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The Emergence of the Delaware Statutory Trust

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Practices: Real Estate

The Delaware statutory trust ("**DST**") has become the vehicle of choice in the offering of fractional interests in real estate to investors for like-kind exchanges. But that hasn't always been the case. For many years, tenant-in-common ("**TIC**") structures were preferred by investors, sponsors and lenders and the DST was considered to be too restrictive. This article discusses both the TIC and DST structures, the key differences between them, and how and why the DST emerged as the clear favorite.

BACKGROUND

Section 1031 of the Internal Revenue Code (the "**Code**") allows the seller of property used in a trade or business or held for investment to defer taxes on the sale by exchanging the property for like-kind replacement property (the "**Replacement Property**"). Under safe-harbor guidelines provided by the Internal Revenue Service (the "**IRS**"), sellers seeking to undertake a like-kind exchange must identify a Replacement Property within 45 days after selling their property and must acquire the Replacement Property within the first of 180 days after selling their property or the date on which the seller's tax return is due for the year in which the sale occurred.

This being enterprising and entrepreneurial America, an industry has arisen that offers property sellers pre-packaged investments that qualify for tax deferral under Section 1031 of the Code.

By way of example, let's say John Smith recently retired and intends to sell an apartment building he invested in many years ago. He anticipates net sales proceeds of $5,000,000. Section 1031 allows Mr. Smith to defer taxes on the sale of the apartment building if he exchanges it for Replacement Property. To qualify for deferral, Mr. Smith would need to identify the Replacement Property, negotiate the purchase and sale of the Replacement Property, arrange for the financing of the purchase, close on the purchase and financing, and then either manage or hire property management once he owns the Replacement Property.

As a retiree, Mr. Smith wants less work, but, as a taxpayer, he would prefer to defer the payment of taxes on the sale of the apartment building. A "sponsor" is the party that can help Mr. Smith with these goals. will offer investors such as Mr. Smith fractional interests in a pre-packaged Replacement Property (which could also be a portfolio of properties) (a "**Replacement Property Offering**"). The sponsor will identify the Replacement Property, arrange for acquisition and financing, close on the acquisition and financing, provide or arrange for the management of the Replacement Property, and then eventually sell the Replacement Property. Assuming in this example the offering price of the Replacement Property is $50,000,000, Mr. Smith would own a 10% interest in the Replacement Property with his $5,000,000 investment.

In addition to easing the administrative burden of completing a like-kind exchange and providing for professional property management of Replacement Properties, Replacement Property Offerings enable sellers such as Mr. Smith to acquire fractional interests in institutional-quality properties they might not otherwise be able to afford.

TIC VS. DST

TIC Offerings

Initially, Replacement Property Offerings utilized TIC structures. In a TIC structure, up to 35 investors would acquire undivided tenant-in-common interests in the offered Replacement Property. In the case of Mr. Smith, he would be the single member of a limited liability company (each, an "**SMLLC**") and the SMLLC would directly own the undivided 10% tenant-in-common interest in the Replacement Property. The SMLLC would be a borrower with other investor-owned SMLLCs on the acquisition financing and Mr. Smith and the other investors would each execute a non-recourse carve-out guaranty and environmental indemnity agreement in favor of the lender.

In short, in a Replacement Property Offering with a TIC structure, there could be as many as 35 separate owners of the Replacement Property, 35 separate borrowers, and 35 separate guarantors and indemnitors of non-recourse carve-outs and environmental matters. In addition, based on guidance from the IRS in Revenue Ruling 2002-22, TIC structures required unanimity of investors for certain major decisions, including lease modifications, and unanimity for loan modifications was effectively required since each SMLLC was a borrower and each investor was a guarantor/indemnitor. These complexities and limitations on the TIC structure make it impractical in many situations and undesirable or infeasible for many investors.

DST Offerings

In 2004, the IRS blessed the use of another vehicle for Replacement Property Offerings when it issued Revenue Ruling 2004-86 (the "**DST Ruling**"). Under the DST Ruling, the IRS held that beneficial interests in a DST could qualify as Replacement Property for purposes of a like-kind exchange, subject to satisfaction of certain conditions commonly known as the "Seven Deadly Sins."

The Seven Deadly Sins provide that:

1. A DST may not raise additional capital after the initial offering.
2. A DST may not amend or terminate any of its leases or enter into new leases unless there is a tenant bankruptcy or insolvency.
3. A DST may not renegotiate its financing or obtain new financing.
4. A DST may not reinvest the proceeds from the sale of its property.
5. A DST may not modify its property except for normal maintenance and minor nonstructural repairs (unless legally required to do so).
6. A DST must distribute all cash on a current basis (other than normal reserves).
7. A DST must hold its reserves in short-term debt obligations.

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An underlying and important concept regarding the DST is that neither the DST nor the sponsor-affiliated trustee that controls the DST (the "**Signatory Trustee**") can take any action that would cause the DST to "vary the investment" as it existed in the Replacement Property Offering. For example, executing a reciprocal easement agreement with a neighboring property owner or extending the term of the acquisition financing could be considered to "vary the investment" and would be prohibited under the DST's trust agreement.

In a Replacement Property Offering with a DST structure, investors acquire beneficial interests in a single entity (i.e., the DST), which owns the Replacement Property and is the sole borrower on the acquisition financing. The Signatory Trustee controls the DST and investors have no say in any decisions. A Delaware trustee is also engaged solely to satisfy the requirement to have a trustee located in the state under Delaware law. In the case of Mr. Smith, he would acquire 10% of the beneficial interests in a DST.

Since the investors do not control the borrower or the Replacement Property, they are not required to execute a non-recourse carve-out agreement or environmental indemnity in favor of a lender. Rather, the person or entity controlling the sponsor will be the non-recourse carve-out guarantor and environmental indemnitor.

The Preferred Structure

Following the DST Ruling, TIC structures continued to be favored by sponsors and investors in Replacement Property Offerings and lenders in financing such transactions. They were a known commodity, and the Seven Deadly Sins seemed to make the DST structure too restrictive.

Then, when real estate markets crashed in 2008, the weaknesses of the TIC structure were exposed. In particular, the unanimity requirement for certain major decisions proved especially problematic when it came to distressed assets. There were instances of properties being lost to foreclosure because a single TIC investor would not approve a lease modification that would have prevented a loan default or a loan modification that would have prevented foreclosure.

From the wreckage of the market crash, the DST emerged as the clear favorite in Replacement Property Offerings. Today TIC offerings are exceptionally rare. As described above, the DST structure is more efficient, less expensive and eliminates key downsides with the TIC structure, particularly the control issues associated with the unanimity requirement.

The following chart outlines the key differences between the TIC and DST structures:

Key Issues	**TIC Structure**	**DST Structure**
Number of property owners	Up to 35	One
Number of borrowers	Up to 35	One
Control	Unanimity required to sell the property, hire a property manager and create or modify any blanket property liens	Sponsor-affiliat trustee

Key Issues	TIC Structure	DST Structure
	Unanimity effectively required to modify the loan because each TIC is a borrower	
Investor Recourse Liability	Non-recourse carve-out guarantor Environmental indemnitor	None

OVERCOMING THE RESTRICTIONS

In the years following the issuance of the DST Ruling, the TIC structure remained the preferred vehicle for Replacement Property Offerings. As noted above, the DST was perceived to be too restrictive and only appropriate for certain limited property types due to the Seven Deadly Sins. DSTs were initially often used for ground leased or single-tenant triple-net leased properties (for example, a Walgreens or a Dollar General).

But the desire to avoid paying taxes is strong and the industry became comfortable with the DST structure after the TIC structure became radioactive. The most problematic aspects of the Seven Deadly Sins are addressed in the following ways in a DST structure:

1. Leasing Restriction: To circumvent the restrictions on leasing under the DST Ruling, the DST will enter into a master lease with the Master Tenant, which is a newly formed affiliate of the sponsor. The Master Tenant controls the Replacement Property and becomes the landlord under the existing leases, enters into new leases as the landlord, and can modify leases.

Lenders often seek to make the Master Tenant a co-borrower under the acquisition financing since the Master Tenant is affiliated with the borrower and controls the Replacement Property and property cash flow. Doing so, however, would create the risk of loss sharing between the master tenant and the investors and jeopardize the investor exchanges.

Instead, the Master Tenant can (a) execute the loan documents (other than the promissory note) for purposes of satisfying the obligations that are delegated to the Master Tenant under the master lease or that are otherwise applicable to the Master Tenant, (b) execute an assignment and assumption of leases in favor of the DST covering a default by the Master Tenant under the master lease (which assignment is then assigned by the DST to the Lender), (c) execute the non-recourse carve out guaranty and the environmental indemnity agreement for its own acts, (d) execute a subordination agreement in favor of the lender allowing the master lease to be terminated if the loan is in default, and (e) agree to be subject to the cash management provisions under the loan documents.

2. Restrictions on Additional Capital: Since the DST cannot raise additional capital, the DST should (and lenders will require the DST to) establish upfront reserves to cover maintenance and repair costs over the term of the loan. Sponsors and lenders must pay particular attention to scrutinizing the condition of the Replacement Property, identifying maintenance and repair items, and adequately reserving funds for such maintenance and repair. As part of the Replacement

Property Offering, the DST will also create a working capital reserve to cover administrative and other costs that might arise.

3. Addressing Emergencies: Because the DST is prohibited from raising additional capital and renegotiating its existing financing, its ability to respond to emergency situations is limited. If these restrictions prevent the DST from addressing a situation that arises with the Replacement Property (such as an imminent default under its loan), the DST can convert (or spring) to a limited liability company (a "**Springing LLC**"). The Springing LLC would be managed by the Signatory Trustee and the beneficial interests owned by investors will become equivalent membership interests in the Springing LLC. Once converted, the Springing LLC can undertake the actions the DST was prohibited from taking under its trust agreement such as renegotiating loan terms. The form of the Springing LLC's operating agreement should be attached to the trust agreement and pre-approved by the lender.

It should be noted that the conversion of a DST to the Springing LLC does not result in an actual or deemed transfer of the property under Delaware law. It is instead a change in the form of ownership. In connection with a conversion, a lender will likely require a title insurance date down and an acknowledgement by the Springing LLC that it is the borrower under the loan documents. In addition, many lenders will have the right to require DST borrowers to convert to the Springing LLC if there is a default or imminent default under the loan documents and will make the failure to convert to the Springing LLC a recourse event.

It is important to note that not all of the Seven Deadly Sins can be resolved. In particular, the restriction on modifying a property (except for normal maintenance and minor nonstructural repairs or unless legally required to do so) prevents the DST from being used for properties requiring more than customary maintenance and repairs. Thus, for example, replacing a roof or adding a building or parking lot will be prohibited in the DST structure.

While it took a few years and a market crash, the DST structure has been fully embraced by investors, sponsors and lenders in Replacement Property Offerings. The DST has emerged as the more efficient, less expensive and more nimble vehicle and, in contrast to the TIC structure, has weathered market volatility and proved capable of addressing emergencies and other unanticipated challenges.

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Masuda Funai is a full-service law firm with offices in Chicago, Detroit, Los Angeles, and Schaumburg.