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The Five C's of 2016

By Stanley Iezman & Chris Macke
American Realty Advisors

Lenders use the five C's of Credit – Character, Capacity, Capital, Collateral, and Conditions – to evaluate prospective borrowers. We evaluate the prospects for the 2016 investment environment using our own five C's: Consumer spending, China, (investor) Confidence, Central bank policies, and Crude (oil).

CONSUMER SPENDING

Consumer spending will be pivotal to 2016 U.S. GDP growth. Business investment is likely to come under increasing pressures as profits and revenue growth face continued headwinds including a strong dollar, weakening global growth, unstable financial markets, rising credit risk premiums, and eventual wage pressures. Consumers are beginning the year well-positioned to drive economic growth, with debt levels and debt service ratios down and household wealth up. Purchasing power has increased as a result of low energy costs, the strengthening dollar and continued employment growth. How much these factors translate into increased consumption depends on consumer confidence.

Consumer spending is critical to both the U.S. economy and to the U.S. commercial real estate sector. Today, occupancy rates and rent levels across the four main property types are near or even above previous highs. Future gains will be directly impacted by U.S. economic growth and levels of consumer spending. While this impact will be most directly felt by retail assets, industrial assets will benefit since goods require warehousing and sorting. Office and multifamily housing will also be influenced by consumer spending, as many office tenants include consumer products companies, and many renters work for companies in a wide variety of industries including goods manufacturers, transportation and warehousing industries, and professional and business services, impacted by consumer spending.

CHINA

The second largest economy is currently experiencing turbulence in both its economy and financial markets, as China's leadership continues the balancing act of transitioning to more of a consumption-based model, liberalizing financial

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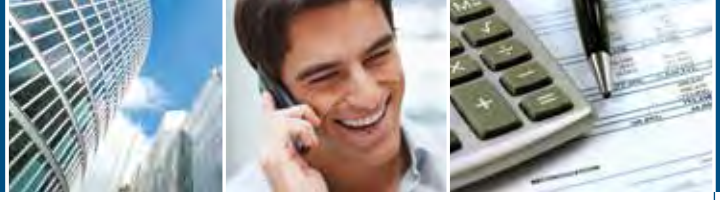

Rights of First Refusal and First Offer in Joint Venture Agreements

By: Peter E. Fisch & Mitchell L. Berg (with assistance by Luca Barone) of Paul, Weiss, Rifkind, Wharton & Garrison LLP

Each party to a joint venture has to balance the need for liquidity against the desire to control the identity of its joint venture partner (especially when there are significant funding obligations or a sharing of management rights). Consequently, joint ventures typically contain restrictions on transfers of interests to third parties, but also contain certain exit mechanisms such as a right of first offer or right of first refusal. These exit mechanisms balance the conflicting goals of free transferability at maximum value and the remaining venturer's wish not to be saddled with a difficult or uncreditworthy partner.

RIGHT OF FIRST REFUSAL

In the joint venture context, a right of first refusal (ROFR) gives the partner desiring to exit the joint venture the ability to transfer its interest to an identified third-party buyer on terms and conditions specified in any contract, term sheet or letter of intent, subject to the right of the other party to purchase the interest by matching the term of the third-party offer. The ROFR offers the benefit of allowing the non-initiating partner to remain in the joint venture under all circumstances.

However, a ROFR creates complications for the marketing of the initiating partner's interest. A prospective purchaser may be unwilling to devote time and money to performing a due diligence investigation and negotiating the acquisition, only to lose the deal after an agreement is reached. A prospective purchaser may require a break-up fee from the exiting partner, which erodes the exiting partner's return unless the agreement permits it to be passed on to the other partner or to the joint venture. A prospective purchaser may also not be willing to wait to consummate its transaction to the extent the ROFR response periods are too long.

Also, the ROFR confronts the non-selling partner with the choice either to buy the interest being sold (which may not be feasible or desirable) or let it be sold to a third party that might not be an acceptable partner. Joint venture agreements often provide that the-selling partner can transfer its interest to the counterparty if the ROFR is not exercised, though on occasion the non-selling partner may retain a limited (such as reasonable) approval right over the incoming partner. Occasionally, the parties may stipulate a set of financial, reputational and experience parameters defining a permitted transferee. The more limiting these parameters are, the more the ROFR suffers as a desirable exit mechanism for the initiating partner.

Third parties will value the property at a higher basis than a partnership interest, and a ROFR on a partnership interest transfer is almost certain to generate fewer proceeds to the exiting partner than its share of the proceeds of an asset sale. A ROFR may be structured so that the initiating partner may obtain a bona fide, third party offer for the joint venture property and present it to the other partner. The other partner then has the right to buy the property from the joint venture on the same terms or buy out the initiating partner at the amount the initiating partner would have received had the property been sold at the offered price and the joint venture liquidated.

This mechanism has the advantage of offering the asset rather than a joint venture interest for sale. Furthermore, by using the liquidation provision to establish the price, existing partner loans and distribution priorities are taken into account. However, a property ROFR suffers from the same chilling effect on marketing as the ROFR involving interests. It also forces the non-initiating partner either to buy, which may not be feasible, or to have its interest liquidated when it would not otherwise have desired to do so.

RIGHT OF FIRST OFFER

A right of first offer (ROFO) is generally preferred by an initiating partner, as it eliminates the chilling effect of a ROFR on marketing. The selling partner triggers a ROFO by notice to the non-selling partner setting forth the material economic terms upon which the selling partner would sell its interest to the non-selling partner. The non-selling partner has a specified period during which to accept or reject the offer.

If the offer is accepted, the partners proceed to close the sale on the terms set forth in the offer, as reduced to a negotiated agreement. If the offer is rejected, the selling partner is free to market its interest to third parties on the terms set forth in its offer. To keep the selling partner honest in formulating the terms, the selling partner will be required again to comply with the first offer notice requirement if it does not complete a transaction substantially on the offered terms within a prescribed period of time (e.g., six to 12 months), or if the selling partner can only complete the transaction on terms that are materially more favorable to the buyer than those in the offer notice.

The ROFO allows the selling partner to market its interest virtually unencumbered (except for the prescribed economic parameters), and the chilling effect of the ROFR is avoided. However, because of the lack of a bona fide, third-party offer, the ROFO creates economic uncertainties as to the terms of sale. The selling partner must make a decision as to where to set the price. A low price will likely result in the selling partner leaving some value behind if the ROFO is exercised, while a high price may result in the selling partner being unable to obtain the price required by the ROFO (thus requiring the selling partner once again to request the approval of the non-selling partner after the market sets the price). Moreover, the ROFO, unlike the ROFR, does not offer the non-selling partner the opportunity to evaluate in advance an identified purchaser as a potential partner. Accordingly, it is even more important in the case of a ROFO than in the case of a ROFR for there to be some limitations on the identity of the transferee, such as reasonable approval rights or parameters. The ROFO may also be implemented with respect to a sale of the joint venture's property rather than a sale of joint venture interests. This eliminates both the chilling effect and concerns about the transferee's identity although it does require the non-initiating partner either to purchase or to accept a sale of the property and liquidation of its interest as discussed above.

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markets, and attempting an orderly depreciation of its currency.

Any large-scale economic transition involves risk, and the speed and magnitude of the evolution of the Chinese economy and financial markets poses significant challenges for global financial markets – especially within the equity markets. As a result, even absent a hard landing, continued deceleration in China's rate of economic growth and sustained financial market volatility will negatively impact global economic growth and equity markets, depressing investor sentiment.

(INVESTOR) CONFIDENCE

Investor confidence will have a material impact on equity markets, interest rates, risk premiums, and real estate returns. We expect diminishing investor confidence in 2016 with continued volatility in equity markets and currencies, weakening global and domestic manufacturing activity, commodity price volatility, divergent central bank policies, and increasing risks of conflict in the Middle East. This will negatively impact capital flows to equity markets, and safe-haven assets should benefit, potentially perpetuating today's favorable long-term rate environment. Spreads between higher and lower quality credit bonds will increase as investors require greater risk premiums, placing increasing pressure on high-yield debt and opening the door for stress to seep into other areas of the corporate bond market.

Absent a severe and importantly, sustained decline in equity values and a resulting over-allocation to commercial real estate, increasing investor preference for safe-haven assets should result in positive capital flows to real estate offering relative income stability and favorable total return potential. We expect core real estate strategies to shift from the yield-chasing seen in 2015 toward strategies focused more on stable income streams, including a reemphasis on higher quality assets with longer term leases in place, markets with greater liquidity, and, most importantly, markets that feature resiliency in the face of adversity. We began advising investors to depart from the herd and take this approach back in 2014 in our newsletter titled, "Two Roads Diverged". This allowed investors time to begin positioning their portfolios for what looks to be an increasingly uncertain and volatile 2016.

CENTRAL BANK POLICIES

Much like in 2015, investors are likely to continue to hyper-fixate on the Federal Reserve and thus potentially miss a key part of the interest rate story – foreign central bank policies. While the Fed will probably increase short-term rates only moderately due to a variety of domestic and global factors, key foreign central banks including the European Central Bank, Bank of Japan, and People's Bank of China will engage in more aggressive monetary policy. As a result, as we outlined in our research newsletter, "Fed Rate Hikes: More Texas Hill Country Than Rocky Mountains", increases by the Fed will have a greater impact on the economy and financial markets than they otherwise would on their own. For example, a 25 bps move by the Fed combined with the ECB lowering rates by 25 bps resulting in an effective 50 bps move to the U.S. markets. This combination of rate movements and their potentially destabilizing effects vis-à-vis capital flows, currency devaluations, and commodity pricing (especially on economies highly dependent on foreign direct investment and commodity revenues) should bear close attention as opposed to viewing Fed rate moves in isolation.

CRUDE (OIL)

It appears that the long drought of financing is over. Although harder to qualify, loans and financing are again available. The products to watch are those made available by the JOBS Act.

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Special Warranty Deeds: An Update

By: John Murray, Vice President-Special Counsel, First American Title Insurance Company

INTRODUCTION

Special and limited warranty deeds (the terms are virtually the same; the term "special warranty deed" will be used in this article to refer to both) afford greater protection to the grantee than a quitclaim deed but less protection than a full or general warranty deed. They are often given in connection with conveyances by trusts (including land trusts) and estates, land contract vendors, and financial institutions that have taken back property by foreclosure or deed in lieu of foreclosure in satisfaction of a defaulted mortgage loan.

These types of grantors (as well as others who are able to negotiate delivery of a special warranty deed in connection with a property sale) will usually argue that they have only limited, incomplete, or indirect knowledge of the status of title to the property and/or have not been in actual possession of the property, but that they are willing to give the grantee greater protection than would be available by delivery of a quitclaim deed. This article will discuss and analyze special warranty deeds and examine court decisions that have ruled on the effect of special warranty deeds, including the encumbrances of title warranted against by the grantor under such deeds.

DEFINITION AND SCOPE OF SPECIAL WARRANTY DEED

A special warranty deed provides that the grantor warrants only that it has not created or suffered any defect in title to occur during the period that it was in title to the property being transferred, i.e., the grantor warrants against its own acts or omissions and agrees to defend the grantee against any action by another party claiming by, through, or under the grantor that it has a superior title to the property conveyed to the grantee. A special warranty deed may contain any of the covenants for title, but they should be appropriately modified to warrant against only those claims arising by or through the grantor.

There is surprisingly little case law (and commentary) regarding the interpretation, scope, and enforceability of a special warranty deed (sometimes also referred to as a "limited warranty deed" (as noted above), "deed with a covenant against grantor's own acts," "bargain and sale deed", or "C deed"). There is a special form of special warranty deed that is required by the U.S. Department of Housing and Urban Development ("HUD") for Buyer Select Closing Agent ("BSCA") transactions. (HUD adopted the BSCA program in 2013 to enable buyers to choose their own escrow/settlement officer.) The

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HUD form can be edited to assist the customer in preparing it.

CASES CONSTRUING SPECIAL WARRANTY DEEDS

The following is a sampling of existing case law with respect to special warranty deeds:

1. In Greenberg v. Sutter, 661 N.Y.S.2d 933 (S.Ct. 1997), the court held that a covenant in the deed stating that the grantor warranted that it did not do or "suffer" anything whereby the property had been encumbered in any way whatever, should be construed broadly so that actual knowledge of an encumbrance is not necessary to cause a breach of the deed covenant.

2. In a 2013 Illinois decision, Chicago Title Ins. Co. v. Aurora Loan Services, LLC, 2013 Ill. App. (1st Dist.) 123510, 996 N.E.2d 44 (2013), the Illinois appellate court -- in a matter of first impression -- ruled that the special warranty deed given by the grantor of the property to the grantee did not protect the grantee against a delinquent special-assessment tax encumbrance.

The special warranty deed in this case stated that [the grantor] "does covenant, promise and agree, to and with [the grantee], their heirs and assigns, that it has not done or suffered to be done anything whereby the said premises hereby granted are, or may be, in any manner encumbered or charged." The court ruled that the grantor had not done anything to cause the encumbrance, i.e., the tax sale was caused by a prior owner who did not pay the special-assessment tax. The court also reasoned that the lis pendens notice that had been filed against the property was not an "encumbrance" and that the tax lien, not the tax sale, was the actual encumbrance. The court also concluded that the grantor had not "suffered" the tax-lien encumbrance because it had not caused (as opposed to "tolerated") the occurrence of the tax sale, which was caused because the prior owner did not pay the special-assessment tax.

The Aurora Loan Services case contains an excellent discussion and analysis of special warranty deeds (as opposed to general warranty deeds) and the existing case law from various jurisdictions regarding such deeds, as well an explanation of terms such as "encumbrance," "suffered," "lis pendens," and "covenant against encumbrances."

3. In another recent Illinois case, Nair v. Bank of New York Mellon, 2014 WL 1814000 (Ill. Cir. Ct., March 16, 2014) (Trial

Order), the Illinois Circuit Court held that the use of a special warranty deed did not bar the grantee's claims to quiet title or for breach of the covenant of seisin (which "assure[s] the grantee that the grantor is, at the time of the conveyance, lawfully seized and has the power to convey an estate of the quality and quantity which he professes to convey (citation omitted)." Id. at p. 4), But the court further held that, as the Illinois appellate court ruled in Aurora Loan Services, supra, the grantee's count for breach of the covenant against encumbrances was barred by the language in the special warranty deed because the grantee did not allege any encumbrances created by the grantor's conduct.

4. In Woolf v.1417 Spruce Associates, 68 F.Supp.2d 569 (E.D. Pa. 1999), the court, noting that "[t]here is a paucity of case law concerning obligations created by the conveyance of property through a special warranty deed," held that a mortgage lien on the property that pre-dated the acquisition of the property by Freddie Mac through a mortgage foreclosure proceeding (Freddie Mac subsequently conveyed the property to the defendant-purchaser by special warranty deed), was created "without Freddie Mac's knowledge, fault, consent, or acquiescence," and therefore "did not constitute a claim arising by, through, or under the grantor." Id. at 571. The court held that Freddie Mac never had a duty to extinguish the pre-existing lien in the first place because it did not arise as the result of any action (or inaction) by Freddie Mac.

5. But in Egli v. Troy, 602 N.W.2d 329 (Iowa 1999), the Iowa Supreme Court held that, as a matter of apparent first impression, where the grantor allegedly knowingly allowed a third party to establish a fence boundary for more than 10 years without any dispute, and the terms of the grantor's special warranty deed warranted for any claim "by, through or under" the grantor, the warranty covered claims permitted by the grantor as well as those affirmatively created by or acquiesced in by her. The court held that there was a genuine issue of fact as to whether the grantor was responsible for any part of the acquiescence during the ten-year period.

6. With respect to title issues concerning special warranty deeds, see, e.g., Chicago Title Ins. Co. v. 100 Investments Ltd. Partnership., 355 F.3d 759 (4th Cir. 2004). In this case the court stated that: [D]efendant gave a special

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Introduction to Real Property 1031 Exchanges

By: S.H. Spencer Compton, First American Title National Commercial Services

Section 1031 of the Internal Revenue Code provides that no gain or loss will be recognized when property held for productive use in trade or business, or for investment, is exchanged for like-kind property which will also be held for productive use in trade or business, or for investment. Most states (Pennsylvania being a notable exception) allow such an Exchangor (as defined below) to defer state capital gains tax as well. Put simply, in a 1031 exchange transaction, the seller of qualified property can use the entire equity in the property to purchase Replacement Property (as defined below). Federal and state capital gains taxes are deferred.

Many real estate advisors regard the 1031 exchange mechanism as one of the few "free lunches" available to ordinary real estate investors. Real estate practitioners should be familiar with 1031 exchange transactions to effectively represent sellers of properties held for business use or for investment. Too many potential 1031 exchange transactions go unrealized, with capital gains taxes paid, due to real estate investors' lack of information or misapprehensions about the wealth-building benefits of exchange transactions. Real estate and tax advisors owe it to their clients to advise them fully of the advantages of a 1031 exchange. When advising a client regarding the viability of a 1031 tax-free exchange, real estate attorneys should always work in concert with the client's tax adviser.

WHAT IS A 1031 EXCHANGE?

Section 1031 of the Internal Revenue Code and the deferred exchange regulations allow a seller of real estate to defer the federal gain on the sale of real property held for business use or for an investment if:

(i) the property is used in a trade or business or held for investment,

(ii) the property is exchanged for like-kind property, and

(iii) certain time frames for identification and acquisition of the replacement property are met.

An Exchangor can defer taxes by selling a Relinquished Property (as defined below) and acquiring Replacement Property at a later date, and provided that all of the rules are followed, the transaction will be considered an exchange rather than a sale followed by a purchase. For this to happen, the Exchangor cannot have actual or constructive receipt of the Exchange Funds (as defined below). In this regard, the Exchangor need not actually take possession of the Exchange Funds after the Relinquished Property closes to create a problem. If any of the Exchangor's agents (such as his or her attorney) takes possession of the Exchange Funds, or if the Exchangor has the right to direct the disposition of the Exchange Funds, the Exchangor can be considered to have constructive receipt of the funds, and the exchange could be compromised.

An Exchangor must have an identifiable interest in both the Relinquished Property and the Replacement Property to have a successful exchange. Acquisition of a 100% interest in an entity whose sole asset is the Relinquished (or Replacement) Property will qualify, but lesser percentages of membership interests, partnership interests or shares of stock in entities that own the real property will not. In a standard deferred exchange, the deed for the Relinquished Property will be from the Exchangor to the buyer, and the deed for the Replacement Property will be from the seller to the Exchangor. During a standard deferred exchange, the QI (as defined below) will never be in title to either property.

To fully defer all taxes, an Exchangor must accomplish two things:

(i) reinvest all Net Proceeds (as defined below) realized from the sale of the Relinquished Property into the

Replacement Property(ies), and

(ii) reacquire debt equal or greater to the debt paid off from the Relinquished Property (or replace with fresh cash).

It should be noted that where an Exchangor invests some, but not all, of the Exchange Funds into the Replacement Property(ies), capital gains tax will be owed on the balance not invested (Boot).

A 1031 exchange begins on the earlier of:

(i) the date of deed recordation, or(ii) the date possession of the property is transferred to the buyer,

and ends on the earlier of:

(i) 180 days after the 1031 exchange begins, or (ii) the due date of the Exchangor's tax return, including extensions, for the taxable year in which the Relinquished Property is transferred. By using some or all of the profit from the sale of one property to invest in another, an investor can continue to defer capital gains on successive transactions while building their equity and rental income stream.

INTERNAL REVENUE CODE SECTION 1031, HISTORY & INTENT

What is the rationale for the 1031 exchange? Where a seller of investment property reinvests its Net Proceeds and retired debt into a like-kind Replacement Property, the seller's economic position has not changed. It has not received an economic gain or cash with which to pay capital gains taxes triggered by the sale. Accordingly, to require the taxpayer to pay such taxes would be unfair. The tax obligation is not eliminated, rather it is deferred until the Replacement Property is sold. If the Replacement Property is sold and another 1031 exchange is not initiated, the original deferred gain plus any additional gain realized since the Replacement Property purchase is taxed.

The 1031 exchange became law with the Revenue Act of 1921 and remained largely unchanged from 1928 to 1984, when time limits were imposed as a result of the Starker decision 602 F2d 1341 (9th Cir.. 1979). Prior to 1979, 1031 exchanges were accommodated in one day long closing where the Relinquished Property was closed, followed by the Replacement Property closing. The impact of the Starker decision was that 1031 exchanges did not have to close the same day; the closings could be delayed. What is now known as a forward or standard deferred exchange allows for the Relinquished Property to be closed on one day followed on another day by the Replacement Property closing. A deferred exchange allows the taxpayer to relinquish property currently and receive like-kind Replacement Property in the future. But in 1984, Congress decided to limit the scope of the Starker decision by enacting Sec. 1031(a)(3), a provision which permits deferred exchanges to occur within a specific time frame. In 1984, the 45 and 180 calendar day limits were imposed, requiring the potential Replacement Property to be identified by the 45th calendar day post-closing with the 1031 exchange completed no later the 180th calendar day post-closing.

GLOSSARY OF TERMS

The terms below are commonly used in 1031 exchange transactions.

ACCOMMODATOR or Qualified Intermediary ("QI"): In 1991, four safe harbors were created as a bright-line test to determine whether the taxpayer is in actual or constructive receipt of funds or property while having initiated an exchange. One of these safe harbors is the use of a Qualified Intermediary to hold the Exchange Funds during the exchange period. The (g)(6) limitations of the 1031 code state that "in no event shall Exchangor receive, pledge, borrow, or otherwise obtain the benefits of the Exchange Account, including earnings, thereon, before the Exchange Period." Once a taxpayer touches the exchange funds or receives a note payable from the property buyer, it is considered boot and taxable. Use of safe harbors prevents the taxpayer from having access to the exchange funds.

ADJUSTED BASIS: The cost of the property adjusted for any capital improvements or depreciation. Original cost of property + Improvements - depreciation = Adjusted Basis.

BASIS: The starting point for determining gain or loss in any transaction. In general, basis is the cost of the taxpayer's property. Note that transactions involving exchanges, gifts, probates, and receiving property from a trust can have an impact on calculating the property's adjusted basis.

BOOT: Boot is an old English term meaning "Something given in addition to." Cash or non-cash consideration, including any property that is not "like-kind," promissory notes, debt relief (mortgage boot) or other property. "Other Property" is property that is non-like-kind, such as personal property, a promissory note from the buyer, a promise to perform work on the property, a business, etc. There are many ways an Exchangor can receive "Boot", even inadvertently. The Exchangor should consult with its tax advisor to understand what can result in Boot. If Boot is received in an exchange, it is likely that all or some portion of the Boot will be taxed.

BUILD-TO-SUIT EXCHANGE (Also known as Construction Exchange or an Improvement Exchange): The build-to-suit exchange allows an owner to use the proceeds from the sale of the relinquished property not only to acquire Replacement Property, but also to make improvements to the property. A build-to-suit exchange is accomplished by having a holding entity (called an "exchange accommodation titleholder" or "EAT") temporarily hold title to the Replacement Property while the improvements are being made.

BUYER: The person acquiring the Exchangor's Relinquished Property.

EXCHANGE ACCOMMODATION TITLEHOLDER (or EAT): A new single purpose entity, usually an LLC, formed by the QI to take title to the Replacement Property prior to the sale of the Relinquished Property (or vice versa).

EXCHANGE FUNDS: The Net Proceeds from the sale of the Relinquished Property

EXCHANGOR: The taxpayer seller/purchaser of like kind investment real property.

CLOSING COSTS: Miscellaneous expenses involved in closing a real estate transaction over and above the price of the land.

I.R.C.: Internal Revenue Code

INVESTMENT PROPERTY: Property located in the USA that is held for productive use in a trade or business or for investment. Under IRC 1031, property used as a personal residence or property held for resale is not investment property.

NET PROCEEDS: The proceeds of the sale of the Relinquished Property less allowable expenses (transfer taxes, brokerage commission etc.) in accordance with IRC Section 1031.

QUALIFIED INTERMEDIARY or QI: See ACCOMODATOR above.

RELINQUISHED PROPERTY: The investment property being sold as the first step of a 1031 exchange transaction.

REPLACEMENT PROPERTY: The investment property being purchased to replace the relinquished property.

HOW A FORWARD 1031 EXCHANGE WORKS

Susan bought an investment property for $300,000 several years ago and put an additional $100,000 into capital improvements. Her basis is now $400,000. Susan enters into a contract of sale for $600,000. Her capital gain would be $200,000 which, assuming a capital gains tax rate of 23.8 %, would mean a $47,600 tax bill. To defer paying this tax, Susan engages a Qualified Intermediary to assist in structuring her sale as the first leg of a 1031 exchange. If Susan wants to defer all gains from the sale of the Relinquished Property, at closing, all of Susan's Net Proceeds are paid by the buyer or closing agent directly to the QI. The funds are deposited into a segregated interest-bearing escrow account controlled solely by the QI. Within 45 days after the date of closing of the sale of the Relinquished Property, Susan identifies in a writing sent to the QI up to three potential Replacement Properties. If Susan wants to identify more than three properties a rule (the "200%" Rule) applies for the identification. In such event, the total value of all identified properties cannot exceed 200% of the value of the Relinquished Property (See "Identification Rules" below). Within 180 days of the sale of the Relinquished Property, Susan directs the QI to fund her purchase of one of the Replacement Properties. If there are any remaining funds held by the QI, they are paid over to Susan together with interest earned. Such non-reinvested funds (which are Boot) are subject to capital gains tax.

TIME PERIODS

The Exchangor has 45 days from the closing of the Relinquished Property to identify Replacement Property. Proper identification of Replacement Property is a requirement for a valid exchange, and the Exchangor can only acquire property which has been properly identified during the 45-day identification period. Replacement Property that is acquired (i.e., closes) within the 45-day time period is considered properly identified. For property not purchased within the 45-day time frame, the identification must unambiguously describe the property (with an address or legal description), and must be made in writing, signed by the Exchangor and sent before midnight of the 45th day. If multiple Relinquished Properties are grouped together in one exchange, the 45-day time period starts to run as of the closing of the first property.

QUALIFIED INTERMEDIARY: WHO SHOULD ACT AS ONE?

For any size exchange, a Qualified Intermediary will ideally be a subsidiary of a high net worth, long standing financial institution, such as a bank or a title insurance company. Although there are many smaller companies, and even individuals, who act as Qualified Intermediaries, the Exchangor will be best protected by a deep-pocketed entity willing and able to provide an indemnity against any employee malfeasance. The greater the volume of exchanges the QI processes, the lower the fees it is able to charge. Certain persons may not act as the QI. Generally, these include certain relatives of the Exchangor, or someone who, within a two-year period prior to the exchange, has acted as the Exchangor's agent, such as her attorney, accountant, or real estate broker.

IDENTIFICATION RULES

If an Exchangor wants to identify more than one Replacement Property, there are several options. The three most common methods to identify multiple properties are:

(i) The "Three Property" Rule: the investor may identify up to three properties without regard to their fair market value; or

(ii) The "200%" Rule: the Taxpayer may identify any number of properties so long as the total fair market value of all of the listed properties does not exceed 200% of the value of the Relinquished Property; or

(iii) The "95%" Rule: If both above rules are exceeded in the number and value of the properties identified, it will be considered valid if at the end of the exchange, the Exchangor has succeeded in acquiring properties worth an aggregate of at least 95% of the fair market value of all of the properties originally identified For example, you may identify $1,000,000 in Replacement Property and acquire only $950,000 in Replacement Property.

"LIKE KIND" RULES

The Replacement Property must be considered "like-kind" to the Relinquished Property. The like-kind requirement is broad for real property exchanges. For example, an office building can be exchanged for vacant land, an apartment building can be exchanged for a single family rental home, or a duplex can be exchanged for a retail strip center. Generally, "like kind" in terms of real estate, means any property held for productive use in a trade or business or for investment that is classified real estate in any of the 50 US states, and in some cases, the US Virgin Islands. A real property within the United States and a real property outside the United States would not be like-kind properties. Multiple properties qualify. For example, a single property may be exchanged for several properties and vice versa.

TIME EXTENSIONS

Extensions for an exchange are not granted on a case by case basis. Where the President declares one or more counties to be federal disaster areas, affected taxpayers who reside, have a business in or are involved in a 1031 exchange with respect to properties in these counties may be eligible for up to a 120-day time extension for completion of their exchange under the 180-day rule, and submission of their 45-day letter identifying prospective Replacement Properties.

WHAT IS A REVERSE 1031 EXCHANGE?

A reverse exchange occurs when an Exchangor wants to acquire Replacement Property prior to the closing of the sale of the Relinquished Property. Although common terminology calls this type of transaction a "reverse exchange," the Exchangor does not actually acquire the Replacement Property first and dispose of the Relinquished Property later. Instead, the Exchangor must arrange for an Exchange Accommodation Titleholder (or "EAT"), a special purpose entity (formed by the QI) which is a separate single member limited liability company that will be used exclusively for the contemplated reverse 1031 exchange transaction, to take title to either the Relinquished Property ("exchange first transaction") or the Replacement Property ("exchange last transaction"). A reverse exchange must be set up and structured with an EAT prior to the Replacement Property closing.

EXAMPLE REVERSE 1031 EXCHANGE TRANSACTION

Perhaps your client has unexpectedly found an investment opportunity that she must act on before she even has time to consider selling or listing her Relinquished Property. Or, she fears the sale of her Relinquished Property may collapse and she does not want to lose her

Replacement Property acquisition that is closing soon. The reverse 1031 exchange allows her to acquire the Replacement Property first and then subsequently list and sell the Relinquished Property within the prescribed 1031 Exchange deadlines. The actual 1031 exchange portion of the reverse 1031 exchange transaction will be a simultaneous 1031 exchange either at the beginning or end of her reverse 1031 exchange transaction (depending on whether it is an exchange first or an exchange last structure). In either instance, the EAT will acquire and hold or "park" legal title to either her Relinquished Property or her Replacement Property during the reverse exchange transaction.

There are two different types of reverse 1031 exchanges – the exchange last transaction and the exchange first transaction. The steps for each type of transaction are outlined below.

REVERSE 1031 EXCHANGE - EXCHANGE LAST TRANSACTION

(i) In an exchange last transaction, the EAT acquires title to the Replacement Property at the scheduled closing. The acquisition is funded by the Exchangor and/or a third party lender.

(ii) The EAT leases the Replacement Property to the Exchangor, and the lease provides that the Exchangor receives all of the income and pays all of the expenses of the Replacement Property.

(iii) Once a third party buyer is found for the Relinquished Property, the Relinquished Property is transferred to the buyer and the Relinquished Property proceeds are transferred to the Qualified Intermediary.

(iv) After the Relinquished Property has been transferred to the buyer, the Exchangor acquires the Replacement Property held by the EAT using the Exchange Funds. If there are remaining Exchange Funds, the Exchangor may acquire additional Replacement Properties as part of the forward exchange, provided that they were properly identified.

REVERSE 1031 EXCHANGE - EXCHANGE FIRST TRANSACTION

(i) In an exchange first transaction, the EAT acquires title to the Relinquished Property prior to the scheduled closing of the Replacement Property.

(ii) The EAT leases the Relinquished Property to the Exchangor, and the lease provides that the

Exchangor receives all of the income and pays all of the expenses of the Relinquished Property.

(iii) On the scheduled closing date, the Exchangor takes title to the Replacement Property.

(iv) Once a third party buyer is found for the Relinquished Property, the Relinquished Property is transferred to the buyer and any net sale proceeds from the Relinquished Property are used to retire any debt, or portion thereof, incurred by the EAT on its acquisition of the Relinquished Property.

Reverse exchanges under the IRS safe harbor rules must be completed within 180 days of the date the EAT acquires title to the Relinquished Property. In an exchange last transaction, the Exchangor has 45 days from the first closing to identify the Relinquished Property. The 180 day timeframe begins on the day the EAT takes title to the Replacement Property. Most rules that apply to tax-deferred exchanges also apply to reverse exchanges. Each of these transactions must be set up as an exchange, rather than as a sale followed by a purchase. To qualify for a safe harbor reverse exchange, the Exchangor must comply with Revenue Procedure 2000-37 which provides how to properly structure a Reverse 1031 Exchange transaction by using a parking arrangement in conjunction with a simultaneous 1031 Exchange.

WHAT IS A CONSTRUCTION OR IMPROVEMENT 1031 EXCHANGE?

An improvement exchange occurs when the Exchangor wants to acquire Replacement Property and build improvements on it during the exchange period. This usually occurs when the Exchangor determines that he will have exchange funds in excess of the cost of the Replacement Property. The excess equity is used to construct improvements on the Replacement Property. In an improvement exchange, the EAT holds title to the Replacement Property, but the construction may be managed by the Exchangor. The Exchangor must identify what will be constructed on the Replacement Property within 45 days after the Relinquished Property is transferred to the buyer. The exchange must be completed within 180 days, but the construction does not need to be completed during that time. Nevertheless, the only property that is considered "like-kind" for exchange purposes will be property that is considered to be real property, i.e., attached to the land or building.

EXAMPLE IMPROVEMENT 1031 EXCHANGE TRANSACTION

The improvement exchange (also known as a build-to-suit exchange) allows an Exchangor to use the proceeds from the sale of its Relinquished Property not only to acquire Replacement Property, but also to make improvements to it. For example, if an Exchangor sells Relinquished Property with a fair market value of $1,000,000, debt of $200,000 and equity of $800,000, he must acquire a property equal to at least $1,000,000 and must invest at least $800,000 into that property. In a build-to-suit or improvement exchange, however, the Exchangor could acquire property worth only $300,000, borrow an additional $200,000 and spend the remaining $500,000 of exchange proceeds plus the $200,000 in loan funds on improvements to the property. This would use up the remaining cash and increase the fair market value of the Replacement Property to $1,000,000, resulting in a fully tax-deferred exchange.

A build-to-suit exchange is accomplished by having the EAT temporarily hold title to the Replacement Property while the improvements are being made. The EAT is necessary because any work done to the property after the Exchangor takes title to it is

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not considered like kind property and therefore will not increase the property's value for exchange purposes.

A build-to-suit exchange can be structured either as a deferred exchange where the existing property is sold before the new property is acquired, or a reverse build-to-suit, where the new property is acquired first. In either case, the entire transaction must be completed within 180 days.

DEFERRED BUILD-TO-SUIT EXCHANGE

In a deferred build-to-suit exchange, the Relinquished Property is disposed of and the sale proceeds go to the QI. The Exchangor must identify Replacement Property within 45 days, including a description of what will be built on the property. The EAT acquires the property using the exchange funds. The Exchangor oversees the construction of the improvements and periodically sends invoices to the EAT, who pays them using exchange funds. The Replacement Property is transferred from the EAT to the Exchangor upon the first to occur of: construction completion, or when the 180 day exchange period expires or when enough value is added to the Replacement Property for full tax deferral.

REVERSE BUILD-TO-SUIT EXCHANGE

In a reverse build-to-suit exchange, the Replacement Property is acquired by the EAT first, using funds from the Exchangor or a lender. As with a deferred exchange, the Exchangor supervises the construction and sends invoices to the EAT, but the EAT must borrow money from the lender or the Exchangor to pay the invoices. At some point during the 180 day period, the Relinquished Property is sold and funds are transferred to the QI. If there is more construction needed, the exchange funds can be used for the construction until the 180 day period expires. As with the deferred build-to-suit, the Replacement Property is transferred from the EAT to the Exchangor on the first to occur of: when the construction is complete, or when the 180 days expires or when enough value is added to the Replacement Property for full tax-deferral.

CONCLUSION

The number of 1031 exchange transactions has grown steadily since the 2013 increase in the capital gains tax rate. To offer effective representation, attorneys should be familiar with the mechanics of this cost-saving, real property investment-friendly feature of the I.R.C. Strategic use of the forward exchange, the reverse exchange or the construction exchange can defer a client's capital gains tax obligations arising out of a sale of investment property. Advising a client about the possibility of capital gains tax deferral should be on every attorney's client intake checklist.

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2016 Winners and Losers

There are times to stretch for additional yield and shoot for making outsized gains . . . but this is not one of them. Rather, conditions suggest that now is the time to focus on stability, superior income growth, and pricing resiliency as the likelihood of an economic downturn or financial instability event increases. There is more downside to being overly aggressive than overly conservative. Investors are being shown definite signs that support overweighting the more conservative end of the risk spectrum.

Despite the warning signs, some investors continue to take on more risk, seeking out smaller markets in search of marginally higher yields at a time when prices are elevated, the economic recovery is entering the mature phase, global growth is weakening, and financial market volatility is increasing. This is likely happening since multi-asset investors are facing weak equity and bond returns and are incorrectly relying on commercial real estate to be the alpha generator in their portfolio. This view leads some real estate funds

to acquiesce, most noticeably by entering secondary and even tertiary markets in search of those extra basis points of return potential. This has happened in the past, as investors convince themselves to take on risk because they generally don't include recessions in their underwriting. Since they don't take into account the longer period of time smaller and more liquidity constrained markets take to recover values and the greater impact that recessions generally have on

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warranty [deed], promising only that [defendant] had not itself created any defect in title – a warranty whose breach would be specifically excluded from coverage. At the point of conveyance . . . any preexisting defect in title became [the grantee's] problem and [the grantee] would have to obtain its own title insurance to protect itself from any problem that might be caused by that defect.

Id. at 763-64.

STATUTORY PROHIBITION OR RESTRICTION OF SPECIAL WARRANTY DEEDS

Some states have statutes that govern the interpretation of different types of deeds. For example, Michigan has an unusual statute (the original version of which was enacted in 1885), which states as follows:

Any person who shall print, sell, or keep for sale any blank forms of deeds containing the words "warranty deed," or "warranty deed-covenant-own-acts," or any similar words printed or written thereon, unless such deed is in fact an absolute warranty deed, and any person who shall knowingly use any such deed for the purpose of conveying title unless the same is an absolute warranty deed, shall be guilty of a misdemeanor.

MCL § 750.275.

This statute appears to make the use of special warranty deeds in Michigan a criminal misdemeanor, at least where pre-printed blank forms of these types of deeds are utilized. However, the author understands that this statute appears to be ignored or disregarded by most practicing attorneys in Michigan and enforcement appears to be non-existent.

An Illinois statute, 765 ILCS 5/8, provides that any deed with the language "grant, bargain and sell" amounts to a covenant that the grantor has done no act, nor created any encumbrance, whereby the estate granted can be defeated, and creates a covenant against the acts of the grantor, except "the rents and services that may be reserved, and also for quiet enjoyment against the grantor, his heirs and assigns unless limited by express words contained in such deed." Covenants are implied only when all the words of the statute are used; and are not created by the use of the word "grant" alone.

Alabama has a similar statute, ALA. CODE 1975 § 35-4-271, which states that the words "'grant,' 'bargain,' 'sell,' or either of them," in all conveyances of real estate must be construed, unless stated otherwise in the conveyance, as limiting the grantor's warranty to be free from encumbrances "done or suffered by the grantor".

CONCLUSION

As evidenced by the cases and statutes discussed in this article, attorneys and title companies -- and the parties to the transaction -- must pay close attention to the form of deed used by the grantor in a real-estate transaction.

If the grantor intends to limit its liability to defects occurring only during its period of ownership of the property, while giving the grantee more comfort than a simple quitclaim deed, then the deed must contain the proper limiting warranties and covenants to ensure that it qualifies as a special warranty deed under applicable law. In recognition of the increasing use of special warranty deeds, the Multi-Board Real Estate Contract version 6.0, which was adopted in July, 2014 and is one of the most widely used basic forms of residential real-estate purchase-and-sale contracts, expressly modified the section regarding deeds contained in the former version 5.0 by deleting the word "general" before "Warranty Deed."

Because there are still relatively few cases (or statutes) regarding special warranty deeds (or their equivalent), real-estate practitioners should proceed with caution in this area and monitor future case and statutory law closely. ◂

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those markets, this approach usually ends badly.

AGGRESSIVE OR CONSERVATIVE?

"Don't get caught in the middle": Assets with either immediate lease rollover or long-term leases should perform better in the near-term in the event of an economic downturn while providing more stable returns over a longer-term hold.

Focus on quality credit: Assets with higher credit tenants with greater access to financing should provide more stable returns both in the short-term and over the market cycle.

Choose markets wisely: Invest in markets that demonstrate ability to withstand economic downturns, and to recover value more quickly following a recession. Markets that don't go in and out of favor depending on where we are in the cycle will fare better, especially in the event of a liquidity shock.

Pay attention to supply constraints: As real estate enters the heart of the supply-response cycle over the next several years, markets that are less prone to excessive supply should do better in the near-term, as well as over the long-term.

Stanley Iezman is American Realty Advisors' Chairman and Chief Executive Officer, responsible for the strategic planning and direction of all firm activities.

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Mary Kay Kennedy
SVP, Operations Manager First American Exchange Company
and Julie Baird
VP, First American Exchange Company

Both Mary Kay and Julie have been involved in all phases of 1031 exchange transactions.

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Mark Your Calendar

ULI — Urban Land Institute
ULI Spring Meeting
www.uli.org • April 19 - 21 • Philadelphia, Pennsylvania

ICSC — International Council of Shopping Centers
RECon: The Global Retail Real Estate Conference
www.icsc.org • May 22 - 25 • Las Vegas, Nevada

NAIOP — Commercial Real Estate Development Association
Commercial Real Estate Conference 2016
www.naiop.org • September 25 - 28 • Scottsdale, Arizona

The Lodging Conference
The Lodging Conference 2016
www.lodgingconference.com • September 26 - 29 • Phoenix, Arizona

PREA — Pension Real Estate Association
26th Annual Investor Real Estate Conference
www.prea.org • September 28 - 30 • Washington, D.C.

CoreNet Global Corporate Real Estate Network
CoreNet Global North American Summit
www.corenetglobal.org • October 16 - 19 • Philadelphia, Pennsylvania

CREW — Commercial Real Estate Women
CREW Network Convention & Marketplace
www.crewnetwork.org • October 19 - 22 • New York, New York

MBA — Mortgage Bankers Association
Annual Convention & Expo
www.mba.org • October 23 - 26 • Boston, Massachusetts

ULI — Urban Land Institute
ULI Fall Meeting
www.uli.org • October 24 - 27 • Dallas, Texas

ICSC — International Council of Shopping Centers
U.S. Shopping Center Law Conference
www.icsc.org • October 26 - 29 • Hollywood, Florida

NAREIT — National Association of Real Estate Investment Trusts
REITWorld: NAREIT's Annual Convention for All Things REIT
www.reit.com • November 15 - 17 • Phoenix, Arizona