender of any default of landowner under the easement, and that lender shall subsequently be permitted a period to cure landowner’s default. Cure period would be shorter for a monetary default and longer for a default requiring lender to obtain possession of the property in order to cure.

- *Developer:* Developer will attempt to exclude an extended cure period that benefits lender.
- **Pledge of wind-energy easement proceeds**
- *Lender:* Lender may require that the amounts payable to the landowner under the easement be pledged to lender in the SNDA and that, upon receipt of notice that lender is exercising its rights upon land owner default, developer must make payments directly to lender otherwise due to landowner.
- *Developer:* If lender includes the above provision, developer should include a provision stating that landowner waives all claims against developer for failure to pay any process due to landowner under the easement.
- **Post-termination relationship**
- *Lender:* Lender may seek to include a provision on the post-termination relationship of lender and developer (if a lender becomes owner of property through foreclosure, etc.). This could include provision that lender will not be obligated to fulfill landowner’s affirmative easement obligations.
- *Developer:* Developer will attempt to exclude language establishing a special post-termination relationship with lender, with preference for easement terms to control.

### WHY SHOULD A LENDER AGREE TO SIGN AN SNDA?

Allowing landowner to enter into a wind-energy-easement agreement provides landowner a new source of income, thus decreasing likelihood of default under the mortgage, and—in the event of foreclosure—lender or buyer would be recipient of the income stream. And, so long as its terms are reasonable, the easement may increase property value. In addition, if lender refuses to consider signing an SNDA, landowner may seek financing for the property from a bank lender that would allow participation in the project.

### RECOMMENDATIONS FOR AGRICULTURAL LENDERS

Because the wind-energy industry is new in many areas, some lenders do not have a process to efficiently review and sign a wind-energy easement SNDA. In addition, some federal lenders (such as USDA) have not yet established criteria for review/execution of these documents. The following recommendations could be implemented by a lender to efficiently work through the review/execution of SNDAs:

- **Educate the authorized reviewer(s).**  
A lender should establish a person/department authorized to review/approve project SNDAs. They should be familiar with key provisions of easement SNDAs and generally familiar with key provisions of wind-energy-easement agreements (e.g., see *Site Considerations and Control* presentation, at [http://www.fredlaw.com/events/archive/Morning-Katie\\_Sue.pdf](http://www.fredlaw.com/events/archive/Morning-Katie_Sue.pdf)).
- **Understand the overall project.** Upon receipt of approval request for a wind-energy SNDA, the lender and developer should discuss the overall project. The following back-up documentation list could be requested by lender:
  - Map of project footprint
  - List of landowners/mortgages within the project footprint
  - Wind-energy easement form
  - SNDA form
- **Review the SNDA form and the easement form.** Lender should review the SNDA form, request necessary changes, and review the underlying

CONTINUED ON PAGE 4 >

# Section 1031 Tax Deferred Exchanges: Safeguarding Exchange Proceeds



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In a tax-deferred exchange under § 1031 of the Internal Revenue Code, the seller/exchangor of the relinquished property may not take receipt or constructive receipt of the sale proceeds. Typically, pursuant to one of the safe harbors provided

in the regulations, a qualified intermediary (QI) is engaged to hold the proceeds and facilitate the disposition of the relinquished property and acquisition of the replacement property. It is not uncommon for the proceeds to be many millions of dollars. Yet too often exchangors have turned over these considerable proceeds to the exchange services company serving as the QI without careful consideration of the risks involved.

One of the obvious risks is misappropriation or fraud. Two high-profile QI failures illustrate this risk. In January 2007 Southwest Exchange, Inc., a large regional exchange services company, failed with nearly \$100 million of exchange funds unaccounted for. Later that same year, the 1031 Tax Group filed for bankruptcy with over \$130 million in exchange funds missing. Both cases involved formerly reputable exchange companies (1031 Tax Group was a rollup of a number of reputable regional QIs) that were acquired by new ownership that allegedly raided the exchange proceeds to fund extravagant personal lifestyles and dubious business ventures.

Bad investment is another risk. Exchange companies have profited, sometimes significantly, from the spread between the stipulated investment return on exchange funds that the QI agrees to pay to the exchangor and the investment return the QI receives from its investment of pooled exchange funds. Those investments, however, are not without risk, as illustrated by the November 2008 failure of LandAmerica 1031 Exchange Services. In that case exchange funds were invested in auction rate securities. When the market for those securities froze, LandAmerica ultimately became unable to meet its obligation to make the proceeds available to

acquire replacement properties. Some 450 exchangors became mired in its bankruptcy proceeding, involving over \$400 million in claims.

Not unlike how a Ponzi scheme operates, a failing QI can mask fraud or malinvestment for a time by using new-customer proceeds to finance pending replacement-property acquisitions, but eventually the enterprise will collapse on itself and end up in bankruptcy.

If the QI goes into bankruptcy, as illustrated by decisions in the LandAmerica case, it is likely that exchange funds held in the name of the QI will be deemed part of the QI's bankruptcy estate. This may be true regardless of whether the funds are commingled with funds of other exchangors, held by the QI in a segregated subaccount for a specific exchangor, or even if held by the QI in a separate account established specifically for these particular proceeds. This means the exchangor could be treated as any other unsecured creditor of the bankrupt QI and might well end up losing a considerable percentage of its exchange proceeds.

Moreover, even if the exchangor is fortunate enough to ultimately recover most of its exchange proceeds, the delay resulting from the bankruptcy proceedings could have other serious consequences. It is likely the exchangor will miss its tax deadline for acquiring the replacement property. The delay may also cause the exchangor to default on its contractual obligations to the replacement property seller. The unfortunate result will be tax liabilities from the blown exchange, together with the forfeited earnest money and other potential contract damages if the exchangor is unable to perform its obligations under its replacement property purchase agreement.

So how can the exchangor protect its exchange proceeds from these risks?

For starters, the exchangor needs to do its due diligence. The exchangor will want to make sure the QI is qualified, experienced, and reputable. The exchangor should also understand how the exchange proceeds will be held and invested by the QI.

“The exchangor could be treated as any other unsecured creditor of the bankrupt QI and might well end up losing a considerable percentage of its exchange proceeds.”

The exchangor, however, should not rely on due diligence alone and needs to consult with its tax advisor and attorney regarding structures that add additional protections for the exchange funds without violating regulatory requirements for exchange treatment. These structures include the following:

- Require a Guaranty. Typically exchange companies serving as QIs do not have significant assets other than the funds they are holding for customers. But they are usually affiliated with title companies or other institutions that are creditworthy and have substantial net worth. If the exchange funds are going to be held by or in the name of the QI, the exchangor should insist that the parent company provide a guaranty of the QI's liabilities and obligations under the exchange agreement. Of course, the exchangor needs to make sure that it has gone far enough upstream in the organizational chart to identify a guarantor that has the wherewithal to perform upon QI failure.
- Use a qualified escrow or qualified trust account. When a qualified escrow account is used, the exchange funds go directly into an escrow account established with a depository bank that serves as the escrow agent, and the QI never takes possession of the funds. This structure is one of the safe harbors provided in Treasury regulations and can be used in conjunction with the QI safe harbor. The requirements that must be met in

CONTINUED ON PAGE 4 >

## > SECTION 1031 TAX-DEFERRED EXCHANGES CONTINUED

order for an escrow or trust account to qualify for the safe harbor are outlined in the regulations but are beyond the scope of this article. Although use of a qualified escrow account alone may not be sufficient to keep the exchange proceeds from initially being caught up in an automatic bankruptcy stay, it offers the best likelihood that exchange funds will not ultimately be deemed part of the bankrupt QI's estate. A qualified escrow account has two additional benefits. First,

the funds are placed in a segregated escrow account and cannot be withdrawn without the exchangor's authorization, eliminating the risk of fraud or misuse of the funds. Also, the exchangor can receive periodic reports directly from the depository bank on the status of the account. Second, the exchangor has a say in the depository institution that will serve as the escrow agent, using a bank it knows is financially sound.

Other structures can be used either alone or in combination with the above to provide additional security. For example, the Q2's obligations can be backstopped with a qualified standby letter of credit. In certain situations the exchangor might be well advised to require that the exchange company create a separate bankruptcy remote entity whose only purpose will be to serve as QI just for the exchangor's particular transaction.

### TAKEAWAY

With any 1031 exchange the exchangor should be aware of the risks described above and should give careful consideration to the various structures available, within the parameters permitted by the regulations, to secure the exchange funds and reduce those risks. To this end, the exchangor needs to work closely with its tax advisor, with a knowledgeable attorney, and with an experienced and reputable exchange services company that is willing to tailor the structure to the exchangor's particular needs ♦

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## > WIND-ENERGY PROJECTS CONTINUED

easement to confirm absence of fatal flaws (since lender will become party to the easement after foreclosure). When final form of SNDA has been agreed upon, individual SNDAs should be executed and returned to the project for recording as quickly as possible.

### RECOMMENDATIONS FOR DEVELOPERS

The following recommendations may help a developer navigate and clear the lender SNDA process:

- **Allow enough time to complete the process.** Many lenders are unprepared to efficiently review/execute wind-energy-

easement SNDAs. The timeline should be realistic (weeks or months, not days).

- **Be organized.** Prepare lists organized by lenders from whom an SNDA will be required, landowners, properties, and loan numbers. Present organized information to each lender, including a map of the project footprint, SNDA form, and wind-energy easement form. Do not submit individual SNDAs until the SNDA form has been agreed upon. Once the form is approved by each lender, obtain necessary landowners' and lenders' signatures on the SNDA forms, and obtain other information/signatures from landowners as required by lender. It is preferable to

send all SNDAs for a particular lender in one package.

- **Determine/follow lender's procedures.** Some lenders will have an established process for the submission of SNDA requests and may have a list of documents that must be submitted with the SNDAs (such as Wells Fargo Bank and U.S. Bank, which require that an application be submitted together with certain back-up documentation). Also, some lenders (such as Agstar) will have their own versions of a wind-energy easement SNDA form that they require.

### TAKEAWAY

At first, the review and execution of wind-energy easement SNDAs may appear overwhelming, from both wind-energy developer's and agricultural lender's perspectives. However, with an understanding of reasons SNDAs are required and what provisions they should contain, the above recommendations should help to make the process efficient for all parties involved. ♦

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# Strategies to Lower Your Property Taxes on Your Commercial Property in a Troubled Economy



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**Y**ear after year, the same thing happens: you open your property tax bill and it keeps going up, up, up. It does not have to go up and, in today's economy, it should not. Published sources suggest that commercial real estate values in some areas

are down by nearly 50 percent from their 2007 peak but that assessments have not gone down proportionately. This article explains why and maps out how to reduce your property tax bills now and into the future.

Property taxes in Minnesota are based on the value of the real property. Assessors will value your commercial real estate using a combination of three methods: (1) estimating the depreciated cost to build the building; (2) looking at the price-per-square-foot for comparable-building sales; and (3) estimating how much money the real property assets of your building earn and capitalizing that stream of income into the value. Identifying the value of the real estate alone using these three methods can be difficult in many commercial properties because value also is often found in non-taxable personal property and intangible assets—including items like furniture and fixtures and intangible assets like chain affiliation, reputation, franchise rights, and in-place workforce—depending on property type.

The first valuation method (cost approach) is the only approach that does not include the value of personal property or intangibles, since the approach is that the assessor is valuing only land and “bricks and mortar.” This cost approach does not work well for older buildings since industry designs, construction techniques, and building costs change so significantly over time. The cost approach can also be problematic for newer buildings with higher building costs, especially in a troubled economy. As anyone who built a commercial property in 2007/2008 likely knows well, cost does not necessarily equate to value. In newer properties, the difference between

cost and value is often due to something called external obsolescence. External obsolescence is a negative impact on property value due to external forces, such as market conditions during an economic recession. Unfortunately, assessors often ignore external obsolescence in establishing taxable value, especially in newer properties, even when changes in economic trends and forces are fairly indisputable.

The second valuation method (sales comparison approach) can also be problematic. Many commercial properties are sold as operating businesses subject to long-term leases. Accordingly, sale prices may include significant amounts of intangible assets and personal property such as furniture, fixtures, and equipment. Also, when a property is subject to long-term lease, the buyer is purchasing the income stream from the lease, not the bricks and mortar alone. Assessors often fail to consider and adjust for these significant amounts of non-taxable assets often included as a part of the sale transaction, ultimately leading to over-assessment and over-taxation of the real property component.

Because the purpose of owning real estate is often to earn income, buyers, sellers, and appraisers of commercial properties often focus very heavily on the third valuation method (income approach). As with the other two valuation approaches, the income approach is not without problems when it comes to segregating the value of the real property components. The problem stems from the fact that in some types of commercial properties, such as hotels or retail properties, some of the income stream derives from non-real property components of the property (e.g., income from in-room entertainment, vending machines, or laundry service; or from amortized tenant improvements). The income stream from such services is not income derived from the real property, but rather is income from personal property, services, or other business income that should be excluded from real property. Many assessors ignore these fundamental deductions when establishing the taxable value of commercial real estate.

“ It is widely commented that an aggrieved taxpayer is much more likely to receive relief opting to appeal property tax assessments initially to the Minnesota Tax Court.”

So, how do you ensure that the assessor is fairly valuing your property? The answer is simple: know your property and its components and pay close attention to tax notices you receive. If the assessor does not listen to reason, then file a property tax petition with the Minnesota Tax Court.

In Minnesota, property taxes are paid in arrears, meaning that the assessor establishes your property value each year as of January 2. However, you do not pay the taxes on that assessment until May 15 and October 15 of the following year. This delay provides taxpayers with opportunities to contest their assessments.

The notification process regarding your property taxes is governed by statute. The assessor must notify you of your assessed property value at least ten days before the initial meeting of your board of appeal and equalization—statutorily required to occur each year between April 1 and May 31. The duties of the local board of appeal and equalization are sometimes transferred to the county, in which case meetings will occur during the month of June. Prior to these meetings, an aggrieved taxpayer may apply to the local/county board for reduction in assessed value and will be offered an opportunity to be heard. This contesting of your taxes is often called an “administrative appeal.” Unfortunately, the assessor has no obligation to reduce any assessment through this process and it often results in little to no reduction. Many taxpayers simply bypass this process and file their appeal directly with the Minnesota Tax Court.

CONTINUED ON PAGE 6 >

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## > STRATEGIES TO LOWER YOUR PROPERTY TAXES CONTINUED

This alternative does not require the completion of the administrative appeal (i.e., no so-called "exhaustion of remedies"). The Minnesota Tax Court is a specialized court established by state legislature to hear appeals relating to issues of state taxation. There are three judges on the court, each of whom is appointed by the Governor for a six-year term. This court generally follows the same rules required in other state courts—such as the rules of evidence—and the judges issue decisions consistent with generally accepted appraisal methodologies and Minnesota statutes and case law. As a result, it is widely commented that an aggrieved taxpayer is much more likely to receive relief opting to appeal property tax assessments initially to the Minnesota Tax Court.

The deadline to file an appeal of your property tax assessment with the Minnesota Tax Court is April 30 of the year in which your taxes are due. Accordingly, the deadline to appeal your 2010 taxes—based on your January 2, 2009, assessment—is April 30, 2010. Because the appeal process is a legal process, and there are backlogs in many assessors' offices and in the court itself, it can take more than a year to complete. During the appeal pendency you must continue to pay property taxes when due, although exceptions including a statutory 10 percent withholding remedy are available. If your case results in a value reduction, either through settlement or trial, you will be entitled to a refund of the taxes you overpaid, plus interest. Given the length of appeal processes, cases are also often resolved on multiple-year bases and often include resolution of assessments relating to taxes due in current/future years. This can be helpful in the budgeting process for anticipated fixed expenses—beneficial in these uncertain economic times.

### TAKEAWAY

If you are concerned that you are being overtaxed on your commercial property, you need to act before April 30, 2010. If you have questions regarding your assessed tax, please contact Fredrikson & Byron's property tax group at 612.492.7118 for a free analysis of your case. ♦

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