

# Bank & Lender Liability

COMMENTARY

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## A Delaware Statutory Trust as an Alternative Borrower for Tenant-in-Common Programs

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In the last four years since the Internal Revenue Service issued Revenue Procedure 2002-22,<sup>1</sup> the market for the sale of fractionalized interests in real estate being offered to Section 1031<sup>2</sup> investors who desire to complete tax-deferred exchanges has skyrocketed. This market has been fueled by investors with limited amounts of funds to reinvest, who desire an ownership interest in better institutional grade properties and who also wish to have no active "hands-on" involvement in the operation of the real estate.

In 2001 the total amount of equity raised pursuant to these programs has been estimated to have been \$166 million. The amount of equity raised in 2005 was \$3.23 billion, and \$5.5 billion is projected for 2006.<sup>3</sup> Almost all of these programs have utilized a tenant-in-common structure whereby each investor would set up his own single member limited liability company, as a bankruptcy remote entity, which would acquire a fractional interest in the real estate, subject to a portion of the overall mortgage indebtedness.

Although this TIC structure has become very common, it does present some complex lender and investor issues, especially if the financing utilized is conduit financing. For example:

- The structure can result in up to 35 separate real estate and loan closings;
- All major decisions regarding the property, including decisions involved in the financing, require unanimous agreement by the investors;

- The investors are required to be recourse with respect to the "bad boy" and perhaps environmental carve-outs;<sup>4</sup>
- The lender is required to underwrite all the investors and to monitor or prevent any transfers of interests, because each investor is a separate borrower; and
- The lender always has a serious concern about potential serial bankruptcy filings by the various investors.

The purpose of this article is to present a Delaware statutory Trust structure as a less-complicated alternative borrower for tenant-in-common programs.

### What Is a Delaware Statutory Trust?

A DST is a separate legal entity created as a trust under Delaware statutory law. Delaware law permits a very flexible approach to the design and operation of the entity. However, to use a DST in a Section 1031 tax-deferred exchange private placement program, it is necessary to comply with the requirements of IRS Revenue Ruling 2004-86<sup>5</sup> so that a beneficial interest in the trust is treated as a direct interest in real estate for income tax purposes. It is also necessary to meet lender requirements, especially if the loan is to be securitized on a secondary market to achieve favorable financing. Therefore, a DST must be:

- A special purpose entity;

- Bankruptcy-remote; and
- A very passive holder of real estate (the trustees will have minimum powers and the beneficiaries will have no powers with respect to the mortgaged property). Thus, the use of a DST will generally be limited to long-term "A" credit triple-net leased properties (a "box-in-one") or properties leased to an affiliate of the sponsor whom will operate the property on a triple net basis (a "master lease").

### Lender Benefits

The DST will own 100 percent of the fee interest in the real estate. Unlike a tenancy-in-common program, the lender only needs to make one loan to one borrower.

The DST is bankruptcy remote, that is, it contains SPE provisions, which prevent the bankruptcy creditors of the beneficiaries from reaching the DST's property and gives the lender greater comfort that it can foreclose on its first mortgage of the real estate should the need arise.

The beneficiaries' only right with respect to the trust is to receive distributions. They have no vote or say in operations of the property. Since they cannot be "bad boys," there should be no need for them to have to sign on any "carve outs." The lender should need to look only to the DST sponsors with respect to the carve outs.

The lender does not need to underwrite or qualify any of the investors because they are totally isolated from the operation of the property. Other than Patriot Act considerations, due diligence investigations of the investors should not be necessary. Further, the better sponsors only sell to accredited investors. All of this eliminates the need for the lender to monitor transfers of beneficial interests.

The signatory trustee of the DST will generally be the sponsor of the private placement offering or one of its affiliates. Unlike a TIC deal, there is no one-year time limit on the trusteeship or the term of the property manager. This will give the lender comfort that the sponsor will have a continuing presence in operating the property.

The trust agreement contains provisions requiring the trustee to comply with all of the terms of the loan documents and states that they are for the benefit of the lender.

A DST also has a Delaware trustee (required by statute), so there is no worry that the trust will inadvertently terminate.

The trust will contain a provision that prevents the trustee from distributing the property as TIC interests to the beneficiaries.

### Master Tenant

As discussed below, the tax law requires that the trustee be prohibited from taking certain actions with respect to leasing, financing and capital-raising with respect to the property, and the beneficiaries have no control over the operations of the mortgaged property; therefore, a master lease is required unless there is a single-property long-term triple-net lease to a credit tenant.

The master tenant (generally an affiliate of and controlled by the sponsor) will enter into leases of the mortgaged property to residential or commercial "subtenants," handle maintenance and repairs, contract with the management agent (also often an affiliate of the sponsor) and, generally, be empowered to do everything that an owner of the mortgaged property would be empowered to do. This also eliminates the concern raised in TIC transactions as to how to ensure the unanimous consent of the TICs to certain necessary management actions.

Loan documents can easily be adapted for this format. For example, a subordination, assignment and security agreement would effect an assignment of leases and rents from the master tenant in favor of the lender, would provide that a default under the master lease would constitute an event of default under the security instrument, require the timely provision of books and records and other financial reports and would directly impose on the master tenant certain obligations and restrictions with respect to the operation of the mortgaged property. The loan agreement would restrict transfers by the master tenant of the lease and of controlling interests in the master tenant.

The master tenant would also be structured as an SPE, adding yet another layer of bankruptcy protection for the lender. Because most master tenants would only be minimally capitalized, the sponsors will be the parties that own and control the master tenant and have the requisite net worth and liquidity to satisfy lender requirements.

The master lease will generally provide for rent to be paid by the master tenant to the DST in a set amount

equal to debt service plus a market rate of return. The master lease structure economically incentivizes the master tenant to maximize the mortgaged property's net operating income because the master tenant retains all net operating income over and above debt service and rent payments under the master lease, and incentivizes the master tenant to cover short-term operating deficits to protect its desired return and its valuable investor reputation in the industry.

Additionally, the better sponsors self-reserve from net operating income (over and above typical lender replacement reserves) for unanticipated repairs and uninsured losses because there is no real ability to negotiate changes in the master lease terms and rent payments with the DST trustee.

### IRS Requirement Causing Lender Concerns

IRS Revenue Ruling 2004-86, which forms the basis for a DST transaction in a Section 1031 exchange program, has prohibitions on the powers of the trustee, in order for a beneficiary to be treated as acquiring a direct interest in real estate for tax purposes. These restrictions are built into the trust agreement and have become known as the "seven deadly sins." They are:

1. Once the offering is closed, there can be no future contributions to the DST by either current or new beneficiaries.
2. The trustee cannot renegotiate the terms of the existing loans and cannot borrow any new funds from any party unless a loan default exists as a result of a tenant bankruptcy or insolvency.
3. The trustee cannot reinvest the proceeds from the sale of its real estate.
4. The trustee is limited to making capital expenditures with respect to the property for normal repair and maintenance, minor nonstructural capital improvements, and those required by law.
5. Any reserves or cash held between distribution dates can only be invested in short-term debt obligations.
6. All cash, other than necessary reserves, must be distributed on a current basis,
7. The trustee cannot enter into new leases or renegotiate the current leases, unless there is a need due to a tenant bankruptcy or insolvency.

Because of these IRS restrictions, the only forms of real estate ownership transactions that will work in a DST are a master lease transaction whereby the master tenant takes on all of the operating responsibilities or a triple-net long-term lease to an "A" credit tenant. The sponsor will also attempt to mitigate against the effect of these seven prohibitions by:

- Acquiring only new or recently rehabilitated Class A properties;
- Raising substantial funds for capital reserves in the offering;
- Having financing terms which go out seven to 10 years, but less than the term of the master lease, and;
- Planning for the sale of the mortgaged property prior to the maturity date of the loan.

The solution to give the lender comfort against the DST's inability to act if the loan is endangered is to place an operative provision in the trust agreement providing that if the trustee determines that the DST is in danger of losing the mortgaged property due to an actual or imminent default on the loan and tax-related restrictions are preventing the trustee's ability to act, (the seven deadly sins), the DST can convert into a limited liability company (the "springing LLC") with a lender pre-approved operating agreement.

Delaware law permits the conversion by what is basically a simple election which does not constitute a transfer under Delaware law. The "springing LLC" will contain the same SPE and bankruptcy remoteness provisions as the DST (for the lender's benefit), but it will permit the raising of additional funds, the raising of new financing or renegotiation of the terms of the existing financing and the entering into new leases. In addition, it will provide that the trustee (or sponsor) will become the manager of the LLC with full operating control.

### Conclusion

A DST borrower with a master tenant owned and controlled by a quality sponsor should be an attractive borrower for a lender. Various financing sources have embraced the DST structure. A steady market should develop for DSTs because they are much less complex than the structure of a typical TIC transaction, they shield investors from liabilities with respect to the mortgaged property and they remove the investors from involvement in operation of the property.

### Notes

- <sup>1</sup> This revenue procedure sets forth the IRS standards for tenant-in-common structures to qualify for a tax-deferred exchange treatment under Internal Revenue Code Section 1031 2002-14, IRB 733 04/8/2002.
- <sup>2</sup> Section 1031 of the Internal Revenue Code of 1986, 26 U.S.C. §1031, basically provides that a taxpayer will not recognize gain or loss on the exchange of property held for use in a trade or business or for investment if such property is exchanged for property of a like kind, similarly held.
- <sup>3</sup> Statistics provided by Omni Brokerage Inc. ([www.omni1031.com](http://www.omni1031.com)).
- <sup>4</sup> Although the real estate loan is generally non-recourse, in certain circumstances where the borrower acts wrongfully, such as intentionally violating the terms of the loan documents, *i.e.*, a "bad boy," the loan becomes recourse to such party and the wrongful act is "carved out" from the non-recourse protection.

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