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A DELAWARE STATUTORY TRUST AS AN ALTERNATIVE BORROWER FOR TENANT-IN-COMMON PROGRAMS



By Arnie Harrison
Jenner & Block

Since the Internal Revenue Service ("IRS") issued Revenue Procedure 2002-22, the market for the sale of fractionalized interests in real estate to 1031 investors who seek tax-deferred exchanges has skyrocketed. Almost all of these programs utilize a tenant-in-common structure, which requires each investor to set up a single member limited liability company as a bankruptcy-remote entity to acquire a fractional interest in the real estate, subject to a portion of the overall mortgage indebtedness. This structure creates complexity, including:

- Up to 35 separate real estate and loan closings;
- All major decisions regarding the property require unanimous agreement by investors;
- Investors are recourse with respect to "bad boy" carve-outs;
- The lender must underwrite all investors and monitor to prevent transfers of interests; and
- The lender is at risk of serial bankruptcy filings by investors.

The Delaware Statutory Trust ("DST") is 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. The DST must **(1)** comply with IRS Revenue Ruling 2004-86 so that a beneficial interest in the trust is considered a direct interest in the real estate and **(2)** 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 "SPE";
- be bankruptcy remote; and
- be a passive holder of real estate (the trustees will have minimum, and the beneficiaries no, powers with respect to the mortgaged property).

Therefore, DSTs work for long-term "A" Credit triple net leased properties or properties subject to Master Leases on a triple net basis.

Lender Benefits

The DST will own 100% of the fee interest in the real estate. Unlike a tenancy-in-common ("TIC") program, the Lender only needs to make one loan to one borrower.

The DST is bankruptcy remote, so it contains provisions which prevent the investors' bankruptcy creditors from reaching the DST's property and gives the Lender greater security that it could foreclose on its first mortgage of the real estate.

The beneficiaries' only right with respect to the trust is to receive distributions. They have no vote in property operations. Because they cannot be "bad boys," they don't need to sign on any "carve outs." The Lender should only need to look to the DST Sponsors for the carve outs.

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, which will give the Lender comfort that the Sponsor will have a continuing presence in operating the property.

The Lender does not need to qualify the investors because they are isolated from the property. Other than Patriot Act considerations, due diligence investigations of the investors should not be necessary. Further, some Sponsors only sell to accredited investors. All of this also eliminates the need for the Lender to monitor transfers of beneficial interests.

Additional Lender benefits include provisions in the Trust Agreement requiring the trustee to comply with the terms of the loan documents and a prohibition on the distribution of the property as TIC interests to beneficiaries and the use of a Delaware trustee to prevent inadvertent termination.

Master Tenant

Because the trustee has limited powers and the beneficiaries have no control over the operations of the Mortgaged Property, a Master Lease is required unless there is a single property long-term net lease to a credit tenant. The Master Tenant will enter into leases of the Mortgaged Property to residential or commercial "Subtenants," handle maintenance and repairs, contract with the management agent and be empowered to do everything an owner of the Mortgaged Property would be empowered to do. This structure eliminates the issue of unanimous consent of TICs regarding management actions. Loan documents can be adapted for this format.

The Master Tenant would also be an SPE, adding another layer of bankruptcy protection for the Lender. Because most Master Tenants are minimally capitalized, the Sponsors 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 an amount equal to debt service plus a market rate of return. The Master Lease structure incentivizes the Master Tenant to maximize the Mortgaged Property's net operating income because the Master Tenant retains net operating income and to cover short-term operating deficits to protect its desired return and its 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 they cannot negotiate changes in the Master Lease terms and rent payments with the DST trustee.

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