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Delaware Statutory Trust Bridge Lending: Considerations for the Borrower, Senior Lender and Bridge Lender

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In this article, the authors discuss the perspectives to take into consideration when using bridge debt on a Delaware Statutory Trust transaction, and explain that balancing the needs of the borrower, senior lender and bridge lender is no easy task.

Broadly syndicated Section 1031[1] investment programs, such as Delaware Statutory Trusts (DSTs) and tenancy-in-common structures (TICs), have been popular with a growing number of real estate investors since the early 2000s due to their ability to allow investors to reinvest in institutional quality real estate without having to pay capital gains and investment taxes. In the early 2000s, TICs were the most popular form of 1031 investment program.

However, since the 2008–2009 market crash, DSTs have become more popular among sponsors of these programs. This is the case notwithstanding the fact that, as the "price" for qualifying as real estate for tax purposes, DSTs are subject to material restrictions on their activities; the most important of which are that DSTs cannot:

(1) Enter into new financing or refinance their properties;

(2) Enter into new leases for their properties;

(3) Raise new capital; and

(4) Materially modify their properties.

When raising capital, the DST structure typically requires that DST sponsors close on the acquisition of an asset prior to syndication, which leads to a "chicken-and-egg" issue because the sponsor does not have its equity capital secured at the closing table. DST investors can only buy into a DST that is fully capitalized with its property and its senior secured financing. Most DSTs are leveraged with senior secured financing around 50 to 75%, which leaves a 25 to 50% gap in the equity required to close on a transaction, which will ultimately be raised post-closing in the DST investor market. This leaves sponsors with one of two choices: (1) use more of their own equity to purchase an asset, or (2) find temporary bridge financing if the sponsor

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does not elect, or is not otherwise able, to invest more of its own equity upfront.

THE DST STRUCTURE

In order to understand DST bridge financing, one must first understand the parties to a DST structure. There are several parties in a DST transaction:

(1) The DST, which is the entity that investors own an interest in and, in turn, owns the property;

(2) The depositor, which is the initial owner of unsold DST interests and is an affiliate of the DST sponsor; and

(3) The trust manager, which manages the DST and is an affiliate of the DST sponsor.

Bridge financing is often used by sponsors on DST transactions to fill the gap of required equity to close on a transaction. The funds filling this gap are considered “bridge” capital, since the intention is that such loaned amounts will be replaced with DST investors shortly after the bridge loan closing, with a common intention to be out of the bridge loan in three to six months. Due to the short term length of these bridge loans, interest rates are typically higher than most other forms of real estate financing. There are many forms of DST bridge financing currently available in the market and a multi-perspective analysis of considerations from the sponsor, senior lender, and bridge lender perspective may prove useful.

BRIDGE LENDER PERSPECTIVE

The bridge lender is motivated to transact due to the fees and higher interest rate that it is able to collect on its investment. However, should the borrower default on its interest payments, the bridge lender needs a remedy to collect the amounts of principal and interest it is owed by the end of the bridge loan term. There are several remedy avenues available to a bridge lender.

First, is the use of pledges, which a DST bridge loan will often make use of. While a DST bridge loan might seem like a mezzanine loan, it will not contain all of the same rights and remedies of a mezzanine lender. For example, a mezzanine lender would typically be able to foreclose on its pledge of equity interest and take over both ownership and control. Here, due to senior lender and investor constraints, a bridge lender is unlikely able to take over control of the trust manager, so the main remedy is generally to obtain a pledge of the depositor’s ownership interest in the DST (or conversely, a pledge of the sponsor’s ownership interest in the depositor).

If there is ever a default under the bridge loan, then the bridge lender would foreclose on its pledge and own the unsold DST interests, and thus be able to collect the income stream associated with the interests; in short, the bridge lender would be in the same position as any other DST investor. Other bridge lenders have instead made use of pledges of income streams, such as the income from the property or even unrelated properties owned by the DST sponsor; this avenue may be more palatable to some senior lenders that do not allow pledges of equity interests. If pledges are used, then the bridge lender should make sure that the foreclosure on such pledges is actually permitted under the borrower’s senior loan documents, as most senior loan documents do not permit the transfer of equity over a certain percentage.

A different common bridge lender remedy is the use of personal guarantees. In addition to, or instead of pledges (if pledges are not permitted under senior loan documents), some bridge lenders may require a personal guaranty from a credit worthy entity for some or all of the bridge loan amount.

Yet another bridge lender remedy is the forced sale provision. Here, if the bridge loan is not paid off by a certain date, the trust manager is contractually required to sell the property (or, in some cases, the unsold DST interests), thus creating proceeds that would result in a payoff for the bridge lender. When relying on this method, a bridge lender should always identify any restrictions on a payoff of the senior loan, as many senior loans may be locked out from prepayment prior to, or for a period of time, after a securitization.

SENIOR LENDER PERSPECTIVE

While many senior lenders do not object to their borrowers obtaining such DST bridge loans, lately agency lenders have been viewing DST bridge debt with a more critical eye. From the senior lender perspective, one needs to understand what rights and remedies are available to the bridge lender. With respect to pledge oriented remedies, many senior lenders will permit the depositor to pledge its interest in the DST as security for the bridge loan (though some lenders admittedly do not allow pledges at all). However, the senior lender should always be aware of pledges of interests in the trust manager, as foreclosure of these interests would shift control of the borrower from the sponsor to the bridge lender. Senior lenders should also be mindful of other bridge lender remedies (such as senior loan default cure rights), as more remedies given to the bridge lender could affect senior loan pricing with a higher spread and secondary market marketability.

SPONSOR/BORROWER PERSPECTIVE

The sponsor/borrower is oftentimes motivated to obtain the bridge loan if they wish to use less personal equity to close on the transaction while still avoiding the “chicken-and-egg” issue of trying to sell DST interests before acquiring the investment property.

With respect to the senior loan, one preliminary issue when deal structuring is the need to anticipate what the senior lender will allow or require with respect to the bridge financing. For example, when selecting a senior lender, the borrower should make sure to choose one that allows the particular structure that the bridge lender intends to use (such as pledges, if applicable). If the senior lender allows pledges in concept, the borrower needs to make sure that the senior loan documents permit both (1) the act of pledging direct or indirect interests in the borrower, and (2) the actual foreclosure on such interests by the bridge lender. This is important because, generally, many “transfers” are prohibited under senior loan documents and, very often, the definition of “transfer” picks up a pledge or a transfer of equity over a certain threshold amount. Unfortunately, this is one way that the borrower could unintentionally close into a default on the senior loan. However, it is avoidable through a careful negotiation of the senior loan document transfer provisions.

With respect to the bridge loan, the borrower will want to understand the remedies available to the bridge lender. For example, if the bridge lender has the right to foreclose out the sponsor's interests in the trust manager (and ultimately management of the asset), then the sponsor would likely need to disclose this to its investors. Additionally, with respect to personal guarantees, liability caps on personal guarantees, which makes the borrower liable for only a certain portion of the bridge debt as opposed to the entire amount, may be appropriate in certain instances.

As DST transactions grow in popularity, so does the use of bridge debt to solve the "chicken-and-egg" issue that arises given the DST structure. There are many perspectives to take into consideration when using bridge debt on a DST transaction, and balancing the needs of the borrower, senior lender, and bridge lender is no easy task.

NOTES:

[1] By way of background, Section 1031 of the Internal Revenue Code (1031) allows real estate investors to defer payment of the federal capital gains tax on the sale of real property if: (1) the property is used in a trade or business or held for investment; (2) the property is exchanged for "like-kind" property; and (3) certain time frames for identification and acquisition of the replacement property are met. Revenue Procedure 2002-22 set forth IRS ruling guidelines that implicitly approved TIC structures as real estate for purposes of Section 1031 and, in Revenue Ruling 2004-86, the IRS ruled that an interest in a properly structured DST that holds real estate is of "like kind" to other real estate.