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Articles

Master Leases In Financing Transactions

Douglas P. Snyder

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Financing a commercial real estate project based on its rental stream brings many challenges for a property owner. Deficiencies in that rental stream only increase these challenges, whether the deficiencies arise from vacant space, scheduled lease expirations, tenant concessions (such as free rent) or other lease attributes that are scrutinized in the lender's underwriting process. Some lenders seek to have perceived rental deficiencies covered by requiring a "master lease".

A master lease is a lease of all or some portion of a commercial project signed by a creditworthy master tenant to provide an additional or back-up rental stream for the project. The master tenant is typically a principal or affiliate of the borrower entity owning the project, which is the landlord. The master lease is assigned to the lender as collateral.

Master leases can be structured in many ways, but their common purpose is to provide the income stream necessary to support project financing. Some common structures include:

The master tenant leases the entire project, and is deemed to be subleasing space to tenants in occupancy of their space;

The master tenant leases specific vacant space only, and the master lease terminates with respect to space later leased to tenants in occupancy;

The master lease covers only the vacant space in the project from time to time, so that the master premises “float” to coincide with actual vacant space;

The master lease covers specific space covered by a lease with an upcoming expiration, and takes effect only if that lease is not renewed or the space re-leased;

The master lease covers space leased to a tenant currently paying no rent due to a rent abatement period, but only during such period.

If the master lease was given as credit enhancement for the loan, in the event of the owner’s default, the master lease performs the same function as a guaranty. The lender is looking to the master tenant as a secondary source of recovery after the lender has foreclosed on the project. At that point, the new landlord – the lender or other successful bidder at foreclosure – would seek to collect rent payments due under the master lease as a source to recover its investment.

As explained below, upon court scrutiny a master lease may be treated as a disguised guaranty of the loan. Whether a master lease is treated as a true lease or a guaranty will have significant implications to both the master tenant and the lender.

Recharacterizing a Master Lease

Under certain circumstances, courts will not honor the form in which a transaction has been documented if the true intent of the parties was a different type of transaction with different legal results. The decisions in these types of cases rely very heavily on the individual facts of each case, and the analysis applied by courts varies from state to state.

However, legal scholars widely believe that courts in many states would have no trouble coming to this result if requested by the master tenant. Questions a court must address include:

Was the master lease a condition to the lender making the loan?

Is the master tenant a party who might otherwise have given a guaranty?

Does the rent called for under the master lease produce just the amount of project income necessary to meet the lender’s underwriting standards?

Did the master tenant never occupy the property?

Did the lender treat space leases as direct leases to the borrower rather than as subleases?

If the answer to some of these questions is “yes” the master lease may be treated as a guaranty. Alternatively, if these facts do not appear and there is an independent business purpose for the master lease which is on market terms, the master lease should be treated as a true lease. Many master leases will fall into the gray area between these extremes, and it is hard to predict how they will be treated.

Master Lease as a True Lease

The difference between treating a master lease as a true lease and a disguised guaranty can be very significant. When a master lease is viewed as a true lease, the lender’s recourse to the master tenant is analyzed in the same way as its recourse to any project tenant. The lender’s collateral will include an assignment of all project leases and rents. Following the borrower’s default, in many states the lender will be entitled to appoint a receiver to run the project and collect rents until the lender can hold its foreclosure sale. Prior to foreclosure, the receiver may enforce the master lease, and after foreclosure the successful foreclosure bidder becomes the new landlord under the master lease, entitled to enforce its terms. If the master tenant does not pay its rent upon demand by the receiver or new landlord, it will be in default under the master lease.

In many states, the remedy for landlords to collect rent from tenants in default is to terminate the lease and sue the tenant for delinquent rent and future rent through the end of the lease term. Each state has its own rules for determining what the landlord may collect for delinquent and future rent, and the duty of a landlord to mitigate its damages by seeking a replacement tenant.

Assuming the master tenant is in default under the master lease, a lawsuit against the master tenant seeking to collect these amounts generally could be commenced any time after a receiver is appointed or a foreclosure sale is held.

Master Lease as a Disguised Guaranty

If a court determines the master lease should be recharacterized as a guaranty, it will rewrite the master lease to follow what it believes was the true intent of the parties. The first question the court must face is determining the amounts guaranteed. Assuming the master lease was signed to provide sufficient income to service the loan, a natural conclusion would be that the master lease constitutes a guaranty of debt service up to the amount of rent called for under the master lease. The guaranty might also cover payment of taxes, insurance and any common area maintenance charges at the project.

The lender would be entitled to demand the master tenant pay the guaranteed amounts, and if not paid the lender would bring a lawsuit to enforce the “guaranty.” Guarantors generally have various defenses to guarantees, known as “suretyship defenses.” While most guaranty documents provide waivers of these defenses, a master lease would not normally contain these waivers. The master tenant may be able to raise suretyship defenses, which generally include the right to require the lender to first exhaust the lender’s remedies against its collateral (the project) and the borrower before seeking recovery against the master tenant.

Some lenders attempt to address this problem by including suretyship waivers in the master lease document. This should assist in enforcing the master lease if it is recharacterized as a disguised guaranty. However, this language in a master lease would clearly show that the parties were cognizant of this risk and may be used as evidence that the parties intended a guaranty rather than a true lease. Both the benefits and risks of including guarantor waivers in a master lease should be carefully considered.

Effective Use of Master Leases

A master lease can be an effective tool for a commercial property owner to enhance its financing opportunities. Whether this legal obligation should be structured as a master lease or a guaranty of cash flow or debt service should be carefully considered by the borrower and lender, with the advice of counsel. In most cases there will be a structure that meets the needs of both parties, and this can be implemented while minimizing the risk of later recharacterization by a court and the unintended results that follow.

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The Abcs Of The New Markets Tax Credits Program

By Stephanie M. M. Smith, Esq.

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INTRODUCTION

The purpose of this article is to provide an overview of the New Markets Tax Credit Program (the "NMTC"), which is intended to encourage lending institutions and private and public investors to invest in economically-distressed communities. Unlike other tax credit programs, such as the Low Income Housing Tax Credits program whose credits are only available to develop affordable rental housing, the NMTC allows a wider range of investment such as affordable and market-rate for-sale housing, and commercial, retail, office, manufacturing, and industrial developments. From an investment standpoint, the NMTC provides investors with a significant rate of return on its investment. From a business standpoint, the NMTC is extremely useful in providing financing for projects that would otherwise be stalled due to a lack of capital.

BACKGROUND

The goal of the NMTC, which is part of the Community Renewal Tax Relief Act passed by Congress in 2000, is to encourage private investments in commercial real estate and business ventures in low-income communities in need of revitalization. The NMTC is administered by the Treasury Department's Community Development Financial Institutions Fund and the Internal Revenue Service under Section 121 of the Community Renewal Tax Relief Act of 2000.

Between 2001 and 2007, the NMTC will have provided investors $15 billion of new markets tax credits, totaling 39 percent of their investment. In order to qualify for these tax credits, investors must make investments through investment vehicles called community development entities ("CDEs"). In turn, CDEs make loans and equity investments to qualified low-income businesses for developing projects in urban and/or rural communities located in qualifying low-income census tracts.

THE PROCESS

Organizations that have expressed an interest in becoming a CDE have typically included non-profits and/or their subsidiaries; banks, thrifts, and bank-holding companies; and government-controlled entities and/or their subsidiaries. An interested organization must make an application to the Community Development Financial Institutions Fund (the "Fund"), become approved through its certification process, and enter into an "Allocation Agreement" with the Fund setting forth the statutory and regulatory terms and obligations that the CDE must meet in order to maintain its status as a CDE.

To become certified, the CDE must meet the following four requirements. First, it must be a domestic corporation or partnership for tax purposes. Second, its primary purpose must be to invest in qualified active low-income businesses ("Qualified Businesses") as described later in this article. Third, it must make qualified low-income community investments ("Qualified LIC Investments") also described later in this article to Qualified Businesses in an eligible community (meaning the community is located within a specified census tract). Fourth, at least 20% of its board of directors must consist of residents of the low-income community it is serving.

Next, the CDE must compete with other CDEs for the tax credits on an annual allocation basis. The Fund awards tax credits based on a CDE's performance, accountability, and record of success in providing assistance to disadvantaged businesses or communities.

Then, if an award is granted to the CDE, the CDE will be able to receive equity from individual and corporate investors and commit those funds to investments or loans to a Qualified Business. Equity invested in a CDE is considered a Qualified Equity Investment if the investment is acquired by the investor at its original issue solely in exchange for cash to substantially be used by the CDE to make Qualified LIC Investments in a low-income community.

Finally, the individual and corporate investors in the CDE become eligible to claim a 39 percent tax credit, based on the amount of their investment, over a seven-year credit allowance period.

THE INVESTMENT

Once a CDE has received the capital proceeds of a Qualified Equity Investment from its investors, it is required to use substantially all of the capital proceeds to make Qualified LIC Investments in Qualified Businesses during the seven-year credit period, which then allows the investors to claim the tax credits over a seven-year period. In general, a Qualified LIC Investment can be:

- Any capital or equity investment in, or loan to, any Qualified Business;
- The purchase from another CDE of any loan made by such entity which is a Qualified LIC Investment;
- Financial counseling and other services specified in statutory regulations to businesses located in, and residents of, low-income communities; and
- Any equity investment in, or loan to, any CDE.

The credit begins on the date in which the investor makes a Qualified Equity Investment in a CDE and continues for a seven-year period. The investors would be entitled to claim tax credits equaling 5% of its Qualified Equity Investment for each of the first three years, and credits equaling 6% for each of the next four years.

In the event the CDE is unable to utilize all of the Qualified Equity Investments issued by the investors for the development project, the investors may be subject to the recapture of all the tax credits issued to date unless the CDE can prove it has used “substantially all” the Qualified Equity Investments. Under the “substantially all” test, the CDE must show that it has used at least 85% of its Qualified Equity Investments in Qualified Businesses for the first six years of the seven-year credit period and 75% of its Qualified Equity Investments in Qualified Businesses in the last year.

THE STRUCTURE OF THE DEAL

The NMTC allows the terms of the deal to be negotiated at the discretion of the CDE and its investors. Although the deal terms may vary, the ebb of the credits and the flow of the equity are structured in two ways.

The Standard Structure

In this scenario, the Qualified Business (the "Borrower") would typically layer its tax credits deal with a conventional loan(s) made by a lender. The lender would loan money directly to the Borrower and the investors would invest their capital as equity into the CDE. The CDE would then in turn loan the money received from the investors to the Borrower less administrative costs and transactional fees.

The Leveraged Structure

In this scenario, the lender does not loan the money directly to the Borrower. The lender here is an active player in the ebb and flow of the tax credits and equity. Typically, the lender would form an entity with the investor (the "upper-tier entity"), generally a limited liability company. The lender would make a loan to the upper-tier entity and the investor would invest capital in the upper-tier entity. The contributions by the lender and the investor are in turn invested by the upper-tier entity into the intermediary CDE. The CDE then in turn loans the money received from the upper-tier entity to the Borrower less administrative costs and transactional fees.

ON THE BUSINESS SIDE…

Over the past few years, certain business owners have shown an interest in qualifying as a Qualified Business. In order to qualify as a Qualified Business, each Qualified Business must satisfy all of the following requirements. First, at least 40% of the business' services performed by its employees must be performed in a low-income community. Second, at least 40% of the leased or owned real property used by the business must be located within a low-income community. Third, at least 50% of the total gross income of the business must be derived from the active conduct of a Qualified Business within a low-income community (which may be reduced to 40% if the first two requirements meet a 50% increment level and not the stated 40%). Finally, no more than 5% of the average of the aggregate unadjusted bases of the property of the business can be attributable to nonqualified financial property (e.g., debt, stock, partnership interests, options, futures contracts, forward contracts, warrants, notional principal contracts, annuities and other similar property).

The NMTC has in its short life span proven to be a worthwhile financial opportunity for businesses, especially start-up businesses that may not necessarily meet the criteria to obtain adequate conventional financing.

However, many businesses are ineligible for tax credit financing. These include businesses involved in:

- The rental of residential real property- if more than 80% of the gross rental income from the development is from dwelling units;
- The rental of unimproved real property;
- Any trade or business consisting mainly of the development or holding of intangibles for sale or license;

- Certain farming operations; and
- Certain "sin businesses" such as massage parlors, gambling facilities and liquor stores.

CONCLUSION

The NMTC is being utilized in many areas of the country, in particular, California, Washington, and Maryland. In recent months, a developer in California utilized the NMTC to finance for-sale affordable housing. Ideally, more and more developers will take advantage of the tax credits to allow for more expansive mixed-use development projects.

For more information about the NMTC you may visit the Community Development Financial Institutions Fund web site at http://www.cdfifund.gov or contact Stephanie M. M. Smith, Esq. at ssmith@clarkhill.com

* * * *

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USA Patriot Act Update for Real Estate Attorneys©

By Kevin L. Shepherd †

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November 4, 2006

In the coming months the Treasury Department, through the Financial Crimes Enforcement Network ("FinCEN"), may issue new regulations that will impose anti-money laundering ("AML") program requirements on "persons involved in real estate closings and settlements." Nearly four years has passed since FinCEN put the real estate industry on notice that the federal government was likely to introduce regulations that would impose AML program requirements on "persons involved in real estate closings and settlements." Many in the real estate industry, including mortgage brokers, real estate agents, title insurance companies, and real estate lawyers, reacted negatively to that prospect. Since that time, the contours of the regulatory regime seems to be taking shape. FinCEN has acknowledged the serious concerns these groups have raised, and it's likely that the regulations that will be issued will meaningfully respond to these concerns.

Treasury issued an advance notice of proposed rulemaking on April 10, 2003 seeking comment on a requirement that "persons involved in real estate closings and settlements" adopt an AML program. By the June 9, 2003 deadline for submitting comments, Treasury received 52 comment letters from interested parties, including a number of bar organizations and real estate industry groups. To date, Treasury has not taken any further public action on the proposed rulemaking.

The 2003 advance notice derives from Title III of the USA Patriot Act of 2001. The act amended a number of provisions of the Bank Secrecy Act. Title III, known as the International Money Laundering and Abatement and Financial Anti-Terrorism Act of 2001, amended the Bank Secrecy Act to facilitate the prevention, detection, and prosecution of international money laundering and to prevent the financing of terrorism.

The Bank Secrecy Act, as amended by Section 352 of the USA Patriot Act, now requires every “financial institution” to establish an AML program that includes the following minimal elements: (a) the development of internal policies, procedures, and controls; (b) the designation of a compliance officer; (c) an ongoing employee training program; and (d) an independent audit function to test programs. The Bank Secrecy Act’s definition of “financial institution” is very broad; it includes institutions that are already subject to federal regulation such as banks, savings associations, credit unions, and registered securities broker-dealers and futures commission merchants –as well as persons involved in real estate closings and settlements.

A wide variety of interested real estate industry groups responded to the advance notice and, for the most part, urged FinCEN to tread carefully in regulating the multi-trillion dollar commercial real estate industry. A number of bar groups submitted comments to FinCEN, including the American College of Real Estate Lawyers (“ACREL”), the ABA Section of Real Property, Probate, and Trust Law, the ABA Task Force on Gatekeeper Regulation and the Profession, the Section of Real Property, Probate and Trust Law of the Florida State Bar Association, and the American College of Mortgage Attorneys. The approaches taken by each organization differ in important respects, but the consistent themes among most of the comments are the concerns that the AML requirements may adversely affect the attorney-client privilege and the duty of client confidentiality, and that they would impose onerous burdens on the real estate industry with no corresponding benefit to the fight against money laundering and terrorist financing.

Since the close of the 2003 comment deadline, ABA and ACREL representatives have engaged in constructive discussions with representatives of FinCEN to air concerns about imposing AML requirements on the real estate industry. These discussions have revealed that one of FinCEN’s policy goals is to meet the statutory goals regarding the regulation of “real estate settlement professionals” while, at the same time, avoiding the unnecessary regulation of attorneys who handle no funds while representing one of the “persons” involved in a real estate closing or settlement. FinCEN is evidently looking to exclude attorneys who act in ways that Treasury considers to be within the historic understanding of performing the functions of an attorney, such as legal analysis, legal advocacy, legal counsel, and other similar, non-financial services.

FinCEN appears to be leaning toward a “financial intermediaries” type of standard. Under this standard, the AML requirements would apply, at most, only to those attorneys who act as “financial intermediaries” and actually handle the receipt and transmission of cash proceeds through accounts that they actually control in the act of closing a commercial real estate transaction. FinCEN has made it clear that it does not desire to regulate attorneys acting within their traditional roles, but once attorneys step outside their traditional roles, they should be subject to the AML requirements.

FinCEN's reticence in seeking to regulate attorneys qua attorneys is well-founded. In a significant decision last year by the U.S. Court of Appeals for the District of Columbia Circuit, the appellate court ruled that the Federal Trade Commission ("FTC") had no authority to subject lawyers to the strictures of the Gramm-Leach-Bliley Act's ("Act") privacy protective provisions. *American Bar Ass'n v. Federal Trade Comm'n*, 430 F.3d 457 (D.C. Cir. 2005). The court ruled that nowhere did Congress authorize the FTC to regulate the legal profession. In response to the FTC's position that Congress sought to regulate the legal profession by enacting the privacy legislation, the court noted that "[Congress] does not . . . hide elephants in mouseholes." Id. at 467. In a metaphor rich passage supportive of the federalism notion that states, and not the federal government, have historically and exclusively regulated the legal profession, the court remarked:

When we examine a scheme of the length, detail, and intricacy of the one before us, we find it difficult to believe that Congress, by any remaining ambiguity, intended to undertake the regulation of the profession of law–a profession never before regulated by "federal functional regulators"–and never mentioned in the statute. To find this interpretation deference worthy, we would have to conclude that Congress not only had hidden a rather large elephant in a rather obscure mousehole, but had buried the ambiguity in which the pachyderm lurks beneath an incredibly deep mound of specificity, none of which bears the footprints of the beast or any indication that Congress even suspected its presence.

Id. at 469. This case lends strong support to the view that, absent express congressional authority, federal regulators cannot regulate the legal profession. Because of federalism principles, it is unlikely that Congress would intrude into this sensitive area.

FinCEN will likely proceed to the next step in the development of the regulations this year. The next step may be the issuance of a notice of proposed rulemaking, which again will contemplate a public comment period before the FinCEN finalizes the regulations. Until then, it's important that the real estate industry continue to engage in a dialogue with FinCEN as it develops this federalized real estate regulatory regime.

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