Accommodate This: Lender Issues in Non-Safe Harbor Reverse Exchanges

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Non-Safe Harbor Exchange Structure in Bartell*

- Exchange Accommodation Party ("EAP") enters into a real estate development and exchange cooperation agreement ("REDECA") with the Exchangor.

- Outside lender provides non-recourse Construction Loan. Additional loan from the Exchangor ("Equity Loan"), who also guarantees the Construction Loan.

- Exchangor has a 24-month fixed price option. No put, but a "deficit make-up” quasi-put.

Non-Safe Harbor Exchange Structure in Bartell

• Construction Management Agreement with Exchangor.

• Relinquished Property identified in the REDECA but later changed.

• Should the Construction Lender care if the REDECA strays too far from the Bartell structure?
Acquisition of Parked Property

- Exchangor negotiates Purchase & Sale Agreement for the Parked Property
- Exchangor assigns Purchase & Sale Agreement for the Parked Property to EAP Parent
- EAP Parent (100% membership Interest)
- EAP
Financing Structure

Exchangor

Equity Loan

Pledge Agreement

Guaranty of Construction Loan

Construction Lender

Construction Loan

EAP Parent

EAP

Parked Property
Construction of Improvements

Exchangor

EAP Parent

EAP Parent makes draws on Equity Loan

EAP Parent Contributes Equity Loan Proceeds to EAP

Construction Lender

EAP

EAP makes draws on Construction Loan

Payments for Project Costs

Contractors

Parked Property (improvements in progress)
Sale of Relinquished Property

Exchangor

Relinquished ("RQ") Property Buyer

RQ Property Purchase & Sale Agreement

Exchangor assigns RQ Property Purchase & Sale Agreement

Qualified Intermediary

RQ Property Sales Proceeds

EAP Parent

Transfer of 100% membership Interest in EAP

EAP

Parked Property (Improved)

RQ Property Sales Proceeds
Close-Out of Equity Loan

EAP Parent repays Equity Loan with RQ Property Sales Proceeds

EAP repays a portion of the Construction Loan balance

EAP Parent contributes the remaining balance of funds (if any) received from the QI to EAP
End State

Exchangor

Balance of Construction Loan

EAP

Improved Parked Property

Construction Lender

9
Issues and Risks for Construction Lender

• Bankruptcy of EAP and/or its parent entity (“EAP Parent”).

• Ability of the Construction Lender to realize upon its collateral (the “Parked Property”).

• Timing concerns – when can the Construction Lender collapse the structure so EAP Parent is out of the picture.
Bankruptcy Concerns

• Bankruptcy of EAP or EAP Parent could subject the Construction Lender’s collateral (the Parked Property), to claims of creditors of the EAP or EAP’s Parent.

• Typically, EAP is a special-purpose entity of which EAP Parent is the sole member. The SPE is typically a limited liability company for state law purposes and a disregarded entity for federal income tax purposes.

• If EAP cannot borrow other than pursuant to the Construction Loan, the structure for the Equity Loan must have EAP Parent as the borrower.
Bankruptcy Concerns

• Interjection of EAP as nominal borrower under the Construction Loan adds the bankruptcy risk and the risk of a “rouge accommodator” (either EAP or EAP Parent) who will not cooperate with completing the exchange and transferring the membership interests to the Exchangor.

• Making Exchangor a co-borrower is risky from a Code Section 1031 perspective.
Bankruptcy Concerns

• Construction Lender’s mitigation strategies:
  • Obtain a full guaranty from the Exchangor.
  • Require that EAP have an independent non-member manager (possibly an affiliate of the Exchangor) who will agree not to vote for bankruptcy. Any removal of the Exchangor-affiliated manager should be an event of default under the Construction Loan.
  • Require a non-consolidation opinion from EAP’s counsel that EAP will not be wrapped into a bankruptcy of EAP Parent.
  • Also make EAP Parent a special-purpose entity.
Construction Lender’s Ability to Realize Upon Collateral

• Construction Lender should obtain a direct note and mortgage from EAP for the Construction Loan.

• Construction Lender should also take an interest in the Equity Loan through either (i) a collateral assignment of the security for the Equity Loan or (ii) an intercreditor agreement with the Exchangor that prevents the Exchangor from exercising its rights in the event of a default under the Equity Loan.
Construction Lender’s Ability to Realize Upon Collateral

• The Construction Loan should be due when construction is completed. Any extension rights should be personal to the Exchangor. Termination of the construction management agreement and default on the Equity Loan to the Exchangor should be events of default.
Timing Concerns

- To fit within the framework established in Bartell, 147 T.C. 140 (2016), the Construction Loan should become due if construction is not complete within 24 months or the Exchangor has not exercised its option to purchase.
Non-Bankruptcy Issues for Construction Loan Documents

• Pre-approval of the transfer of membership interests in EAP from EAP Parent to the Exchangor.

• Financial information regarding EAP and EAP Parent?