DISTRESSED PROPERTY AND THE DELAWARE STATUTORY TRUST STRUCTURE: WHAT NEW CAPITAL SOURCES NEED TO CONSIDER[1]

In the economic upheaval of 2008, properties owned through the tenant in common structure (the "TIC Structure") attempted to negotiate loan modifications with their lenders to avoid defaulting under their financing or being foreclosed on by their lenders. Unfortunately, many of these work-out attempts were thwarted because of the various unanimous consent requirements imposed on the co-owners of the distressed property. As a surprise to none, after the lessons learned from the 2008 financial crisis, the structure of choice for 1031 investor property became the Delaware statutory trust structure (the "DST Structure") and the popularity of the TIC Structure significantly declined.

While the issues created by the current Covid-19 crisis for the real estate industry are somewhat different than those that arose from the events of 2008, we have seen the first ripples of disruption in the industry – lenders backing out of deals at the last minute, buyers seeking price reductions, tenants refusing to pay rent or requesting rent reductions. Many anticipate that the ripples of disruption will become a tidal wave, swamping the commercial real estate industry with financial distress. For properties owned through the DST Structure, the issues to be considered in addressing the fallout from the current crisis, including modifying loan terms, working out loans, and recapitalizing the properties, are much different than those faced under the TIC Structure following 2008. The following is a discussion of some of the issues that should be considered by a potential equity source looking to make an investment in distressed property that is owned in a DST Structure.

Overview of the DST Structure

Like the TIC Structure, the DST Structure was developed to provide real estate investors with a vehicle through which they could acquire in interest in commercial real estate that would be treated as qualifying replacement property for purposes of the like-kind exchange rules of Section 1031 of the Internal Revenue Code (the "Code"). Under the like-kind exchange rules of Code Section 1031, an interest in real estate that is held through a multi-member limited liability company or through another structure that is treated as a partnership for federal income tax purposes cannot be treated as qualifying replacement property notwithstanding that the underlying asset is commercial real estate.

The DST Structure, which is based on Revenue Ruling 2004-86, is designed to allow multiple investors to acquire interests through a structure that, if properly structured, will not be treated as a partnership for federal income tax. Under the DST Structure, the like-kind exchange investors acquire beneficial interests in the Delaware statutory trust (the "Trust") and the trustee of the Trust and the asset manager of the property are

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affiliates of the sponsor. For the reasons discussed below, there are instances in which the DST Structure will also include a master lease with a master tenant that is also an affiliate of the sponsor. Under Revenue Ruling 2004-86, the like-kind exchange investor holds a passive investment in a property that is being managed and operated by the sponsor (i.e. a third party).

Because the Trust is a tax-driven structure, there are certain limitations imposed on what the Trust (and the trustee, the asset manager and the master tenant) can do. Specifically, under a properly structured Trust the following limitations will apply during the period that the property is held by the Trust: (i) the Trust cannot raise new capital; (ii) other than in the case of a tenant bankruptcy or insolvency, the Trust cannot renegotiate or modify an existing loan nor can the Trust refinance or enter into a new loan during the period that the property is held by the Trust; (iii) the Trust cannot renegotiate or modify its existing leases or enter into new leases other than in the case of a tenant bankruptcy or insolvency (in the case of a Trust that adopted a master lease structure, this limitation applies to the master lease and not the underlying third-party leases); (iv) the Trust cannot reinvest the proceeds from the sale of the property; (v) the Trust cannot modify or improve the property other than undertaking normal maintenance or minor non-structural repairs; (vi) the Trust cannot hold its reserves other than in cash or short-term obligations; and (viii) the Trust must distribute all of its cash, other than cash held for normal reserves, on a current basis.[2]

The Springing LLC – Threshold Questions

The Trust Agreement provides that the trustee is generally prohibited from taking any action that would cause the trust to violate of any of the above-referenced limitations. However, one exception to this prohibition is generally described as the springing LLC provision. In general terms, many trust agreements will provide that if the trustee is faced with the need to undertake action to protect against the loss of the property, the trustee has the ability to convert the Trust into a multi-member limited liability company in certain circumstances (the “Springing LLC”). The conversion to the Springing LLC is a “single entity” reorganization under Delaware law that does not cause an actual or deemed transfer of the Trust’s property to the Springing LLC.

Note that the ability to trigger the conversion of the Trust into the Springing LLC can occur only if the conditions set forth in the trust agreement to do so are satisfied and, in most cases, if the Trust’s lender has consented. Typically, the conditions include circumstances in which the loss of the property is imminent. If the conditions set forth in the trust agreement for the conversion cannot be met or the Trust’s lender does not consent, the Trustee has no ability to convert the Trust into the Springing LLC (this is not

[2] Note that a recapitalization of a Trust raises certain issues under securities laws, including that a new private placement memorandum would be required, but such issues are beyond the scope of this article.

something that can be done solely upon the discretion of the Trustee). Accordingly, an equity source that is contemplating an investment in a distressed property that is owned by a Trust should first understand the circumstances that must arise in order to convert the Trust (which cannot restructure the debt or take on new capital) to the Springing LLC. The Springing LLC is not subject to the limitations on the Trust and provides the opportunity to recapitalize the property, modify or refinance the existing debt and otherwise "right-size" the property.

Springing LLC – Lender Consent and Lease Issues

In a properly structured Trust, the ability to obtain the consent of the lender in order to convert the Trust into a Springing LLC will be built into in the loan agreement, providing for conversion to avoid a loan default or to raise additional capital. In some rare cases, the loan agreement will provide that consent is deemed given if the conditions set forth in the loan agreement are satisfied. Most commonly, the loan agreement will require the Trust to obtain the consent of the lender to complete the conversion.

In many cases, the consent of the lender will likely not be given unless the parties can also present a comprehensive plan on how the distressed property will be recapitalized once the conversion to the Springing LLC occurs.

Springing LLC – Issues related to the Consent of the Existing Investors

Unlike in a TIC Structure, obtaining the consent of the owners of the beneficial interest of a Trust is not required to trigger the Springing LLC provisions or to sell the property. However, the cooperation of at least some of the current owners of the beneficial interests will be required for a recapitalization of the property. The terms of the LLC agreement for the Springing LLC are established at the time the Trust acquires the property (i.e., the initial investment) and a copy of the LLC agreement for the Springing LLC is attached as an exhibit to the trust agreement. In many cases, the LLC agreements used in the DST Structure provide only for pro rata distributions to the existing holders of the beneficial interests in the trust-based upon their initial ownership interest and do not anticipate having a class of membership interests that has a preferred return or a priority distribution right. Accordingly, triggering the Springing LLC provisions of the Trust Agreement and obtaining lender consent for the conversion are only the first steps in the process.

In the recapitalization of the property, a mezzanine loan or a new class of membership interests are often used. In a mezzanine loan structure, the property is owned by a single-member LLC that is owned by the multi-member LLC with the mortgage lender making the loan to the single-member LLC and the mezzanine loan lender making the loan to the multi-member LLC. Alternatively, a new equity provider will take a new class of membership interests that provides for a preferred return, a priority distribution right in respect of the new equity and a sharing of distributions with the holders of the other class of membership interests. Thus, because the adoption of a structure needed for the investment of new equity will likely require new mezzanine financing or a structure other than the pro rata distribution structure as provided in the LLC Agreement for the Springing LLC as set forth in the Trust's trust agreement, the consent of some or all of the members may be required.

The Springing LLC will be a Delaware LLC. As a result, the adoption of the appropriate structure with the consent of less than all of the member might be possible through the use of a merger structure. Alternatively, the LLC agreement for the Springing LLC may provide for an amendment of the LLC agreement with something less than unanimous consent. Thus, as part of the process of undertaking an investment of new equity in a distressed property that is owned by a Trust, the mechanics of obtaining the required cooperation of the existing owners of the beneficial interests in the Trust cannot be ignored.

Springing LLC – Master Lease Issues

As with any change of ownership, as would be the case of a conversion of the Trust to the Springing LLC, the underlying leases would need to be reviewed to address assignment issues and tenant estoppels would need to be obtained in connection with any restructuring of the entity that is the owner of the property. However, with a Trust, there could be one more level of lease issues to address. As noted above, a Trust will commonly use a master lease structure if the underlying tenant leases would require renewal during the term of the Trust. Under the master lease structure, the Trust enters into a lease with the Trust and the master lease entity, in turn, enters into or is assigned the various leases with the underlying tenants.

As part of a recapitalization of the property in a DST Structure, the tax-driven need for the master lease structure might no longer exist and the parties would need to examine whether the master lease structure should be dismantled. Even if the parties determine that the master lease should remain in place, the economics of the master lease should be revisited to adopt "flow-through" master lease structure.

Determining When to Start Discussions

As of the date of this article, the full impact of the Covid-19 issue on commercial real estate is unknown. However, the limitations imposed on Trusts will cause them to be less nimble in addressing tenant and cash flow matters than non-Trust owners. Unlike property owned by multi-member LLCs and investment funds, which can readily raise additional capital from their existing owners or new investors, property owned by a Trust might face more difficulty in avoiding monetary and non-monetary defaults under their loans. Since making a recovery from the 2008 crisis, many in the commercial real estate space have focused on having “dry powder” for when a downturn occurs.

At some point, providers of equity will have an opportunity to pursue an investment in a distressed property owned by a Trust. Those providers that understand the DST Structure, the mechanics of Springing LLC, the lender consent discussions and the need for cooperation of the existing investors of the Trust will have a better opportunity for a successful transaction than those that treat the opportunity like any other distressed deal.