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## **Are TIC Workouts Working Out??**

*By: Coni S. Rathbone & Timothy M. Dozois*

The depressed and unstable commercial real estate market continues to challenge owners, lenders and brokers. Sponsors and tenant-in-common owners of syndicated properties are not immune from current market conditions and, in many instances, are more seriously impacted than typical commercial property owners because, unfortunately, some sponsors syndicated properties at questionable prices that exceeded market value in order to generate up-front fees; most TIC syndications occurred at or near the height of the real estate feeding frenzy, prompting the payment of artificially inflated prices; and tenants in common typically do not possess the financial resources or the desire to supply the additional funds needed to support their properties through this difficult real estate market.

Many tenant-in-common owners of syndicated properties are in the midst of their retirement years. These retirees purchased TIC interests with the expectation of passively “clipping coupons” or, at most, overseeing their properties from a distance while master tenants or asset managers generated the revenue necessary to distribute fixed monthly payments to the owners. In the new real estate market, master tenants and asset managers are failing to generate anticipated revenues and, as a result, failing to make monthly payments, thereby thrusting owners into active participation in the property preservation process. Suddenly, these owners are compelled to make decisions about their master tenants, their asset managers, their tenants and their lenders. Many face financial ruin if they are unable to replace the master lease payments or monthly profit distributions that were funding their living expenses. These dire circumstances prompt the need for TIC workouts. Due in part to the nature of the typical TIC investor (i.e. a purchaser through a Section 1031 exchange), TIC workouts involve many of the same complexities as TIC syndication work, and in some cases more complexities, thereby demanding multi-disciplinary expertise and multi-disciplinary solutions. As a result, there are relatively few professionals with TIC workout experience. To be a valuable counselor to tenants in common in workout situations, your professionals need expertise in TIC structuring, tax, securities, real estate (including Section 1031 expertise), lending, financing, and potentially, even bankruptcy.

This article will discuss some of the most common workout scenarios and provide practical tips to aid tenant in common owners, sponsors, brokers and lenders who are enmeshed in workout situations.

## **What Is A TIC Workout?**

A TIC workout situation is typically triggered by a TIC Owner group receiving notice from their sponsor, master tenant or asset manager that their distributions will be reduced or eliminated. The notice may be a mere warning of looming financial challenges, or it may be accompanied by an acknowledgment of economic failure and an accompanying proposal for a modified master lease or asset management agreement. Any number of circumstances might prompt such a notice, including depleted reserves, loss of key tenants, loan defaults, imminent refinancing needs, master lease defaults, insolvent or bankrupt sponsors or lender enforcement proceedings. Regardless of the notice trigger, it places the burden on the tenant-in-common owners of the property to make decisions. Sometimes, the decisions are simple, involving nothing more than an understanding of the troubled economics and an affirmation of the existing asset management and lending relationships. More commonly, the decisions are complex, because they involve agreements (i.e. master leases and loan documents) that are in default, and, in extremely troubled situations, master tenants that are insolvent.

### **Getting Started.**

The most important initial step for tenant-in-common owners of a troubled property is to get organized. The organization process begins with contact information for all owners. Contact information can often be obtained from closing documents, from the sponsor of the property, or from the title company that closed the TIC syndication. The broker dealers that were fundamentally involved in the sale of the TIC interest can also be helpful in providing information and assisting in the organization process. Once contact is established, the owners should connect by conference call and/or email to assess the property-related problems and to identify one or two sophisticated owners to act as the conduit for communications among the owners, the sponsor, the lender, and the professionals hired by the owners to assist with the TIC workout. The owners can organize through a simple owner representative agreement that provides no agency or authority to the owner reps, or they can organize through a very narrowly crafted power of attorney that grants the owner representatives limited authority to bind the group. Either document should be created only with the assistance of counsel, given that an improperly drafted agreement or power of attorney can threaten the integrity of the tenancy in common ownership of the property.

Once the organizational process is completed, the owner representatives, together with their cooperating broker dealers and professionals, should approach the sponsor, the master tenant (if applicable), the asset manager and/or the property manager for financial information, occupancy details regarding the property and relevant demographic information. An analysis of this information is critical for developing pro forma financial statements for the property, which in turn will indicate whether the property can be saved. This financial analysis can be performed by knowledgeable owners, by broker dealers who were involved in selling the initial investments,

by new potential asset managers for the property, or by paid professionals. The sponsor might also assist with this analysis, although the sponsor's willingness to cooperate may be influenced by a number of factors, including the extent of deterioration in the financial condition of the property and the sponsor's relationship with the owners. Unfortunately, sponsors are often uncooperative or unrealistic about the prospects for the property, and as a result adopt an entrenchment philosophy that is not conducive to cooperative solutions.

Simultaneous with evaluating the financial condition of the property, the tenant-in-common owners should engage experienced legal counsel to guide them through the various agreements and relationships related to the property. An independent legal advisor can assist the owners in spurring cooperative, reasonable behavior from difficult and aggressive sponsors, master tenants and asset managers. Moreover, even if sponsors, master tenants or asset managers work cooperatively with the owners to address issues related to such agreements and relationships, the inherent conflicts of interest facing such parties make it critical for the owners to have an independent advisor.

As the professionals analyze and develop information regarding the property, its financial condition, and its related agreements and relationships, there are three realities that the owners must accept: 1) no matter how good your workout professionals are, they cannot turn a bad property into a good property; 2) most decisions related to a workout must be made unanimously by the owners; and 3) the golden rule applies; the one with the gold makes the rules; meaning that almost everything that happens must be approved by the lender.

### **Is The Sponsor Doing Its Job?**

Clients call almost daily asking whether we can assist them in "replacing their sponsor." Although our answer could generally be "yes," we never answer the question directly, because the first question to answer is: "why do you desire to change sponsors?" In this economy, an underperforming property does not necessarily indicate that the sponsor is underperforming. If the sponsor is acting in a commercially reasonable manner, is diligently working to address challenges related to a property, and is transparent in its efforts, owners may be best served by riding out the economy with the sponsor. Relevant agreements may need to be altered in some manner, such as a re-structuring of a master lease into an asset management agreement, thereby eliminating fixed owner payments and replacing them with distribution of all revenues in excess of expenses, debt service and reserves. However, an alteration of existing agreements is usually much less complex than wholesale replacement of the sponsor, and therefore the least disruptive solution for the property.

Unfortunately, many property-related problems arise from troubled sponsors. Sponsors' troubles can uniformly be traced in part to the real estate downturn, but sponsors who diligently and conscientiously respond to the economic challenges can often avoid the "troubled" moniker. The truly troubled sponsors are often the ones that fail to properly communicate with the TIC owners,

fail to properly communicate with the lender, fail to address financial challenges before they become crises, and in the most egregious situations, commit outright fraud.

### **Identifying the Source of the Sponsor's Difficulties**

Sponsors' difficulties, and the resulting challenges to tenant-in-common owners, are amplified when a property is encumbered with a master lease. In a master lease structure, investors, through single-member limited liability companies, become co-owners of the property as tenants-in-common and then enter into a master lease with an affiliate of the sponsor, typically known as the "master tenant." The master tenant has the power to sublease the property to tenants who occupy the property. In turn, the master tenant pays a fixed amount of rent to the tenant-in-common owners. If the property operates profitably, then the structure facilitates the payment to owners of their anticipated return, while also allowing the master tenant to receive a premium from the profitable operating property. Of course, when the tenants disappear and vacancies increase, the property no longer produces enough revenue to pay the property expenses and the rent to the owners, thus causing a default under the master lease.

Although less common, sponsors' troubles can also be prompted by poor property selection, poor management, fraud or unethical practices, violation of securities laws, disregard of contractual obligations, or any combination of any of the foregoing. When these factors are present, there is greater potential for legal proceedings or bankruptcy, making it particularly important for owners to seek adequate representation.

Solutions for the troubled sponsor dilemma may involve counseling the sponsor into action, through broker dealers, registered representatives, investors, and legal counsel, or replacing the sponsor. Our advice to a sponsor who has lost the confidence of its owner group is to willingly step aside. Not all sponsors share our view.

### **Lender Challenges.**

Lenders to syndicated properties are generally either portfolio lenders or securitized lenders, managed through servicers. When the loan is held by a portfolio "warm body" lender, a workout may be relatively painless, and can often be accomplished in a number of weeks. If the loan has been securitized and sold on the CMBS market, there will likely be more pain and cost surrounding a restructure. The servicer is responsible to manage the loan on behalf of a trust that exists for the benefit of undefined bond holders. The servicer does not have an identified client that can give it permission to restructure the loan, and the servicer is therefore constrained by the provisions of its servicing agreement. The servicing agreement generally provides the servicer with very limited discretionary authority to alter the terms of the loan. However, the servicing agreement almost always provides the servicer with authority to foreclose on the property. As a result, the servicer is at less risk to its bond holders if it forecloses on the property than if it works out a creative solution with the owners. For this reason, and others, lenders and servicers

have grown to disdain the TIC structure and are reticent to engage in typical restructuring activities such as extending loans and reducing interest rates.

Unfortunately, the current real estate market demands creative solutions. So, rather than working through the complexities of the TIC structure, lenders and servicers will often demand a “roll up,” which is the restructuring of the owner group from a tenancy in common into a partnership entity (either a limited partnership or an LLC), so that the lender has a single entity and governing body with which to work. Although such a transformation may be advisable for some TIC groups, there is typically significant resistance because the roll up changes the character of the investment and, in most cases, eliminates the owners’ ability to exchange the property in the future in a Section 1031 transaction.

With or without a roll up, other loan modifications may be appropriate, such as deferred principal payments, interest rate reductions, waiver of default interest, or release or reduction of required reserves. Lenders are often hesitant to implement any of these modifications without the owners’ commitment to infuse additional capital into the property. If the issues with the lender are not addressed promptly, the lender or servicer may seek the appointment of a receiver for the property. In such event the loan will be transferred to the special servicing department and default interest and other fees will accrue. If things go very badly with the lender, the owners may ultimately be forced to choose between a deed in lieu of foreclosure or the rigors of lender foreclosure.

### **Conclusion**

TIC structures were complicated when created, and are even more complicated when re-created. TIC workouts that result in continued tenancy in common ownership or restructured ownership through a partnership entity can be successful but should not be attempted by the inexperienced or faint of heart. Hopefully, the material in this article will help a TIC owner group start down the right path.

## SEC keeps quiet about proposed TIC exemption

Consolidated into single transaction, 'tenant in common' deals, often include securities

**W**ill they or won't they? That is the question that many real estate brokers are asking today. Will the seemingly sleeping giants in the Securities and Exchange Commission grant an exemption that could dramatically affect the bottom line for real estate brokers?



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The SEC could do this by making a decision to allow real estate brokers (who are not licensed securities salespeople) to receive advisory fees in connection with the sale of tenant in common securities.

A tenant in common (TIC) is the owner of an undivided real property interest. That real property interest could be a commercial office building, a retail center or an individual residence. In the TIC industry, sponsors find properties, investors and lenders and consolidate them into a single transaction.

Depending on the elements of a transaction, a TIC interest may be sold in a way that becomes a security under an investment contract analysis. An investment contract is created if an individual makes an investment of money into a common enterprise with the expectation of making profits based solely or primarily on the efforts of others.

The sale of TIC properties often involves the sale of securities as a result of the sponsor's active participation, coordination and management of the property and transaction.

The analysis hinges on whether the investors are expecting to, and in fact make, their profit based on the efforts of the sponsor – or whether they are truly buying a real estate asset, and the profits result from the economics of the asset.

Because a picture is worth a thousand words, the concept might be more easily understood through the diagrams at left – showing one TIC product that clearly is a security and one that should not be deemed a security.

In the first diagram, you see that the sponsor master-leases the property from the TIC owners and has its affiliated property manager operate the property with no TIC owner approval of leases or lease terms.

The sponsor is the borrower of the loan and its principals guaranty the loan. Clearly, this would be considered a security because profits are based on the efforts of the sponsor.

In diagram two, the TIC owners approve and execute all leases and manage the property. The TIC owners are borrowers of the loan. The sponsor arranges aspects of the deal, and gets out, so

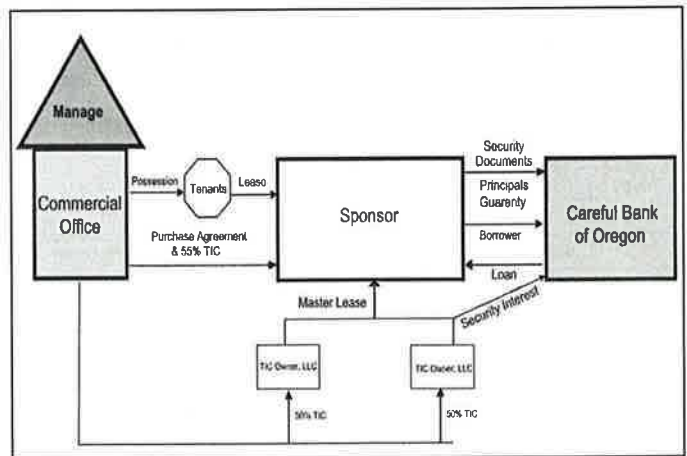
this would not likely be considered a security because profits are based on the efforts of the TIC owners.

Last October, the National Association of Realtors submitted a request to the SEC for an exemption that would allow a real estate adviser fee to be paid to a non-securities licensed real estate broker in a TIC securities transaction.

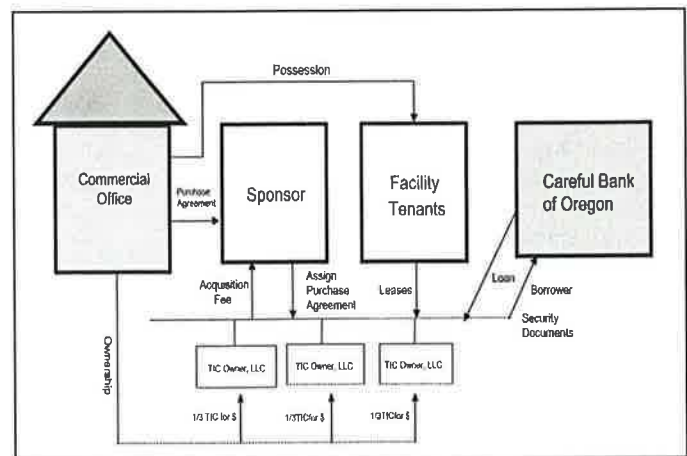
If approved, the proposed exemption would apply if the transaction included the following criteria:

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**Diagram one: Clearly a security**



**Diagram two: Not a security**



• The broker is a commercial real estate broker with substantial experience selling commercial real estate who is predominantly engaged in the sale of commercial real estate (not including TIC securities).

- The TIC interest must be sold as a security and generally sold as 1031 replacement property.
- Each buyer must receive a deed.
- There must be a written buyer's agent agreement with the broker.
- The broker can only participate in real estate-related activities.
- The broker cannot advertise a TIC security, or that it sells TIC securities.
- There must be a securities broker dealer involved in the transaction.

It is very unusual for the SEC to allow the payment of any fee to an individual that is not either a licensed securities salesperson or does not fit within their definition of a finder. As a result, the proposed exemption is quite controversial, as demonstrated by the comments that the SEC has received to date. That contro-

versy may be what is causing the delay in the adoption of an exemption that many TIC insiders believed would come about prior to the end of 2007.

As with any legislation or rulemaking, there will be many questions left unanswered if the exemption is adopted.

For example, will the SEC establish a separate enforcement arm related specifically to this exemption since real estate brokers are not subject to FINRA oversight? What will further define "substantial experience" and "predominantly engaged in"? Finally, post-exemption, will the SEC flex its regulatory muscle against real estate TIC sponsors?

The only certainty at this point is that controversy will surround any decision.

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## FOCUS

# SEC continues to mull tenant-in-common exemption

Last November the Securities and Exchange Commission asked for comments on a proposal to let real estate brokers receive commissions when tenant-in-common properties are sold.

The proposal came by way of an exemption requested by the National Association of Realtors. The proposed exemption proved extremely controversial. It has set off a firestorm of comments, which are available on the SEC's Web site.

In the past, the Internal Revenue Service has outlined 15 elements that it will evaluate to determine if a real property interest structured as tenant-in-common ownership can be considered a real estate interest for tax purposes, or whether it is the owner's participation in a partnership. This is Revenue Procedure IRC 2002-22.

This determination is critical to evaluating whether the purchaser can use the benefits of tax deferral provided in Section 1031 of the Internal Revenue Code. That section allows owners who sell a property to exchange into a replacement property and defer the tax on the gain so long as the replacement is "like kind."

A partnership interest is personal property and therefore not "like kind" with respect to the sale of investment real property.

Following the introduction of Revenue Procedure 2002-22, a cottage industry of TIC sponsors exploded. The sponsors locate properties, complete due diligence, arrange financing and then syndicate the ownership of the property to investors, who are often completing the second leg of their 1031 exchange transaction. The sponsors do all this to obtain the equity necessary to satisfy the acquisition financing requirements.

These structures always involve the sale of real estate, but they also often involve the sale of a security under what's called the Howey analysis.

In *SEC v. W.J. Howey Co.*, the United States Supreme Court provided a definition of an "investment contract," which is relevant to determining whether an interest in real estate could be a security.

Based on *Howey* and subsequent cases, if an individual makes an investment of money into a common enterprise with an expectation of making profit based solely or primarily on the efforts of others, then the product purchased is often an



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investment contract, and thus a security.

The TIC interests sold by sponsors are often TIC "securities" because the sponsor puts forth all or a significant portion of the effort to pull the project together and then manages the property on behalf of the investors following closing.

Many sponsors have continued selling their TIC product as real estate and have avoided, or tried to avoid, the Howey analysis by causing the investors to have hands-on responsibility for managing their own investments.

This is sometimes handled through requirements for unanimous approval of master leases or the investors' personal selection of a property manager.

The National Association of Realtors wants an exemption to allow commissions to be paid to licensed real estate agents or brokers for the sale of TIC securities.

The exemption would allow a "real estate advisory fee" to be paid in a TIC securities transaction if the commercial real estate professional had substantial experience in the sale of commercial real estate. That would be evaluated on a facts and circumstances test, but would include certain common broker certifications.

The exemption would apply only if the broker's primary business is the sale of commercial real estate other than TIC interests.

This last noted criteria can be puzzling since one would expect the SEC to prefer the experienced brokers who specialize in the sale of TIC properties.

In every transaction in which a real estate broker is going to be paid a commission, there must also be a securities broker dealer involved and earning a commission. There are a variety of other less crucial elements that apply to the exemption, but if all of the elements are satisfied, then the sponsor would be allowed to pay a commission to a real estate broker for participation in the sale of the TIC security.

Some TIC industry insiders I have spoken to believe that the exemption will be issued substantially as it was when released for comment.

Other authors believe that the exemption will never be passed.

The real question is what will the SEC do if the exemption is adopted? If that happens it's likely that some real estate TIC sponsors will shift their program to sell TIC securities because they will be able to pay commissions to the real estate brokers they have been working with for many years.

This will be particularly likely among those TIC sponsors who have received indications that the SEC views their product to be a security because of a master lease or other similar structure.

However, some TIC sponsors will resist the switch because of their well established marketing channels and the fact that in the sale of real estate by brokers, there is no prohibition on advertising and general solicitation, while securities brokers and real estate brokers who are selling TIC securities will not be able to advertise and generally solicit.

**Industry rumors have questioned whether the SEC will make a pronouncement that all TIC interests are securities.**

If the exemption is adopted, the SEC will likely flex its enforcement muscle and pressure TIC real estate sponsors who are "on the line" into converting to a securities product.

Industry rumors have questioned whether the SEC will make a pronouncement that all TIC interests are securities. However, I personally don't think the SEC would take any such action as it could face an uphill, precedent-setting battle in court under a Howey analysis.

Whatever happens, the road to the exemption is a bumpy ride, and whatever the result, the process will dramatically affect the industry. This will be an interesting dynamic to observe as the exemption unfolds.

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## Obtaining development financing by way of securities

### Developers who conduct private placements usually sell interests in new LLCs

One of the most challenging elements of a real estate transaction or development is finding the money.

We all know about financing a real estate "project" through conventional methods; however, more and more, financing is occurring through private sources. Venture capitalists, angels and other investors are looking to make an investment that's secured by collateral and is therefore less risky than the stock market, but provides for a higher return than government bonds or other secure investments.

In many instances, raising capital from such investors is accomplished through private placement of securities. Real estate securities typically qualify as such under the investment contract definition, which in most states is defined as, "an investment of money, in a common enterprise, with the expectation of profit, based solely or primarily on the efforts of others."

There are three primary reasons to care whether this investment vehicle is a security: registration, disclosure, distribution.

#### Registration

To avoid the significant time and expense of a public offering, the offering of real estate securities must qualify for an exemption from registration. Most issuers seek exemption under Regulation D of the Securities Act of 1933. The Regulation D exemptions each have different rules with respect to the dollar amounts raised, and the number and type of investors that can be included; however they all prohibit advertising and general solicitation.

#### Disclosure

With respect to disclosure, the goal of the Securities Act of 1933 is to protect investors and ensure they have the information necessary to make a rational decision. The amount and type of disclosure that is required depends on the qualifications of the investors who will be participating in the offering.

"Accredited investors," as defined under



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the Securities Act, are those with certain minimum asset or income thresholds who are deemed to have the knowledge and sophistication necessary to protect them, so no specific disclosure is required for them.

However, "non-accredited investors" are individuals who are not deemed to have sufficient knowledge and sophistication to protect themselves,

and therefore, specific disclosure is required. Severe penalties, both criminal and civil, may result from failing to comply with the securities disclosure provisions, which essentially require the issuer to tell about the deal; tell about the owners and their experience; tell about the risks; and tell about the finances and returns.

#### Distribution

Distribution defines who can sell the security that is being offered. It is safe to assume that in most instances you should be a licensed security salesperson in order to sell any security. Of course, there are exceptions, and these rules vary from state to state. However, the consequences for failing to be licensed include significant civil penalties and potential felony criminal charges.

#### Raising funds

There are three primary ways to raise funds through real estate securities offerings:

- Sell entity interests, such as corporate stock, limited partnership interests, and member or manager managed LLC interests.
- Sell promissory notes.
- Sell tenant-in-common real property interests.

The most common structure for a real estate private placement is for the issuer to create a limited liability company to own the project. The issuer obtains the maximum debt financing available for the project and typically personally guarantees the debt. Then they raise the required equity through the sale of LLC interests to investors who will own a proportionate amount of the company. This LLC interest is personal property to the investor.

In this structure the investors typically

receive priority returns from the LLC and the issuer maintains management control over the entity and project. The issuer will often take a fee for its management efforts and will typically reserve for itself a percentage of the equity as a reward for structuring the transaction and for guaranteeing the loan.

It is also common for an issuer to form the same LLC to own the project as just described, and then raise funds by issuing secured promissory notes from investors. The collateral for the loans is often a proportionate participation interest in a deed of trust that encumbers the project. Each note holder is secured by a piece of the trust deed. The note and trust deed are personal property to the investor. As you might imagine, the complicating factor is that a group of beneficiaries own the same trust deed and must take all actions in concert. An agent of the beneficiaries must act on behalf of all of the beneficiaries for any action taken under the trust deed.

Finally, quickly gaining prominence as a way to finance a real estate project is the creation of a tenant-in-common structure. This is where the same issuer creates the same LLC and obtains and guarantees the same loan as above. The distinction is that to raise the required equity, the issuer sells undivided TIC interests in the real property as opposed to the personal property the investors own under the other structures.

Because the investors own land and improvements, if properly structured, this type of investment can qualify as a "like kind" 1031 exchange for the sale of other real property. This is significant because an investor that relinquishes real property cannot do a 1031 exchange into an investment that produces personal property.

Each of the structures discussed here has strengths and weaknesses, and each can be used with many variations to create the proper funding vehicle for your real estate acquisition or development. However, the creation and sale of securities is not advisable for the inexperienced, so proceed cautiously with the appropriate real estate professionals.

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## Legislature looks to tweak condo conversion rules

Residential home builders in Oregon historically have run into frustrations with home buyers when trying to get a homeowner association organized and operating. So a legislative action committee made up of the Community Associations Institute, The Condominium-HOA Working Group and Oregon Washington Community Association Managers has helped write House bills 2665 and 2666 to address this and other problems arising from the work of homeowner associations.

Thursday, we looked at how HB 2665 will change the way associations can operate with regard to boards of directors, communications and voting, reserves and maintenance, and insurance. Today, we examine three other important bills, all of which are expected to pass into law.

### HB 2666 amends condo, community acts

HB 2666 covers a variety of unrelated clarifications, updates and improvements to the Oregon Condominium and Planned Community acts. The bill if passed would enact several changes:

- An association would be incorporated prior to the recording of a plat if the property is to be conveyed to the association.
- The sale of nonresidential condominium units would be exempt from the disclosure statement and other sales requirements intended to protect residential unit purchasers.
- Associations would be incorporated if a condominium were to consist of more than two units.
- Unit boundaries would be clarified with respect to windows and doors.
- A sub-condominium could be created within a master condominium unless prohibited by the declaration.

HB 2666 would amend the Oregon statutes governing condominiums and planned communities, Oregon Revised Statute 94. It is expected to be enacted into law with an effective date 90 days after the legislative session ends.

### HB 3186 tightens condo conversion requirements

HB 3186 was introduced at the request of the Community Alliance of Tenants to tighten the requirements for conversion of apartment buildings into condominiums. The increased conversion of apartments to condominiums compelled the tenants to request greater protections. This bill has passed the House and, if passed by the Senate, will amend the current conversion requirements in the Condominium Act. It will likely be effective Jan. 1, 2008.

Developer's currently must abide by a 120-day notice requirement that will be changed. HB 3186 allows rehabilitation of apartments during the 120-day notice period but only during normal business hours.

Also, according to the bill, a landlord must assure each tenant always has safe dwelling unit access during rehabilitation work.



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During the 120-day notice period, a landlord may not terminate tenants without cause. Also, during the 120-day period, landlords cannot increase rents beyond the inflation rate.

A tenant may recover statutory penalties for violation of these legal requirements. Tenants asserting these claims will, however, have the burden of proof, and the prevailing party will be entitled to attorney fees under the residential landlord/tenant statute.

### SB 543 guides Arizona bank into Oregon market

Senate Bill 543 was introduced at the request of Community Association Banc to require association funds be deposited in Federal Deposit Insurance Corp-insured bank accounts but allowing the use of out-of-state banks for such purposes. This bill would permit Oregon homeowner associations to move their checking and savings accounts to Community Association Banc, an Arizona bank that specializes in serving homeowner associations around the United States and is entering the Oregon market. Previously some associations have invested their funds in questionable ways and in some cases have lost all or part of the association's funds as a result.

SB 543 is expected to pass into law, and because it contains an emergency clause it will be effective immediately upon passage.

### Read the measures

Those who deal with condominiums or planned communities and their homeowner associations will want to read these bills and the final legislation carefully because technical requirements will be clarified and updated in ways that will require changes in both documentation and operating practices.

For anyone dealing with condominiums and planned communities, these expected statutory changes are numerous and will require changes in the drafting of declarations and bylaws as well as in the operation of existing associations.

Although the transition will take some effort, the legislation will make many needed improvements and clarifications that are welcome improvements to the Oregon homeowner association laws.

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## Oregon House looks to help fill empty HOA boards

Have you ever given a party to which no one showed, even though you sent invitations to the right addresses and with plenty of time? You probably felt hurt because nobody thought the party was worth attending.

Residential home builders in Oregon have felt this same disappointment because of home buyers too often failing to join homeowner associations, hampering developers that want to turn over control of their buildings.

To address this, a legislative action committee made up of the Community Associations Institute, the Condominium-HOA Working Group and Oregon Washington Community Association Managers has written house bills 2665 and 2666.

The bills would amend the Oregon revised statutes governing condominiums and planned communities, ORS 100 and 94, respectively. Both are expected to be enacted into law with an effective date 90 days after the legislative session ends.

Additionally, HB 3186, which would tighten requirements on apartment-to-condominium conversions, last week passed the House. And Senate Bill 543 was introduced to require association funds be deposited in Federal Deposit Insurance Corp.-insured bank accounts but allowing the use of out-of-state banks for such purposes. Both of these bills are expected to pass into law. SB 543 contains an emergency clause and would be effective immediately upon passage. HB 3186 would be effective Jan. 1, 2008.

Over the next two days, we will explore these bills and their impact on homeowner associations in Oregon.

### Board of directors appointments eased

HB 2665 supplements the Planned Community Act and the Condominium Act so that, if a homeowner association fails to fill vacancies on the board sufficient to constitute a quorum, an owner or its lender may request the circuit court appoint a receiver to manage the affairs of the association. The salary of the receiver would be a common expense.

Previously there was no statutory remedy if members of a homeowner association failed to elect a board to perform its duties. This hampered developers in turning over association control to uncooperative buyers. HB 2665 provides that, if a home builder has complied with its responsibilities and yet the owners still fail to elect the directors and assume control, the declarant is relieved from further administrative responsibility.

The bill also simplifies the administrative process so that, if any meeting cannot be organized because of a lack of a quorum of owners present in person or by proxy, the meeting may be adjourned and a new meeting held at which a much lower quorum requirement will be applicable to facilitate a successful meeting.

### Communications, voting expanded

HB 2665 also allows greater flexibility in the dissemination of information and clarifies the process for association voting. At discretion of the board, any required notice or information may



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be e-mailed or faxed notwithstanding any requirement under the declaration or bylaws.

However, electronic communications may not be used to give notice of certain matters such as failure to pay assessments, foreclosure of an association's lien or an action the association may take against an owner.

Vote-by-mail has also been expanded to allow voting by e-mail, but there is an opt-out provision so owners cannot be forced to use e-mail for communications or voting.

Annual meetings still have to be held in person, except for second home associations.

### Maintenance plan clarified

In the previous legislative session, a bill was passed to require an annually updated condominium maintenance plan to avoid unnecessary repair and replacement expense and disputes due to inadequate maintenance.

HB 2665 reflects the clarifications and changes needed based on experience with this relatively new maintenance plan requirement. It helps the association determine how much owners must pay into the operating account for maintenance work and into the reserve fund for the future repairs and replacements of the common elements as they wear out.

Condominiums are exempted from these reserve and maintenance requirements unless there are more than two units in the condominium. Most homeowner associations will, however, be subject to the reserve and maintenance requirements.

#### Insurance law updated

HB 2665 updates the law on insurance for condominiums and planned communities. If the declaration and bylaws do not assign payment responsibility for the deductible in an association's insurance policy, the board may adopt a resolution to assign responsibility to all owners or specific owners affected by the loss.

Among other insurance changes, the bill addresses the problem of old documents having deductible limits too low due to not being inflation indexed.

Last, the bill allows the board to exceed maximum deductibles specified in bylaws if it is in the best interest of the association.

Tomorrow, we will look at the other bills affecting Oregon homeowner associations.

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## Legal structure sets tone for real estate projects

Developers, contractors and owners spend countless hours planning and designing their buildings and developments. They hire the best designers and engineers they can find to assure the structural integrity of their buildings. They realize that each project is unique and requires individualized plans and designs. They recognize that a well-engineered structure and strong foundation are essential to creating a building that will stand the test of time.

Unfortunately, those same developers, contractors and owners often don't recognize that the "legal" structure selected for their buildings and developments can be equally important. Just as a properly designed building foundation is critical to accomplish the goal of holding up the walls of the building, the properly designed legal foundation is critical to accomplish the owner's goals relating to taxation, liability protection and exit strategies.

The legal structure is the entity created to own the assets and to achieve the proper separation of assets. There are many entities available for use in Oregon. They include corporations, small business corporations, general partnerships, limited partnerships and limited liability companies.

*The properly designed legal foundation is critical to accomplish the owner's goals relating to taxation, liability protection and exit strategies.*



### Choosing your structure

The elements to consider when selecting your structure include whether the entity has one or two levels of taxation, whether the entity provides limited liability, whether use of the entity creates a self-employment tax problem and whether the distribution of appreciated assets from the entity to the owners is a deemed sale.

An overriding consideration and the primary reason that you separate assets into different entities is to create a liability shield for the owner's other assets. So long as the owners of an entity

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limited liability to all owners, we can dismiss the use of partnerships and limited partnerships.

And since owners want to be protected from paying two levels of taxation on the same dollar, we can also dismiss use of a regular business corporation. Of course, there are always exceptions to these general rules. However, typically, the best choices are S corporations or limited liability companies.

### S corporation or LLC?

How do you decide between an S corporation and an LLC? The best way is to analyze the issues of self-employment tax and distribution of appreciated assets.

In an S corporation, there is no self-employment tax on distributions of profits to the owners. So, if you own a profitable operating business and you take a reasonable salary, then you can take the remaining profits of the S corporation as distributions and avoid paying self-employment tax on those distributions. With an LLC, you likely will be required to pay self-employment tax on distributions from the company. Therefore as a general rule if you are structuring for a profitable operating business you should use an S corporation.

Alternatively, if you are creating an entity that will own appreciating assets, like real estate, then a primary consideration is whether you can distribute the appreciated assets to the owners of the entity without creating a deemed sale. Deemed sale means that for tax purposes, the Internal Revenue Service will treat the conveyance as a sale of the property for fair market value, and tax the transferor as if a sale had taken place. Therefore there is a tax event without a cash event, thus creating undesirable phantom income.

In an S corporation, the transfer of the appre-

ciate asset to the shareholders is a deemed sale. In an LLC it is not. So, as a general rule, if you are holding real property inside an entity for the always important limitation of liability, then the proper entity is an LLC.

As an example: Joe Developer owns in his own name four apartment buildings; one each in Salem, Lake Oswego, Portland and Beaverton, all in Oregon. If there is a liability-creating event in excess of Joe's insurance limits in Salem, the creditor can take all four buildings and also Joe's house.

A better ownership structure is for Joe to create four separate LLCs, and convey each apartment building as a capital contribution to a separate LLC in exchange for the ownership interests in the LLC. That way, when the same liability-creating event occurs, the creditor can take only the Salem building and not the other buildings or Joe's house.

Another example: If Jane Manufacturer, as a sole proprietor, owns land and a building upon which she operates a profitable forklift manufacturing business, and if Jane suffers a large product liability judgment, the creditor can take Jane's manufacturing business, her land and Jane's house.

With proper structuring, by conveying the operating business assets to an S corporation and the land and building to an LLC, each owned by Jane, and then creating an arm's-length lease between the two entities, the same judgment creditor could take only Jane's manufacturing business, but not her land or her house.

As with each unique building design, each unique legal structure design is governed by the particular needs and goals of each project and owner. As you can see from the examples above, even the most basic structuring efforts can allow the owner's assets to stand the test of time.

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# Twelve obstacles to closing your transaction

Getting to closing is the goal of any real estate transaction, but it isn't always easy to reach. A few simple obstacles can delay or kill your closing. They can come during negotiation or happen because of timing, due diligence (or lack thereof) or finances. Here's what you should watch out for:

## Negotiation obstacles

- Avoiding the hard issues.

Have you ever heard parties in a negotiation say, "Leave it to the lawyers to work out the details," or, "We'll figure it out at closing"? It's code for: "We're too chicken to talk about the hard stuff."

If you have inadequate documentation that fails to clarify all important business terms, issues will pop up throughout the transaction and at closing, such as how will net profit be calculated when determining an earn-out payment?

Make sure all parties have a consistent understanding of terms through proper documentation.

- Deal-killers. Lawyers sometimes push deals to the breaking point - and even over the cliff - by arguing about language of minimal importance.

Every negotiator should understand that if she wins every point in negotiations, she should watch her back at closing. Every transaction needs a deal-making lawyer, not a deal-killing lawyer.

- An abused party. A party who has felt abused in negotiations

will often become immovable at closing. The abused party will arrive at closing with the attitude that he will give the other side



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"not one penny more." This attitude makes resolving routine last-minute issues nearly impossible.

## Timing obstacles

- No clear timelines. When is your closing date? Is it date-certain or is it based on 30 or 60 days from something else? If it's something else, is that time frame determinable?

Prior to signing the agreement, outline key dates to make sure they flow to an ultimate closing date.

- Last-minute schedules. Don't wait until closing to complete asset lists, liabilities assumed or exhibit documents such as non-competes and assignment documents.

If you haven't attached exhibit documents well before closing, be prepared to compromise on the terms you want or need.

## Due diligence/ title obstacles

- The survey. If a survey is going to be required, or if your lender is going to demand extended-coverage title insur-

ance, be sure you order the survey immediately. Surveys - and the problems they bring up - take time and often raise issues.

- Legal descriptions. It is pretty frustrating to get to closing and learn that the recorder will not record your deed due to a faulty legal description. Work with your title company to make sure that yours is accurate and that it is consistent with the survey.

- Title exceptions. Everyone has experienced last-minute title exceptions, unrecorded or recorded leases, mechanics or judgment liens. You should request an updated preliminary title report shortly before closing to confirm there is nothing new.

- Environmental discoveries. In nearly every significant real estate transaction, a Phase I environmental site assessment is ordered, and everyone progresses based on finding nothing.

Identify red flags, and if there are any, give sufficient time to receive the Phase I and address any issues.

## Financial obstacles

- Prepayment penalties. If the seller doesn't calculate his prepayment penalties into the financial aspects of the sale, he can arrive at closing without enough funds to close.

Prepayment penalties can often be reduced through negotiations, but not if you wait until the closing date.

- Lender delays. Often, lenders won't deliver loan docu-

ments until the day before closing in an effort to minimize negotiation of their standard language. An issue growing in frequency is having a primary lender that is participating portions of the loan. If one of the participants drops out at the last minute, the lender will not close until she finds a replacement, leaving the parties at the lender's mercy.

- Defeasance. Defeasance is a process by which a seller can complete a transaction despite having a prepayment prohibition in its existing loan. This situation arises when a lender has participated portions of the original loan to participants who have a right to a specified stream of payments.

In the defeasance transaction, the mortgage payments are substituted with government securities, thus enabling the seller to pay off the mortgage and sell the property. As with many of the obstacles, although a defeasance transaction is often available, it takes time.

Every experienced purchaser, seller or practitioner can run into obstacles that delay closing. By following this checklist, your transaction should go smoothly, and you should make it to closing in a timely and painless manner.

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