

# REAL ESTATE SECURITIES GROUP **Alert**

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## Refinancing TICS: Roll Ups And Recapitalizations

For TIC deals (performing and nonperforming) with loans maturing in the near term, today's credit market upheaval presents significant challenges. The loan securitization market that once drove TIC financing has evaporated, with few signs of returning to meaningful levels, and portfolio lenders are entertaining fewer loans on commercial real estate. Existing TIC programs seeking to refinance will likely face lenders who require a single borrower rather than multiple borrowers as a condition to funding a new loan. Generally, this will require TICs to contribute their interests in property to a newly formed limited liability company (LLC) or Delaware Statutory Trust (DST), which is often referred to as a "roll up" of their interests. In addition, because property values have fallen and lenders have reduced the amount of permissible leverage, a refinancing may require significant additional equity capital. At the same time, more non-traditional lenders (investment funds, Real Estate Investment Trusts (REITs), strategic investors, etc.) are surfacing or are expected to surface in the coming months as another potential source of refinancing. There are different structuring opportunities and pitfalls with a non-traditional lender. Hirschler Fleischer's Real Estate Securities Group is equipped to counsel our clients through this process and create new business opportunities for them.

Although the refinancing process will differ from property to property, and from lender to lender, a roll up will require that each TIC contribute its interest in the property to a newly formed Delaware LLC or DST (NewCo). The TIC would then hold an equity ownership interest in NewCo and, in turn, NewCo would own a 100% interest in the property (assuming all TICs contribute their interests). If new capital will be injected into the deal, the new capital investors will contribute capital to NewCo in the form of cash and will receive equity interests in NewCo. It is likely that these ownership interests would be preferred equity interests entitling the new investors to a preferred return and a return of capital prior to TIC investors receiving distributions. NewCo would be the borrower under the new loan. Lenders will likely require the sponsor to oversee the roll up and maintain a management role in NewCo and at the property.

As a promoter of the roll up, you will be offering a new security (LLC or DST interests) to the TIC investors and creating a new property ownership structure for them. You should consider the following challenges, among others:

- Negotiating key transaction and loan documents with multiple stakeholders: TICs, their financial advisors, the new lender (or multiple lenders), any loan servicer and any new investors.

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- Creating a deal structure that addresses any unique requirements of the new security, for example incorporating a master lease agreement into the DST structure in order to effectively manage the property and meet Internal Revenue Service guidelines.
- Providing comprehensive securities disclosure to describe the new investment format to the TICs, as well as proxy disclosure to solicit the contribution of TIC interests to the new entity.
- Identifying available Federal and state securities exemptions for the roll up.
- Addressing the hurdles created by any “hold out” TICs and buyout provisions.

A significant question for you as the promoter of the roll up is how to finance the costs associated with the roll up (loan application fees, appraisal and other third party report costs, other lender fees, legal costs for documentation and negotiation, and transfer taxes and other real estate costs). You also need to consider how to fund any required capital infusion:

- Are TIC capital contributions possible, likely or sufficient? Should TICs who contribute new capital receive preferred equity?
- Should you as the sponsor advance costs, loan funds or capitalize NewCo, and how will such an investment be repaid or redeemed, especially if the refinancing fails?
- Are joint venture partners or opportunistic investors available sources of financing at a feasible cost? Do you as a sponsor have a related investment fund that could serve as a capital source? Will the TICs stomach a new investor with preferred distribution rights?

You should also be aware of issues your investors may consider when deciding whether to vote for or against a roll up. For investors who purchased the TIC interest in a 1031 exchange, tax implications of the roll up can be paramount:

- Both LLCs and DSTs offer the potential for tax recognition deferral, but refinancing requires careful structuring to avoid the possibility of unanticipated taxable income resulting from the new debt and to create exit strategies that preserve the ability to continue tax deferral in a new investment.
- Many lenders will prefer or even require an LLC structure, which is more flexible than a DST (particularly in the distressed context) but may foreclose the opportunity for a future 1031 exchange.
- Individual investors may want to consider some tax recognition in view of suppressed real estate values and (still) historically low tax rates on capital gains.

The LLC and DST ownership structures may present opportunities not available under the TIC structure. For sponsors, the LLC or DST can provide consolidation of control, removal as manager only “for cause” and continuing fees. For investors, a roll up into a LLC or DST avoids the forced sale of the property (or even foreclosure) at a time of low property valuations and could position investors for future diversification and liquidity through a contribution to a REIT or pooled investment fund. In certain cases, for a well performing property a roll up may not be required prior to contribution of the property to a REIT. A REIT can receive a direct contribution of real estate in exchange for interests in its operating partnership. However, this diversification strategy must be carefully documented and would foreclose future tax deferred exchanges for investors. Our team continues to consider other potential structures that would accomplish a refinance for investors and be mutually beneficial for lenders and our clients.

The breadth of Hirschler Fleischer’s practice enables us to provide comprehensive and practical advice to our clients on virtually any legal matter that they face. Hirschler Fleischer’s Real Estate Securities Group is a highly experienced inter-disciplinary team that regularly advises clients on the complex corporate, securities and related real estate matters our client face as they refinance existing portfolios, roll up real estate interests, seek new capital investors for existing programs and offer new real estate funds or REIT programs.



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