DELAWARE STATUTORY TRUSTS

Inland Private Capital Corporation

WHAT IS A DELAWARE STATUTORY TRUST ("DST")?

A DST is a separate legal entity created as a trust under Delaware statutory law. The law permits a very flexible approach to the design and operations of a DST. However, to use a DST in a Section 1031 syndication program, it must comply with the requirements of IRS Revenue Ruling 2004-86 and must also (if the DST's property is debt financed) meet lender requirements. To satisfy these requirements, each of our DSTs must:

- be a Special Purpose Entity ("SPE");
- be bankruptcy remote; and
- be a very passive holder of real estate, with minimal trustee powers over the operation of the DST's real estate, and no powers over the DST or its real estate at all in the hands of the DST's beneficiaries.

LENDER BENEFITS

The DST will own 100% of the fee interest in its real estate, so unlike a tenancy-in-common ("TIC") program, the lender only needs to make one loan to one borrower. The DST is bankruptcy remote. That is, the DST's trust agreement contains provisions which prevent the creditors of the DST's beneficiaries from reaching the DST's property, and gives the lender greater security that it can foreclose on its first mortgage of the real estate should the need arise. The beneficiaries' only right with respect to the DST is to receive distributions, and they have no vote or say in operation or management of the property. As a result, lenders should not require them to execute any nonrecourse carve outs guarantees. Lenders should also not need to qualify or otherwise perform due diligence on any of the investors, which saves all parties time and money. The trustee of the DST will be the sponsor or an affiliate. Unlike a TIC deal, there is no annual renewal requirement for the trustee or the property manager, which gives lenders comfort that the sponsor will always be in control of the property. The DST's trust agreement contains provisions requiring the trustee to comply with the terms of the loan documents and making the lender a "third party beneficiary" of that requirement. A DST also has a Delaware trustee (required by statute), so there is no worry that the trust will inadvertently terminate. The trust agreement will contain a provision which prevents the trustee from distributing the property as TIC interests to the beneficiaries.

INVESTOR BENEFITS

Unlike a TIC transaction, there is no need to set up individual single member limited liability companies ("SMLLC") for each investor. Each investor owns a beneficial interest ("BI") in the DST, which shields the investors from any liabilities with respect to the property. This ownership arrangement is much simpler than a TIC arrangement for investors to understand, and saves the investors substantial money with respect to the formation costs and annual fees. There are also substantial governance differences between a TIC transaction and a DST transaction. Unlike a TIC transaction, which requires the investors vote unanimously for all major decisions, a BI holder in a DST is not permitted to vote. This eliminates the concern over the "rogue investor." Because there is a single borrower—the DST—and not 25 or 30 separate SMLLC borrowers as in a typical TIC transaction, there should be no need for the sponsor to have to collect, or for the lender to have to review, investor tax returns, financial statements, and credit authorizations. In addition, because the investors have no role whatsoever in the management of the DST or its real estate, the investors should not be required to execute any nonrecourse carve out indemnifications or guaranties. Generally, a TIC structure is limited to 35 investors or less. This is a product of both Revenue Procedure 2002-22 relating to permitted TIC deal structure and from the fact that lenders wish to limit the amount of individual loans they are making in a TIC deal. There is no such limitation on the number of permitted beneficiaries in a DST deal, and because DST deals involve only a single borrower, lenders should be indifferent to the number of investors in a DST deal. A DST will permit a beneficiary to do a tax free exchange on its pro rata share of the DST property when it is sold. Since a DST transaction is less complicated and the lenders have better protection from potential bad acts of the investors, the availability and terms of financing are much more favorable for DST transactions than TIC transactions.

IRS REQUIREMENT CAUSING LENDER CONCERNS

IRS Revenue Ruling 2004-86, which forms the basis for DST transactions, sets forth prohibitions on the powers of the trustee, which have become known as the "seven deadly sins." They are:

1. Once the offering is closed, there can be no future capital contributions to the DST by either current or new beneficiaries.
2. The trustee cannot renegotiate the terms of the existing mortgage loans nor can it obtain any new mortgage financing from any party except where a property tenant is bankrupt or insolvent.
3. The trustee cannot enter into new leases or renegotiate existing leases except where a property tenant is bankrupt or insolvent.
4. The trustee can not reinvest the proceeds from the sale of its real estate.
5. The trustee is limited to making the following types of capital expenditures with respect to the property: (a) expenditures for normal repair and maintenance of the property, (b) expenditures for minor non-structural capital improvements of the property, and (c) expenditures for repairs or improvements required by law.
6. Any cash held between distribution dates can only be invested in short term debt obligations, and
7. All cash, other than necessary reserves, must be distributed on a current basis.

Because of these restrictions, the only types of real estate transactions that will work in a DST are a "master lease" transaction, in which the master tenant takes on all leasing and other property operation responsibilities or, a triple-net long-term lease to quality tenant.

THE SPRINGING LLC AS THE "EMERGENCY PARACHUTE"

The trust agreement for our DSTs provides that if the trustee determines that the DST is in danger of losing the property due to its inability to act because of the "seven deadly sins," it can convert the DST into a limited liability company (the "Springing LLC") with preexisting agreed-upon terms. Delaware law treats a conversion as if the Springing LLC is the same entity as the DST, which means that the real estate is not transferred and the borrower remains the same. The Springing LLC operating agreement will contain the same SPE and bankruptcy remoteness provisions that are contained in the trust agreement (for the lender's benefit), but it will not contain the prohibitions against the raising of additional capital contributions, the raising of new financing, the renegotiation of the terms of the existing financing, or entering into new or modified leases. In addition, it will provide that the trustee (or sponsor) will become the manager of the Springing LLC. The only minor problem with the structure is that once the DST is converted into an LLC, it will be treated as a partnership for federal income tax purposes and the investors will not be able to do a tax free exchange of their interests in the Springing LLC. However, even this can be ameliorated because nothing would prevent the Springing LLC, once the problems triggering the conversion are dealt with, from converting back to a DST at that time.

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