Legal Considerations for Those Holding or Assembling a Portfolio of Commercial Real Estate

by David Warren Peters

Conventional financial wisdom suggests that a portfolio of investments can diversify, and thereby reduce, overall risk. Attractive financing arrangements, increased leverage, and other economies of scale can make assembling a portfolio of commercial real estate holdings an appealing option. If not managed properly, though, the process of diversifying a real estate portfolio could actually create an overall level of risk greater than the sum of its component parts. From the author's perspective as both a lawyer and real property broker, the purpose of this article is to highlight general considerations for assembling such a portfolio as well as specific strategies to reduce such aggregation risk.

ACQUISITION PHASE CONSIDERATIONS

The urgency to consummate transactions often overshadows good common sense and matters which could have been resolved with little time and expense at an early phase can create significant and unnecessary problems later. If unchecked, such risk will only be magnified by the number of properties in the portfolio.

The Brokerage Relationship

Knowing that the law tolerates a buyer's lack of due diligence less in the commercial context than a residential one, and because many buyers of commercial property have considerable real estate industry experience, less importance is often placed on the assistance an experienced,

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qualified commercial real estate brokerage firm can provide. Like lawyers who represent themselves, however, buyers who rely only on their own real estate industry experience may have a myopic perspective of the transaction that an objective, independent professional might have been able to counteract.

Beware dual agency

Surprisingly, the very dangerous "dual agency" representation arrangement—where the same real estate broker(age) represents both the buyer and seller in the same transaction—occurs commonly in both residential and commercial transactions. Even more surprisingly, while many "buyers only" residential brokerages have developed over the past few years (because many lawyers think it can be virtually impossible for the same broker to properly discharge all duties owed to both buyer and seller in a transaction), this author is not aware of any such "buyers only" brokerages in the commercial area. This is believed to be the result of a false sense of security among both brokers and clients in the commercial real estate arena that, perhaps because of the perception that a higher level of expertise and objectivity prevails in the commercial context, there is less likelihood of a breach of duty in a dual agency arrangement, or that the typically more savvy commercial buyers are more able to protect themselves from it. The author would politely suggest that: (1) the risk in the commercial context is the same or greater; (2) because the principals negotiating the transaction will often not personally occupy the premises, it is greater still; and (3) such risk will most likely be magnified in a portfolio context.

Particularly in a situation where the representatives negotiating the transaction are using "other people's money" (*i.e.*, investment proceeds) to acquire the property in question, which is more likely in the portfolio context, the importance of a zealous, independent advocate representing the buyer exclusively cannot be understated. Although the commercial broker should not be viewed as the ensurer of objectivity in a transaction, a reputable brokerage firm with appropriate professional liability insurance coverage will most likely have implemented safeguards to reduce the risk of claims under such policies. Although the coverage (if available) under such policies would most likely still apply in a dual agency situation, the point is that the buyers don't want an insurance claim—they want the certainty of a sound transaction. The dual agency arrangement creates the greatest possible incentive that the limited judgment and due diligence of a broker will be unavailable. Of course, because the brokerage commission is based upon the full and proper discharge of the broker's fiduciary duty to the client, this author would submit (again politely) that a client would most likely receive less in a dual agency situation.

Structuring the Purchase Agreement

Many potentially significant problems can be eliminated through proper initial structuring of the acquisition agreement. Once again, the pressure to complete the transaction can often compromise the better judgment of those negotiating it.

Avoid taking title in principal's name(s), even briefly

A common and problematic practice in the commercial real estate arena is to make an offer, or sign the acquisition agreement, in any name other than that of the business entity which will eventually hold the property. Frequently, principals make the offer, or acquire the property, in their own personal names, or in the name of a parent company, with the view to transferring all rights under the agreement to a business entity to be formed some time before the close of escrow. But what about the (1) lawsuit risk relating to the acquisition transaction; or (2) a later lawsuit in which all parties on title will be named? In each case this practice only affords the plaintiff another individual or entity to pursue. Also, given the considerable risk for every name in the "chain of title" in environmental matters, how could it possibly be prudent for principals to take title in their own names, even for a "moment?"

Even if just a single property is purchased, the practice of taking initial title in a principal's name can contribute to a plaintiff's ability to assert that the company to which the principal(s) transferred the property was their mere *alter ego*, and should therefore be disregarded by a court. In the portfolio context this practice can be even more damaging—if a claimant can show that the principals or parent companies have customarily acquired property directly and then transferred it to have entities formed to hold it, it could be even more difficult to refute such an allegation.

Another common misconception is that principals must hold interests in their own names for purposes of IRC §1031 exchanges. Even if a limited liability company (LLC) selling property has some members who want to trade and others who don't, those who want to trade can form a new LLC and those who don't can form another. The property can then be transferred to the two LLCs jointly and sold.

The LLC with the members who want to do the 1031 exchange can then apply the sale proceeds to an exchange, while the other LLC can simply distribute profit to its members.

Advantages of environmental insurance

Long thought to be a tool best suited to close deals involving known environmental uncertainty, environmental insurance should now be considered by every investor who cannot afford to lose both (1) the full amount of their investment in the acquired property; and (2) all other assets in their name which were not properly asset-protected prior to any notice of claims. Though costly, the increasing availability of environmental insurance could provide considerable comfort to both buyer and seller, possibly justifying a sharing of the expense. Remember, a Phase I (or follow-up) Environmental Site Assessment can fail to reveal major problems, and liability can extend for an indefinite amount of time under certain circumstances.

A relatively new product available from several insurers is a portfolio policy, which can provide limited "blanket" coverage for all properties owned. In addition to the traditional benefit that environmental coverage can allow transactions to occur which otherwise wouldn't, portfolio coverage can insure properties which might not have been cost-effective to insure separately.

Structure of the Property Owning Entity

Choice of entity

LLCs and limited partnerships (LPs) have become a predominate choice of entity to hold commercial real property in many states. Although the considerations involved in the choice of entity alone far exceed the scope of this article, a common trade-off in many states is that the limited partnership may be available at a lower overall tax rate than the limited liability company, but has the requirement of at least one general partner (with absolute liability for the venture) be involved and the risk that limited partners may, through their mere involvement in the operations of the company, be deemed general partners (and therefore subject to general partner liability).

Often, in the portfolio context, a corporation or limited liability company is used as a general partner in one or more limited partnerships to approximate the liability protection of a limited liability company. Usually this is done for reasons of tax savings alone. The perceived tax savings should be weighed against the risk that, sooner or later, one or more limited partners could become involved in the operations of the company and thereby subject to general partner (*i.e.*, absolute) liability. Because this may occur on a gradual basis and without knowledge of counsel, limited partners may be highly troubled to learn that their newfound (and perhaps considerable) personal liability could have been avoided through the initial selection of the LLC form of entity.

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Caveats re: single-member LLCs

An increasing number of states are now offering single-member LLCs, and many lenders require such entities to be formed to hold real property on which they will lend. The popularity of such entities for this purpose should not infer their suitability for all purposes. For example, because (1) the laws of many states limit the recourse of creditors of a partner in a partnership to a charging order (*i.e.*, a court order directed to the partnership to pay all distributions to which the debtor partner would otherwise be entitled instead to the judgment creditor); and (2) because such protections have been applied to LLC interests in many states (most of which, until recently, required LLCs to have more than one member), it would be a mistake to conclude that the same partnership-type protections would apply to a single-member LLC. After all, a single-member LLC can hardly be claimed to be a partnership. The author believes that precedent also exists in certain international jurisdictions which makes the "piercing of the veil" of liability protection in a single-member LLC easier than with a multi-member LLC, because the distinction between the LLC and its sole member is less meaningful than would be the case for an entity with multiple independent members.

Special purpose entities

Lenders increasingly require "special purpose" business entities to hold title to the commercial real property on which they lend. This term generally

refers to provisions in the Articles of Organization and/or Operating Agreement of the property owning company that restrict its activities to those reasonably related to the ownership and management of the property. Additional "special purpose" provisions this author has seen added to organizational documents have included terms whereby even for as much as a "year and a day" after all obligations to the lender have been fully and indefeasibly satisfied, the borrower may still not take certain actions without the lender's express approval, which can often be withheld in the lender's "sole, absolute, and unfettered" discretion. Borrowers eager to secure attractive financing terms may overlook such provisions, but should carefully consider whether an institution will have sufficient incentive to act reasonably in granting or withholding such approval in all cases.

Avoid "funds": one building per company

Many holders of commercial real estate portfolios group smaller properties into "funds" of a number of properties. Although this strategy makes sense from an economic perspective, it can be problematic from a legal one—a lawsuit against any property in the "fund" can reach equity in the other properties. Particularly given the significant risk an environmental hazard could present, the perceived savings from such practices might eventually seem very small. If a property is worth acquiring, it is worth acquiring in a "dedicated" entity, and such entities can, in turn, be grouped into "funds." If this is not done, have investors in the "fund" been apprized of the risk of the aggregation of properties?

No prior transaction record for property owning entity

Some portfolio owners "recycle" business entities after a property has been sold or when used in making an unsuccessful offer. A business entity used to acquire real property should not have been used for other matters previously. Claims associated with such prior activity could reach the equity/profits in the new venture. As stated in Section III, below, such business entities should be dissolved as soon as possible after their use has been completed, so as to start the applicable statute of limitations running.

Use landlord/tenant structure if owner occupied

Often, a firm will seek to own the building it occupies. Conventional tax wisdom and asset protection considerations may both require that such buildings be held by a separate company created to hold the property exclusively (thus establishing a "landlord-tenant" relationship). A company engaging in business which owns the property it occupies unnecessarily subjects the equity in the property to all of the business risks otherwise associated with its operations. Thus, a lawsuit related to any of its products or services could needlessly reach the property equity.

Raising Capital

Holders of commercial property portfolios commonly raise capital through the public or private issuance of securities. Considerable care should always be taken in the offering and issuance of securities (qualified counsel should always be consulted), but especially when made in connection with a real estate portfolio.

Avoid consolidation of issuances

Many real property portfolios are properly comprised of a number of business entities each holding a separate piece of property, and the funds to acquire each property are properly raised in the name of the respective property owning entity (rather than in the name of a parent company). The problem with this arrangement is that, while each of these affiliates may raise the maximum amount it can under applicable securities laws, if the offerings were aggregated and attributed to the parent company, registration would be unavoidable. Because most such acquisitions and offerings are not structured to consider the possibility of aggregation, savvy issuers should re-evaluate this risk with each new issuance.

General securities guidelines

Although the need to take particular care and consult qualified counsel in connection with even the mere offering of securities cannot be understated, it is especially critical in the portfolio context because of the tendency of parent companies holding commercial real estate portfolios to raise capital on a project-by-project basis. If the techniques and procedures used to offer and sell such securities are not absolutely consistent with applicable law, they are likely to be repeated for each entity in the portfolio. Then, in the event of a securities lawsuit, information about these practices may be solicited from subscribers of other affiliated issuances. Thus, bad practices relating to one issuance could be used to support allegations relating to another, or aggregation of all projects together.

Financing

Avoid cross-collateralization

Those acquiring a portfolio of commercial real

property often use the same lender for the acquisition of more than one property. Although this is not necessarily an unwise practice, lenders may offer more attractive terms if loans are "cross-collateralized" (*i.e.*, the borrower pledges equity in more than one property for the repayment of a particular loan). The problem with cross-collateralization, however, is that a negative development with one property can adversely impact the operations of others. For example, an environmental claim relating to even one "cross-collateralized" property (indemnity of the lender, for example) could reach the equity in all other profitable properties.

Ensure an "exit strategy" for "special purpose" provisions

As stated above, many lenders require "special purpose" provisions in the Articles of Organization and/or Operating Agreements of borrower firms. Often these terms can be creative and onerous. Thus, it is important that a company considering a loan that would require such "special purpose" provisions ensure an appropriate "exit strategy" whereby all foreseeable needs to refinance, market, and eventually sell the property are carefully anticipated.

HOLDING/MANAGEMENT PHASE CONSIDERATIONS

When a number of properties are held in a portfolio, factors which might be more easily monitored and identifiable in a situation where only a single large property was held require special attention. Additionally, because authority for matters may be spread across a number of different individuals and locations, the need for consistent implementation of appropriate firmwide policy is critical.

Equity Reduction Arrangements

In a single large property, increases in equity can be easily tracked. In a portfolio, comparable sales near one property or another can increase equity in those properties while other factors can decrease value in others. Consequently, it can be more difficult to monitor overall and building-specific equity when a number of properties are held in a portfolio, rather than a single, large property. Nevertheless, because the equity in a building or in a portfolio, may be available to prospective claimants, the property owner should periodically review and consider reducing available equity. Subject to the limitations of investor and lender preference, this can be done by establishing an affiliated firm to make junior, equity-reducing loans on the properties in the portfolio. Fundamental asset protection considerations suggest that such a firm should (1) not engage in business other than the making of the contemplated loans (*i.e.*, if it engages in other forms of business, claims relating to such business could reach the assets of the firm); and (2) be substantially differentiated from the parent company to reduce appearance of a partnership or affiliation in the event of a lawsuit.

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Operating Expense Reduction Arrangements

Property owners often attempt to achieve economies of operation and reflect those savings in their operating profit. A classic example of this is when a firm owns the building it occupies, rather than setting up a separate company to serve as the lessor. In a portfolio context, the failure to set up and properly allocate expenses for an independent management company could lead to the appearance of excess profitability for any particular property. Of course, the problem with such arrangements is that the false appearance of profitability can be both attractive to claimants and available for judgment collections. If services or benefits which would otherwise be characterized as deductible expenses are not charged to the company, in the event a judgment is obtained against the firm, it may be more difficult to persuade a judge that the true profitability of the firm is actually less than is reported on its financial statements. A lack of profitability can also serve to discourage nuisance claims in their inception. Nothing in this article should be construed to advocate the false assertion of expenses or the failure to comply with applicable tax law—only the reconsideration of any failure to knowingly assert any lawful deduction from operating income.

Avoiding Liability for Parent or Management Companies

Particularly because a single firm managing a number of smaller properties may have less control over the operations of any of the particular properties than if it managed only a single larger building, additional care should be taken to limit the risk of liability from the operations of such affiliated firms. This should include periodic spot-checking to ensure the proper implementation of overall company policy.

Personal Asset Protection Considerations for Principals

The strong liability limitations of LLCs, and to a lesser extent LPs, can create a false sense of security for those involved in the highly litigious real property arena. While there is no substitute for holding each piece of property in a separate LLC, allegations of personal liability can always surface, and appropriate personal asset protection planning will always be most effective if completed in the absence of notice of any claims. One can always be sued for one's personal involvement in a matter, and nearly all of one's personal assets can be at risk in such proceedings.

Once thought to be practical for only the very wealthy and available only through complex arrangements in remote jurisdictions, considerable personal asset protection can be afforded through the proper formation of a family limited partnership, irrevocable trust or other domestic alternatives, without the need for any offshore arrangements. Those seeking an increased level of security (using a "portfolio" theory of asset protection) may prefer to diversify by holding a portion of their wealth in an offshore arrangement and the remainder in domestic asset-protected entities. Diversifying either way, this has never been easier or less expensive to do.

RESALE PHASE CONSIDERATIONS

Because the focus of the commercial property acquisition decision is often on operating revenue, the thought of resale can often be given limited consideration when properties are expected to be held for some time. Some property owners make the mistake of thinking that decades of deferred maintenance and disregard of important operating procedures can be cured by hasty corrective action shortly before a property is sold. Because it should be assumed that every property will eventually need to be sold, however, appropriate policies and procedures should be implemented at as early a point as possible, because the eventual buyer will want to examine documents relating to the entire period of ownership.

Property Should be Transferred to LLC at the Earliest Possible Point

Given that the vast majority of real estate lawsuits are by buyers of property against sellers, often involving claims of failure to disclose, savvy sellers will transfer the property to an LLC as far in advance of the sale as possible (preferably taking initial title to the property in the name of the entity, rather than their own). Under this arrangement, the LLC is the party making the disclosures to the buyer, rather than any of the particular principals, even if one or more principals actually signs the disclosures as manager of the company. Provided the company complies with all legal formalities, and the manager acts in good faith, there is generally no automatic liability for the principal acting as a manager of the LLC for the obligations of the company. If the principal had signed the same disclosure as an owner of the property, all of his or her personal and family assets would be at risk in the event of a lawsuit relating to it. Given the increasing risk of environmental and landlord / tenant litigation, buyers and lenders are also becoming more reluctant to have principals' personal names included at any point in the "chain of title," even temporarily, as had been accepted practice for years.

"Custom Sale" Agreement Terms

A growing trend in larger transactions is to depart from the standardized purchase and sale agreements, many of which are produced by organizations of brokers in an attempt to balance the interests of buyers and sellers. Although reducing the likelihood of lawsuits is often a primary goal of the parties drafting these agreements, an increasing trend among savvy sellers is to have a "custom" agreement already prepared, ready to be signed by both parties when acceptable terms are reached, rather than using the standardized agreements which may have been designed to achieve goals which are not shared by the parties to the particular transaction.

An even more important advantage of these custom contracts is their ability to proactively reduce lawsuit risk. For example, a potentially beneficial provision for sellers (and, arguably, for buyers as well, to the extent it discourages litigation), is to create arrangements whereby the buyer is given broad access to the property during an extended pre-closing inspection period, but then after closing

occurs, the buyer's recourse is particularly limited against the seller (absent fraud, concealment, etc.). The rationale behind this trend is to give buyers a very strong incentive to actively and diligently inspect the property before closing by using contract language which makes initiating claims after closing particularly difficult. The mere "as is" language in many standardized agreements will rarely be sufficient to accomplish this goal.

Another important benefit of such "custom" purchase and sale agreements is the opportunity to insert enhanced dispute resolution provisions. For example, by requiring any party alleging harm to give the responsible party written notice and an opportunity to cure the problem before initiating litigation, many small matters which shouldn't lead to lawsuits can be resolved informally. A provision whereby the parties each agree to restrict the time period in which either can bring a claim of any sort can also provide considerable comfort, at least for sellers. More detailed arbitration provisions can also afford the parties greater certainty—because arbitrators are generally not required to follow the law in their decisions, and there may often be no meaningful judicial review (*i.e.*, appeal) of certain arbitral decisions, many believe that greater specificity in drafting arbitration provisions is the only way to reduce the risk of an unpredictable result.

A particularly troubling California case for sellers, *Jue v. Smiser* (1994) 23 Cal App 4th 312, supports the proposition that, under certain circumstances, a buyer learning of a misrepresentation of sellers prior to closing can nevertheless proceed to close escrow and then sue for damages later. Based on the holding in the *Jue* case, prudent sellers will want to restructure some of the more standardized agreements (or preferably rewrite them altogether because the pre-*Jue* transaction structure usually has a pervasive effect throughout these documents) to: (1) cause all disclosures to be made ***before*** the time the contract is signed; and (2) specifically address the *Jue* case to set an operative date, ideally after all due diligence of the buyer is complete, on which the buyer affirmatively waives rights under the *Jue* case, ideally in exchange for reasonable independent consideration, and affirms in writing the desire to complete the transaction notwithstanding any newly discovered information.

Documentation of All Disclosures to Buyer

Comprehensive, early disclosure is also essential—sellers need to evaluate each document in their possession by considering whether any argument can be made that it could influence either a buyer's decision to purchase or the price to be paid. No matter how insignificant, a lawsuit will invariably allege that it would have. Accordingly, the decision not to provide any arguably relevant document to the buyer as early in the transaction as possible should be scrutinized ***very*** carefully. Careful records should be kept to prove exactly which documents had been disclosed and when.

Considerable economies of scale can result from the aggregation of properties, or at least business entities holding individual properties, into a portfolio. Considerable care should be taken in such arrangements, however, because, in the same way the goal of portfolio management is to multiply and maximize small profits from individual holdings, comparatively small liabilities can also be multiplied if unchecked.

Environmental Reports for the Benefit of Sellers

Increasingly, sellers are obtaining environmental reports and inspections before listing property for sale, and providing copies of such reports to prospective purchasers, rather than relying on the buyer to obtain these, as had been accepted practice for decades. This serves to document the seller's notice of possible problems with the property, or the absence of the same. The fact is that the buyer may simply not obtain these reports, or the ones they do obtain may not be reliable. Particularly in light of the *Jue* case, above, such reports and findings should be disclosed to the prospective purchaser ***before*** the contract is signed.

Reiterate Environmental Insurance

As stated previously, the objective of a seller of real property is not just to receive a high sales price but also to permanently retain it. Because the laws of many states require repayment to a business entity of distributions to LLC members under certain circumstances, arrangements that can limit the likelihood of such repayment will be most attractive to investors. The protracted risk of environmental claims makes environmental insurance particularly attractive in this regard.

Beware Seller Financing

The risk of claims by buyers against sellers can

be increased in situations where sellers provide significant financing for the acquisition. While certain market circumstances may require seller financing for transactions to occur, sellers should consider strong contract language to limit a buyer's assertion of "self help" remedies such as an offset to payment. If financing is to be significant, sellers might consider setting up an independent entity to make market-rate loans against the property, rather than "carrying back paper" themselves.

Dissolve As Soon As Possible After Sale

A business entity that sells a property should properly dissolve as soon as reasonably possible after the sale thereof to activate the appropriate statute of limitations. Dissolution is normally a four step process—(1) appropriate organizational authority for dissolution must usually be obtained or independently exist; (2) appropriate notice to creditors of the firm must be provided; (3) tax clearance from the appropriate taxing authorities must be obtained; and (4) Articles of Dissolution or another similar document are normally filed with the appropriate office(s) of the Secretary of State for each state in which the company is qualified to do business. A common mistake among dissolving firms is to disregard or improperly address the first step. Often, liquidating distributions are paid in their entirety before any consideration is given to proper organizational dissolution procedures. Frequently, funds which should have been withheld as reserves are instead paid out to members and the cost of recovering those funds in the event of claims may be prohibitive.

Members will never have a greater incentive to execute the documents to properly dissolve the company than before receiving any liquidation or other distribution. This also represents a perfect opportunity to ascertain whether members have knowledge of any claims against the company. Because the laws of most states require that appropriate reserves be retained for known liabilities of the company, members should be required to confirm in writing any claims they have or know of against the company at the time distributions are to be made. Ordinarily, this will provide members the greatest incentive to downplay or underestimate any claims they might perceive against the company so as to maximize the size and speed of the distribution they will receive. In the event they later bring a claim, such written confirmation could be very effective in estopping the member's assertion of claims which should reasonably have been identifiable at the time of the distribution, provided the company relied upon the member's representations.

CONCLUSION

Considerable economies of scale can result from the aggregation of properties, or at least business entities holding individual properties, into a portfolio. Considerable care should be taken in such arrangements, however, because, in the same way the goal of portfolio management is to multiply and maximize small profits from individual holdings, comparatively small liabilities can also be multiplied if unchecked. REI