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Structuring Real Estate Loans With Foreign Borrowers, Trusts and Tenants in Common

Documenting U.S. Assets of Foreign Guarantors, Reviewing TIC Agreements, Revocable vs. Irrevocable Trusts, and More

TUESDAY, MARCH 28, 2017

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Today's faculty features:

Gerard C. Keegan, Jr., Partner, **Alston & Bird**, New York

Jon S. Robins, Partner, **Klehr Harrison Harvey Branzburg**, Philadelphia

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Structuring Real Estate Loans With Foreign Borrowers, Trusts and Tenants in Common

Gerard C. Keegan, Esq.
Alston & Bird LLP
gerard.keegan@alston.com

Jon S. Robins, Esq.
Klehr Harrison Harvey Branzburg LLP
jrobins@klehr.com

I. Foreign parties as investors and guarantors

A. OFAC, anti-money laundering and other due diligence

B. Requirement of domestic assets (if guarantor)

C. Need for domestic single purpose entity

D. Appointment of U.S. agent; loan document revisions

II. Tenants in common

A. Overview

B. Tenancy In Common Requirements

C. Issues for Lenders and Two General Contexts

D. Key provisions in TIC agreement

General

Lender Requirements

D. Need for each TIC to be an SPE

E. Appointment of managing TIC or other designated manager

F. Additional Management Structures

F. Subordination of TIC agreement and TIC claims; loan document revisions

G. Related Topics

III. Trusts as investors and guarantors

A. Revocable vs. irrevocable trust—nailing down trust assets

B. Role of trustee, beneficiaries—identifying control issues

C. Transfer and other loan document revisions

I. Foreign Parties as Investors and Guarantors

A. OFAC, AML and other diligence

- First step, the organizational chart
- Disclosure / privacy "tug of war"
- Organizational chart pitfalls and solutions
- Client search requirements – 10% / 20% / Control
- Reviewing search results
- Carrying closing diligence forward - due on sale / transfer provisions

B. Requirement of domestic assets

- Difficulties of obtaining and exporting judgments
- Opinions
- Timing
- Hostility of local courts
- Local law risks
- Customizing Net Worth and Liquidity Covenants

C. Need for Domestic Single Purpose Entity

- SPE structuring considerations: BK remote, perpetual existence, independent director

- Certainty of legal interpretation: scope of ID fiduciary duties; springing member provisions

- Substantive consolidation considerations; foreign non-con

- Local law concerns

D. Appointment of US Agent; loan document revisions

- Importance of agent for service of process

- NW and liquidity covenant revisions

- Gross up provisions

- Transfer provision revisions

- SPE provision clarifications

II. Tenants in Common

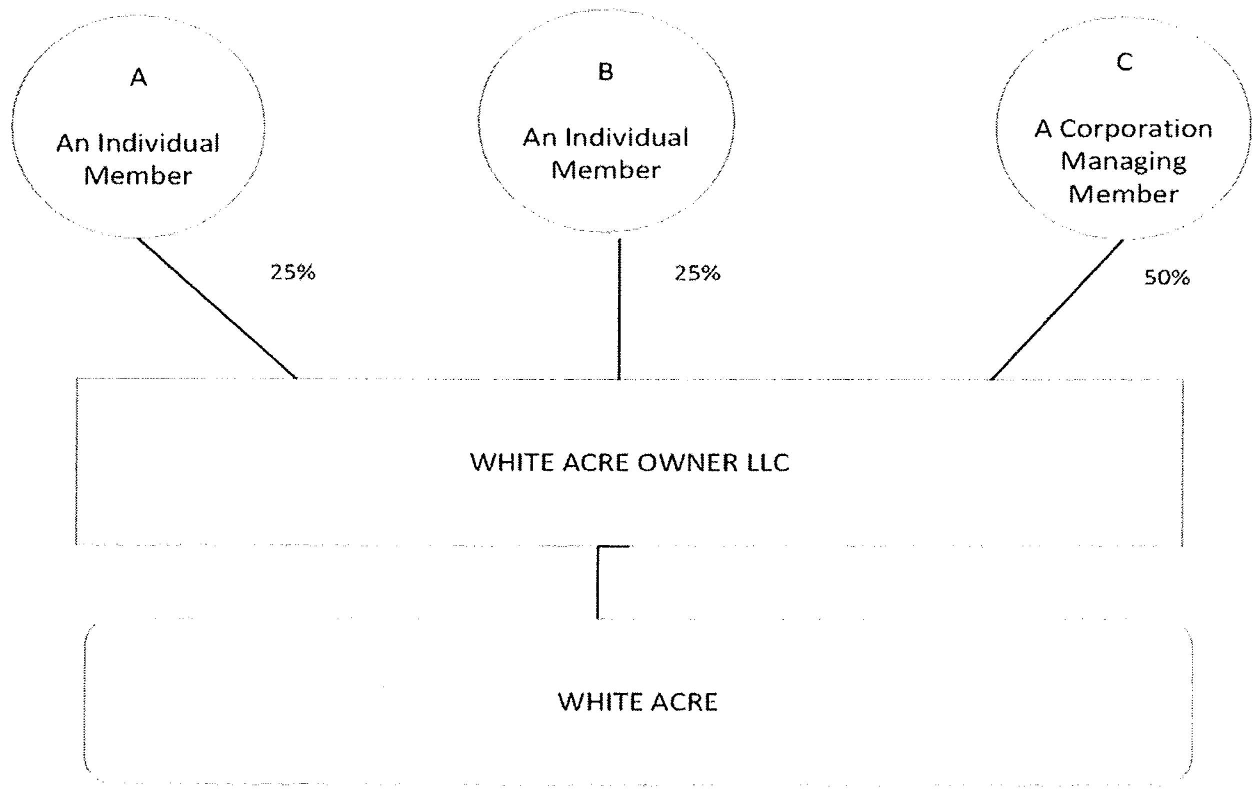
A. Overview:

1. What is it–undivided fractional interest in the whole property–generally expressed as a percentage interest

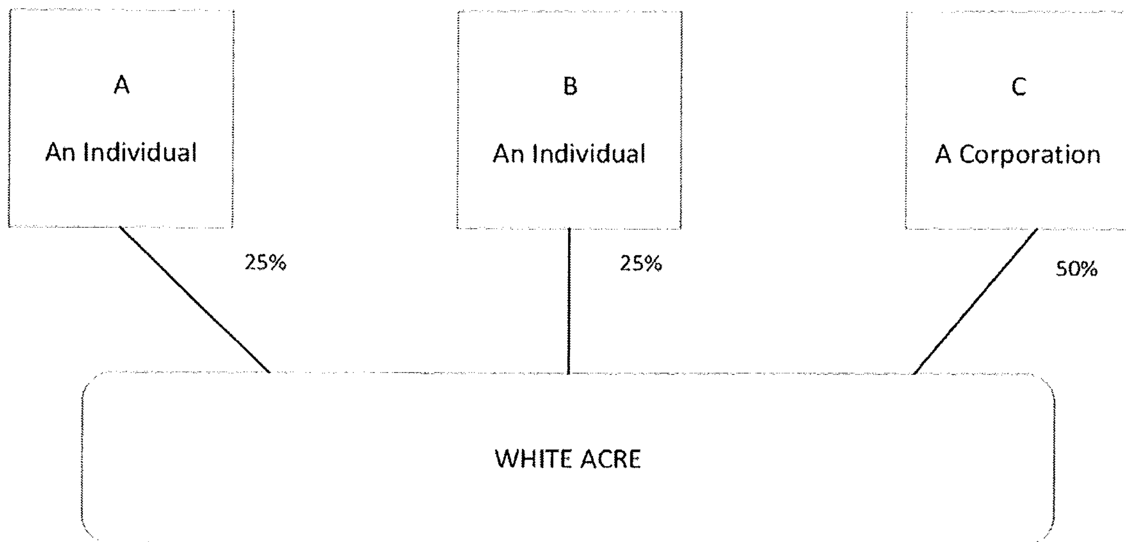
2. Why are they used – deferral of taxes on disposition (exchange) of other real property

- Section 1031 of the Internal Revenue Code permits the tax deferred exchange of like kind assets. Basically all real estate is like kind. For example, exchange of investment rental housing property for shopping center is like kind.
- Exchange is generally accomplished as a sale of one property and the purchase of another through an intermediary.
- Not permitted to exchange real estate for interests in joint venture, partnership, limited liability company or corporation.
- Permitted to exchange into a tenant in common interest.

LIMITED LIABILITY COMPANY



TENANCY IN COMMON



Tenancy In Common Requirements

- State law not determinative as to whether or not a partnership exists. If a tenancy in common is treated as a partnership by IRS, each tenant in common (each "TIC") will lose tax deferral.
- No absolute safe harbor or requirements under the code. There are guidelines contained in Revenue Procedure 2002-22.
- Material Requirements:
  - ✓ Tenant in common under state law
  - ✓ No more than 35 TICs
  - ✓ TICs may not hold themselves out as partners
  - ✓ Each TIC must have right to approve: (i) property manager, (ii) property sale, (iii) leases, and (iv) mortgage upon the entire property. Any negotiation of indebtedness secured by blanket mortgage or property management agreement must be unanimously approved
  - ✓ Each TIC must have right to sell, mortgage or partition its interest (may be subject to customary commercial lending restrictions)
  - ✓ Management Agreement must be renewable at least annually
  - ✓ Leases must be bona fide leases with fair market value rents (which may not be based on percentage of profits (but percentage of receipts okay))

Issues For Lenders And Two General Contexts

A. Four main categories of issues for lender:

- Multiple ownership issues
- Property Management issues
- Partition issues, and
- Additional documentation issues

These issues are intertwined in many instances

B. Two general contexts:

- Closely Held TIC – Limited number of TIC investors (e.g., one TIC that is an LLC managed by deal sponsor, and one TIC wholly owned by an investor with a tax issue who the deal sponsor is accommodating with TIC structure)

- Syndicated TIC – Popular before the last crash. Sponsors or syndicators assemble numerous, disparate real estate investors who exchange existing, separate real estate owned by them into a TIC Interests in the sponsor guided real estate investment

- While the technical requirements are generally the same, the larger syndicated deals increase risk for lenders due to the number of TICs and the nature of the investment, as well as concerns about compliance with securities laws. The deal sponsor also often has a need for a window of time to admit additional TICs.

Key Provisions in TIC Agreement General:

- Tenancy In Common Agreement is agreement among all of the TICs
- To Bind Successor TICs Record TIC Agreement or a Memorandum – Lender's require to be recorded after (or, if pre-existing to be subordinated to) the Mortgage
- Structure to avoid recharacterization of the TIC as a partnership –
  - Activities generally limited to the owning, maintaining, repairing and leasing the property and proportionate sharing of rents or profits
  - Profits from the ownership of property not from the carrying on of a common venture

- Proportional sharing of distributable cash based upon percentage interest
- Proportional Sharing of Costs
- Unanimous Decisions for sale, appointment of property manager, blanket mortgage, and leases
- 50%+1 Generally for other decisions
- Purchase options (calls) at fair market value at the time of purchase are permitted – use as a potential tie-breaker for deadlocked decisions or TIC not performing its obligations, attempting partition or prohibited transfer
- Appoint a manager for the day to day management of the property. The IRS guidance allows this to be the sponsor. The contract must be subject to renewal at least annually. The manager cannot be granted a general power of attorney by any TIC, and it cannot exercise decisional authority over major decisions.
- Manager to control a centralized account for the collection of revenues and payment of expenses, prior to any distributions to the TICs

Key Provisions in TIC Agreement Lender:

- Waiver by each TIC of right of Partition (for borrower counsel – prudent to acknowledge that the waiver is a lender requirement)
- Property Manager to be a qualified manager, and to have all permissible authority to deal with lender on day to day matters, and negotiations subject to required TIC approval
- Subordination of all purchase options and any cross indemnities to the mortgage debt
- Waiver and subordination of any lien rights and agreement to standstill as against other TICs during loan term
- No amendment of TIC agreement without lender consent and rating agency no downgrade letter

- Lender to be named an intended third party beneficiary of the TIC Agreement

- Restrict Transfers of TIC interests – no transfer that is in violation of the loan documents

- Default by TIC in additional capital contribution: (a) loan of proceeds from other TIC would violate SPE; (b) dilution of TIC interest for failure to contribute capital is effectively prohibited by the Rev. Proc.; (c) one solution, require non-spe sponsor to loan funds to defaulting non-spe owner of defaulting TIC and contribute the funds to such TIC and such TIC to contribute the funds to the property

Need for Each TIC to Be SPE

A. Borrower – Equity Owner Considerations:

- No exchange permitted into partnership or limited liability company interests – However, IRS will permit the replacement property (here, the TIC interest) to be held by a disregarded entity of the taxpayer

- A disregarded entity is a single member limited liability company that has NOT elected to be taxed as a corporation

B. Lender

- Because each TIC is an owner of an interest in the real estate, each TIC must be a Borrower

- As each TIC is an owner of an interest in the real estate and a Borrower, lender has the same risks (and some different ones) from a Bankruptcy of a TIC, the dissolution of the TIC or the assertion of liens or judgments against a TIC

- Require each TIC to be a DE single member, special purpose, bankruptcy remote limited liability company
  - ✓ No Assets other than TIC interest
  - ✓ No debts other than mortgage loan and permitted, unsecured trade payables
  - ✓ Standard SPE covenants
  - ✓ Independent director(s) (generally waived for smaller loans)
  - ✓ Springing Member
  - ✓ Opinions (Authority, Enforceability, DE Opinions, Non-consolidation opinion) (subject to deal size as to the Delaware and non-consolidation opinions)

- No Amendment of Organizational Documents without Lender Consent

23

Appointment of Managing TIC or Other Designated Manager

A. Equity and Lender Issue

- Need for day to day management of the property
- Need for timely decisions re: leasing and operations
- Need for point person in dealing with lender (or for lender to deal with) and third parties

B. Lender Requirements

- Require qualified manager
- Manager to have day to day management responsibility and maintain books and accounts for Tenancy In Common and prepare financials
- Manager to control the operating account for the tenancy in common
- Manager to waive lien rights and subordinate its fees to the loan, and agree to customary lender termination rights (e.g., upon an event of default)

- No amendment, modification or termination of management agreement without lender consent
- No replacement of manager without lender consent
- Manager to have authority to negotiate leases and loan modification terms, subject to the approval of the owners
  - (Open issue, for multi-family projects where manager would typically be given leasing authority – whether or not it is permissible to give manager authority to enter leases within guidelines set forth in management agreement and on approved form lease)
  - Consider notice and deemed consent provision for lease approval
- Manager to have authority to submit loan reserve draw requests

- Note, many of these functions may be performed by sponsor or its TIC under the TIC Agreement or a separate management agreement. Sponsor may retain a third party manager to perform some of the more standard property management functions

- Record the management agreement or a memorandum thereof

26

Additional Management Structures

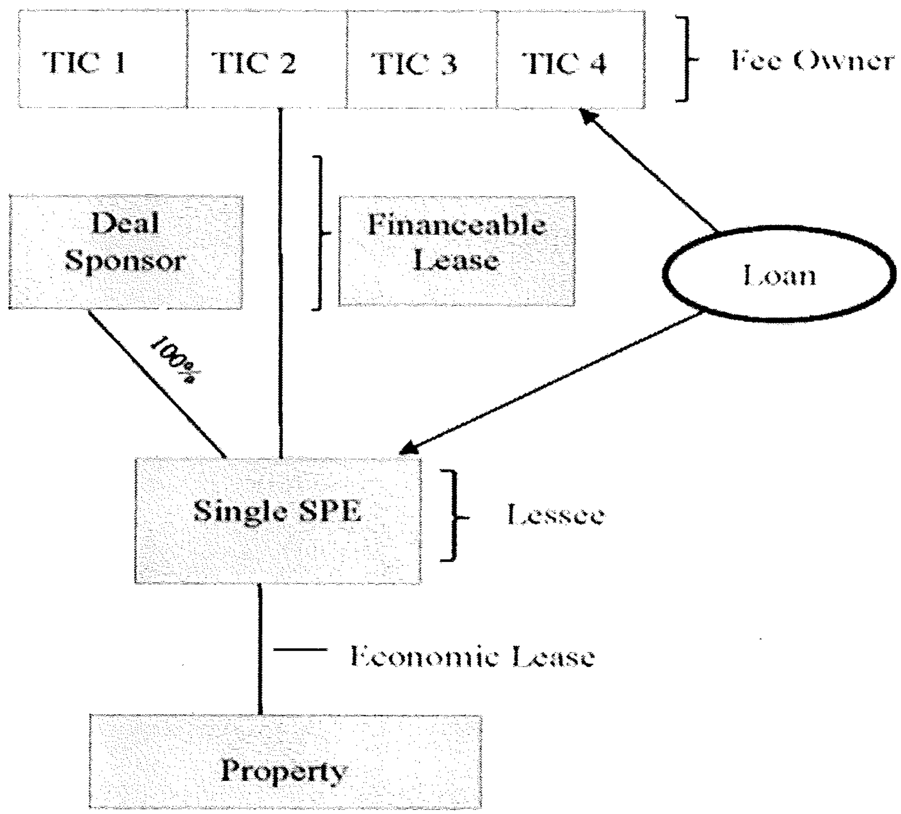
A. Master Lease: TICs lease the property to a master tenant controlled by sponsor

- To comply with revenue procedure the lease has to be a bona fide lease, and rent must be market.
- Rent based on a percentage of income or profits is not permitted
- Make lease a triple net lease, with all obligations upon tenant
- Consider making lease financeable
- Grant lender fee and leasehold mortgage with right to foreclose upon either or both interests

- Master lease very beneficial for resolving day to day management and leasing issues and allowing additional activities of the Borrower with respect to the property (e.g., potential redevelopment)

- Difficulties – 1) economics of lease structure for the TIC Investors (possible for TIC Investors to form joint venture to be the tenant, but must be bona fide lease), 2) even if lease is financeable, questionable to have work out or refinance without consent requirement of fee owners

TIC Structure (w / Financeable Lease Enhancement)



- TIC's and Single SPE are co-borrowers on loan
- Lease is long term, fully financeable lease
- All property level controls are conveyed to lessee under ground lease (including refi + leasing decisions)
- Mitigates fee level TIC issues
- Takes advantage of pre-existing structuring for 1031 exchanges

B. Non-Member Manager: Each TIC appoints the sponsor (or an SPE entity wholly owned and controlled by the sponsor) as its non-member manager

- Allows the sponsor to control the decisions of each TIC
- Has worked well for closely held TIC transactions for non-defaulted investments
- Have not seen tested yet for syndicated TIC transaction, in work-out situation or in litigation

Subordination of TIC Agreement and TIC Claims; loan document revisions

A. Subordination:

- TIC Agreement and Management Agreement to be subordinate to mortgage (include subordination language in the document and record after the mortgage is recorded)
  - Lender will want to be assured that all rights under these documents are eliminated by foreclosure
- Purchase options and any similar rights to be made subordinate to the mortgage
- TIC lien rights to be waived, and to the extent non-waivable to be subordinated to the mortgage
- Management fees to be subordinated to the mortgage

B. Loan Document Revisions:

- All TICs to execute the loan documents as borrowers and to be jointly and severally liable thereupon

- Deal Sponsor to sign the carve-out guaranty and the environmental indemnity. In addition to standard carve-outs, guaranty to provide full recourse for any partition action and for any TIC filing an involuntary bankruptcy against any other TIC

- Each TIC to provide a carve-out guaranty and indemnity for its following acts: (i) seeking partition (full recourse for the loan), (ii) filing voluntary bankruptcy (full recourse for the loan), (iii) consenting to or colluding in involuntary bankruptcy as to itself or any other TIC (full recourse for the loan), (iv) filing an involuntary bankruptcy or any enforcement action against any other TIC (full recourse for the loan), (v) any prohibited transfer or encumbrance (full recourse for the loan), (vi) fraud, (vii) misrepresentation or misappropriation, (viii) breach of the TIC agreement or the management agreement, (ix) violation of SPE provisions, (x) contesting foreclosure or other lender remedies, (xi) failure to comply with any roll-up provision (full recourse for the loan), or (xii) failure to appoint or renew the property manager (full recourse for the loan)

- Among other thing, individual TIC sponsor recourse is important protection to serial bankruptcy risk

- Each TIC to pledge and assign its purchase options and similar rights under the TIC agreement to lender

- Each TIC to pledge and assign to Lender its right of first refusal under Section 363(i) of the bankruptcy code

- Require that sponsor of each TIC be an accredited investor and obtain a securities law compliance representation and warranty from each TIC

- Limit Transfers:
  - Sale of TIC interest is transfer of real estate which would require title endorsement, new UCC filing, joinder to mortgage and other documentation similar to a loan assumption
  - If transfers to be permitted, transfer of membership interests in non-controlling TIC(s) holding up to not more than 49% of the TIC interests
  - No change in control of deal sponsor or manager. Deal sponsor to retain a stated minimum interest.
  - Limit maximum number of TICs

- Provide that upon an event of default, lender may require that the TICs “roll-up” the tenancy in common into a limited liability company

- Include prohibition on partition in the documents and obtain legal opinion as to the waiver of partition included in the TIC agreement

- Include covenants as to the performance of the TIC agreement and the management agreement

- Require lockbox with hard cash management upon default or other deal specific trigger event (e.g., DSCR test)

Related Topics

A. Reverse 1031 Exchange

- In reverse exchange, the taxpayer acquires the replacement property before selling its exchange property
- In such a case, the exchange accommodator will be the owner of the TIC, until the TIC sponsor has sold the exchange property
- Loan documents include covenants and recourse carve-outs to ensure that the transaction is completed
- Financeable lease structure where the sponsor controls the master lessee can be required until the exchange is completed

Delaware Statutory Trust

- Like a TIC, the DST provides a vehicle for multiple investors, in this case the beneficiaries of the trust, to own direct beneficial interests in real property, rather than through a business entity. As with a TIC, allows the owners to structure Section 1031 like-kind exchange transactions without the need for sole and exclusive ownership. IRS Rev. Proc. 2004-86.
- There are a number of negatives, but the advantage of the DST over the TIC structure for the lender is that there is a single borrower, the DST. The individual investors' only right with respect to the DST is to obtain distributions and they have no management authority.
- The utility of the DST vehicle is severely limited by statutory restrictions intended to prevent the DST from behaving as an actively managed business.
- To preserve eligibility for 1031 exchanges, these restrictions include the 7 deadly sins which a DST must not do: (1) dispose of the property and acquire new property, (2) renegotiate leases at the property, (3) enter into new leases, (4) workout a loan, (5) refinance a loan, (6) invest cash flow, or (7) perform property alterations
- In effect, the DST may only be appropriate for a long-term, NNN lease of the entire property to a single tenant.
- If an issue arises that cannot be addressed by the DST without violating the statutory restrictions on its activities, the DST's trust instrument ordinarily provides that the trustee can convert it into an LLC. To prevent the DST from reaching an impasse if the trustee is unwilling to act, the loan documents and trust instrument should grant the lender the power to cause the conversion.

 36

III. Trusts as Investors and Guarantors

A. Revocable vs. irrevocable trusts

- Difficulty in policing the difference

- Reliance on entropy

- Trust as Guarantors vs. “Family Entity” or individual

- Business Trust vs. Family Trust

- Opinions

B. Role of Trustee, Beneficiary

- Settlor, trustee and beneficiaries

- Search issues

- Org chart issues

- Investor "landmines"

38

C. Transfer and Other Loan Document Provisions

- Approach to transfer provisions generally

- "Family Group" concept

- "Sponsor Family Entity" shall mean shall mean an entity which is (i) wholly owned by one or more members of the Sponsor Family Group and (ii) which is controlled by one or more members of the Sponsor Family Group having commercial real estate experience at least comparable to that of the management of Borrower as of the date hereof.

- "Sponsor Family Group" shall mean either of the Persons comprising the defined term "Sponsor" and/or their respective spouse or lineal descendants and/or a family trust for the benefit of either of the Persons comprising the defined term "Sponsor", their respective spouse or lineal descendants.

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