

The Property Line: Freezer Burn: Legal Landmines in Cold Storage Real Estate

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Welcome to The Property Line, a commercial real estate podcast brought to you by Seyfarth Shaw's Real Estate department. The Property Line is a brief discussion of current market trends, bringing you insights from our acclaimed national team of real estate attorneys. Each episode focuses on a key takeaway for the busy real estate professional. Now, on to this week's discussion.

Jay Wardlaw

Hello and welcome back to The Property Line. My name is Jay Wardlaw, and we're excited to be joined today by Mike Delaney to give us a bit of an introduction into the world of cold storage. Prior to joining Seyfarth, Mike served as chief legal officer for two multinational third party logistics and warehousing businesses, including one of the largest cold storage companies in the world. He currently represents a large cold storage company in the United States with respect to its commercial agreements with customers, including storage and handling agreements and master services agreements. So welcome to the podcast, Mike, and appreciate your joining us to share your unique perspective on this interesting sector of the real estate market.

Mike Delaney

Thanks, Jay. It's great to be here. I'm happy to talk about cold storage. It's a fascinating industry.

Jay Wardlaw

Excellent. Well, that's a nice lead in to my first question, which is, can you give us a general overview of the cold storage industry?

Mike Delaney

Sure thing. So you think about cold storage as part of you know that critical backbone in the global supply chain. It's focused on ensuring that highly perishable goods, you know, everything from food to pharmaceuticals, are stored safely and efficiently in the appropriate environment. So these aren't just regular warehouses. They're specially designed refrigerated facilities that are focused on maintaining precise temperature and humidity levels depending on the product stored. So this precision is the key part of their service, because it preserves product quality, extends shelf life of product, and most importantly, it ensures consumer safety and protect products from turning back.

Jay Wardlaw

And what does the inventory of that product look like right now?

Mike Delaney

It depends on the on the facility. So there's a couple of different types. There's public warehouses where an operator will store products for a variety of different clients, and usually those are already completed products. You don't think frozen pizza, frozen peas, french fries for quick serve restaurants, all those sorts of things. But there are also facilities that are plant dependent. They're attached to a manufacturing facility and receive the goods being produced and freeze them and have them prepared for distribution to the next stage of the manufacturing process. And there are also other facilities that have what they call flash freezing capabilities, where they can take product and raise it quite quickly so it can be distributed out into the marketplace.

Jay Wardlaw

I see. That's really helpful. What are the some of the most critical safety and liability risks that lenders or investors need to be attuned to with cold storage facilities? I know, for example, ammonia.

Mike Delaney

I was going to jump in and just say ammonia. That was probably the biggest risk. Of all of the facilities out there, about 90% of the facilities in the US use anhydrous ammonia in their cooling systems. It's a choice for industrial cooling because it's quite efficient and it's also quite inexpensive. However, it does have some downsides that create some liability and risks that folks need to think about if they're going to invest or construct a facility. The gas itself is very toxic and corrosive, and even a low level exposure can cause physical irritation in your lungs or on your skin, and high level of exposure can cause serious injury or worst case, death. The other problem with it is it's actually flammable, so oftentimes, when a leak occurs, it's heavier than air, so it'll float along the surface. And you know, if there's an ignition site nearby, you can have an explosion. So it has that wrinkle to it as well. And lastly, kind of like a gremlin that reacts strongly with water and can cause a very caustic solution that can cause tissue damage and damage to the facilities themselves. So definitely a tough product to work with, but a very efficient one when it comes to refrigeration.

Jay Wardlaw

I see, yeah. So something you need to really understand going in. There's been a lot of news over the last several years about food recalls, other issues, and then their pack of liens that we hear about a lot. So can you tell us a little bit about how you will deal with those issues if you're structuring or underwriting a cold storage loan?

Mike Delaney

Yeah, so when it comes to the loans to construct or purchase a facility, most lenders need to focus on the collateral being the facility itself. You know, mortgage on that building, you know, securing interest in the equipment and fixtures, because oftentimes the inventory held in the facility isn't owned by the operator of the facility. It's a third party's goods that are, you know, held on bailment. And while the warehousemen may have a lien on those in order to get paid, that lien is limited to really fees owed and that sort of stuff. So when a lender looks at a building, they really need to look at more the traditional security you would get when you lend into a real estate purchase.

Jay Wardlaw

Okay, something else that you mentioned when we were talking earlier was that there's been something of a shift in the ownership to more of a REIT TRS structure, and I was curious if you could tell us a little bit about some of the special considerations that come into play with that continuing evolution of the ownership side of the business.

Mike Delaney

Yeah. So the organization I was with was one of the first ones to actually structure themselves and REIT back in the late 90s. And they're a little bit of unique animal in the REIT world. Traditional REITs are, you know, landlords that lease out office buildings like wherein the tenants to operate their own businesses, where in the cold storage business, many of the companies that are buying and building cold storage facilities today are structuring themselves as a REIT, where the REIT owns the facility and then leases the facility to a taxable REIT subsidiary to operate that facility. Again, like I mentioned before, like a third party warehouse, where they take goods in third party customers through the REIT structure. You know, the REITs rules require them to derive, you know, at least 75% of their income from rent, and then they have to distribute about 90% of that taxable income to the shareholders to continue to keep that tax, you know, tax positive arrangement. So in short, the REIT owns the buildings and the TRS handles the operations. So what the TRS allows a cold storage REIT to do is offer storage and handling, you know, logistics services such as trucking management and refrigerated transportation and other value added services like inventory management and other logistics focused activities. This income is operational income and non-qualified for a REIT, so it'll be taxed at a corporate level under the TRS. But again, it allows the REIT to take advantage of the REIT rules when it comes to distributing tax free income while we're you know, and continue to remain compliant in these regulations, while also offering the suite of services customers are going to expect when they work with a warehouse.

Jay Wardlaw

Very interesting. Thank you. I guess, as we are rapidly running out of time, I'll try to get us to our final question, at least for today, which is, how should lenders, I think you address some of this, but how should the lenders think about their collateral, and then particularly remedies in situations where the facility is being operated as a cold storage facility, or otherwise, kind of in the Agra business or food related context, where, you know, there's obviously issues about creating discontinuity of operations?

Mike Delaney

So one of the things that warehouses will do is work with lenders to sometimes subordinate their loan against the lender's loan, lender's security interest rather. But really, when a lender or investor looks at a cold storage warehouse investment, most times the value is going to be in continuing the operation, the opportunity to find other tenants can often be difficult because it's a smaller universe than a traditional, you know, ambient temperature warehouse. And so oftentimes, they should really think about alternatives to the traditional foreclosure tool that they could use on a typical real estate investment, and think more of step in rights or getting a third party operator to step in if this operator is failing to achieve the business needs. Think about receivership provisions and forbearance agreements. You know, there's also the opportunity maybe appointing a special service on the loan, or appointing, like I mentioned, a third party operator to kind of come in and run the facility with the current customer base to, you know, continue to service the loan. You know, again, you can foreclose. But then

that kind of puts a wrinkle sometimes in the actual business. And, you know, and the ability to kind of reach the best recovery attainable.

Jay Wardlaw

Yeah, no, it makes perfect sense with the heightened time sensitivity of everything in the facility.

Mike Delaney

Yeah, and you're dealing with perishable product, even in a frozen state, it does have a life, you know, you know, a shelf life to it.

Jay Wardlaw

Yeah. No, exactly. And are there operators that you see that are poised to step in, in their kind of remedial?

Mike Delaney

There are. In fact, we help the client in a little different context. They were building a greenfield facility, and they were engaging a third party operator to come in and just do everything, soup to nuts management of the facility for them. So they're out there, there's quite a few good ones out there, and always, you know, they're quite capable of coming in and operating for a lender.

Jay Wardlaw

Well, this has been fantastic, Mike. Really appreciate your sharing your knowledge, expertise and experience here today. Is there anything else that you think is worth sharing that I didn't touch on?

Mike Delaney

One little factoid, just because I think you know investors need to understand the marketplace a good bit, is the age of these facilities. The US, on average, we're looking between 30 and 37 years for the age of the facility. And in major markets like Chicago, it creeps into the 40s, and overall, about 75% of the operating warehouses and cold storage in the US were built before 2000. Now what we're seeing, though, is the industry has begun to build quite a few new, modern facilities, you know, ones that are automated, ones that are much more efficient with the use of electricity for refrigeration, all those sorts of things. So there's been a dramatic shift, but there's still a lot of old assets out there, so investors will need to be careful when they're looking at facilities, when they consider the older ones, just because, you know, they have inefficiencies and their locations may not be as good as new modern facilities are.

Jay Wardlaw

That's a fantastic way to wrap this up. So we're at the end of our time here, Mike, we really appreciate you joining us today and sharing your unique insights into this area of the market. And a special thanks to our listeners for tuning in today. Please keep an eye out for future episodes, and we'll see you out there.

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