

FOLEY EXECUTIVE BRIEFING SERIES



**Investments In Distressed Properties And
Loans 2009 — Issues And Opportunities**

April 28, 2009
7:30 a.m. – 9:30 a.m. Pacific

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Program Introductions

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Key Tax Issues for Private Equity Investments in Distressed Debt

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Common Transactions

- Debtor repurchases its own debt and/or negotiates write-down with lender.
- Related party repurchases debt from the lender.
- Unrelated party purchases debt (Distressed Debt Funds).

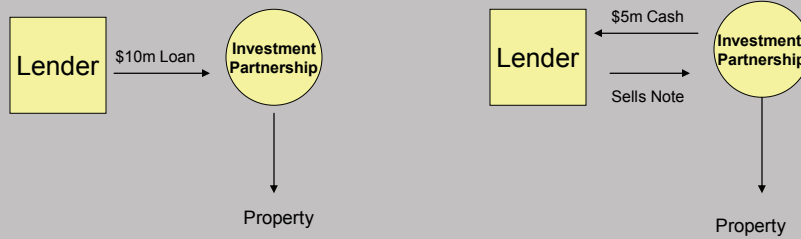


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Debtor Repurchases Own Debt

Example #1: Investment Partnership borrows \$10m to purchase an office building in 2005. During 2009, the Investment Partnership repurchases the debt from the lender for \$5m.

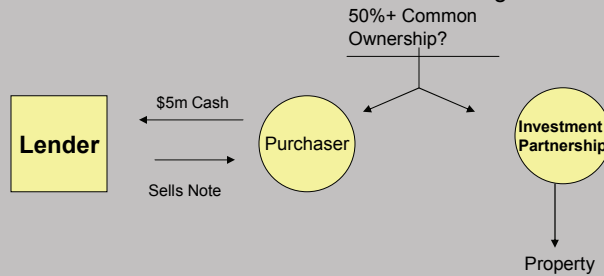


Result: Investment Partnership has \$5m of taxable COD income unless exceptions apply. Same result if borrower and lender instead negotiate a reduction in the debt from \$10m to \$5m.



Related Party Purchases the Debt

Example #2: Same as in Example #1 except that “related” party purchases the note and the debt remains outstanding.

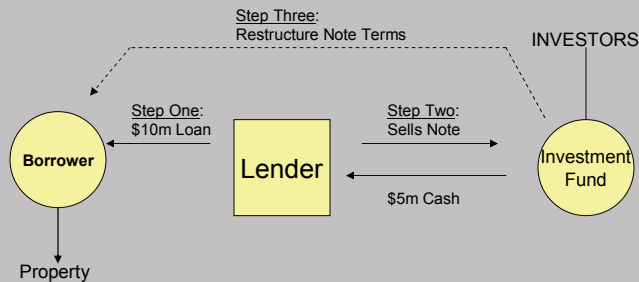


Result: If Purchaser is “related” to borrower (as defined in Sections 267/707 of the tax code), then Investment Partnership has \$5m of taxable COD income unless exceptions apply. Also, Purchaser has \$5m of “phantom” interest income over the remaining life of the note (and borrower has deduction).



Unrelated Party Purchases the Debt

Example #3: Same as in Example #1 except that “unrelated” party purchases the note and the debt remains outstanding.



Result: It depends. Is the note publicly traded? Is it “significantly” modified? Is the debt in default? Tax results could be very surprising.



Unrelated Party Purchases Debt Non-Publicly Traded Debt

- “Significant” modification of the debt terms following acquisition (extension of maturity, adjustment to yield, etc.) will create a deemed exchange of “old” note for “new” note with modified terms.
 - For Borrower: \$10m face of new note repays in full the \$10m “old” note. Thus no COD income.
 - For Investor: \$10m face amount of “new” note issued in exchange for “old” note (\$5m tax basis) results in \$5m of STCG!!!!
 - Exceptions: Could be tax-free if borrower is a corporation. If partnership/LLC borrower, might qualify under “installment method” of deferred reporting, subject to \$5m limits. Also can maybe avoid taxable exchange if modifications are done prior to purchase.
- If non-publicly traded debt is not significantly modified, then purchaser has \$5m of “market discount” which accrues and then, to such extent, is taxable as OI, not capital gains.
 - Possible exception for defaulted/deeply discounted debt?



Unrelated Party Purchases Debt

Publicly Traded Debt

- “Significant” modification of the debt terms following acquisition (extension of maturity, adjustment to yield, etc.) will create a deemed exchange of “old” note for “new” note with modified terms.
 - For Investor: \$5m FMV minus \$5m basis equals \$0 gain.
 - For borrower: \$5m FMV new note issued in satisfaction of \$10m face old notes creates \$5m of COD income!!!! Same general COD exceptions could apply, including new deferral rules.
- If non-publicly traded debt is not significantly modified, then purchaser still has \$5m of “market discount” which accrues and then, to such extent, is taxable as OI, not capital gains.
 - Possible exception for defaulted/deeply discounted debt?



Distressed Debt Funds

Additional Phantom Tax Issues

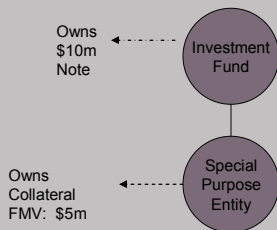
- Holder of note acquiring title to the collateral (e.g., through foreclosure, deed in lieu, etc.) can trigger additional phantom tax gains to holder to the extent the FMV of the collateral exceeds the holders tax basis in the note.
- Example #4: Investment Fund acquires a \$10m face amount note for \$5m. Then, at a time when the underlying collateral FMV is, say, \$7m, the Investment Fund (through foreclosure, deed in lieu, etc.) obtains title the collateral. Result: \$2m taxable gain to Investment Fund (possibly OI under the market discount rules).



Distressed Debt Funds

Interesting Legal Structure for Owning Property

Example #5: Investment Fund purchases \$10m face amount note for \$5m. Then, some time later the Investment Fund takes ownership of the underlying collateral. Instead of taking conveyance in satisfaction of the debt, the Investment Fund conveys title to a separate legal entity and debt remains outstanding.



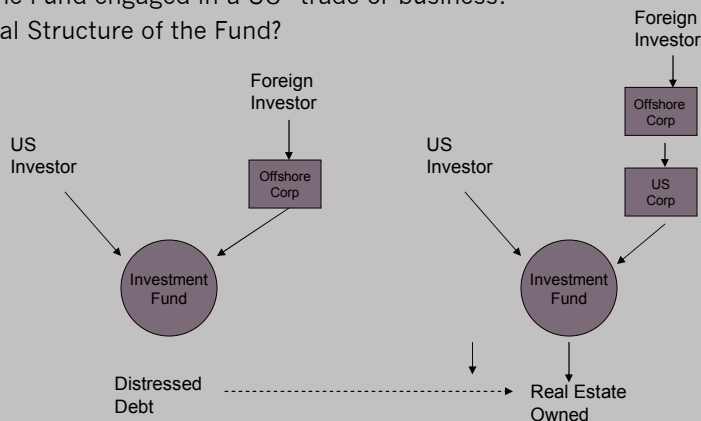
Result: Investment Fund has equity ownership of property yet maintains “first-priority” secured position vis-à-vis future creditors.



Distressed Debt Funds

Special US Tax Issues for Foreign Investors

- Is the Fund engaged in a US “trade or business?”
- Legal Structure of the Fund?





Questions & Answers

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TITLE

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Questions & Answers

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Distressed Real Estate and Environmental Due Diligence

If it Looks too Good to be True . . .

S. Wayne Rosenbaum



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Why Due Diligence?

- Valuing the investment
- Monetizing the liabilities
 - Civil
 - Criminal



What Should be Considered

- The Dirt
- The Structure
- The Operation



The Dirt

- Contamination
- Wetlands/Waters of the State and United States
- Endangered Species
- Conservation Easements



Contamination

- Is there a current ASTM compliant Phase I?
 - Innocent land owner defense
- What does it say?
 - Exclusions
 - Limitations of liability
 - Qualifications of the preparer



Wetlands/Waters of the State or United States

- Is there a current jurisdictional determination done to Army Corps standards?
- What does it say?
 - Wetlands
 - Streams
- Is there a Fish and Game riparian determination?
- Are there vernal pools?
- Is there ground water?
 - Does it have a beneficial use
 - Will dewatering be required
 - Temporary
 - Permanent



Endangered Threatened and Fully Protected Species

- Is the property habitat for an endangered species?
 - Is the habitat occupied?
 - Is the habitat covered by a habitat plan?
- Is the property habitat for a fully protected species?
 - Is the habitat occupied?
 - No provisions for mitigation.



Conservation Easements

- Is the property encumbered by a conservation easement?
 - What does it say?
- Is the property adjacent to a conservation easement?
 - What does it say?



The Structure

- Underground Storage Tanks
- Asbestos
- Lead Based Paints
- PCBs
- Pesticides and Herbicides



Underground Storage Tanks

- Should be identified in the Phase I
 - Frequently are not.
- Prior uses of the property
 - Petroleum products
 - Others
 - Chlorinated Solvents
- On-site and off-site plumes



Asbestos

- Not part of a standard Phase I
- Building built before 1979
- Subject to Prop 65 warnings
- Asbestos removal



Lead Based Paint

- Not part of a standard Phase I
- Subject to Proposition 65 warnings



PCBs

- Transformers and ballasts



Pesticides and Herbicides

- Use
- Storage



The Operation

- Existing Permits
 - Air
 - Permits
 - Transferability
 - Currency
 - New sources
 - Water
 - Process
 - Dewatering
 - Storm water
 - Solid Waste
 - Hazardous
 - Universal
 - Medical Waste
- New Uses
 - CEQA



Solution

- Single Purpose Entities
- Use and Location Rankings
- Public Files



Questions & Answers



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**Thank you for joining us for
today's program.**