

MEZZANINE LOANS INVOLVING A DELAWARE STATUTORY TRUST

By: David F. Belkowitz, Esq.

Many tenant in common (“TIC”) syndication sponsors have begun exploring the use of Delaware Statutory Trusts (“DSTs”) as their syndication vehicle because of (i) lender resistance to multiple borrower parties, and (ii) the ability to syndicate the ownership to a larger number of investors. Numerous articles have been written regarding DSTs and their limitations. This article addresses special issues associated with mezzanine loans for DSTs. To understand these issues, it is first necessary to explain mezzanine financing in a TIC syndication.

MEZZANINE FINANCING IN TIC SYNDICATIONS

In a TIC syndication, the sponsor sells undivided fee simple TIC interests in a property to multiple investors. If the offering is not fully syndicated (sold out) by the closing date, it is not uncommon for the sponsor to obtain a mezzanine loan to bridge the equity gap. Due to special purpose entity and senior lender debt restrictions, the mezzanine loan is not made to the sponsor affiliate that owns the remaining unsold undivided interests in the property (the “Sponsor Entity”), but is instead made to the sole member (the “Sole Member”) of the Sponsor Entity, and is secured by a pledge of the Sole Member’s ownership interest in the Sponsor Entity. Upon the occurrence of an event of default under the mezzanine loan, the mezzanine lender can foreclose on the Sole Member’s membership interest in the Sponsor Entity. At that point, the party that buys such membership interest at foreclosure owns and controls the Sponsor Entity and can continue to sell out the Sponsor Entity’s remaining undivided interests in the property.

Mezzanine lenders vary in their view of control of the property as part of their repayment strategy. Some mezzanine lenders look solely to the sale of the TIC interests as their repayment source. However, this may be false security, because a default in the mezzanine loan is often attributable to the failure of the Sponsor Entity to sell those TIC interests prior to the maturity of the mezzanine loan.

This article
addresses special
issues associated
with mezzanine
loans for DSTs.

Other mezzanine lenders view control of the property as an additional critical attribute in underwriting the mezzanine loan. Note that in most TIC syndications, the Sponsor Entity is party to a tenants in common agreement (the “TIC Agreement”), which restricts the right of the Sponsor Entity to control the property and force a sale or refinancing, absent unanimous consent of all other TICs. However, TIC Agreements often provide call rights whereby “dissident” TICs can have their interests purchased by other TICs if a supermajority of the TICs want to take one action but the dissident TIC objects to the action.

Mezzanine lenders that place great importance on maintaining control of the property might not permit TIC interests to be sold if the amount of interests sold would result in the Sponsor Entity owning less than a supermajority of TIC interests the property. By doing so, the mezzanine lender knows that if a foreclosure of the Sole Member's membership interest in the Sponsor Entity occurs, the mezzanine lender would gain control of the Sponsor Entity, which in turn would hold the supermajority, thereby allowing the mezzanine lender to control the buy out of "dissident" TICs. Alternatively, the mezzanine loan may contain a springing full recourse clause that would allow the sponsor to sell an amount of interests that would result in the Sponsor Entity owning less than a supermajority, so long as a creditworthy guarantor with liquid assets guarantees the mezzanine loan.

MEZZANINE FINANCING IN DST SYNDICATIONS

Mezzanine lending for DSTs poses a broad range of issues. The investors in a DST own beneficial interests, but they do not control the operation – such as it is – of the DST. Control of the operation of a DST is vested in a signatory trustee, which is typically an affiliate of the sponsor. Notwithstanding its affiliate status, the signatory trustee owes a fiduciary duty to the owners of the beneficial interests.

If an offering is not fully subscribed (sold out) at the time of the acquisition of the property, the sponsor will form an entity to hold the unsold beneficial interests (the "Sponsor Beneficiary"). If the Sponsor Beneficiary has not sold enough beneficial interests and bridge financing is needed, the mezzanine loan is made to the Sponsor Beneficiary and is secured by a pledge of the sole membership interest in the Sponsor Beneficiary, a pledge of the sole membership interest in the signatory trustee, and a pledge of the sole membership interest the master lessee that leases the property from the DST.

DST agreements are not drafted with call rights like those in TIC Agreements, because beneficial interest owners do not make the decisions for the DST, as

TICs do. If the Sponsor Beneficiary defaults on the mezzanine loan, the mezzanine lender can foreclose on the pledged membership interests and thereby control the Sponsor Beneficiary, the signatory trustee and the master lessee.

There is a potential conflict of interest between the interests of the mezzanine lender and the other investors that own beneficial interests in the DST. On one hand, the mezzanine lender will view selling out the unsold beneficial interests of the DST as the primary loan repayment strategy, but as with a TIC syndication may also view the control of the property as the loan repayment strategy, be it through a sale of the property or a refinancing. On the other hand, the other investors have invested with the intent to hold the property. How does the trustee, which owes a fiduciary duty to all owners of beneficial interests, fulfill its fiduciary duty to parties whose interests may conflict? Simply stated, it cannot, and therein is one difficulty in making mezzanine loans involving a DST.

The DST statute permits the owners of beneficial interests in the DST to waive the fiduciary duty owed by the signatory trustee to the beneficial owners, but notwithstanding the waiver of the fiduciary duty there is imposed on the statutory trustee an implied covenant of good faith and fair dealing when it takes any action. The implied covenant of good faith and fair dealing cannot be ignored but can be addressed by explicit disclosure to the investors of the risk of the sale of the property by the statutory trustee. The disclosure will need to be made in the private placement memorandum and in the subscription agreement, and the power to sell the property must be clearly stated in the DST Agreement itself.

CONCLUSION

Mezzanine loans can be made in DST syndication transactions. However, mezzanine lenders need to be aware of the added complexities of a DST if control of the property is an important element of its underwriting. Also, sponsors need to make sure that the relevant disclosures are included in their offering documents.