BINGHAM

Estate Planning Challenges for Real Estate Developers and Owners

By Edward A. Saxe and David L. Silvian

Any significant estate requires advance estate, tax and business planning. However, for a real estate developer or owner, there are not only some unusual situations and problems but also unique opportunities to solve or minimize such matters. Peculiar to the real estate business is that it is usually conducted in multiple entities, involving separate partnerships for each property with unrelated investors or joint venture participants, separate financing, personal guarantees to lenders or tax-oriented investors, and management by a separate company. As a result, upon death, the estate and its executors and trustees will be forced to deal (as did the decedent) with many entities, partners of all types, multiple lenders, tax matters and other issues—unlike most non-real estate closely-held companies or entities that operate only in one or a few entities.

The planning goals below may be applicable to any business entrepreneur but do present different issues and possible solutions for the entrepreneur in the real estate business. These goals include:

- Securing orderly probate administration
- Maintaining continuity of the business
- Retaining control of all the properties
- Deferring or minimizing estate taxes
- Providing needed liquidity for taxes, ongoing business expenses and family support needs
- Reducing or eliminating creditor or lender issues that may affect the business

Advance planning can be very effective and is critical in order to reach these goals, since there will not be any opportunity to do so after the real estate developer's death.

This article focuses on the practical challenges and possible steps that can be taken in advance in order to accomplish these goals. Planning techniques for estate and gift taxes will be discussed only generally. This article assumes that beginning next year there will be a federal estate tax similar to that which was applicable in 2009 and prior years.

ISSUES THAT REQUIRE IMMEDIATE ATTENTION—LIQUIDITY, CONTINUITY AND PROBATE

One immediate concern of the estate is liquidity—funds are needed to continue the business that is spread out in various business entities, to support the decedent's family and, unless most or all of the estate is left to a

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Purchases From Distressed Sellers: Is 363 the Magic Number?

By Steven Wilamowsky and Henry S. Healy

The current economy presents many attractive opportunities to purchase properties from distressed sellers. Nevertheless, many potential buyers are scared away by the formidable risks that are presented by a possibly insolvent seller who may be stumbling toward bankruptcy.

Properties owned by distressed sellers usually come with a number of challenges that are not ordinarily found with better-situated sellers. Efforts to stay afloat are likely to have resulted in several layers of mortgages. There may be attachments or judgment liens resulting from lawsuits and tax liens resulting from unpaid taxes. Properties that have had recent construction may have incurred substantial mechanics' liens imposed by contractors, subcontractors and suppliers. There may be below-market long-term leases or unfavorable supply or management contracts. There may be pending lawsuits that could result in substantial liabilities.

The buyer must also consider the possibility that the seller may be pushed into bankruptcy prior to the closing of a sale. If the seller is insolvent at the time the sale closes, but is not yet a bankruptcy debtor, there is a significant risk that the sale may be challenged in a subsequent bankruptcy proceeding as a "fraudulent transfer"—*i.e.*, a purchase by the buyer from an insolvent seller for less than "reasonably equivalent value." These are only some of the potential landmines that a potential buyer may face.

On the other hand, most of these problems are eliminated if the buyer waits until after a bankruptcy proceeding has commenced before purchasing the seller's property. Once the seller has filed for Chapter 11 (or Chapter 7), the Bankruptcy Court has a broad array of powers, including the power under Section 363 of the Bankruptcy Code, after notice and hearing, to approve the sale of property out of the ordinary course of business. Under Section 363(f), such a sale may be made free and clear of liens and other interests of third parties. This means that once the sale has been approved by the court, the buyer gets the property free and clear of mortgages and other liens, avoids fraudulent transfer risks, is free of claims resulting from lawsuits against the seller and other legacy liabilities, and may be able to obtain the property free of unfavorable contracts and leases.

The Bankruptcy Court also has the power to authorize a sale of property under a plan of reorganization that has been approved by creditors and confirmed at the completion of a Chapter 11 proceeding, but this involves much greater delay and uncertainty for the potential buyer. For this reason, buyers usually find a Section 363 sale preferable, and it has been used in many recent high-profile cases such as the General Motors and Chrysler matters as well as sales of landmark hotel properties. Note, however, that if the property is located in a jurisdiction that imposes significant stamp taxes or similar transfer taxes on sales and other transfers of property, a sale through a plan may be the only way to avoid transfer taxes.

What is required in order for the Bankruptcy Court to approve a Section 363 sale—a process that does not afford creditors and other stakeholders the same degree of input and protection as is available in the context of a Chapter 11 plan process? In general, the ground most frequently used in supporting approval of a Section 363 sale is a finding that the seller has a critical need for the cash proceeds from the sale in order to avoid a complete liquidation, which would result in a lower recovery by creditors when the Chapter 11 proceeding is completed. Currently, this is a very common situation given the constricted credit markets, particularly for refinancings of commercial property. Another reason for Section 363 sales early in a Chapter 11 case is to permit the seller to salvage the value of a deteriorating asset (often called a "melting ice cube" or the paradigmatic "fish on the dock") when there is insufficient time to permit a fulsome Chapter 11 plan process and still preserve the bulk of the property's value.

How does the Section 363 process work? As in most purchase and sale transactions, the process is likely to begin with the negotiation of a non-binding letter of intent or term sheet between the prospective buyer and seller describing the basic business terms of the proposed transaction. The sale process differs from the ordinary purchase and sale in a number of significant ways. Rather than the buyer having the exclusive right to purchase, the transaction ordinarily must be "exposed to the market" through an auction process, with the prospective buyer being the "stalking horse" for itself and other bidders. While a private sale is possible, it is unusual and requires a compelling "melting ice cube" type of situation where there is a manifest risk of rapid deterioration in asset value. This is an almost impossible hurdle in the case of a sale of real property, particularly in a single-asset case.

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Loan Purchase Transactions: Current Trends

By Richard A. Toelke and Teresa L. Cella

BACKGROUND

As commercial real estate investors continue to look for debt purchase opportunities as an alternative approach to achieving ownership of real estate assets (so-called "loan-to-own" transactions), we expect the trend toward increasing loan purchase transactions in the marketplace that began during the liquidity crisis and recession to continue. Many sellers are banks seeking to shore up their capital and reduce exposure to real estate. A number of these transactions involve investment banking firms and other lending institutions selling loans that they have been unable to syndicate on favorable terms. The degree of difficulty in many of these transactions is highlighted by the presence of complicated debt stacks, as loans are often structured to include senior, subordinate and mezzanine components. The priority of payment, control of remedial actions after default and other intercreditor provisions are typically covered in a participation agreement and/or an intercreditor agreement between the holders of the interests in such loans, and the loan purchaser must be acutely aware of the interplay between the various debt tranches and provisions in these agreements as it could have a material impact on the purchaser's underwriting and intended course of action with respect to the loan. These complex transactions require multidisciplinary legal skill and experience in such areas as finance, securities, real estate and bankruptcy.

DUE DILIGENCE; TRANSFER DOCUMENTATION

As a threshold matter, the prospective note purchaser must conduct a full due diligence investigation of the completeness and adequacy of the loan file and the loan documentation. In addition to customary property-level due diligence, the acquisition of a loan also involves due diligence regarding the loan file, as well as the borrower and guarantor. It is also important during the due diligence process to engage local or special counsel in order to determine, among other things, the enforceability and sufficiency of the collateral package, whether or not there are any transfer tax implications in connection with the foreclosure of the collateral, and the likelihood and possible effect of a borrower bankruptcy filing on the transaction. The prospective note purchaser should also determine whether any consents are required to consummate the transaction, as it is often the case that the consent of a senior lender or senior participant is required. Once consent has been obtained or it has been determined that consent is not required, the interest in the loan is typically transferred pursuant to an assignment and assumption agreement. In addition, in more sophisticated loan transactions, the prospective purchaser must be a so-called "qualified institutional lender" and must meet certain "eligibility requirements," which often include ownership of total assets in excess of $600 million and regular engagement in the business of making loans or owning the type of real estate secured by the loan in question. If the prospective purchaser must be a qualified institutional lender, it will be important to analyze the loan-specific definition of such term early in the process to ensure that the intended purchasing entity will, in fact, qualify.

Pricing of these loan purchase transactions is based on a percentage discount of the face value of the loan being purchased and will vary dramatically depending on the value of the underlying real estate. When a party acquires a loan or a participation in a loan, the operative transfer documentation will vary depending on the nature of the transaction and the parties involved. In some cases, a loan purchase and sale agreement is executed and contemplates a due diligence period and interim loan servicing. In other instances, the purchaser will conduct its due diligence while simultaneously negotiating ultimate transaction documents. In either case the transfer documents should contain a number of provisions that are essential to provide proper protection to the purchaser.

TRANSFER AGREEMENTS: ESSENTIAL PROVISIONS FOR PURCHASER PROTECTION

The transfer documentation should contain certain representations and warranties with respect to the assignor and the underlying loan such as (among others) representations that the assignor is the record or beneficial owner of the underlying loan and that the underlying loan is free from all liens and encumbrances; that there are no defaults under the underlying loan; and that the loan documents delivered to the transferee are all of the documents related to the underlying loan. It should also contain representations as to the outstanding principal balance, accrued interest, escrow balances and reserves of the underlying loan.

In the event that a loan purchase and sale agreement is executed, the agreement should also contain a requirement that the seller must continue to service the loan in accordance

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Taxation of Carried Interests in Real Estate: Pending Legislation

By John S. Brown and Matthew D. Schnall

It is common for sponsors of real estate investment entities to receive two forms of compensation for their efforts: fees for services they provide to the entity or fund and a so-called "carried interest" representing a right to share in the appreciation in value of the underlying real estate. Carried interests are also used to provide returns to fund sponsors and managers in other investment sectors, such as the hedge fund, venture capital and private equity industries. In periods of strong investment performance, income from carried interests can represent a significant percentage of a sponsor's or manager's overall income.

Historically, carried interests have been structured as direct or indirect interests in the underlying partnership that holds the investment assets. The tax rules governing partnerships are designed to treat a partner as if he or she had directly received income from the same sources from which such income is recognized by the partnership and allocated to the partner. As a result, the holder of a carried interest is treated — much like any other investor in the partnership — as receiving a share of the partnership's investment income.

Investment income is taxed more favorably, in a number of respects, than compensation for services. Compensation income is subject to employment or self-employment taxes; investment income generally is not. Compensation income is taxed at ordinary income rates (up to 35 percent in 2010; top rate currently scheduled to increase to 39.6 percent in 2011); investment income may be eligible for reduced rates, *e.g.*, maximum rates of 15 or 25 percent for most long-term capital gains and 15 percent for qualified dividend income in 2010. As a result, a sponsor receiving income from a carried interest normally is taxed more favorably than the sponsor would be had he or she received an equivalent amount of fee income.

In recent years, various members of Congress have criticized the differential tax treatment of income from carried interests and fee income. Beginning in 2007, legislation has been proposed to address that differential by taxing certain income from carried interests as compensation income. Similar provisions were included in the Obama administration's fiscal year 2010 budget proposal. Although prognosticators do not expect the proposals to be acted upon during the current lame-duck session of Congress, the proposals could resurface as a revenue offset during the 112th Congress.

While most of the rhetoric around the carried interest proposals has focused on the hedge fund and private equity industries, the proposed legislation that has been introduced and debated would apply generally to all carried interests, including interests in real estate funds. This article focuses on the most recent version of the proposed legislation, as embodied in Senate Amendment 4386 to H.R. 4213 (the so-called "Baucus Amendment" to the Jobs Act).

IMPORTANT CONSIDERATIONS FOR HOLDERS OF CARRIED INTERESTS IN REAL ESTATE PARTNERSHIPS

- The rate of income tax on income from carried interests is increased, and such income is subjected to self-employment tax.
- Flow-through losses are generally disallowed until there is offsetting income from the partnership. Real estate partnerships frequently produce flow-through losses attributable to nonrecourse financing, which may become unavailable under this rule.
- In a tiered structure with special-purpose entities holding separate properties, the disallowance may apply on a property-by-property basis if those special-purpose entities are partnerships. Aggregation should be available if the special-purpose entities are disregarded entities for tax purposes.
- The exceptions for "qualified capital interests" and "straight-up partnerships" as described below may not apply in a tiered structure or a family partnership.

PROVISIONS OF THE PROPOSED LEGISLATION

The proposed legislation generally provides that 75 percent of the income from an "investment services partnership interest" ("ISPI"), including allocations of partnership income and income on the disposition of the interest, will be treated as ordinary income and subject to self-employment taxes. The percentage is reduced from 75 to 50 percent in the case of dispositions of partnership assets held for at least five years, including the portion of gain on a disposition of an ISPI held for at least five years that is attributable to appreciation of partnership assets held for at least five years. Gain on disposition that is required to be included as ordinary income under these rules will be recognized even though a non-recognition rule would otherwise apply, and built-in gains are required to be recognized upon a distribution

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Environmental Insurance Update

By William J. Squires

Buyers, sellers, owners and developers of real property and their lenders should be aware of potential environmental liabilities and should carefully consider options for minimizing their exposure to such liabilities. As a component of the environmental due diligence process, such parties should consider the merits of obtaining environmental insurance. Although environmental insurance does not eliminate the statutory liability of owners and operators of contaminated property, it is a potential vehicle to minimize exposure to these risks that can be used as a supplement to or in place of contractual allocation of liability between buyers and sellers of real property.

One major advantage of obtaining environmental insurance for newly acquired real property is that policies are issued by insurers with deep pockets who are backed by state insolvency funds, whereas environmental indemnification agreements are often issued by entities or individuals whose assets may be limited to the proceeds from the sale of the real property in question and from whom it may be difficult to collect. Nevertheless, the scope of coverage offered by an environmental insurer is often more limited than the scope of an indemnification given by a seller to a purchaser.

The federal Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA") provides for strict, joint and several liability for parties potentially responsible for the release of hazardous substances. Potentially Responsible Parties ("PRPs") under CERCLA include, among others, current owners and operators of real property and past owners and operators of real property who owned or operated such property at the time of disposal of any hazardous substances. PRPs are liable for all remediation, response action and natural resource damages costs as well as certain other costs incurred as a result of the release of hazardous substances. States impose similar liabilities on PRPs for releases of hazardous substances, though such laws vary considerably from state to state. Liability protections available under CERCLA and state laws are limited and typically unavailable to most PRPs. Although not a panacea, environmental insurance is often helpful in mitigating exposure to environmental liabilities.

OVERVIEW OF ENVIRONMENTAL INSURANCE PRODUCTS

While insurers have different names for environmental insurance coverage for owners, operators and developers of real property and their lenders, the two most common types are typically referred to as Pollution Legal Liability ("PLL") and Cleanup Cost Cap ("Cost Cap" or "Stop Loss") policies.

In general terms, PLL policies provide some or all of the following coverage: cleanup costs, third-party claims, and business interruption for unknown pre-existing and new pollution conditions. Although limited coverage can often be negotiated for certain known pollution conditions under PLL policies, the basic policy form is intended to provide coverage for unknown or known and fully resolved pollution conditions.

Cost Cap policies essentially provide cost-overrun insurance for response actions associated with known contamination. In light of the significant risks to insurers associated with such coverage and the substantial efforts necessary for underwriting such policies, Cost Cap policies are usually used for sites with significant contamination (typically sites with response cost estimates well in excess of $2 million) that have been the subject of extensive environmental studies and subsurface investigations. The insured must have a detailed understanding of the extent of contamination and a robust estimate of future response costs necessary to achieve regulatory closure before an insurer might be willing to issue a Cost Cap policy. Cost Cap policies are most effective when combined with or supplemented by PLL coverage since PLL policies can provide coverage for any unknown pollution conditions discovered during the performance of subsurface investigations and other response actions associated with the known conditions covered by Cost Cap policies.

NEGOTIATING SCOPE OF COVERAGE

The scope of coverage under PLL and Cost Cap policies is often subject to extensive negotiations between the insured and insurer. Although the policy limit, policy term, self-insured retention amount (similar to a deductible) and premium are important considerations when negotiating any insurance policy, more mundane provisions shape the scope of coverage.

When negotiating a PLL policy with an insurer, the insured must decide what types of coverage should be included within the scope of the PLL policy. Specific types of coverage vary somewhat between insurers, but typical coverage options offered in PLL policies include on-site cleanup of pre-

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ESTATE PLANNING CHALLENGES, *CONTINUED FROM PAGE 1*

surviving spouse or charities, to pay estate taxes. Federal estate taxes are generally due nine months after the date of death (there is a one-year repeal of the federal estate tax for deaths in 2010), leaving a very short time to gather cash to pay what can be a significant bill. Deferral of estate taxes is available to many small businesses, but advance planning, as discussed below, is required to structure real estate operations in a manner that will qualify for deferral.

A developer may expect to be able to pay estate taxes and other expenses from the proceeds of the sale or refinancing by the estate of some portfolio properties. In the current market environment, and likely in a future one, you cannot count on being able to sell or refinance. We have gone through three difficult periods in the last 20 years — even in "normal" circumstances one cannot count on sale or refinancing as a source of rapid liquidity. At worst, if a sale is needed within the short period after death, it is likely that a much-reduced value may be the result.

The effect of the developer's death on each entity and each loan has to be reviewed and appropriate steps taken to name successors and satisfy lenders. In most cases, the death of a guarantor is a default permitting a lender to call the loan, thereby potentially increasing the financial pressure on an estate.

The developer should pay close attention to the effect his death would have on control and on continuing cash flow. In joint ventures, partners may have the ability to veto the estate's choice of a substitute general partner or manager. Death of the developer may be a default that automatically allows another partner to take over control of the property. The change in control may give the partners the ability to terminate the developer's management company and replace it with an unrelated management company, taking away a major source of cash flow.

PRACTICAL STEPS TO TAKE NOW

- Provide in your will that the executors will have full authority to do everything necessary in connection with all your business interests, including borrowing money, signing or assuming guarantees or other liabilities, and borrowing from or making loans to affiliated entities including proceeds available in life insurance trusts. Also provide that the executors will be able to apply for immediate appointment as temporary executors in order to minimize the delay after death in handling the business and other assets of the estate.
- Arrange for additional authorized signatories on business checking accounts to allow payments to be made without awaiting appointment of executors by a probate court, including permitting transfers of needed funds from a common source or other related entities.
- Analyze existing loans, mortgages and documents to determine how guarantees or other obligations might be affected by the death of the guarantor. Determine if changes can be made in the terms of individual guarantees so as to provide corporate or other separate entity guarantees upon death or, at a minimum, to have adequate time after a death to replace the guarantor. With respect to new developments, which involve guarantees for construction or permanent loans, try to structure guarantees that will provide the most flexibility upon death. Even if a property covered by a guarantee is performing well, the lender may still try to exercise its rights, extract additional collateral, or take other steps that create a burden to the estate.
- Partnerships involving tax-credit investors usually have long-term guarantees, sometimes up to 15 years. This creates an administration problem since it is difficult to keep an estate open for such a long period. Try to modify existing guarantees, or in connection with new guarantees, determine if the lender will permit the guarantor to be a limited liability company or other entity rather than an individual, and try to build in limitations such as an expiration or reduction in the guarantee if the property has been performing satisfactorily for a certain period of time.
- If the developer is the general partner of a limited partnership or manager of a limited liability company, provide for a named successor who will have the same management rights and obligations as the decedent. Loss of control of an entity could mean loss of voting rights, the ability to retain the management company, future residual values or fees.
- Consider funding a controlled corporation or limited liability company that could act as a guarantor, general partner or manager in the event of death, with the goal of limiting the estate's liability, limiting the estate's duration, and providing continuity for business operations. This entity could hold various partnership or membership interests, as well as liquid assets, sufficient to allow it to replace existing individual guarantees after death or currently.

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- Make sure that the estate retains control of a management company that will provide steady cash flow to the family, particularly if other sources of income might be eliminated or delayed due to death. Lifetime gifts or specific bequests of the management company may divert this source of liquidity from the estate.
- Review life insurance policies to determine if they meet the needs of the business in addition to whatever may be required for taxes and family living expenses.
- Consider buy/sell arrangements with partners that would permit a sale to them of the decedent's interest.
- If a property owned by an entity with other partners may need to be sold or refinanced, make certain that there is a right to require the sale (or refinancing) of the property, particularly after the death of the decedent. Most agreements give consent rights to material investors, but it is possible to negotiate provisions that permit a sale (or refinancing) or, alternatively, force a buyout by or of the partners. In addition, try to have the agreement permit lifetime transfers of non-controlling interests to family members.
- If an estate plan contains cash gifts or transfers of specific assets, permit the executors or trustees to defer payment for a reasonable period of time in order to help meet the liquidity requirements of the estate. In many states, such transfers are required to be made within a short time after death. If not paid on time, the estate may owe substantial interest. Permitting the executors or trustees to defer these payments without interest gives them more flexibility to meet cash needs.
- Determine management succession for the business. Executors or trustees named in the estate planning documents may not necessarily desire or be qualified to run the business. To avoid disputes among family members, there should be written instructions by the decedent as to how the business should be operated (or in some cases liquidated). Management may be required to act quickly if the business is faced with difficult decisions such as completing or financing construction, or dealing with lenders and partners.

TAX PLANNING STEPS TO TAKE NOW

Careful planning can reduce the value of the taxable estate, reducing the estate taxes payable after death. The general goal is to transfer assets when their value is low, allowing future appreciation to accumulate outside of the developer's taxable estate. Real estate offers many opportunities for appreciation. Keep in mind that the transferred assets will no longer appear on the developer's financial statement, potentially reducing the developer's ability to obtain financing in the future. At the same time, the recipients of assets can use those assets to engage in business activities, including providing funds or guarantees, although they would of course then become subject to the risks incident to such activities.

- Transfer limited partner or membership interests. Gift tax values of transferred assets are measured by their fair market value. It makes sense to make gifts in the current environment where values are low. In addition, minority, non-controlling interests can offer substantial valuation discounts because those factors are taken into account in determining the gift tax value if the partnership or LLC is structured properly.
- The estate tax value of a property or partnership interest is also determined by its fair market value. When making lifetime transfers, consider giving up direct control of entities. Doing so should reduce the estate tax value of the retained interest. Giving up control obviously involves many non-tax considerations, but it may also help with an orderly transition of management after death.
- Transfers can be made directly to family members or to an irrevocable trust for their benefit. A trust is often preferable because it offers some measure of retained control over the transferred interests. In addition, an irrevocable "grantor" trust can be used. The irrevocable grantor trust is treated as belonging to the donor for income tax purposes while its assets remain outside of the donor's estate for estate tax purposes. This structure allows the donor to utilize personal tax losses to offset the trust's income. In addition, the donor continues to pay the trust's income tax, allowing the trust property to accumulate tax-free from the beneficiaries' perspective. There are a number of specialized trust techniques, such as GRATs, installment sales and partnership freezes. These techniques, which can be explained further by an estate planning lawyer, are used to take maximum advantage of future appreciation and minimize the gift tax cost of making transfers.
- The developer should carefully consider the income tax characteristics of assets before making transfers. Transfer of a partnership interest or property with so-called "negative basis," or a mortgage in excess of basis, need to be made very carefully, if at all. Those properties, if

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retained in the estate, would receive a step-up of basis to fair market value on the death of the owner (except for deaths in the year 2010). Property that is outside of the estate does not receive a step-up, greatly increasing the ultimate tax due on sale of the property.

- In connection with new developments or acquisition of properties, real estate offers an opportunity not necessarily found with other types of assets. Family members or trusts can be made initial partners in the entity acquiring a property. The developer or owner can provide all or substantially all of the equity needed in the form of capital or loans. Loans can work particularly well in the present low interest rate environment. Loans can also be made to grantor trusts free of income tax consequences. The increase in value after the equity or loans are repaid would belong to the family members, outside of the developer's or owner's taxable estate. The developer or owner could still control the project and retain as much of the equity as may be desired. Partnership agreements can be structured so that depreciation and tax benefits can be substantially retained by the developer even though the potential upside value would belong to the family members.
- If life insurance is to be acquired on the life of the developer or on the spouse or both, the policies should be owned by an irrevocable life insurance trust, which would keep the proceeds from being subject to estate tax, but could be used to meet tax or other business needs.
- Take advantage of Section 6166, a provision of the Internal Revenue Code that permits deferral of the estate tax attributable to business interests over a period—up to 15 years—at very low interest rates. Real estate interests can qualify for Section 6166, but advance planning is critical in order to meet the technical requirements for deferral. Deferral may be the best way to allow enough time to properly dispose of real estate assets or otherwise provide funds to pay the estate tax. If the estate plan defers taxes until the death of the surviving spouse, it is important that the Section 6166 requirements be met at the time of the subsequent death of the spouse.
- Make certain that partnership agreements require use of a Section 754 election to allow the estate to stepup the basis of partnership interests to values at date of death. This will provide substantial tax benefits.

In conclusion, reviewing and properly structuring a developer's estate plan as well as all present and future business interests and agreements can be very beneficial. While the nature of the real estate business makes it impossible to eliminate all entrepreneurial risk, a developer can avoid or minimize probate administration problems; defer or reduce estate taxes; protect family members from many creditor or financing problems; and provide assets to a spouse, children or grandchildren at lesser gift or estate tax costs. <

TAXATION OF CARRIED INTERESTS, *CONTINUED FROM PAGE 4*

of partnership property. In addition, the flow-through of losses from an ISPI is allowed only to the extent of the net income that has flowed through from the ISPI after the effective date of the legislation.

A partnership interest is treated as an ISPI if (1) there is a person who, at the time of acquisition of such interest, was reasonably expected to render to the partnership substantial services in the nature of investment advice, asset management, arranging financing or a related support activity, with respect to specified categories of assets, and (2) the interest is owned, directly or indirectly, by that service provider or a related person. The specified assets include real estate held for rental or investment as well as securities, commodities, options and derivatives, and interests in a partnership. If the owner of a partnership interest (or a related person) begins to render the types of services described in the legislation after the interest is issued, the interest may become an ISPI.

An interest in a "straight-up" partnership in which all allocations and distributions are made *pro rata* based on "qualified capital interests" will not be treated as an ISPI. If the partnership holds interests in lower-tier partnerships, all of those partnerships must be straight-up in order for the upper-tier partnership to be considered straight-up. Qualified capital interests are essentially the book capital accounts.

There is also an exception, even if an interest is an ISPI, for allocations with respect to a partner's qualified capital

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Once the basic business terms are worked out, the seller and the prospective buyer negotiate a purchase and sale agreement and the form of sale order. The seller, being a debtor in the Chapter 11 proceeding, must then file a motion with the court seeking approval of the sale process. The proposed order approving the sale process will usually include approval of the designated stalking horse bidder and the form of purchase agreement, arrangements for marketing to other potential bidders, bidder qualification procedures, due diligence arrangements and deadlines, the auction date, the date for approval of the sale order, and other matters necessary to the process of marketing and selling the property and the qualification of bidders. The prospective stalking horse buyer usually will require that the purchase agreement provide for a breakup fee to be payable to it as an administrative expense in the event that someone else is the successful bidder and, if so, it will want advance approval of the breakup fee, as well.

After notice to creditors and other parties and a hearing, the court will determine whether to approve the proposed sale procedures. Once the court has approved the sale procedures, the marketing and due diligence periods have expired, and potential bidders have been qualified, there is a formal auction based on a sale in accordance with the terms and conditions of the approved form of sale agreement. If there are no bids in excess of the price the stalking horse prospective buyer has agreed to pay (plus any additional amount necessary to meet a designated minimum for overbids), the stalking horse will be declared the winner, subject to final court approval. Following the auction, the court will hold a hearing to determine whether the sale should be approved. If it is approved, a final sale order will be entered authorizing the closing of the transaction. If the sale order contains the necessary findings (primarily regarding the good faith of the buyer and the arm's length nature of the transaction), the buyer should be protected against a subsequent appeal of the order.

What are the disadvantages from the standpoint of a prospective buyer? The first disadvantage is delay. Due to the Bankruptcy Court marketing and auction process, these transactions usually take longer. The ability of creditors of the seller to object to proposed sale procedures or entry of the final sale order increases the risk of delay and the complexity of negotiations.

Cost is another disadvantage. Because the buyer must engage bankruptcy counsel in addition to its usual deal counsel, costs are necessarily higher. Due to the public auction requirement, the process is not confidential. The stalking horse buyer does not have the exclusive right to purchase, so there is always the risk that the stalking horse will be outbid. Even after the auction is over, the Bankruptcy Court probably has the right at any time prior to entry of the final sale order to reopen the auction and entertain higher offers.

The risk that a prospective buyer will be outbid is increased in some situations due to the ability of secured creditors of the seller to "credit bid." Section 363 permits a mortgagee of the property being sold to offset or "credit bid" the debt secured by the property against the purchase price. This gives the mortgagee who wishes to credit bid a distinct advantage, particularly in today's market where financing is difficult to find. The advantage held by mortgagees seeking to credit bid is marginally reduced by a 2008 decision of the Bankruptcy Appellate Panel for the 9^{th} Circuit (covering California and several other Western states). In that case, the court ruled that a secured creditor seeking to credit bid its debt and purchase a mixed-use luxury condominium and retail property in a Section 363 proceeding could not take title free and clear of a junior lien. While this decision has been sharply criticized, and to date has not been confirmed by a higher 9^{th} Circuit Appellate Court or followed in other jurisdictions, it still may give pause to senior mortgagees seeking to credit bid their debt.

Notwithstanding these disadvantages, the availability of a Section 363 sale often provides the safest route for buyers seeking to purchase properties from distressed sellers and should be an important addition to the toolbox of anyone seeking acquisitions in today's challenging market. <

TAXATION OF CARRIED INTERESTS, *CONTINUED FROM PAGE 8*

interest that are made on a *pro rata* basis with significant allocations to non-service provider partners: such allocations are not recharacterized as compensation. However, where the partners not providing services are related to a partner who is providing services, it is unclear whether the exception will be available.

CONCLUSION

The prospects for enactment of the proposed carried interest legislation are unclear in the current political environment. If enacted, however, the legislation would create significant additional tax burdens for sponsors of real estate development and investment partnerships and other persons holding carried interests in real estate entities. <

LOAN PURCHASE TRANSACTIONS, *CONTINUED FROM PAGE 3*

with past practices until the closing. In addition, a prospective purchaser will often negotiate the right to consent to or approve any borrower actions after any deposit money has gone "hard." Prospective purchasers should also try to include similar conditions precedent to those found in real estate purchase agreements to protect themselves from changed conditions or circumstances after the execution of the contract, such as the occurrence of a borrower bankruptcy, casualty, etc. Prospective purchasers must also protect themselves from a seller default. In the pre-closing context, this will often involve a purchaser termination right and a right to recover third-party costs. In the post-closing seller default context, sellers typically insist that purchaser's only remedy is that seller must repurchase the loan at par. Prospective purchasers should resist this and either require the seller to cure the default (if curable), or at a minimum insist that if the default is not curable, the repurchase price of the loan should include additional liquidated damages or the reimbursement of third-party costs.

PARTICIPATION AGREEMENT; RELATIONSHIP OF THE LOAN PARTIES

In a transaction in which a senior loan or mezzanine loan is separated into senior and junior tranches within such loan (often referred to as the "A" and "B" pieces), the parties customarily enter into a participation agreement governing their relationship. In reviewing or negotiating a participation agreement, some significant issues to consider are control with respect to major decisions, the priority of payments to the senior and junior noteholders (both pre- and post-default), and any cure or purchase rights of the junior participant.

The controlling participant, typically the junior tranche holder, should control major decisions (such as when to enforce remedies) as the junior participant has greater exposure given the senior participant's priority with respect to payments under the loan. The participation agreement should make it clear that the loan servicer is required to follow the direction of the controlling participant. In the event of significant value deterioration in the underlying asset, control often shifts to the senior participant in a so-called "control appraisal event." It is critical that a purchaser have a full understanding of the often complicated formula described in the agreement in order for control to shift and the likely timing of such shift.

Prior to an event of default under the underlying loan, both the senior and junior participant will be entitled to receive ordinary course debt service payments. After an event of default, the senior participant will be entitled to all amounts paid by the borrower until the senior participant has been paid in full. In addition, after an event of default under the underlying loan, the junior participant should have the right to cure borrower defaults. The junior participant should also have the right to purchase the senior participation interest after an event of default. Both the cure and purchase rights of the junior participant are subject to time limitations negotiated between the parties (with longer time periods negotiated in the event of non-monetary defaults). Cure and purchase rights on the part of the junior participant are essential to enabling it to protect its position. A purchaser needs to carefully evaluate all of these timing considerations, as they will have a bearing on when the purchaser might ultimately be in a position to exercise remedies and obtain ownership of the asset.

INTERCREDITOR AGREEMENT; SENIOR AND MEZZANINE LOAN INTERPLAY

When a transaction involves both a senior loan and a mezzanine loan, the parties customarily enter into an intercreditor agreement governing the relationship between the respective loan holders. Similar to the participation agreement, some significant issues to consider when reviewing and negotiating an intercreditor agreement are the priority of pre-default and post-default payments, notice requirements, and any cure and purchase rights of the mezzanine lender.

As one would expect, both the senior lender and the mezzanine lender would be entitled to receive debt payments until an event of default, after which the mezzanine lender would not be entitled to payments until the senior lender is paid in full. It is critical that the intercreditor agreement require the senior lender to notify the mezzanine lender of any defaults under the senior loan as the mezzanine lender will want to carefully track the performance of the borrower. In order to avoid being wiped out by a foreclosure of the senior loan, the intercreditor agreement should also grant the mezzanine lender the right to cure borrower defaults until the mezzanine lender is in a position to either buy out the senior loan or foreclose on the membership interests in the borrower and become the owner of the collateral securing the

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senior loan, and the intercreditor agreement should include sufficient time periods for the mezzanine lender to effectuate such purchase or foreclosure. The recent New York litigation involving Stuyvesant Town and Peter Cooper Village emphasizes the critical importance of clear and precise drafting in order to avoid unexpected results if the rights of the parties are challenged. In reviewing the intercreditor agreement, a prospective purchaser needs to identify and evaluate the sufficiency of the mezzanine lender's purchase, cure and enforcement rights. Failure of the intercreditor agreement to include such safeguards and to describe them accurately could create additional risks for a purchaser.

INTERDISCIPLINARY CONSIDERATIONS

In addition to the foregoing, a prospective note holder should also carefully consider the effects of a borrower bankruptcy or a potential foreclosure action on the transaction overall as delays caused by bankruptcy or foreclosure proceedings may dramatically affect investment returns. It should be noted that the Bankruptcy Code provides for accelerated proceedings in the event of bankruptcy or reorganization proceedings involving a single asset real estate debtor and that the time periods and procedures for completing a foreclosure vary greatly from state to state. Prospective purchasers will also want to carefully consider whether there are transfer tax implications to the transaction, both in connection with the purchase of the loan, but more likely in connection with a foreclosure proceeding or deed in lieu of foreclosure and upon subsequent sale of the underlying real estate. Finally, a prospective purchaser must carefully consider the income tax implications of the transaction as a whole with respect to the discounted purchase price and, if the purchaser is a REIT, the possibility of "bad income." These are all matters that should be analyzed by the prospective purchaser and its counsel in the early stages of the transaction, as they likely will impact underwriting assumptions.

CONCLUSION

An end to the market conditions resulting from the recent recession is not on the immediate horizon. It is expected that loan purchase transactions will continue to be a major factor in the marketplace, requiring multidisciplinary legal expertise and experience in areas such as finance, securities, real estate and bankruptcy. In particular, experience in the analysis and negotiation of the complexities of intercreditor arrangements will continue to be of critical importance to potential purchasers. <

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existing or new conditions, off-site cleanup of pre-existing or new conditions, third-party claims for on- or off-site personal injury and property damage, business interruption and liability for transportation, and off-site disposal of hazardous waste.

Once the type of coverage has been selected, the insured must carefully review the language of each coverage section as well as the extensive exclusions, limitations, conditions and restrictive definitions in the PLL policy to evaluate how they impact the scope of coverage. In our experience, negotiating coverage offered by a PLL policy often results in more than 20 endorsements modifying language contained in the standard PLL policy specimen.

Before the insurer binds coverage (and ideally at the beginning of the negotiation process), the insured must disclose all reports, data, documents and other information pertaining to the environmental condition of the insured property. Typically, insurers expect that an insured will, at a minimum, have an ASTM E1527-05 Phase I environmental site assessment relating to the subject property (which buyers and lenders should obtain as part of the environmental due diligence process for any real property, whether or not they intend to obtain environmental insurance). If environmental reports identify contamination or other potential environmental issues on the subject property, insurers will typically exclude or limit coverage for such matters under a PLL policy. While PLL policies do not typically provide coverage for known pollution conditions subject to ongoing response actions, careful negotiation can often broaden the scope of potential coverage for such known issues or, at a minimum, incorporate a reopener when the issue is resolved to the reasonable satisfaction of the insurer.

In light of these complexities, it is critical that a party seeking environmental insurance coverage work with a broker and a law firm who are experienced in negotiating environmental insurance policies and, ideally, also have experience asserting or defending against coverage claims under such policies. <

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