This is a program I gave a few years back at an ALTA commercial conference. I’ve repurposed it a bit for today

There are a couple of things I want you to take home from today.

* + High Level Familiarity with Complex Structures, the general rules and the terminology. Hoping to get you past the deer in the headlights look when someone approaches you about one of these more complex structures.
  + Understanding how to focus down on the Title Issues. We don’t have to know all of the tax and structuring rules for these. We need to know the title parts. And for many of these structures, the title issues are the same ones we deal with every day.
  + We’re going to get into the “Why” behind Some of the Commercial Endorsements. What they are trying to accomplish in the context of these structures – and many are tailored specifically for certain types of transactions and shouldn’t be used in others.
  + Need for review of selected Transaction Documents. In contrast to residential, where EVERYONE uses the approved Fannie/Freddie form for you states, and all we are really looking it is whether they filled in the blanks correctly. Complex commercial transaction documents are heavily negotiated and we have to review those that affect title in toto, to make sure they create a valid and enforceable mortgage, to make sure that any subordinations put things in the right order.
  + As part of this, you’ll be Spotting Secondary Legal Issues
    - Future advances and their validity
    - What parts of the total transaction documents must be recorded in the state for constructive notice
    - Importance of Recording Acts in protecting the title industry. – and you will see that come up in any of the transactions where we are asked for non-imputation coverage.

[SLIDE]

In our standard situation, you start with a Buyer and a Seller. The buyer wants a property that the Seller has.

[CLICK]

So buyer gives Money to the Seller, and the Seller gives a deed to the property

[CLICK]

And we insure that new ownership.

Sometimes the buyer doesn’t have enough of his own money to do this.

[Click] so he contacts his friendly banker, who

[CLICK] gives him the money he needs in exchange for a mortgage

[CLICK] and we’ll also insure that mortgage is a valid lien upon the property with the priority that they have agreed to.

And the transaction looks exactly the same from our perspective if

[CLICK] the lender is an international bank

[CLICK] or a life insurance company

Although each of these sources of capital are subject to different bodies of laws and regulations – and each makes internal decisions as to their own appetites for risk that they are willing to accept that limit and each of those affects their lending parameters.

And while it’s nice to know that International lenders aren’t all subject to the High Volatility Commercial Real Estate loan regs brought to us by Dodd Frank and adjusted a few years ago in the Economic Growth, Regulatory Relief, and Consumer Protection Act (Reform Bill) – or that life insurance companies are often willing to make longer term mortgages – because those considerations can be very important for our customers in structuring their loans – those factors don’t much affect how we handle the title portion of our jobs.

[SLIDE]

And very often our friendly local banker doesn’t hold onto the mortgage themselves. Either because they want the credit risk off their own books, to free up capital to make more loans or they planned it that way in the first place. And there can be competitive advantages to designing a loan to fit REMIC or CMBS parameters from the get-go.

So they contact an aggregate buyer – a Real Estate Mortgage Investment Conduit – a REMIC. Which is a tax driven term from the 1986 Tax Reform Act, Fannie & Freddie are some of the biggest REMICS -- or a CMBS aggregator,

[CLICK]

The REMIC gives money

[CLICK]

In Exchange for the assignment of the mortgage.

[CLICK]

And because of the expansive language we put into the 2006 policy forms, the REMIC automatically gets the benefit of our already existing title insurance coverage.

We may or may not ever know of this assignment, and it doesn’t affect how we do our title business.

[CLICK]

And the REMIC or CMBS aggregator issues mortgage backed bonds, or Collateralized mortgage obligations, and

[CLICK]

They get money from that to repeat the entire process.

[SLIDE]

So why would a lender – or a borrower -- prefer to have their mortgages packaged into a Commercial Mortgage Backed security. Better Terms.

* CMBS standards are Generally less stringent than banking standards
* Often non-recourse

One of the drawbacks to a CMBS model is that the bondholders are making an investment with a set term. In the residential mortgage backed securities, there is often a provision that allows the substitution of another mortgage to replace one which is paid off early. It doesn’t always work out well -- for example when interest rates drop and everybody wants to refinance at once.

But in Commercial bonds, each loan is a bigger portion of the total bond and it is very hard to find a like-kind replacement with a similar risk profile. And the government regulations don’t restrict pre-payment penalties like HUD and Fannie Freddie guidelines do.

So in commercial mortgages planned to be sold into CMBS, we often see a pre-payment penalty.

But we don’t want to stop the ability to sell the property – so the prepayment penalty says that if you want out early, you have to put up substitute collateral. You have to go out and buy U.S. Treasuries that have payouts more or less matching the timing of payments due under the mortgage, and give them to a trust bank to hold for the bondholders. So that the income stream flowing to the bonds is unchanged – and the security of our collateral is actually improved.

There are sometimes tax law limitations on interest rates earned on defeasing bonds – especially those in connection with a tax exempt financing and muni bond financings. The IRS doesn’t want interest rate arbitrage at the expense of tax revenue.

That process is called defeasance.

And in a perfect world, the mortgage should be released of record at the time you put up the replacement bonds. In the real world you sometimes run into that problem and it can be a real bear to get sorted out because your original CMBS borrower is no longer there.

[SLIDE]

Now let’s look at a special subset of REMIC/CMBS financing – that’s the Fannie Mae, Freddie Mac multi-family program.

From a developer stand point these are great financing programs. The cost of money is low – based on a spread over Treasury rates. Fannie and Freddie will go up to 80% on Loan to Value. That’s higher than most banks – and do it on a non-recourse basis.

There are two interesting twists:

* As you get a project leased up and values increase, They will allow subordinate financing – and even make the subordinate loans. So if your value increases, you can take out a second, a third even a fourth mortgage with Fannie/Freddie to take out some of your equity.
* The loans are assumable. So you have built in financing for your outsale. And the buyer can take on a subordinate loan of up to 80% of the then current value to pay for part of the purchase.

Something this good has got to have limits or it would take over the world – and be an unfair competition for private lenders.

So the government sets a $ limit, a Cap, on both Fannie and Freddie multifamily loans each year. It had been running about $35B, but in 2019 increased to $100B/year

And in spite of the Caps, About 60% of total multifamily permanent financing was with Fannie and Freddie in 2017.

For this discussion, here is the take-home. The caps don’t apply to all types of multifamily. Low income and historic restoration loans are not subject to the aggregate lending caps.

In a few slides we’ll be talking about tax credit sweeteners – and you can use the tax credit sweetener’s with Fannie/Freddie financing.

[SLIDE]

Seller Carry Back Financing is pretty basic. Under IRS rules, this is characterized as an installment sale obligation, and the seller only recognizes gain when they actually get paid.

The mechanics are as follows

[CLICK]

The seller gets some cash at closing; That portion is immediately taxable

[CLICK]

The property is transferred to the Buyer;

[CLICK]

We insure the new owner

[CLICK]

and the seller provides some or all of the funding on the transaction and takes back a note secured by a mortgage on the property.

The general rule is that an installment sale defers the recognition of the gain until you are actually paid. But it’s much more complex than that. You may have to recapture prior depreciation in the year of sale as ordinary income. If there is no or a nominal interest rate on the debt, a portion of the future payments will be recharacterized as interest received. And any transaction involving the installment sale obligation may trigger immediate recognition.

None of that concerns us as title professionals.

[CLICK]

The hard question is whether your underwriter is willing to insure the mortgage back to the seller.

If the seller had a prior owners title policy, they have continuing coverage for any defects that existed at the time they bought it.

If you are to insure the new mortgage, your insurer is basically giving up subrogation rights against the seller even against the prior owners policy. On top of that, the insurance is putting the seller in a better title position as to anything the seller might have done, including potential unrecorded liens.

So that one is an ASK YOUR UNDERWRITER

[SLIDE]

Structurally, everything we’ve looked at so far looked very similar. You have a single buyer, a single lender, and you are going to insure both.

Sometimes a plan to assign the resulting mortgage to someone else – be that a REMIC pool for CMBS, a larger bank, Fannie/Freddie.

* Those secondary assignments are automatically covered in our loan policy forms – review the definitions of Insured
* And largely invisible to us as title professionals

The title issues in these examples are the ones we are used to.

But before we get into the alternative structures I’m going to get on my soapbox

In the last 10 years – probably longer, I’m seeing more and more good agents trying to apply crappy residential search and exam standards to their commercial transactions.

I think that is a product of us going too long without training a new generation in how to PROPERLY Examine.

But that practice is very high Risk to the agent and to the underwriter. And if you have good lawyers representing the parties – you are going to be embarrassed – and ultimately lose business – if you aren’t doing proper searches.

Searching back to patent is a pain in most cases – and I’m not saying that is always going to be required.

I strongly urge you to negotiate the coverages that affect the depth of your search right up front with the buyer and lender. Ask things like

* How concerned are you with the Mineral rights? That’s an expensive search in most states -- so if I insure against damage from someone else’s drilling or mining with an ALTA 9 or 35, may I take a blanket exception for mineral interests.
* As lender, will you accept “short form” type or “Generic” exceptions for easements and restrictions – so long as we affirmatively insure against their impact on your loan with an ALTA 9 and 28?
* And get it in writing. You never want a delayed closing to be blamed on you not having done a deep enough search.

Then, Don’t think you are going to get away with “Kitchen Sink” exceptions copying every exception you found on some nearby parcels.

* It is embarrassing to take an exception for a railroad that you can see a quarter mile from your property,
* Or for roads that aren’t anywhere close to your property.

You are going to be asked to provide copies of the instruments behind every exception – and if the Surveyor hasn’t done it for you on and ALTA/ACSM survey, someone in your office is going to be asked – SHOW ME HOW THIS AFFECTS MY PARCEL.

* What endorsements will they require EARLY – and plan for the due diligence I need to do to issue each?
* As soon as you have identified parties, verify the authority. On larger deals you run into more Delaware entities and they want to charge money for hard copies.

CONFIRM THE DOCS WORK

* We insure that the Deed is Valid, that the Mortgage creates a valid lien and has been properly executed, that any subordinations set up the priority we are insuring.
* In Residential we see the same Fannie/Freddie mortgage form used for pretty much everything. And we can quickly check the fill in the blanks, the party names, the address, legal description, etc.
* In commercial, the docs are highly negotiated. While you have good lawyers involved, the drafting is sometimes by out of state lawyers, or lawyers who don’t specialize in real estate law – and this becomes more prevalent when we talk about some of the alternative financing structures.
  + it is still your responsibility to review those documents and make sure they are effective to actually create the interests we are insuring.
  + And you occasionally find errors of a type that impact insurability.
    - Deeds without all the states formalities
    - Subordinations that don’t subordinate the right senior liens.
    - Definitions incorporated from other documents that SIMPLY DON’T WORK.

And these same worries apply – perhaps even more – as we move into alternative financing structures. The concepts are the same, but the documents get much more complex.

[SLIDE]

As we get into the alternative structures, there is a lot of overlap of economic concepts – and it’s tough to organize. So for this presentation, here’s how we’ve chosen to organize things.

[SLIDE]

Sometimes the transaction is that I’m just going to sell the equity in the entity that owns the property.

Old owner owns 100% of whatever entity owns the project.

The project was insured to that entity for the original purchase price.

He sells that equity ownership interest to the new owners – and all of the existing mortgages, leases and other contracts remain in place unchanged.

[CLICK]

Old owner gets cash,

[CLICK]

New owner(s) get the entity that owns the property.

[CLICK]

New owner wants to insure the property for its current value – which is much greater than the existing policy. And we’re happy to sell him a new policy or increase his policy limits.

[CLICK]

Because the Buyer’s counsel understands that the recording act won’t protect his buyer for anything that’s unrecorded against the property since it was first acquired by the ENTITY – and knows that we have “Agreed, Suffered and Assumed” and the “Known but not disclosed in writing” exceptions to our policies – she’s going to insist on an ALTA 15 series non-imputation endorsement.

Which loosely translated says – we won’t deny coverage based on something the old owners or the old officers of the company knew.

[CLICK]

There may or may not be financing for this transaction,

[CLICK]

but if there is it will often be secured by the assets of the Entity – the building, and

[CLICK]

the lender will want the mortgage loan insured.

[SLIDE]

We have two additional title issues in this structure.

The first is the GAP.

The recording act in almost all states says something like a bona fide purchaser of real property for value is protected from any interests that are not recorded at the time they acquired their interest or recorded their deed.

In this structure, there is no purchaser of the real property! Imagine that the entity that’s owned this property for 20 years gave an easement to someone – or even a mortgage to a buddy – and that didn’t get recorded.

We rely a great deal on the protections of the Recording Act in what we do. Think about that. With this structure and this endorsement, we are giving up all those protections – and that isn’t something to be done lightly.

Your search isn’t going to pick it up because it wasn’t recorded.

Of course, the old owner and the old officers of the entity know about it because they signed it.

But the new owners – our insureds – want us to assume the risk of this 20 year recording gap by issuing a non-imputation endorsement.

Each of your underwriters is going to have slightly different due diligence requirements – usually varying with the structure and size of the transaction for issuing that endorsement.

There are three flavors of non-imputation endorsement.

The second issue is one we don’t have to think about as much anymore - -and that’s creditor rights challenges.

If they buyer of the equity causes the company to mortgage the building as collateral for their loan – a classic leveraged buyout – that structure is subject to challenge in bankruptcy as a preferential transfer or even a fraudulent conveyance. The entity which pledged its assets received absolutely NO CONSIDERATION.

As you all know, all of our policies exclude coverage for creditors rights issues in the CURRENT TRANSACTION.

And I don’t believe any of your underwriters will issue the now withdrawn ALTA 21 endorsement or any other types of creditor rights coverage anymore.

But in the next transaction, you have to watch for the creditor rights coverage – for example if I’m insuring an amended and restated mortgage? Or potentially even a modification with an updated effective date I’m potentially creating a litigation issue where we have to defend it.

[SLIDE]

There are two primary scenarios in this category

One is tax advantaged in which we create Tenancy in Common Interests in income producing commercial property that are sold as the exchange property in a 1031 exchange.

The other is basically a crowd funding model for an acquisition. .

Your office is approached with something that looks like a normal acquisition except there are multiple unrelated parties as buyer.

[CLICK]

They are going to give the Seller Cash,

[CLICK]

The buying group is going to get deeded the property,and

[CLICK]

They want you to insure it.

[CLICK]

But somewhere off to the side there is a group – usually of affiliated entities –

[CLICK]

Which organized the group of buyers -- and may even be retaining some of the interests in the property for itself.

[CLICK]

Which is going to manage and maintain the property, collect rents and see to the rents – less a reasonable handling fee – are paid to the property owners.

[SLIDE]

There aren’t too many title issues raised by this structure.

But it’s an administrative nightmare for the closing office, getting the names and percentages right, getting the documents negotiated with all parties, getting everything signed.

And it’s a headache on the back-end – who can make a claim, who do you talk to settle a claim, how do you reach agreement on a cash payout to resolve a claim?

What I’ve described is probably a Security for federal and state laws. While real Estate is generally excluded from the definition of securities – the rule changes when Someone is making an investment and someone else is going to manage it and generate cash flow on their behalf.

If it’s a security, It may require registration, it definitely requires disclosures and there is strict liability for violations. Even though we are not the ones who rounded up the investors, who sold them on the deal or were being paid for managing the property, the folks in this room are likely to be the deep pockets still around when one of these deals goes sideways – meaning we’ll be named In the suit.

Our position is not to insure these with more than 6 in the group, unless it is syndicated institutional investors.

SLIDE]

We have a developer

[CLICK]

who wants to build a condominium project.

He has the land already.

[CLICK]

So he sets up a special purpose entity, transfers the land to the SPE and will let that entity do the contracting for work.

[CLICK]

And they ask us to insure their ownership for the full as built value.

Now how is out developer going to fund the project.

[CLICK]

He goes to his local banker – who says, “I’d Love to fund this for you – but after Dodd Frank,

[CLICK]

this would be a High Volatility Commercial Real Estate Loan – so I’m limited in how much I can lend on this type of project. And on top of that, my board of directors has set other limits. So I can only fund 75% of the costs of this project on a construction loan. You have about 10% in equity in the land you already own.

And because of my Bank’s policies, we won’t permit you to have any junior mortgages.

So the banker agrees to make the construction loan for 75% of the cost in exchange for a construction mortgage and prohibition on subordinate financing.

[CLICK]

And of course, wants you to insure the Construction Mortgage

Our Developer has about 10% of the project cost in equity in the land that it already owns.

So where is he going to get the last 15% he needs to complete the project.

[CLICK]

He goes to another friendly lender

[CLICK]

who agrees to lend him the 15%

[CLICK]

but as collateral wants the developer to pledge all of its ownership in the special purpose entity that owns the property on which this is going to be built. So if there is a default – this banker will own the project – still subject to the construction mortgage – and will generally acquire it without the need for a long drawn-out foreclosure against the land.

This structure is commonly referred to as Mezzanine Debt or a Mezzanine Loan – because it falls in between the debt secured by the property and the ultimate equity

[CLICK]

In addition to that, the banker asks for a Collateral assignment of the Owner’s title insurance policy – in case there is a claim – and usually of all rights under the various development agreements.

[CLICK]

Mezz Lenders sometimes also want the pledge of the equity interests insured. And there is a special type of UCC Policy issued by some of title underwriters that will cover those interests.

[SLIDE]

* Mezz Loan is treated as “Equity” from the standpoint of the Project Entity.
  + As part of Dodd-Frank, a great many new restrictions were adopted on banks making risky loans. Among these were capital requirements – requiring greater capital reserves be held for riskier loans. The US Adopted a variation of the BASIL III restrictions developed for international banks. Among the restrictions requiring extra reserves were characterized as High Volatility Commercial Real Estate (HVCRE) loans
  + The first round went a little far, and In the Economic Growth, Regulatory Relief, and Consumer Protection Act (Reform Bill) signed into law May 24, 2018 Congress adjusted the law so that fewer loans fell into the HVCRE standards, but raised the capital requirements on those that did
    - You may see these terms in the loan commitments.
    - Generally require a current (raw land) appraisal and an “as built” appraisal
    - Developer must put up at least 15% of the as built value in equity.
* ALTA developed a specific endorsement for use with Mezz loans – it is signed by the property owner and assigns their interest in the owners policy to the Mezz lender and does on to include a concept very similar to the Non-imputation endorsement so that the MEzz lender will not be subject to policy defenses based on something the developer should have known about.

[SLIDE]

The opportunity zone is our current SEXY topic.

It was part of the 2017 tax reforms and created a brand new tax planning tool to use for those with capital gains.

* If someone takes the proceeds they recognized on selling a capital gain asset and within 180 days invests that in a qualified Opportunity Fund.
  + The gain you’ve already recognized can be DEFERRED until April 2027.
  + If you hold the investment in the Opportunity fund for 5 years, the total amount of past gain is reduced by 10%; if you hold it for 7 years before April 2027, it’s reduced by 15%.
  + You always pay taxes on at LEAST 85% of the already recognized gain in April 2027.
  + Better yet, any gain or appreciation on the Opportunity Fund investment is permanently excluded from your taxes – you never pay on that portion.

[SLIDE]

A couple of definitions come into play.

The first is an Opportunity Zone. Basically each state’s governor could designate up to 25% of the census tracts in their state if they met certain criteria. And were then approved by the IRS.

The Brookings Institute estimated that 57% of all census tracts could meet these standadrs.

The Second definition is that of a qualified Opportunity Fund – That is an entity which intends to invest at least 90% of holdings in one or more Opportunity Zones. The investment can be in

* Partnership interests in businesses that operate in a qualified Opportunity Zone
* Stock ownership in businesses that conduct most or all of their operations within a qualified Opportunity Zone.
* Property such as real estate located within a qualified Opportunity Zone.
  + construction of new buildings
  + substantial improvement of existing unused buildings. If existing building, it must invest more in the improvement of the building than it paid to buy the building.
  + Improvements must be completed within 30 months of purchase.

You are not limited to real property investments. Any kind of property can qualify.

[SLIDE]

There is nothing unusual in handling an Opportunity Fund investment from a title or escrow standpoint. It looks like any other cash or financed purchase of property.

The things keep in mind is we don’t insure the tax treatment of our transactions.

Nor as title professionals should we advise on Taxes – unless we’re also tax lawyers or accountants,

But I will point out that for someone who has not already triggered his capital gains recognition, the Opportunity Fund may not be as as favorable as a 1031 exchange especially if the taxpayer keeps rolling the gains until death.

Under the 1031, your Gain can be deferred beyond 2027. Under the opportunity fund, you are always paying on the gain recognized in 2027. Under a 1031, the basis in the property is stepped up to fair market value upon death – so there is no taxable gain paid.

Under the opportunity fund, the taxable gain is already recognized, just deferred. So dying doesn’t get you out of paying the tax.

[SLIDE]

EB-5 Immigrant Investor Visas

If a foreign person puts up a $1 Million at risk Investment – it’s only $500k in a Targeted Employment Area, and the application gets approved, at the end of 2 years they can get a green card for themselves, their spouse and any unmarried children under the age of 21. And they get to keep the return on their investment.

In the program, each investor has to show their investment created 10 new American jobs.

At first, these were direct investments in a new job creating business. Later they allowed “Regional Centers” who basically became brokers lining up and qualifying these investors to put together much larger pools of money. The largest to date has been about $600M for a project in New York.

Because the investor is getting something very valuable – the effective rate of return and investor controls are lessened. So it’s a very desirable funding source for most developers.

The limiting factor is that most project can’t create enough jobs to fully fund the project with EB-5 funding. So you have to fall back to traditional mortgage sources. And the rules they impose.

[SLIDE]

So in your normal structure, you will have a developer who has decided on a project and created the special purpose project entity.

Our developer customer has identified a project he’d like to build,

[CLICK]

He has set up an special purpose project entity and acquired the land.

Which you were happy to insure.

[CLICK]

He reaches out to his favorite banker

Who says, if you’ll give me a mortgage, I’ll give you about 70% of the money for constructing the project. The 70% is below the High Volatility Commercial Real Estate threshold so the Feds aren’t going to make me tie up too much capital for making this loan.

But I’m also going to impose restrictions on second mortgages and subordinate financing because I want to be able to sell this mortgage into the CMBS market when I’m done

Nothing unusual so far. You go through the usual hoops to make sure that work hasn’t begun on the project, that you don’t have a broken priority situation And you insure that mortgage.

[CLICK]

Now your developer still needs more money and has been getting pitched by a an approved Regional Center to let them line up money for his projects.

And their pitch is:

For a small fee,

[CLICK]

We’ll line up a bunch of individual investors who want green cards, and we’ll work with the state to get your project designated as a Targetted Employment Area so that the investors only have to put up $500k each, rather than a $1 million.

And we’ll create and certify a New Commercial Entity to act as the go between

And since the investors are placing their money “at risk” as equity in the New Commercial Entity, as soon as their application is approved that investment will qualify each of them and their spouses and under 21 Y.O. children for visas

And when we’ve done all that for you

[CLICK]

We’ll transfer the funding in the form of a Mezz Loan – or preferred stock investment.

The loan will be secured by a pledge of your ownership of the Project Entity.

[CLICK]

And your title agent buddy can arrange a UCC Policy to insure that

[CLICK]

And will issue a Mezz Endorsement on the primary owners policy in favor of the NCE as well. And that Mezz endorsement is also an assignment of the underlying policy.

[SLIDE]

New Market Tax Credits

This is the same concept behind all tax credit models. In order to encourage more investment in certain things that Congress considers “Good Things” – like low income housing, historic restorations and investments in businesses and projects in low income communities, Congress allows the U.S. Treasury to hand out a certain amount of monopoly money every year. And the person who receives that monopoly money can use it to pay your Federal Income Taxes dollar for dollar.

If the feds have given Monopoly money to a project that can be handed out, the costs of getting someone to invest real dollars into the project has gone down.

Being the federal government it is much more complex than that with a lot of buzzwords and acronyms and lawyers to design and structure the packages so that they meet all of the federal tax rules.

* IRS allows **Community Development Entities** (CDEs) make the loans or investments and “sell” the tax credits.
* Tax Credit investor gets 39% of their investment in the form of dollar for dollar tax credits.
  + These are spread over 7 years and allocated 5% for each of the firth 3 years, then 6% for each of the next four.
  + No one is going to pay a dollar for 39 cents worth of tax credits, that because of the time value of money is probably only with 30 cents.
  + The reality is that those who want to buy tax credits generally have their own investment preferences. They may or may not like the underlying project. So this 39% limit makes it more complex and expensive to find investors.
  + So we leverage the investment the tax credit investment so that Tax credit investor can stand alone – can grab their tax credits and be out of the deal – and the sources of the leverage capital, who like the underlying deal can be paid back over time for their 70% leverage.
* Strict standards for types of investments and locations. Tricky terminology.
* Structures get messy – especially when coupled with other funding sources
* Title should focus on the parts that concern us - -while it is nice to understand the big picture, my message today is to focus on the parts that affect our ability to insure.

So lets look at a simple structure of one of these

[SLIDE] In your handouts, this is all laid out on one page. For the projection, I had to split it in half.

Every year congress authorizes a certain amount of new market tax credit funding

It’s been running about $3.5B per year. The US treasury allocates the authority to use that monopoly money to a series of CDEs A Community Development Entity.

While it is not required, most CDEs create a subsidiary CDE on a transaction by transaction basis. And give them the monopoly money/tax credits

The tax credit investor puts up $30 – which is roughly the present value of the stream of tax credits that total $39 over 7 years at a 6% discount rate.

Someone else puts up the other $70 and it all goes into a combined Leveraged Funding pool. Then the $100 goes into the Sub-CDE. And to keep the tax credits, that money needs to go into a qualified business in a qualified area. Lots of technical hoops

[SLIDE]

[CLICK]

We’re going to assume this one is a commercial development project

First step is the developer puts his equity into a special project entity that can be qualified as a **Qualified Active Low-Income Community Business** (QALICB)

[CLICK]

then the funding from the Sub-CDE comes into the project. It may come in as equity, as debt, or some combination. It may be secured by a mortgage

[CLICK]

In which case they probably want you to insure it.

[CLICK]

The developer works with other lenders and gives them a first mortgage.

[CLICK]

Which they want us to insure.

[CLICK]

They take those funds and buy the land to be developed.

[CLICK]

We insure the deed

[CLICK]

And the developer completes a beautiful project and leases it to the business that was lined up in advance.

[CLICK]

And we can insure that lease too.

[CLICK]

A month later, and every month for a long while, the business pays their lease, which is used to pay operating expenses and to repay the CDE for some of its invested funds – be they equity or a loan.

And the majority of what flows to the sub-CDE flows back to the leverage investor.

Now on the side of the charts in your handouts, there are various places I show Funding Sources. Because the Monopoly money coming into the mix greatly lowers everyone’s costs, it is not uncommon for the ultimate users of the property – the business to fund some of the leverage up front.

Since there are multiple programs that each target the same lower income, high unemployment areas, the NMTC program is often coupled with other grants, loans, and tax benefits and local government funding.

As more of that happens, the chart gets more and more complicated and circular.

[SLIDE]

Synthetic leases.

These largely went out of favor after ENRON and the resulting changes to the accounting rules. Off balance sheet financing became evil. And we’ve seen very little of it in the past 15 years. With recent changes in FASB rules, and the IRS 100% expensing of capital expenditures having a useful life of less than 20 years some law firms are suggesting that we’ll see more Synthetic leases again.

In the Enron days, the lease was between parent and subsidiary companies – with extra owners brought in so that even though the parent was ultimately liable for it, the asset and the debt didn’t appear on the parent company’s balance sheet. After Enron, the FASB fixed that. Today’s synthetic lease structures usually involve a financial institution’s affilliate as the property owner & lessor

The grossly simplified statement about synthetic leases is that they are treated as an asset purchase and depreciated for IRS purposes, and as an operating lease for GAAP reporting.

For a strong credit player, they can amount to 100% financing of a new headquarters, new factory, new aircraft, new equipment at effective interest rates about the same as the company’s credit facility.

So think of it as cheap financing which preserves cash.

These get very complicated in having to be carefully fit within both the accounting rules and the IRS rules.

[SLIDE]

So let’s walk through a hypothetical transaction.

[click]

First, the lender sets up and fund the Special purpose entity which is going to acquire the property and lease it to the very credit worthy company .

In exchange for the cash, they take a combination of equity and debt.

On occasion, the banker will also take a mortgage on the property that is to be acquired. And if they do, they want that insured.

This happens most frequently when they have brought in other investors to own part or all of the SPE.

[CLICK]

Then the Special Purpose Entity acquires the assets – in this example a build do suit headquarters building.

[CLICK]

And we can insure that deed.

[CLICK]

Then the corporation leases the completed project from the SPE.

The lease usually includes an option to purchase the property or renew the lease or a combination. And we can issue an ALTA 13 leasehold endorsement on the lease.

[CLICK]

Now everybody involved knows that this is a cutesy structure – and the economic substance is that the Corporation owns the building and has financed it with the bank – and all of the documents say the opposite.

That means that if a judge – say a bankruptcy judge -- tries to sort this out. There is a real risk that the whole thing will be recharacterized as what it really is. That the future lease payments will be set aside in bankruptcy it gets really ugly.

So as a backstop, there often be a conditional mortgage recorded, and sometimes they want that insured too.

As to title, there are many permutations of this. And in the handout, Ive suggested that many underwriters will take exception to all of the transaction documetns and a separate exception for the risk of it being recharacterized in whole or in part.