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Ten Unexpected Issues When a Property Sale Becomes an Entity Sale

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On occasion, a “straight” sale (a Property Sale) of real property (effectuated through a deed by the owner of the property to the purchaser) may morph into a sale of equity interests (an Entity Sale) in the property owner (effectuated through one or more assignments of direct and/or indirect interests in the property owner). There are many reasons this might occur. In some cases, an Entity Sale structure may reduce the deed transfer taxes on the transaction.¹ In others, an Entity Sale may have U.S. federal income tax benefits

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¹ In many jurisdictions, however, a sale of a controlling interest in an entity that holds real estate may nonetheless be subject to real estate transfer taxes. *See, e.g.*, New York Tax Law, §1401 and §1402 (sale of a “controlling interest” is subject to New York state real estate transfer tax; a “controlling interest” generally means 50% or more of the voting power or capital, profits, or beneficial interest in the entity). For those jurisdictions that impose a real estate transfer tax on transfers of controlling interests in entities, some states impose real estate transfer taxes only if substantially all of the entity’s assets consist of real estate. *See, e.g.*, Pa. Stat. Ann. §8102-C; Pa. Stat. Ann. §8102-C.5 (Pennsylvania Realty Transfer Tax generally does not apply to transfers of entities, except in the case of certain acquisitions of “real estate companies,” which are entities for which more than 90% of the fair market value of the assets consist of real property or interests in other real estate companies). State and local taxing jurisdictions impose different aggregating rules to determine when a series of transfers is taken into account to determine whether a “controlling interest” has been transferred. *Compare* N.Y. Comp. Codes R. & Regs. tit. 20, §575.6(b)(1) (transfer of controlling interest occurs when a person or group of persons “acting in concert” transfers a controlling interest) *with* Pa. Stat. Ann. §8102-C; Pa. Stat. Ann. §8102-C.5 (an “acquisition” does not occur unless 90% or more of the ownership interest in a real estate company changes within a

for the seller, including exemption from U.S. federal income and withholding tax for gains realized by a non-U.S. investor in a domestically controlled private REIT on a sale of REIT shares.² An Entity Sale could also permit the parties to avoid the necessity of directly assigning a material agreement with an onerous assignment restriction.

When a transaction is recast as an Entity Sale, the parties may agree to adjust the purchase price (or provide a purchaser credit) to reflect any transaction cost savings, tax savings, and known liabilities of the entities being purchased. The purchaser’s legal counsel will try to confirm that his client is no worse off as a result of conversion of the deal into an Entity Sale, while all the time recognizing that full recourse credit protection is rarely — read, never — provided, and some degree of risk assumption is inevitable. Only in a utopian world will the price adjustment compensate the purchaser for 100% of that risk assumption. In reviewing the purchase and sale agreement, the purchaser’s counsel will likely consider the well-known differences between a Property Sale and an Entity Sale, namely the following:

- In an Entity Sale, the purchaser is buying all assets and liabilities of each entity being purchased, whereas in a Property Sale, the purchaser is just buying the property itself.
- In an Entity Sale, the entities being purchased continue to be bound by all pre-existing obligations, whether contractual or arising in tort, whereas in a Property Sale neither the property nor the purchaser (absent an express assumption thereof) will generally be bound by such matters.
- In an Entity Sale, the recording statute will not protect the purchaser (and entities being pur-

three-year period). Other states may impose a transfer tax on a Property Sale but not on an Entity Sale. For those state and local taxing jurisdictions that impose a real estate transfer tax on Property Sales but not Entity Sales or, in cases where a non-controlling interest is being sold in a jurisdiction that imposes a tax on transfers of controlling interests, it may be possible to avoid transfer tax through an Entity Sale (although particular care should be taken, given that the rules in each jurisdiction differ).

² *See* §897(h)(2) of the Internal Revenue Code of 1986, as amended.

chased) against any existing encumbrances of which the purchaser does not have prior notice.³

- In an Entity Sale, the business enterprise associated with the property being purchased will be more easily continued by the purchaser on an uninterrupted basis.

As a threshold matter, the purchaser's counsel should investigate the possibility of requiring the direct or indirect interests in the property to be assigned to one or more newly formed special purpose entities immediately before the sale. This step often is not possible to accomplish, but where it is, it will benefit the purchaser by potentially helping to cleanse the purchased entities of pre-existing liabilities, hence eliminating many of the issues described herein.

In order to address the issues for the purchaser inherent in an Entity Sale, in addition to any purchase price reduction (or credit), "entity-level" representations and warranties ("Entity Level Reps") are customarily added to the purchase and sale agreement. The Entity Level Reps include representations and warranties of the seller covering matters of interest to the purchaser as the purchaser of one or more entities rather than a piece of real property, including: (i) the absence of undisclosed liabilities and obligations, (ii) the accuracy and completeness of organizational documents delivered to the purchaser, (iii) insurance policies (both current and covering any statute of limitations period), (iv) the U.S. federal income tax classification of the entity (e.g., as a REIT, a partnership, or a "disregarded entity") and the absence of material unpaid tax liabilities for past periods, (v) single purpose entity status, and (vi) the absence of litigation.⁴ The Entity Level Reps are often tied to a surviving indemnity provision.

The seller will commonly collateralize the Entity Level Reps with cash, a letter of credit, or a guaranty from a creditworthy entity. The collateralization of the Entity Level Reps is usually hotly negotiated, in particular with regard to: (i) the type (or types) of collateral to be provided, (ii) the amount of such security (we have seen this range from 1% to 5% of the purchase price, subject to any negotiated caps (see clause (iv) below)), (iii) the period of time over which the security will "burn off" in whole or in part (this can range from six months to three years, and may or may not include a mechanism for early release of a portion of the collateral if no claims are outstanding at such

time), (iv) the status of Entity Level Reps as capped or uncapped (tax liabilities, among others, generally are uncapped), and (v) Entity Level Rep baskets, establishing a "de minimis" aggregate amount of loss (perhaps \$50,000 or \$100,000) below which the purchaser will not be able to bring a claim, although such baskets generally do not apply to tax liabilities.⁵ Sometimes, the Entity Level Reps and collateralization provisions are the only substantive adjustments made to the purchase and sale agreement to address the purchaser's concerns regarding an Entity Sale. Frequently, these adjustments prove to be materially adequate for purposes of protecting the purchaser's interests. In recent transactions, however, the authors have found several other hidden issues and unintended consequences that arise in connection with Entity Sales that may be unexpected to real estate practitioners. Ten such issues are discussed herein.

1. Watch Out for Lingering Liabilities under Defeasance Documents.

A typical defeasance provision will require the seller to arrange for the defeasance of the loan pursuant to "customary defeasance documentation" (or use similar nomenclature). Unfortunately for the purchaser in an Entity Sale transaction, the defeasance documentation commonly in use by servicers and rating agencies does not include an unconditional release of the property owner from any liability with respect to the defeased loan. Rather, the property owner usually remains liable for (i) pre-existing defaults, (ii) indemnities and other obligations that survive repayment of the loan, and (iii) certain representations, warranties, and undertakings with respect to the defeasance collateral.⁶ In the context of a Property Sale, the purchaser is largely indifferent to the content of the defeasance documents, as it is to other potential post-closing liabilities of the property owner. Not so in the case of an Entity Sale transaction. Fortunately, the purchaser has the ability to mitigate

⁵ In the corporate mergers and acquisitions context, representation and warranty insurance is commonly obtained by the seller or the purchaser. We have not seen such insurance in the context of a classic real estate deal (including an Entity Sale), perhaps in part due to its significant cost, which can range between 3% and 5% of the deal value, and high retention (deductible), commonly between 1% and 3% of the deal value.

⁶ The obligations with respect to the defeasance collateral mentioned in clause (iii) are typically not overly troublesome for the purchaser given that they relate to actions within the purchaser's control (for example, taking further actions that the servicer may require to maintain a perfected first priority security interest in the collateral). The purchaser should, however, take care to ensure that the defeasance collateral obligations do not include the obligation to "top off" the collateral in the unlikely event the basket of securities constituting the defeasance collateral proves to be insufficient for purposes of repaying the defeased loan.

³ See, e.g., New York State Real Property Law, §291 *et seq.*

⁴ In connection with litigation, it behooves the purchaser in an Entity Sale to complete a litigation search of all entities being purchased, and also confirm that the relevant entities had adequate liability insurance in place for the relevant periods of time.

these liabilities. The servicer may be persuaded to release the property owner from any monetary defaults, and to provide an estoppel statement to the property owner as to the absence of any knowledge of non-monetary defaults. The purchaser should also ensure that any post-closing liabilities with respect to the defeased loan are indemnified by the seller under the purchase and sale agreement, and that those liabilities are backed by the post-closing collateral. The proper time to consider these requirements is at the time the purchase and sale agreement is negotiated.

2. Watch Out for Lingering Liabilities under Existing Loan Documents. If an existing loan is being paid off, in its payoff letter the lender being repaid may reserve certain claims against the property owner. Indeed, it is not uncommon for payoff letters to reserve claims “pursuant to indemnity and other provisions that pursuant to the loan documents expressly survive repayment of the loan” (or comparable language). Occasionally, a lender being paid off will include additional reservations, whether or not consistent with market, such as the lender’s right to recalculate the payoff amount if there was a mistake. Again, in the context of a Property Sale, the purchaser is almost indifferent to the content of these payoff letters, so long as they suffice for title insurance purposes. Not so in the case of an Entity Sale. Ideally, the purchaser in an Entity Sale transaction should require as a condition of closing a “clean” payoff letter that provides a complete release. Alternatively, or in addition to such provision, the purchaser should insist that any lingering liabilities pursuant to the payoff letter be indemnified by the seller, such indemnity to be backed by the post-closing collateral.

3. Keep Your Eye on the Non-Imputation Endorsement. In an Entity Sale transaction, the purchaser should assess whether it is cheaper to “date down” the existing policy insuring the property owner or buy a new policy. In either event, a non-imputation endorsement (ALTA form 15, or equivalent) will be needed to ensure that the undisclosed prior acts and/or knowledge of the seller (and/or its affiliates) are not imputed to the purchaser, thereby vitiating title coverage as to such matters. While title insurance is usually a purchaser charge, where the Entity Sale structure is beneficial to both parties, it is not unusual for the seller to bear that cost or for the parties to split responsibility for the cost of the non-imputation endorsement because it is costly and it is only necessary because of the Entity Sale structure. A prudent purchaser should seek to have the issu-

ance of a non-imputation endorsement (and, if applicable, title coverage) included as a condition precedent to closing. It is also prudent to attach the agreed form of non-imputation endorsement (the endorsement form itself has blanks for the relevant seller persons and entities; these should be agreed to before closing). In connection with the non-imputation endorsement, the title company will require a non-imputation affidavit and indemnity from the seller, which should also be addressed in the purchase and sale agreement. From the seller’s perspective, such an undertaking to the title company may effectively expand the seller’s exposure pursuant to the Entity Level Reps (notwithstanding the fact that such exposure would be to the title company rather than the purchaser directly). If the issuance of a non-imputation endorsement is not included as a condition precedent to closing, then, at minimum, the purchaser should insist that the agreed form of affidavit and indemnity be attached to the purchase and sale agreement.

4. Consider UCC “Owner’s Insurance.” The purchaser should consider obtaining a UCC Owner’s policy. Fidelity National Financial’s UCCPlus® Owner’s Policy is one such policy. The policy insures the purchaser against loss or damage incurred by the purchaser by reason of failure of the seller to own the interest sold, failure of the purchaser to acquire ownership of the interest upon transfer thereof, the existence of any security interest perfected against the seller in all or any part of the interest, and any claim by a lien creditor against all or any part of the interest.⁷ While such policy may cover some of purchaser’s concerns in connection with an Entity Sale, it does not obviate the need for a full set of Entity Level Reps. In particular, it is not clear that the policy would insure the purchaser against the existence of undisclosed agreements and obligations (including taxes). In addition, counsel should carefully review the exclusions to coverage, which may include, among other things, inaccuracies in the books and records of the entity being purchased. It may be possible to negotiate modifications to any such exclusions with the title company and, if necessary, to negotiate additional Entity Level

⁷ Please refer to the form of UCC policy itself to determine its precise terms and conditions. This is only a rough summary of such terms and conditions. The purchaser’s counsel should also bear in mind that this type of UCC policy is a fairly new, relatively untested product. Little, if any, precedent exists for the handling and payment of claims under such a policy or of the title insurance company’s interpretation of the parameters of its coverage.

Reps covering the excluded matters. As with the non-imputation endorsement, it is not unusual for the seller to bear the cost or to agree to share in the cost of the UCC Owner's policy, particularly where the added comfort offered by the policy allows the purchaser to limit some of the Entity Level Reps.

5. Consider a Separate Transfer Tax Escrow. The purchaser should consider whether it is possible that a post-closing audit of transfer taxes payable on the Entity Sale transaction (potentially combined with other prior entity-level transactions) could occur and whether additional taxes could be found to be due. If it is possible that additional taxes could be found to be due, and transfer tax liabilities were at closing borne in whole or in part by the seller, the purchaser should confirm that any post-closing liabilities will be borne in the same manner. The purchaser may find it necessary to have the seller establish a separate transfer tax escrow, which remains in place for the likely audit period (plus a 30-90 day tail), in order to ensure that seller's share of any such liabilities are timely paid. The purchaser should avoid, if possible, having to rely upon the Entity Level Rep collateral for this purpose.

6. Beware of "Minor" Defects in Organizational Documents. The organizational documents of the entities being purchased should be carefully reviewed. The importance of this exercise should not be underestimated. If an entity being sold was not properly formed, the purchaser may be purchasing an empty shell. Even seemingly benign defects in organizational documents can have serious consequences. For example, if an attempt was made to convert a Delaware limited partnership into a Delaware limited liability company pursuant to a certificate of conversion that was not properly executed, the conversion failed and no limited liability company came into existence. Any real property subsequently deeded to the purported limited liability company will not be vested in the limited liability company, because no limited liability company exists. Any purchaser of that purported limited liability company intending to gain indirect ownership of the real property will be out of luck. Fortunately, many of these issues can be remedied before closing, given sufficient time. If the purchase and sale agreement is executed before the completion of the purchaser's organizational document due diligence, the purchaser should consider including a clause requiring seller's cooperation in the correction of any defects.

It bears noting that, while an Entity Sale simplifies the mechanics of a transaction in many re-

spects, it also gives rise to a few additional checklist items. While a new property owner does not need to be formed, the operating agreements of all entities being purchased will usually need to be amended and restated. The purchaser should also be sure to require as a condition precedent to closing the written resignations of any directors, non-member managers or officers of the entities being purchased.

7. Require a Release by Sellers. Frequently, an entity being sold has agreed to indemnify or provide other benefits to the seller and its affiliates pursuant to its organizational documents or other agreements. The purchaser should require that the seller and such entities, or the seller to the extent that it is in control of such entities, release such entity from all such liabilities and obligations, effective from and after the closing date. The seller may request (and the purchaser may accept) that such release exclude any claims that may be brought by a seller pursuant to any insurance policy.

8. Anticipate New Lender's Recycled Entity Requirements. The purchaser's new lender may require certain additional "recycled entity" representations and warranties from the purchaser where the mortgagor entity has been in existence for a significant length of time before the closing date. In this regard, the purchaser may be required to represent and warrant to its lender that the mortgagor entity (and any other applicable entities in the ownership structure) complied with all separateness covenants since the date of its formation and before the purchaser's period of ownership. The purchaser may get comfortable with these representations and warranties if the purchaser's due diligence has confirmed that, during all relevant periods, the only asset of the relevant entities was the property, and has uncovered no "non-SPE" activities of the relevant entities. The purchaser should attempt to make the seller's Entity Level Rep as to "SPE" status as robust as possible. If possible, the purchaser should confirm that such Entity Level Rep is broad enough to cover all of the recycled entity representations and warranties to be required by the new lender.

9. Carefully Review Tax Obligations. Federal, state, and local income and property tax liabilities are probably the most significant potential liability of the entities being sold as part of an Entity Sale, and they merit special attention. A robust package of Entity Level Reps relating to tax matters should be included in the purchase and sale agreement. These include representations of seller as to (i) the absence of federal, state, and local tax

liabilities, (ii) timely filing of all returns and payment of any amounts due thereunder, (iii) the delivery to purchaser of true and accurate copies of tax returns for a period of time corresponding to the statute of limitations period (usually three tax years) and (iv) the purchased entities' U.S. federal income tax classification (e.g., as a REIT, partnership or "disregarded entity"). In addition, the purchaser should review the tax returns referred to in clause (iii) above in order to confirm that the tax returns do not include any information inconsistent with the Entity Level Reps (especially with respect to the purchased entities' tax classification).⁸

⁸ In this regard, we note that, beginning with taxable years after 2017, new rules will apply with respect to U.S. federal tax audits of certain entities that are classified as partnerships for U.S. tax purposes as a result of the enactment of the Bipartisan Budget Act of 2015 on November 2, 2015 (the "Budget Act"). Among other changes, unless a partnership elects out, the new rules impose an entity-level tax (plus interest and penalties) on the partnership (rather than the partners) for any understatements of partnership income. The new rules could result in different partners

10. Remember the Tenant Notices. This is a simple, but important, point which, fortuitously, permits us to round out our list at 10 issues. As part of the Entity Sale, the property leases will not need to be assigned, but the tenants will nevertheless need to be notified of the change in accounts, managing agent, and the like, and the correct address/account for payment of rent. Therefore, the parties should not overzealously delete the tenant notices along with the deed and assignment of leases from the closing deliverables.

bearing the tax than the partners who owned the entity at the time the tax liability was incurred (e.g., if a partner sold its interest in the partnership and if the partnership were subsequently audited). Accordingly, an acquirer of an interest in a partnership potentially affected by the new audit regime will want to ensure that appropriate indemnities and undertakings are obtained to ensure that the acquirer does not indirectly bear any such tax that should be attributable to former partners or to other partners in the partnership. Future Treasury regulations may clarify the application of the new rules to entities that cease to be treated as partnerships for U.S. federal income tax purposes (such as would be the case if all of the interests in a partnership were acquired so that it became a disregarded entity for U.S. federal income tax purposes).

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