



Know Your Borrower: Understanding the Concept of Control

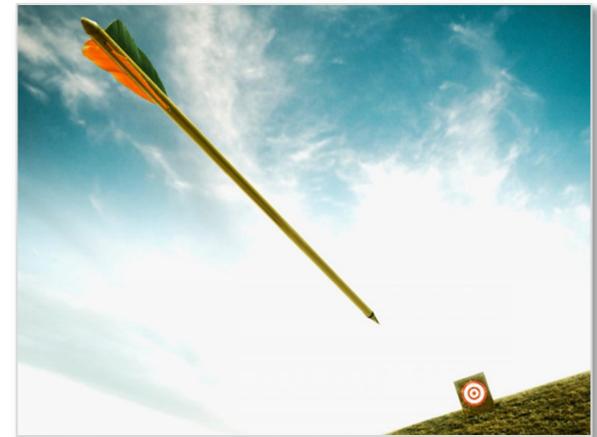
2016 Regional Seller Workshops



Key Takeaways

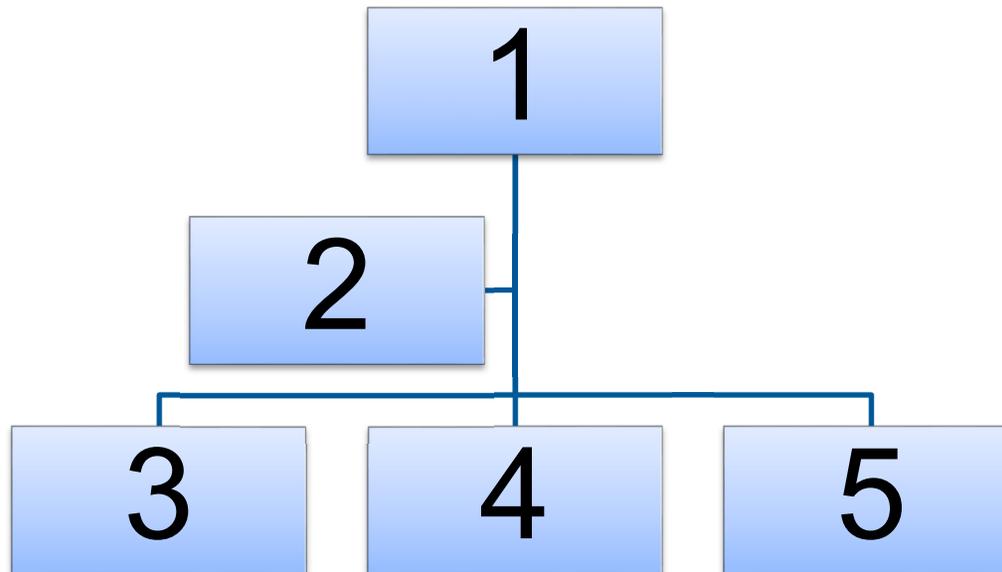
By the end of this training you should take away an understanding of the following:

1. The new streamlined Borrower Principal due diligence requirements
2. How Designated Entities for Transfer (DETs) are determined and why they are important
3. Why the concept of *control* is so important in evaluating transfer requests



Role of the Org Chart in Understanding Borrower Structure

- Org chart serves as a road map to understand the Borrower structure – distills the contents of the organizational documents
- Identifies individuals or entities that are ultimately in control
- Provides a framework for evaluating transfer provisions or other document modifications



Guiding Principles for an Org Chart



- A good org chart will:
 - » Include the role and percent ownership for all individuals and entities
 - » Identify who has control at each level
 - » Drill down on intermediate entities until the entity type is either an individual, public company, or pension/investment fund
 - » Identify the state of formation for Borrower and Single Purpose Equity (SPE) Owner
 - » Note the guarantor and SPE Equity Owner
 - » Add up to 100%
 - » Be easy to read and understand
 - » Not include personal information (e.g. SSN or federal Tax ID)

New Approach to Borrower Principal Due Diligence



- The definition of a Borrower Principal is not changing
 - » Person or entity with at least a 25% ownership interest or a controlling interest or a Guarantor

- Implementing a new risk-based approach to defining Borrower Principal due diligence requirements
 - » Differentiating between Borrower Principals in different levels of the organizational structure:
 - Direct owners
 - Guarantors
 - Individuals or entities that manage or control the Borrower

Borrower Organizational Structure Levels Defined



- First Level:
 - » Any individuals or entities that directly own or control the Borrower
 - » If any direct owner of the Borrower is a pass-through entity, then the first person or entity that is not a pass-through entity
 - » Any joint venture in which a preferred equity contribution is being made - regardless of its position in the organizational structure
- Intermediate Level:
 - » Entities with indirect ownership interest in the Borrower, which connect the First and the Final Levels of the organizational structure

Borrower Organizational Structure Levels Defined, Cont'd



- Final Level:
 - » The ultimate individuals or entities that indirectly own or control the Borrower
 - » Organization type is an individual or one of the following entities (in which no individual or entity holds more than a 25% ownership interest, or else that would be considered the Final Level):
 - Publicly Held Corporation
 - Pension Fund
 - Private Real Estate Fund
 - Public Real Estate Fund
 - Real Estate Investment Trust
 - Settlor (grantor) of Living Trust

Borrower Principals Subject to Due Diligence



 FORM 1115 BORROWER/ BORROWER PRINCIPAL CERTIFICATE	FORM 1116 REAL ESTATE SCHEDULE	FINANCIAL STATEMENTS	CREDIT REPORT	OFAC/ SDN list, FHFA SCP list, Exclusionary list, Internet Google search
BORROWER	YES	<ul style="list-style-type: none"> • YES if entity is not SPE/SAE • NO if SPE/SAE 	YES	YES
GUARANTOR	YES	YES	YES	YES
FIRST LEVEL BORROWER PRINCIPALS	YES	<ul style="list-style-type: none"> • YES if not an SPE equity owner • NO if an SPE equity owner 	YES	YES
INTERMEDIATE LEVEL BORROWER PRINCIPALS	NO	NO	NO	YES
FINAL LEVEL BORROWER PRINCIPAL	YES	YES	YES	YES

Forms 1115 Borrower Certificate and 1116 Real Estate Schedule have been revised to include a list of Required Entities for the purposes of the respective form

Borrower Principals Subject to Due Diligence: Newly Formed Entities



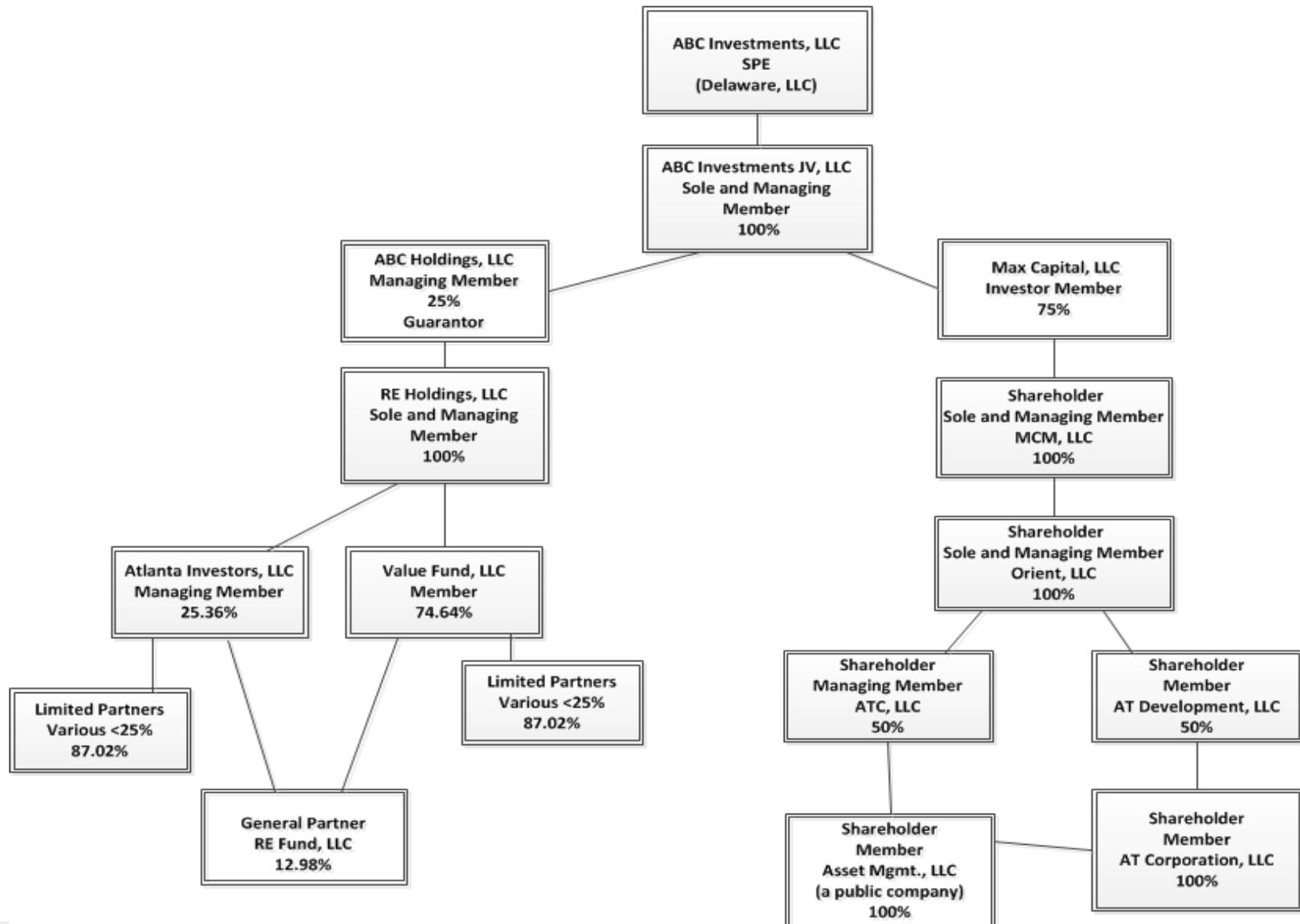
- Streamlining requirements for newly formed Borrowers/Borrower Principals –
 - » Not required to submit Financial Statements, Form 1116 or a Credit Report (only Form 1115 required)
 - » Applicable for an entity that was not in existence prior to the proposed transaction and has been or will be formed solely for the specific transaction (usually no more than 60 days prior to the submission of the underwriting package)
 - » Must be identified in the Preliminary Legal Issues Memorandum (PLIM)

Test Your Knowledge – Activity #1

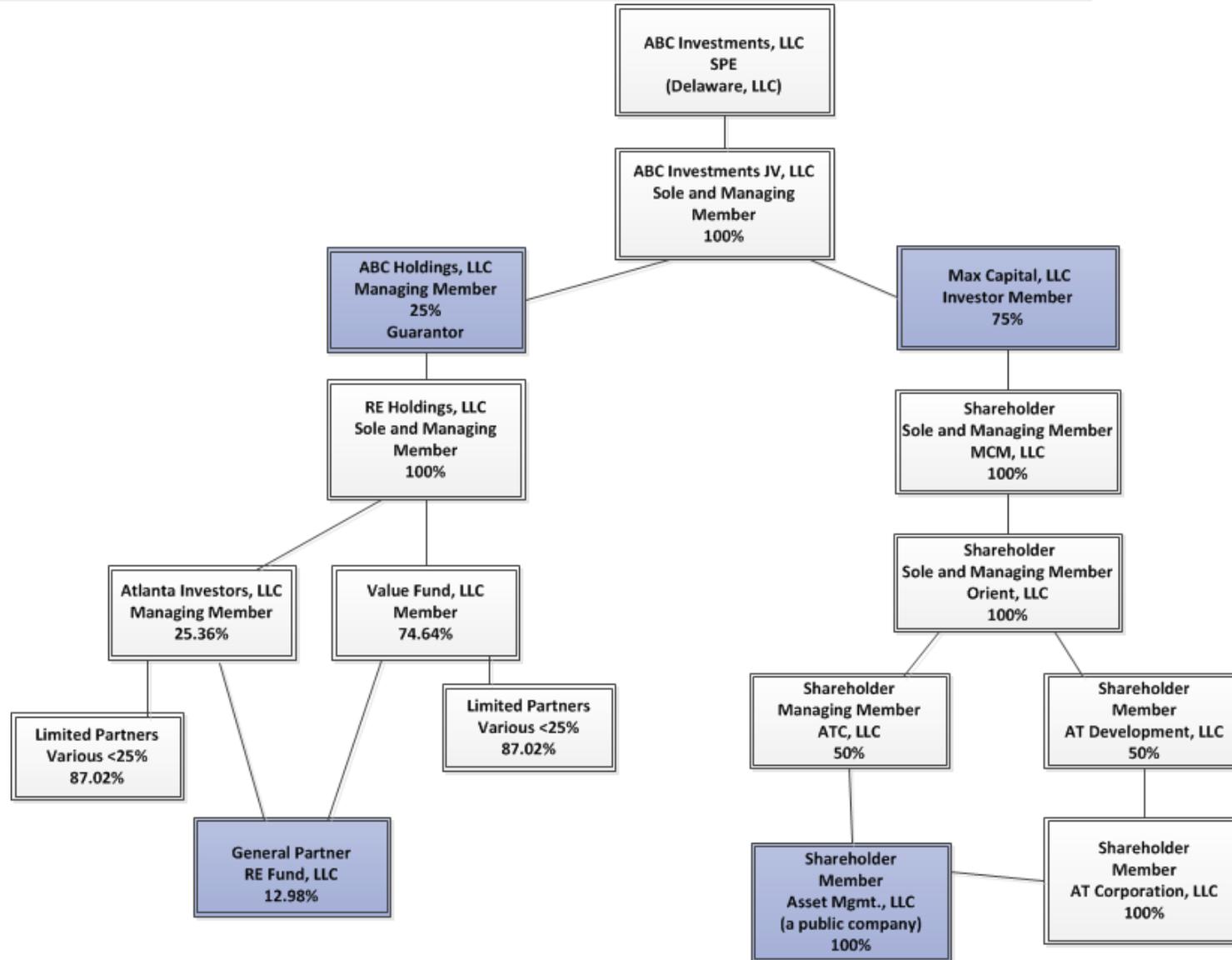


- Using the following two org charts, let's quickly run through a couple of key concepts:
 - » Identifying the First Levels and Final Levels
 - » Understanding what due diligence material is required for selected individuals/entities

Test Your Knowledge – Example #1



Test Your Knowledge – Answer #1



Test Your Knowledge – Example #2



Designated Entities for Transfer (DET)



- Designated Entities for Transfer (DET): A concept to ensure that the ultimate individuals/entities are in control of the Borrower or have substantial equity in the Borrower remain in the deal
- DETs are entities that are subject to restrictions on transfer of ownership interests because of the potential impact on the control of the Borrower
 - » Underwriter identifies entities which need to remain in the deal (for their experience and financial wherewithal) unless lender's approval is otherwise obtained or a transfer is pre-approved
 - The restrictions on the transfers of the ownership interests in the DET are the same as the restrictions on the Borrower in the Loan Agreement
 - If an entity is not named as a DET, then lender's approval is not needed for transfers of interests in that entity
 - » The sooner an entity is identified as a DET, the sooner we can work with such entity to identify its needs for potential transfers of ownership

Designated Entities for Transfer (DET), Cont'd



- What is typically named a DET?
 - » Must be an entity (not an individual)
 - » GP or managing member
 - » A guarantor with a direct or indirect ownership interest
 - **Must be shown on the Org Chart**
 - » In general, an entity with a 25% or greater equity interest that exercises some control over the Borrower
 - In the case where this entity has a purely passive position in the Borrower, it will probably not be named a DET

Designated Entities for Transfer (DET), Cont'd



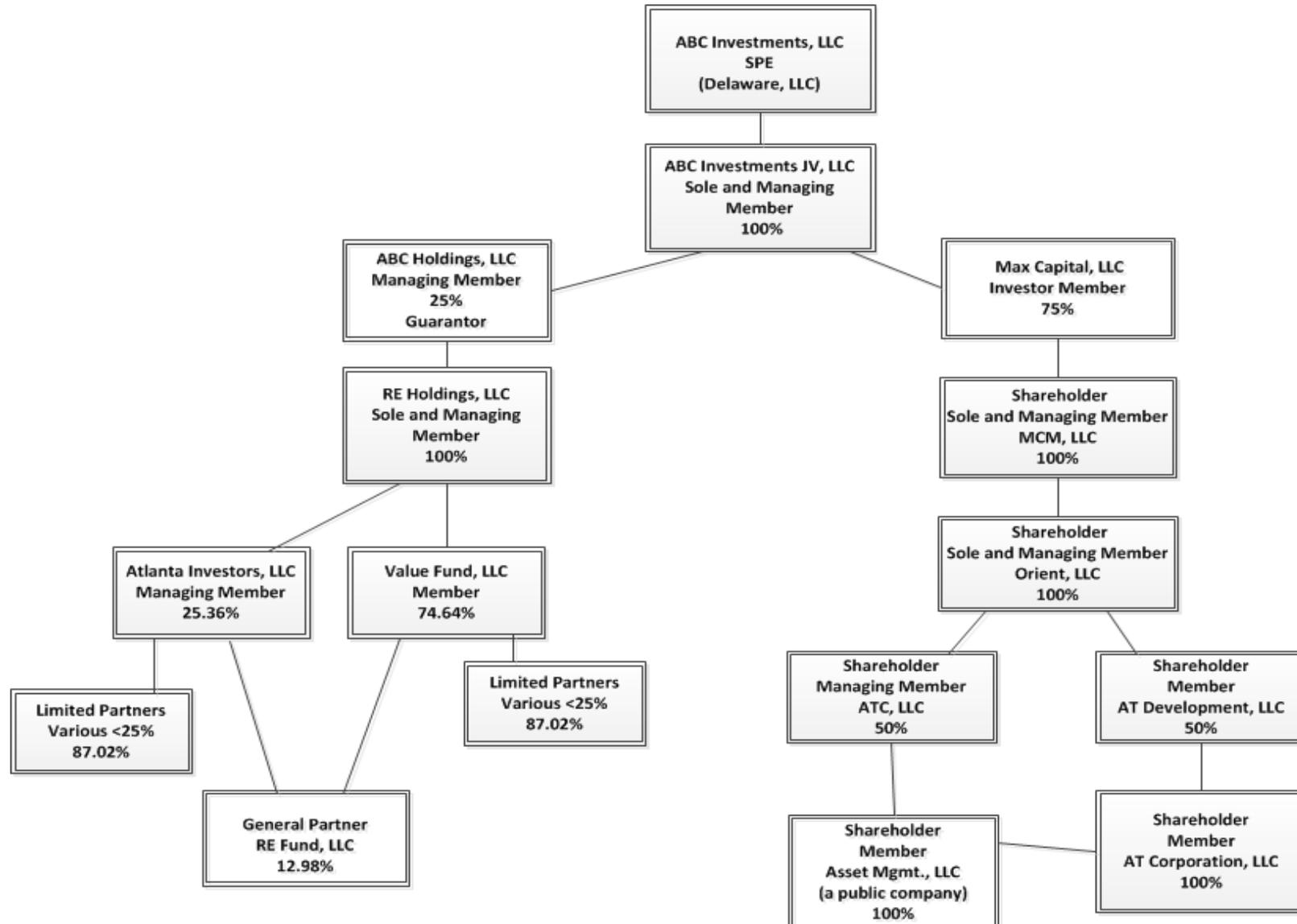
- How the concept of DETs ties into the org chart:
 - » “Draw a line”: Any intervening entities between the Borrower and the individuals/entities that you expect to remain in the deal must be listed as a DET
 - In other words, draw a line between the two and include all entities in between
 - » Ensure the org chart is complete: It must identify the owners (both percentage and control) for every DET
 - If not, Servicer cannot determine whether or not a future transfer is permitted
 - » Do not “leap frog” over any entities in the chain back to the Borrower – if there is a gap in the chain, the ability to keep any individual or entity past that “gap” in the deal is lost

Test Your Knowledge – Activity #2

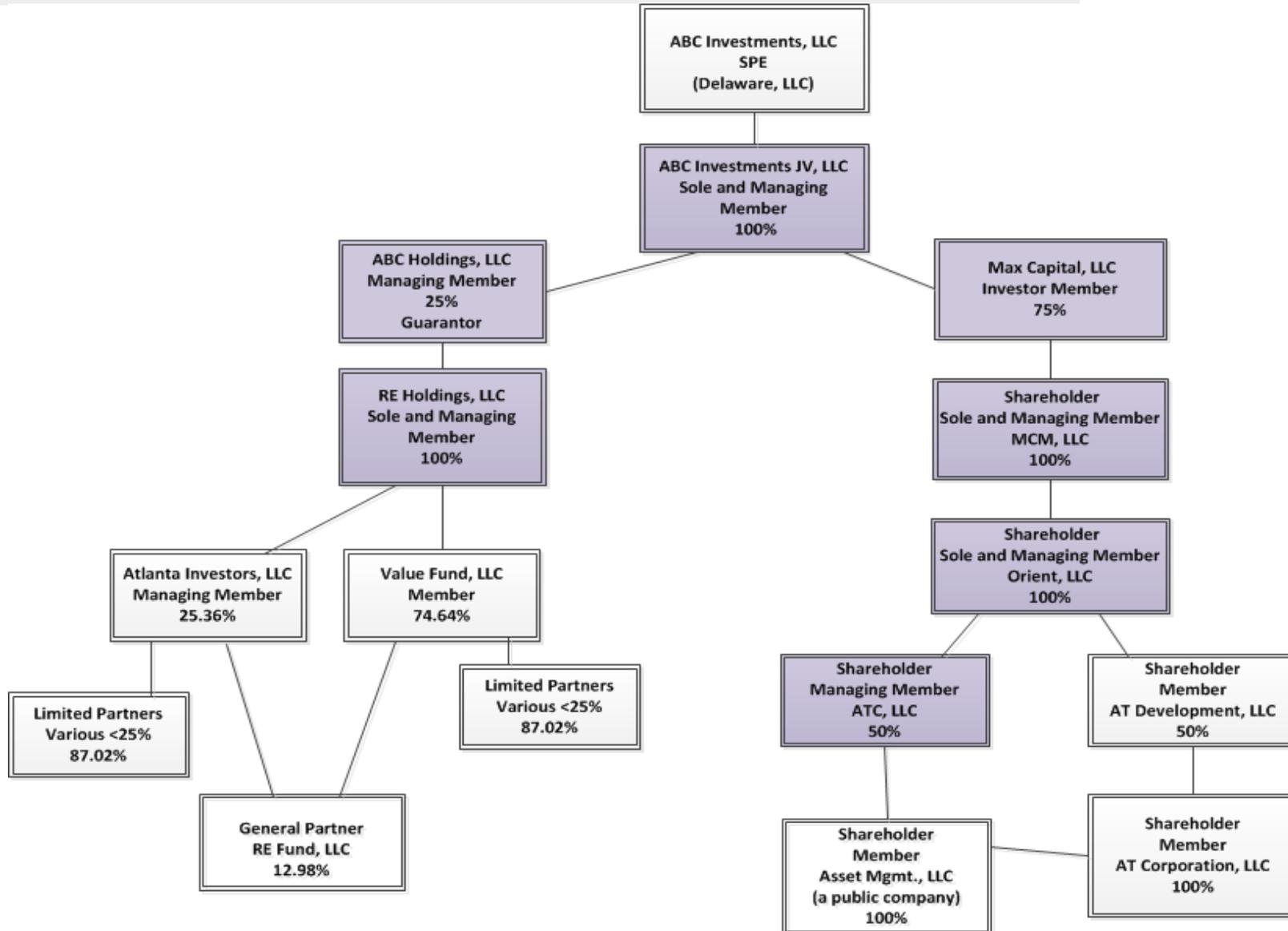


- Using the same two org charts, identify each DET that would be listed in the commitment

Test Your Knowledge – Example #1



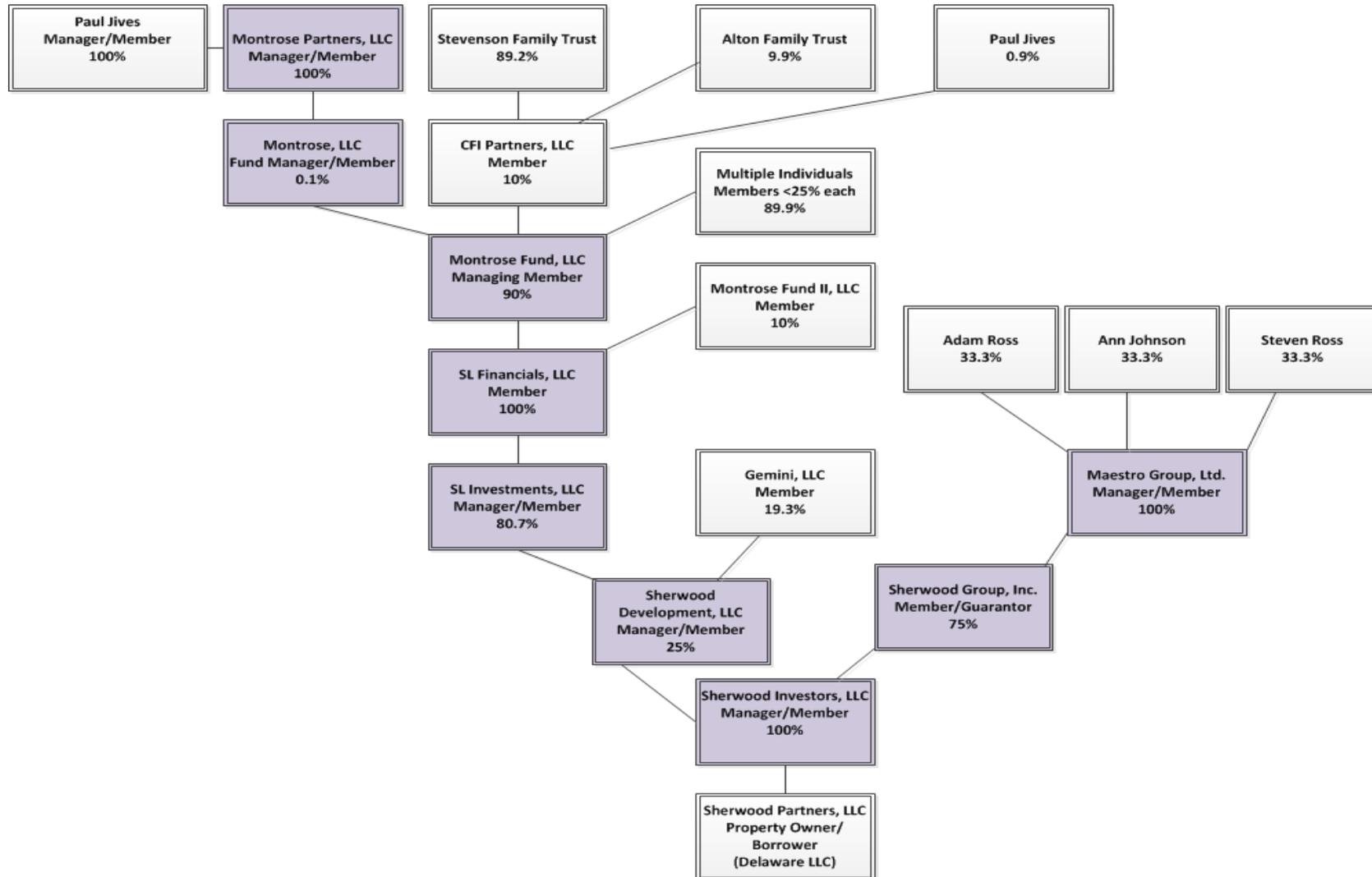
Test Your Knowledge – Answer #1



Test Your Knowledge – Example #2



Test Your Knowledge – Answer #2



DETs vs Borrower Principals



- Differences between DET and Borrower Principals
 - Borrower Principals include individuals
 - Borrower Principals must be identified in the underwriting phase for purposes of:
 - Providing certain information (via form 1115, credit reports, etc.)
 - Checking the Office of Foreign Assets Control (OFAC) specially designated nationals list
 - Borrower Principals have on-going obligations under Loan Agreement
 - Delivering financial statements
 - Making representations about the Borrower and/or the Property
 - DETs apply only to transfers of ownership interests in Borrower or other DETs

DETs vs Borrower Principals, Cont'd



- » Each DET will be a Borrower Principal; however, not all Borrower Principals will be a DET

- Examples:
 - A Guarantor will be a Borrower Principal, but a Guarantor that is not in the organizational structure of the Borrower will not be a DET, since the Transfer provisions do not apply to an entity that is not in the organizational structure of the Borrower

 - Someone who owns 25% or more of the Borrower is a Borrower Principal, but may not be a DET if an individual or if there is no control over the Borrower or the Property

Freddie Mac Transfers Fall Into 5 Basic Categories



Permitted Transfers

- Such as: Leasing the property to tenants pursuant to the Loan Agreement, transfers resulting from condemnation, or Transfers to which the Lender has consented

Prohibited Transfers

- Such as: Transferring the Property, placing liens on the Property, or transferring more than 50% interest in the Borrower or DET

Prohibited Transfers which require Lender's consent

- Typically, an assumption or Transfer of certain managing interests in a Borrower or DET

Conditionally Permitted Transfers

- Such as: Transfers resulting by death or incapacity, granting an easement in the Mortgages Property, Transfers of interests in publicly traded entities, transfers of certain non-managing interests in Borrowers/DETs, Affiliate Transfers, and Buy-Sell Transfers

Preapproved Intrafamily Transfers

- For estate planning purposes

Common Pre-Approved Transfers



- We are going to highlight 3 of the most common pre-approved transfers
 1. Limited Partner/Non-managing Member Transfers
 2. Affiliate Transfers
 3. Buy-Sell Transfers

Limited Partner/Non-Managing Member Transfers



- Limited Partner/Non-Managing Member Transfers
 - » Current Loan Agreement provides for Transfers of non-controlling interests up to and including 50% of the interests in Borrower or DET without Lender's approval
 - » Limited Partner/Non-managing Member Transfers above 50% are conditional transfers
- Noteworthy conditions above the unrestricted 50% interests
 - » 30 days advance Notice
 - » Following the Transfer, no change of Control and management of the day-to-day operations of the Borrower or DET
 - » If the Transfer results in a party owning 25% or more of the Borrower or DET:
 - \$15,000 transfer processing fee
 - Certification of no fraud or bankruptcy
 - A current OFAC search

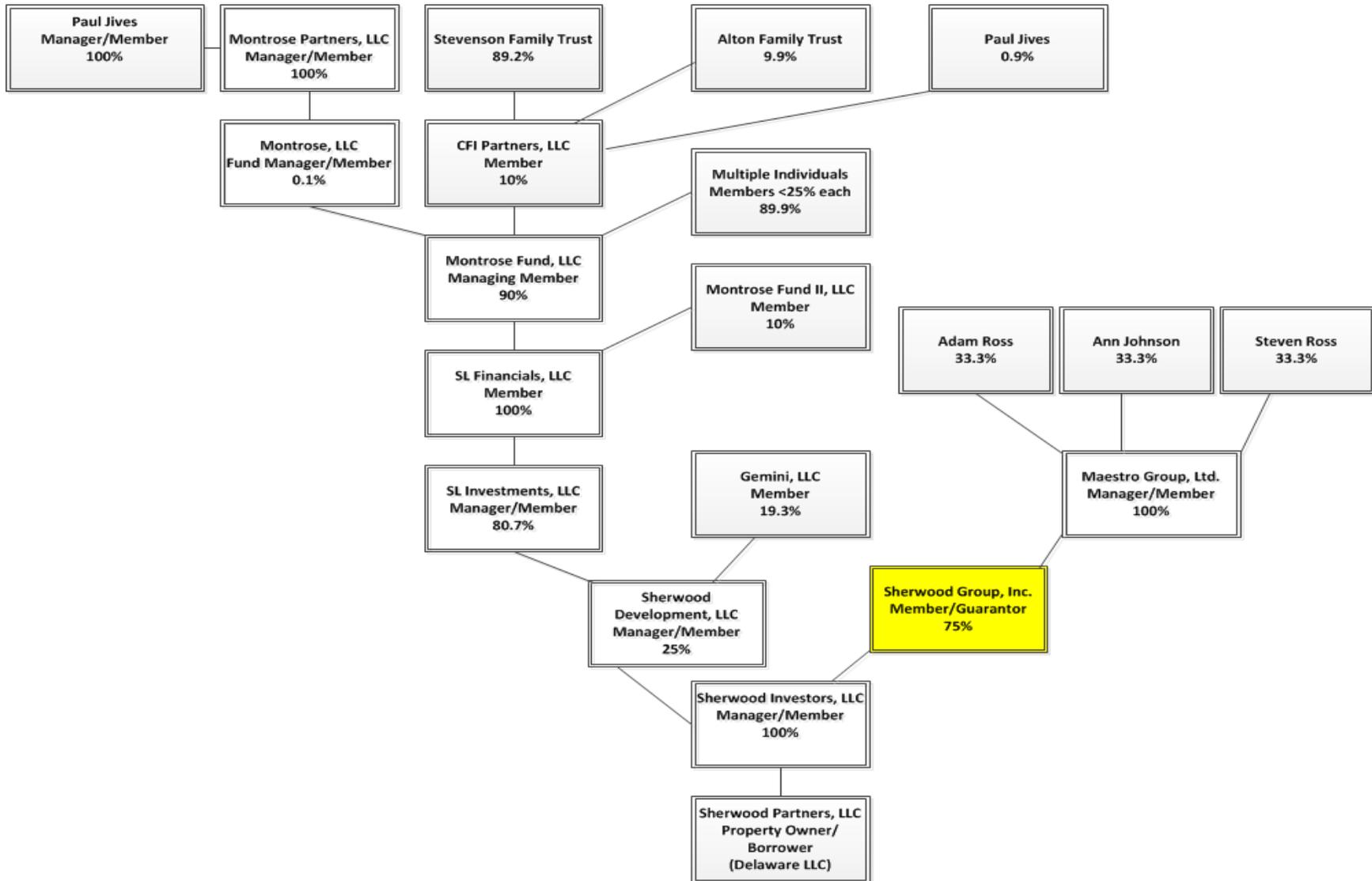
Affiliate Transfers



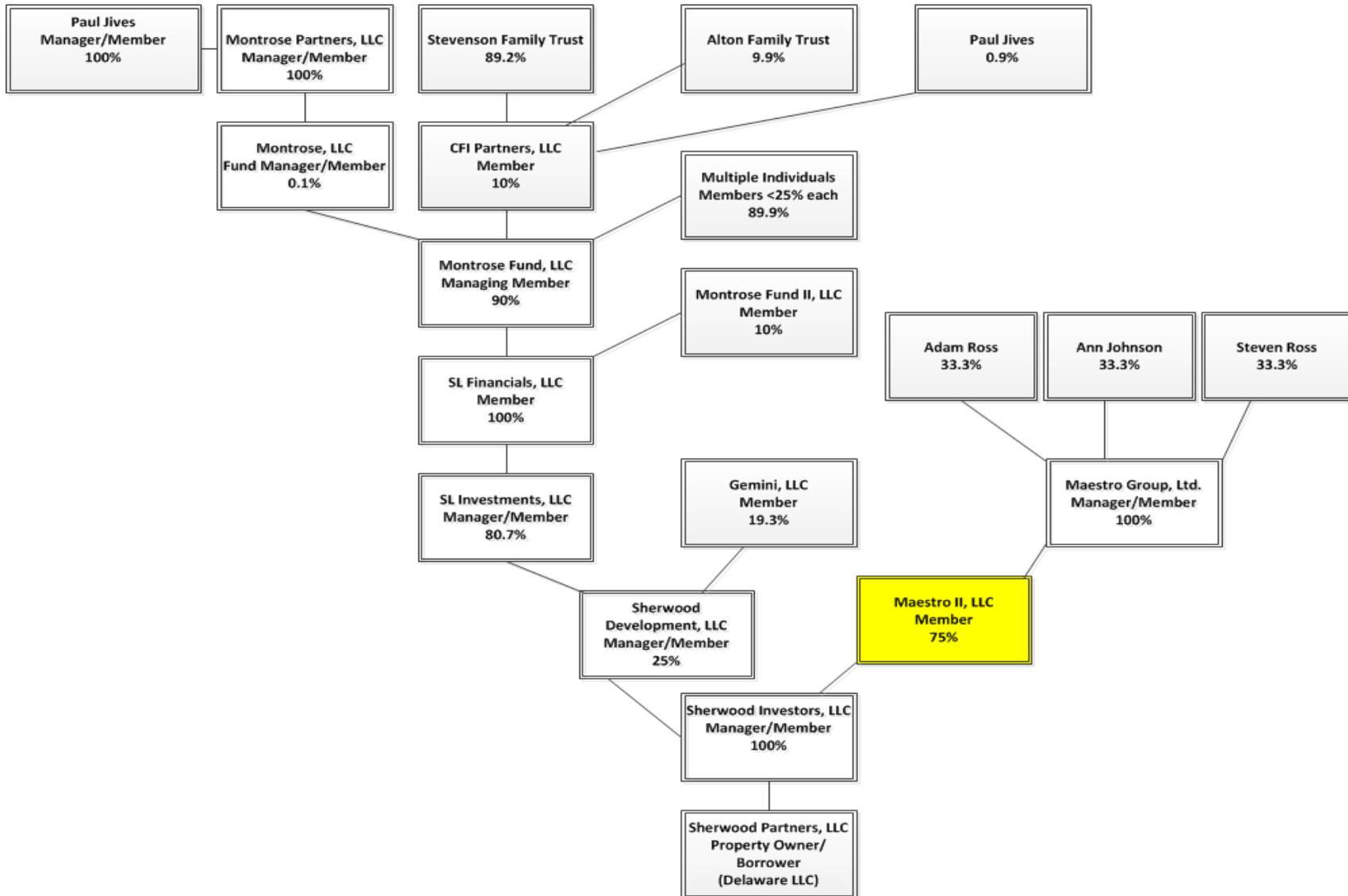
- An Affiliate Transfer is a transfer of any direct or indirect interest in a Borrower or DET held by an identified entity to that party's Affiliate
- An Affiliate is a person or entity that directly or indirectly is in Control of, under Control of, or under common Control with the identified person or entity
- Affiliate transfers are often requested to allow entities within org structure to manage their internal organizational/investor requirements
- When approving an Affiliate Transfer request, it is critical that the transfer would not inadvertently let the underwritten equity and management or the guarantor out of the organizational structure
- Noteworthy conditions:
 - » 30 days advance notice
 - » Following the Affiliate Transfer, no change of control and management of the day-to-day operations of the Borrower or DET
 - » Affiliate must meet Lender's eligibility, credit, management and other standards

- Affiliate Transfer Example:
 - Proposed Affiliate Transfer:
 - Sherwood Group, Inc. to transfer 100% of its interest in Sherwood Investors, LLC to an Affiliate of Maestro Group, Ltd

Pre-Affiliate Transfer Org Chart



Post-Affiliate Org Chart



- A Buy-Sell Transfer is the one-time transfer pursuant to the organizational documents of an entity or joint venture agreement for one party to purchase the interests of another or for control to shift from equity to another
 - » It is usually a transfer of management interests to the equity holders (such as in preferred equity) or involves management buying out equity
 - » Any party having a Buy-Sell Transfer right must be underwritten at loan origination
 - » The party having a Buy-Sell Transfer right must certify at the time of transfer that its net worth and liquidity are substantially the same as at loan origination with no litigation or credit issues that would affect such net worth and liquidity

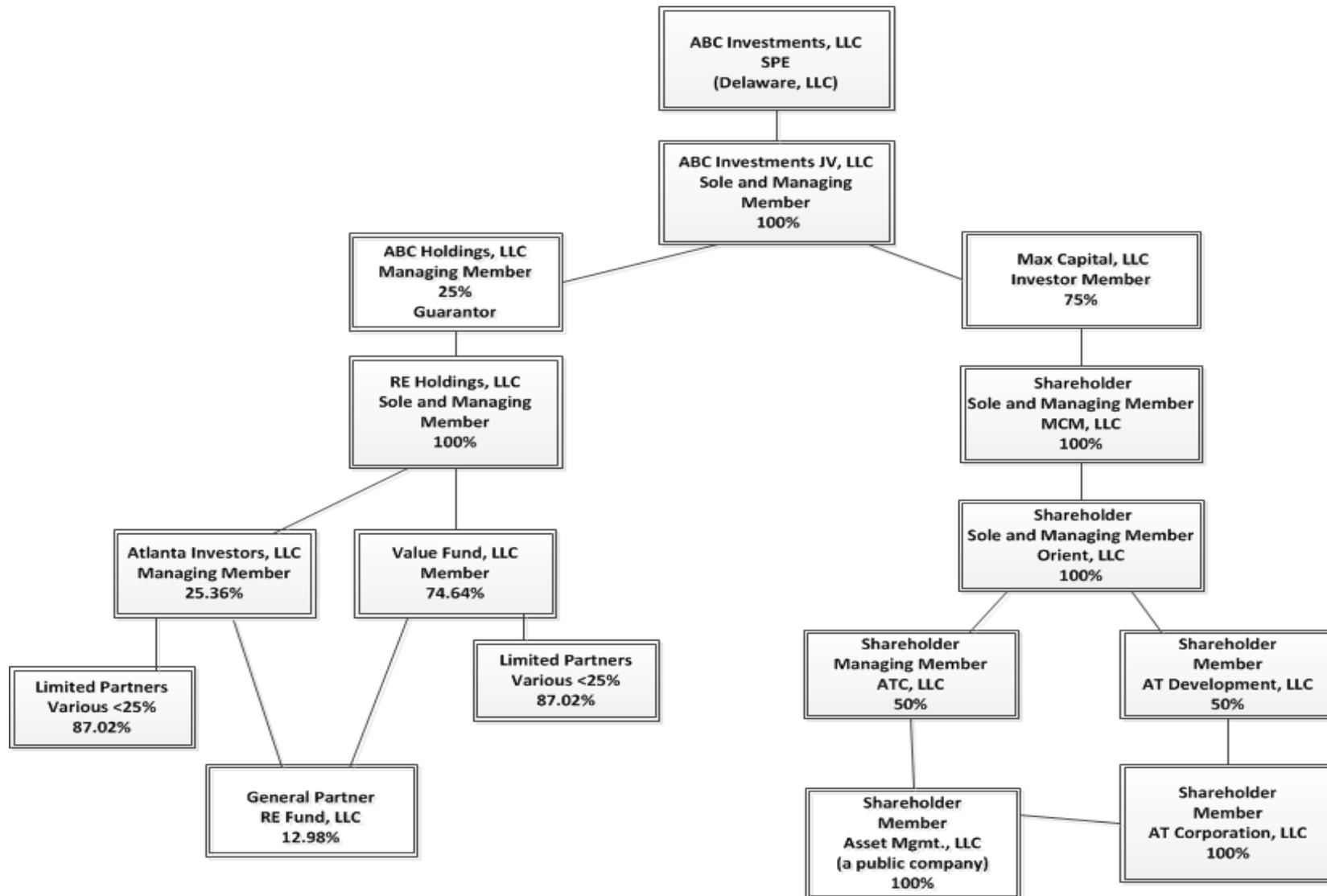
Buy-Sell Transfers, Cont'd



- » A party with a Buy-Sell Transfer right may be required to provide a new guarantor
- » The equity ownership structure must be listed as DETs
- » Noteworthy Conditions:
 - 30-days advance notice
 - \$15,000 transfer processing fee
 - If a new manager of Borrower, then replacement guarantor
 - No change in property management
 - Possible OFAC search
 - Non-consolidation opinion updates

- Buy-Sell Transfer Example:
 - » Proposed Buy-Sell Transfer:
 - The Transfer of ABC Holdings, LLC (“Manager”) interests in ABC Investments JV, LLC, the sole member of the borrower to Max Capital, LLC or to its wholly owned Affiliate (“Equity”)

Borrower Org Chart Pre-Buy-Sell Transfer



Borrower Org Chart Post-Buy-Sell Transfer

