Financing Tenants in Common Property in Capital Markets

Jon S. Robins

Demand is burgeoning for capital market financing of tenancy in common property. The tenancy in common structure presents unique risks and issues to capital market lenders, but with sound structuring, good loans can be made to tenant in common borrowers.

Recently, capital market lenders have been receiving numerous requests to finance property held by multiple borrowers as tenants in common. Although the tenancy in common ownership structure has been around for centuries, it is unwieldy and not typically used in commercial finance transactions. The tenancy in common's current popularity is tax driven. Section 1031 of the Internal Revenue Code (together with the Treasury Regulations, the "IRC") allows a property owner to exchange real estate held for investment for "like kind" property without paying capital gains tax at the time of the exchange. An interest in a partnership, limited liability company, corporation or trust does not qualify as like kind property, even if the entity's sole purpose is to own real estate. Tenancy in common interests in real property do qualify, because tenancy in common interests are direct ownership interests in real property under the common law.

Although tenancies in common solve tax problems for borrowers, their structure presents certain unique risks and issues for lenders making loans intended for securitization. These risks and issues can be broadly categorized as: multiple ownership issues, passive ownership or centralized management issues, partition issues, tenancy in common document issues, and additional structuring issues. These risks and issues and suggested solutions are addressed below.

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Nature of Tenancy in Common

A tenancy in common is not an entity. It is an ownership estate under which multiple parties each own a direct, undivided interest in a property. Each such party is referred to as a tenant in common (a "TIC"). TIC ownership interests are generally expressed as percentage interests.[1] Because each TIC owns an undivided interest in the whole property, each is entitled, no matter how small its percentage interest, to possession of and the profits from the entire property, subject to the rights of the other TICs.[2] Also, each has the undivided burdens of ownership, subject to rights of contribution against the other TICs. Although there is no legal requirement that they do so, TICs typically enter into a tenancy in common agreement to allocate the benefits and burdens of ownership. Absent such an agreement, the TICs have the rights and obligations accorded to them by law.

As a matter of law, TICs have a "right of partition." Partition is the right to have the property divided into separately owned parcels. Partition is generally initiated by a TIC filing a partition action and is performed by the court. Each TIC receives individual title to a separate portion of the property corresponding to the percentage tenancy in common interest that it had held in the whole.[3] Dividing property in this way is difficult when farmland is involved (e.g., who gets the farm house, the barn, the livery?), but is essentially unworkable for commercial real estate. Where physical partition is untenable, the court will generally order the sale of the entire property and divide the proceeds among the TICs.[4]

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The fact that each TIC is an owner of the property and its rights as such, including the right of partition, have significant implications for the structuring of loans to tenant in common borrowers.

Section 1031 Exchange

In analyzing the special issues raised by lending to TICS, it is helpful to understand borrowers' motivation for using a tenancy in common. Under Section 1031 of the IRC, no gain or loss is recognized upon an exchange of property held for productive use in a trade or business or for investment to the extent that it is exchanged solely for property of "like kind" to be held either for productive use in a trade or business or for investment.[5] As an example, Section 1031 would allow a person owning an apartment building that has significantly appreciated to exchange that property for a strip shopping center of equal value without the owner having to pay any capital gains tax on the transaction. The exchanger's tax basis in the relinquished property, the apartment building, will become its tax basis in the exchange property, the shopping center. The gain on the sale of the apartment building is deferred until a sale of the shopping center occurs.[6]

A $10 million dollar strip center could obviously not be exchanged for a $100 million dollar office building, but as a business proposition, it could be exchanged for a 10 per cent interest in that office building. To accomplish this, the exchanger could sell the strip center and purchase an interest in a partnership formed with other investors to purchase the office building. Because exchanges of or for partnership interests are not covered by Section 1031, the exchanger would have to pay capital gains tax on the disposition of the strip center. Section 1031, however, allows the taxpayer to exchange the shopping center for a 10 per cent tenancy in common interest in the office building.

Unlike partnership interests, tenant in common interests are themselves real property interests and are exchangeable under Section 1031. The tenancy in common structure allows the shopping center owner to trade its strip shopping center for an interest in a much more significant property with stable rents and professional management. Such a transaction allows, the shopping center owner to exchange what may have been an hard to manage, risky asset for a passive investment in a property with predictable, stable cash flow.

The Internal Revenue Service (the "Service") rules with respect to Section 1031 exchanges involving tenancy in common interests in rental real property have been unsettled and only very recently has the Service issued some guidelines pertaining to such exchanges (the "New Guidelines").[7] The Service is generally conservative in its view of exemptions from tax recognition and tends to interpret provisions such as Section 1031 restrictively. It remains to be seen how the New Guidelines will be applied to actual transactions. The risk for a TIC in any transaction is that the tenancy in common will be deemed by the Service to be a partnership for tax purposes and the exchange treated as a taxable disposition. It is important for lenders to appreciate this recharacterization risk, because it impacts upon the structure of the tenancy in common and constrains the TICs' flexibility to accommodate lender requirements.

Multiple Ownership Issues

One implication of each TIC's ownership of a direct interest in the property rather than an interest in a property owning entity is that each TIC must be a borrower under the loan documents. Among themselves, the TICs will typically agree to (and compliance with the New Guidelines would require) proportional liability for the loan based upon each TIC's percentage tenancy in common interest. Under the loan documents, however, each TIC should be jointly and severally liable for all of the borrowers' obligations.[8] This is essential for the lender. The lender should not be in a position where less than all of the TICs are in default or where lender could only foreclose on the defaulting TIC's tenancy in common interests and not upon the property as a whole. Joint and several liability is not onerous to the TICs. Each TIC will be a single purpose entity whose only asset is its tenancy in common interest in the property. The loan will generally be non-recourse, subject to carve-outs. Effectively, all that a TIC will have at risk will be its interest in the property. If one or more TICs do not pay their share of loan obligations, then the non-defaulting TICs can protect themselves by paying the defaulting TICs' share of such obligations and pursuing their rights of contribution and indemnity against the defaulting TIC under the tenancy in common agreement or at law.

SPE Structure

Under existing law, the trustee in the bankruptcy of any one TIC has the power to sell the bankrupt TIC's tenancy in common interest or, subject to certain limitations (including a right of first refusal in favor of the non-debtor TICs), to sell the entire property and divide the proceeds among the TICs in accordance with their respective percentage interests.[9] The bankruptcy of any one TIC would stay any foreclosure action by lender upon the property. Lender has essentially the same bankruptcy risk with each TIC as it would have with a single borrower on a standard loan.

To address this risk, lenders should require each borrower (and therefore each TIC) to satisfy the rating agency requirements for a bankruptcy remote, single purpose entity (an "SPE") to the same extent as if it were a single borrower under a non-tenancy in common loan of similar size. If the loan is of a size that lender would normally require the borrower to meet rating agency standards for large loans, including independent director or manager requirements (e.g., loans in excess of $15 million for most lenders), then lender should require each TIC to meet such standards. In this way each TIC is made to be bankruptcy remote to the same extent that lender would require any single borrower to be so under a standard loan. Because whatever bankruptcy risk there is for any one TIC is multiplied by the number of TICs to determine the bankruptcy risk of the deal, lenders should consider whether or not this standard is sufficient under the circumstances of any particular transaction.

The type of entity that must be used for the SPE is largely dictated by the requirements of Section 1031. Although a person cannot generally exchange real estate for interests in a partnership or a limited liability company, for tax purposes, a single member limited liability company (a "SMLLC") is a disregarded entity and is not treated as separate from its sole member. Therefore, the tenancy in common interest in the property may be acquired by an exchanger through a SMLLC wholly owned by it.[10] This is so despite that, for state law purposes, the exchange results in the exchanger owning all of the membership interests in a SMLLC rather than a direct interest in real property. The SMLLC is the standard entity used by TIC borrowers in capital market loans. For TICs with respect to which Section 1031 tax deferral is not an issue (e.g., someone desiring to participate in the deal without exchanging an existing property), there is no requirement that a SMLLC or other specific type of entity be used, but such entity should be an SPE to the same extent as the other TICs.

Most if not all state limited liability company acts now permits SMLLCs. Although over time, it is likely that the rating agencies and lenders will become comfortable with SMLLCs organized under state law other than that of Delaware, currently Delaware law is preferred and perhaps required for large loans. As with any loan to a SMLLC, if the loan amount is large enough for the lender to require an independent manager (e.g., loans in excess of $15 million for most lenders), then the so-called "Delaware single member" opinions should be obtained with respect to each SMLLC TIC. In keeping with the theme, if the loan is large enough that a non-consolidation opinion would typically be required, then appropriate non-consolidation opinions should be obtained with respect to each TIC.

Underwriting

Because each TIC must be a borrower, each TIC must be underwritten as such. Underwriting requirements may vary somewhat depending upon the size of each TIC's percentage interest, the number of TICs in the deal and the percentage interest to be retained by the loan sponsor's TIC, if any, among other factors. Standard lien and litigation searches and appropriate creditworthiness requirements with respect to each TIC and its principals are appropriate. The fact that each TIC is an owner of a direct interest in the property means that lender can expect that each TIC will be a necessary party to any foreclosure action. In light of each individual TIC's ability to fight lender by contesting a foreclosure, filing a bankruptcy or otherwise, lenders need to be wary of allowing any person with a poor credit history or litigious background to control a TIC.

Recourse Carve-Out Guaranties

One issue that overlaps legal structuring and underwriting is that of carve-out guaranties. Some borrower sponsors, particularly in syndicated deals, will request that only its principals be carve-out guarantors and environmental indemnitors. Any such request needs to be evaluated on a deal by deal basis. If the property is to be managed by an affiliate of the borrower sponsor and none of the TICs will have possession of the property or access to cash flow, it may be appropriate to limit personal liability for environmental matters and property specific matters, including liability for misappropriation or misapplication of insurance proceeds or other funds, to a deep pocket principal of borrower sponsor. Liability under recourse carve-outs for voluntary bankruptcy, fraud, failure to adhere to the SPE requirements and other carve-outs that are principally designed as disincentives to bad borrower conduct should arguably not be so limited. Making the borrower sponsor's principals liable for the fraud or bankruptcy of a TIC that it does not control is not likely to prevent that TIC's bad conduct. It is more effective to place such liability upon the person with the power to prevent such conduct, the principal of the subject TIC.

Despite borrower sponsors' typical resistance to recourse liability for carve-outs upon investor principals, personal guaranties by the principals of each TIC are recommended for the following and appear to be generally acceptable in the marketplace:

- voluntary bankruptcy of the subject TIC, the involuntary bankruptcy of such TIC if such TIC and its principals are not using their best efforts to obtain the dismissal of the same, or the filing of an involuntary bankruptcy by such TIC against any other TIC,
- filing any action for partition,
- violating any of the SPE provisions of the loan documents,
- fraud by such TIC or its principals, and
- replacing the designated property manager as its agent with respect to the day to day management of the Property and day to day interaction with the lender.

Consistent with the purpose of these carve-outs as disincentives to undesirable conduct by any TIC, only the guarantor of the offending TIC should be liable in the case of any of these occurrences, and not any of the other TIC guarantors.

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Partition Issues

Subject to any peculiar requirements of applicable state law, a TIC's inherent right of partition exists whether or not it is provided for in any agreement.[11] Although the right of partition is problematic for a lender, neither it nor its exercise divests a mortgage. If tenancy in common property is partitioned into multiple parcels or is sold in lieu thereof, then any mortgage on the property prior to partition survives and encumbers all such partitioned parcels or the property sold as a whole, as applicable.[12] This is not much comfort to a capital markets lender. A physical partition of the property would be similar in many of its effects to the dissolution of a partnership borrower. In addition, the sum of the partitioned parts may produce less income to pay debt service than did the whole. In the likely case of a sale of the entire property, the capital market lender loses its control over who may be a transferee of the property and under what circumstances.

Traditional Approach

Lenders' traditional approach to partition is to require that each TIC waive its right of partition. The waiver need not be forever, but must be irrevocable at least until the loan has been fully repaid. Generally waivers of the right of partition that are limited in time are respected by the courts.[13] Prudent lenders often require an opinion of borrower's counsel as to the enforceability of the partition waiver under applicable state law. The preferred form of opinion also addresses the enforceability of the waiver in the event of a TIC bankruptcy. The waiver or a memorandum thereof should be recorded on the land records and title insurance affirmatively insuring such waiver obtained.

Section 1031 Tax Issue

Prior to discussing a possible alternative strategy for dealing with partition, some tax background is in order. Because partnership interests are not eligible for tax deferred exchange under Section 1031, Borrowers use tenancies in common to pool their resources as in a partnership, while deferring capital gains taxes. Although a tenancy in common is not a partnership under state law, the Service has the power to recharacterize it as such for federal tax purposes and to thereby disallow the tax benefits of the exchange. The more a tenancy in common looks and acts like a partnership, the greater the risk of recharacterization.

The IRC does not contain safe harbor provisions for Section 1031 exchanges involving tenancies in common. Up until very recently, the Service was evaluating these transactions and would not issue private letter rulings or otherwise bless any particular transaction,[14] and TIC exchange participants were left with the uncertainty of trying to structure Section 1031 compliant transactions based upon general tax principles and existing case law.

On March 19, 2002, the Service issued Revenue Procedure 2002-22 in which it agreed to consider requests for advance rulings and letter determinations as to whether or not a particular exchange transaction involving a tenancy in common qualifies for tax deferral under Section 1031. Other than in extraordinary circumstances, the Service will not consider granting a ruling with respect to any such transaction unless it complies with all of the structural guidelines set forth in such revenue procedure and defined above as the "New Guidelines." Technically the New Guidelines are only to assist taxpayers with ruling requests, and are not substantive rules. The ultimate determination as to whether or not any exchange involving a tenancy in common qualifies for gain recognition deferral under Section 1031 will be based on all of the facts and circumstance of such transaction. Compliance with the New Guidelines does not assure that a ruling will be granted or the tenancy in common structure respected.[15] On the other hand, Section 1031 exchange participants using a tenancy in common structure that does not comply with the New Guidelines may, as a practical matter, almost face a presumption that their tenancy in common is a partnership or other business entity for tax purposes and thus ineligible for tax deferral under Section 1031.

Generally, a waiver of the right of partition has been viewed as a bad fact in the analysis of whether or not a tenancy in common is in effect a partnership. Some tax counsel have taken the position that the existence of such a waiver would automatically cause the Service to treat a tenancy in common as a partnership in any Section 1031 exchange that it chose to review. Although this view has not been shared by all practitioners and is not required by any controlling legal authority, it is strongly supported by the New Guidelines.[16] Under the New Guidelines, in general, each TIC must have the right to transfer, encumber and partition its interest in the property without the prior approval of any other person. Restrictions upon such rights required by a lender that are consistent with customary commercial lending practices are permissible. Rights of first offer in the case of desired transfer and an agreement by a TIC that it will offer its undivided interest in the property to the other TICs at fair market value before seeking partition are also permissible.[17] In light of these provisions, lenders can expect more borrowers and their tax counsel to refuse to grant outright waivers of the right of partition. Such a refusal is not necessarily the death of the loan transaction.

Alternative Approach

The right of partition is similar in many ways to a right of alienation (particularly in the commercial real estate context where actual, physical partition is extremely unlikely). Generally rights of alienation or transfer are not waived by borrowers, but restricted under the loan documents. The right of partition can be similarly

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treated. A covenant can be added to the mortgage or loan agreement that no TIC will commence or prosecute any partition action. The filing of any such action should be made an immediate event of default. Any TIC that commences a partition action and its guarantor should be made personally liable for the whole loan or at least made liable to the same extent as it would be for violating any transfer restriction. These loan document provisions should make partition very unlikely. In addition, lender may require that any TIC that brings a partition action sell its tenancy in common interest to the other TICs at fair market value (perhaps less saved selling and closing costs). Further, lender may require that borrower sponsor or its SPE nominee purchase any partitioning TIC's tenancy in common interest that is not purchased by the other TICs. Lender may consider making such purchase obligation personally recourse to the borrower sponsor. With the exception of such personal recourse, these purchase rights and obligations are frequently desired by borrower sponsors and the TICs themselves.

Often borrowers' counsel will request that if such a buy-out is accomplished, then the event of default triggered by the partition shall be deemed cured and the personal liability of the partitioning TIC and its guarantor released. This deemed cure is generally acceptable provided that:

- such partitioning TIC and its guarantor remain personally liable for the payment of all costs and losses, including reasonable attorneys' fees, incurred by lender as a result of the partition action,
- there are no other existing events of default,
- the cure is effected within a specified time period (e.g., 60 days),
- the partition action is dismissed by a final, unappealable court order within such specified cure period,
- prior to the completion of the cure, lender shall be free to exercise any and all remedies with respect to such event of default, and
- borrower's cure right shall end at any time that, as a result of the exercise of any such rights or remedies or otherwise, lender acquires title to the property.

The foregoing alternative does not guaranty that a partition action will never be filed, but does significantly reduce the likelihood of such a filing. Under such a structure, the risk of partition is no more likely than a voluntary bankruptcy or prohibited transfer. The alternative structure also provides lender with what appear to be adequate remedies in the event that a partition filing does occur. Although the foregoing alternative has been used in some transactions intended for securitization, it is not entirely clear that it will be accepted by the rating agencies in the large loan context. In light of the New Guidelines, however, lenders may find that most borrowers are unwilling to provide the traditional waiver and the foregoing or some other alternative will need to be employed to close loans to TIC Section 1031 exchange participants.

Passive Ownership or Centralized Management Issues

By its nature a tenancy in common involves multiple parties with rights in a property. If each such party attempted to actively manage the property, chaos or paralysis would likely result. Day to day management needs to be centralized. This is generally provided for in a tenancy in common agreement or a property management agreement. Typically the TICs will appoint a party related to the borrower sponsor as the property manager. Often this property manager has had the express right to appoint a third party, professional property manager as a sub-property manager. Although not entirely clear, under the New Guidelines, the hiring of a sub-property manager may require the unanimous consent of all of the TICs.

Section 1031 Issue; and Lender Requirements

From the lender's perspective, the more centralized the management the better. The less parties that lender must deal with in connection with the transaction, the easier and quicker for it to obtain results. However, management that is overly centralized begins to look like a partnership. Additionally, the Service is likely to find a partnership if the property manager provides services to the tenants other than the maintenance and operation of the property.[18] Therefore, most tenant in common borrowers insist that the TICs maintain authority over major decisions concerning the property or the loan. Such decisions often include whether or not to amend the loan, whether or not to sell the property or whether or not to make a significant improvement to the property. Compliance with the New Guidelines would require unanimous consent of all of the TICs to the appointment of a property manager for the property, any sale of the property, the granting of a mortgage upon the property or the lease of all or a portion of the property. The New Guidelines permit other decisions requiring the approval of the TICs to be made by majority vote.[19] Even with the New Guidelines, various tax counsel will differ as to how much delegation is too much in any case, but lender should require that day to day management of the property, including at least the management of the operating accounts, maintenance of books and records of account, and ordinary course interaction with lender, including specifically the making of reserve draw requests and application of the proceeds thereof, be delegated to the property manager. Such a level of delegation appears to be consistent with the New Guidelines, although the

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New Guidelines do not address the issue of reserve draws specifically. Typically it has been recommended that each TIC appoint the property manager as its agent and attorney in fact with respect to the delegated areas of responsibility. The New Guidelines, however, do not permit global powers of attorney. Specific powers of attorney are permitted and it may be possible, for example, for the TICs to grant property manager a power of attorney for making all reserve draw requests under the loan documents within certain specified parameters.[20]

Probably the greatest source of concern under the New Guidlines for capital markets lenders are the above described limitations on the delegable powers of the TICs as they relate to leasing. Requiring each TIC to approve every lease, particularly if there are more than a couple of TICs or if the property generates frequent leasing activity in the event that a TIC disagrees with a provision of a lease or its signature cannot for some other reason be obtained. This risk is generally not acceptable to lenders.

While a literal reading of the New Guidlines might require each TIC to physically sign each individual lease, a broader view would seem to allow the TICs to unanimously approve at the outset of a transaction: (a) leasing guidelines set forth in the property management agreement, and (b) a form of approved lease. The authority to enter into leases on the approved form and only in accordance with such leasing guidlines would then be granted to property manager, together with a power of attorney specifically limited to executing qualifying leases. Alternatively, or in addition, leasing and other key management decisions could be an event of default and would trigger personal recourse to the objecting TIC.

Typically, the TICs do not want to be hands on managers and the issues that arise with respect to the delegation of management are tax driven.

Often the tax lawyer for the TICs has required that each TIC or some percentage of them acting in concert maintain the right to replace the property manager. Generally lenders require that any replacement of the property manager requires lender's consent under the loan documents. Because chaos or paralysis are likely results if individual TICs appoint different property managers or become self managers, a lender should consider imposing personal liability upon any TIC that replaces the property manager or votes to do so without lender's consent. Under the New Guidelines, removal of the property manager may require unanimous action by the TICs. If this provision is in place, then the risk of removal of the property manager without lender consent is no greater and may be less than under a non-tenancy in common loan. Under the New Guidelines, property management agreements are to be renewable at least annually. Such a renewal feature may increase the risk of replacement without lender consent. One way for a lender to protect against this would be to require that the management agreement renew automatically each year unless terminated, and to prohibit non-renewal without lender's prior consent in the loan documents. Regardless of the ultimate appointment and removal rights of the TICs, in all cases, the property management agreement should be subject to lender's standard form of subordination of management agreement.

Qualified Sub-Property Manager

To try to ensure the smooth operation of the property, lenders should consider requiring the sub-property manager to be a Qualifying Manager" as defined by the rating agencies. The sub-property manager and any management agreement executed by it should be subject to the same approval rights as the lender typically reserves in non-tenancy in common loans of similar size. The sub-property manager should execute lender's standard form of subordination of management agreement.

Lockbox

In addition to qualified management, lenders should consider requiring an hard lockbox. Many tenancy in common transactions provide for a fixed or guaranteed return to the TICs. As a preliminary matter, any such return should be limited in the tenancy in common agreement or other governing agreement to cash flow available after the payment of all amounts due to lender, including debt service and reserve deposits, and after the payment of all operating expenses. An hard lockbox helps to control against the temptation to divert funds from operating expenses to TIC distributions. If an hard lockbox is not obtainable, then a soft lockbox is recommended. In addition to protecting against cash leakage, a lockbox ensures that the rents are centrally collected and are subject to the exclusive control of lender and the designated property manager, and not the various TICs.

Centralized Notice

The loan documents should allow lender to provide notice to any and all TICs by a single notice addressed to all of the affected TICs at one centralized address. Providing notices to the various TICs at multiple addresses with copies to multiple attorneys creates too many opportunities for error, and a single centralized notice provision is a practical necessity.

Caveat

One cautionary note. None of the foregoing will prevent a lender from having to deal with multiple borrowers in the event of a serious problem with the loan. This means that any work-out is potentially more difficult and costly, because the individual TICs may have differing views on how best to proceed. One somewhat

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aggressive approach to ameliorate this risk is to make any TIC that contests a foreclosure or other enforcement action personally liable, together with its guarantor, for all of lender's enforcement costs, including attorneys' fees.

Tenancy in Common Document Issues

The tenancy in common and property management agreements contain the business deal among the various TICs and between the TICs and the property manager, respectively. The two agreement structure and the affiliated property manager construct itself serve both business and tax functions, and are widely used. There is no required form of either such agreement. To ensure that any good faith purchaser for value of any TIC's interest in the property will be bound by the tenancy in common agreement, such agreement or a memorandum thereof should be recorded on the land records and should meet any formal requirements of applicable state law for creating interests in, or covenants running with, the land. The property management agreement or a memorandum thereof is also sometimes recorded. These documents should be recorded after the mortgage.

The tenancy in common agreement and the property management agreement typically create various rights in favor of the parties, including rights of first refusal or similar rights applicable whenever any TIC desires to sell its tenancy in common interest. These documents and the rights of the TICs thereunder should be pledged and assigned to lender. Generally the assignments by the TICs can easily be incorporated into the mortgage. The mortgage should also expressly include all of the TICs' tenancy in common interests within the definition of "mortgaged property."

Rights, Remedies and Indemnities

Tenancy in common agreements and property management agreements generally include rights and remedies for breach and also typically include various cross indemnities. These indemnities are often somewhat broader than those found in third party property management agreements or in organizational documents (to which the tenancy in common agreement is somewhat analogous).

Technically these indemnities represent other obligations or contingent indebtedness of the borrower (because each TIC is a borrower), which are restricted by the SPE requirements. The exercise of remedies by one TIC against another or by the property manager against the TICs could result in a judgment lien on any TIC's interest in the property. On the other hand, these rights and indemnities are important to the TICs and the property manager, and retaining the same will almost certainly be a deal point for them. Subject to the lender protections described below, to the extent that such rights, remedies and indemnities are similar to those found in third party property management agreements or organizational documents, or relate to the TICs as co-owners of the property or to the property manager in its capacity as such, such rights, remedies and indemnities seem to be appropriate to the deal structure, are generally acceptable to lenders and should be acceptable to the rating agencies.

Lender Protections

The first lender protection with respect to such rights, remedies and indemnities is that each TIC and the property manager should waive for the term of the loan any and all lien rights it may have against the property or the interests of any TIC. Beyond that, the TICs and the property manager should subordinate their respective rights, remedies and indemnities to the loan, and generally agree to stand still from enforcing the same while the loan is outstanding. Typically a provision tolling applicable statutes of limitation is included so that the parties can preserve their rights until after the loan is repaid. Additionally, amounts due to the TICs as a return on their investment or to the property manager as fees should be payable only to the extent of available cash flow and should be expressly subject and subordinate to the loan. A carve-out is often provided for the payment out of operating expense funds to property manager of up to a market rate property management fee, but only to the extent that property manager is obligated to pay such a fee to a third party sub-property manager.

The tenancy in common agreement often contains rights of first refusal (although such rights, as opposed to rights of first offer, are not expressly sanctioned by the New Guidelines), rights of acquisition (upon the filing of a partition action for example) and similar rights. These rights, and transfer rights generally, should be made expressly subject and subordinate to the loan documents. Additionally, the TICs should expressly agree that any tenancy in common interest acquired by any of them pursuant to the exercise of any such rights shall be subject to and encumbered by the loan documents.

The subordination provisions, lien waivers and delegation to property manager of day to day management of the property and ordinary course interaction with the lender are generally included in the tenancy in common and property management agreements themselves, rather than in separate agreements. Lender should be made an express third party beneficiary of these provisions with a right to enforce the same, because they benefit lender. The loan documents should prohibit the amendment of the tenancy in common agreement or the property management agreement without lender's consent. Failure to comply with these agreements should be an event of default under the loan documents. Finally, these agreements are important to the lender and should be covered by the enforceability opinion delivered at closing.

Additional Structuring Issues

There are two basic sets of circumstances under which borrowers bring tenancy in common transactions to capital market lenders. One typical set of circumstances involves a limited number of investors. Several of them may form a limited partnership or a limited liability company. One of the investors desires to acquire its interest using a Section 1031 exchange and the other investors are willing to cooperate. Under this scenario, there are often only two tenants in common. Often the documents between the parties allow one or the other of them to collapse the tenant in common structure upon the expiration of some minimum holding period. Generally, these transactions are easier and less time consuming to bring to closure than syndicated transactions, because there are less parties involved and the investors typically have a fair amount of flexibility with respect to the terms of the tenancy in common relationship.

Syndicated Transactions

The second basic set of circumstances is where a sponsoring entity acts as a syndicator. The sponsoring entity identifies the property and prepares a private offering circular offering tenancy in common interests to accredited investors within the meaning of federal and applicable state securities laws. These transactions typically involve a relatively large number of TICs who have no relationship among themselves or with the sponsoring entity outside of the tenancy in common documents. These deals are generally more time consuming and labor intensive and give rise to some additional considerations.

Maximum Number of TICs and Sponsor TIC Ownership Interest

Although more typically an issue in syndicated deals, in any tenancy in common transaction, lender should consider the number of TICs that will be permitted. Too many TICs may cause the Service to treat the tenancy in common as a partnership. The New Guidelines limit the maximum number to 35 (although husbands and wives count as one).[21] Tax compliance is not the lender's issue. The more TICs the more unwieldy the transaction becomes and the more pronounced the multiple borrower issues become. A reasonable cap on the number of TICs would appear to be between 10 and 12, but this is an underwriting issue for lender to determine.

A related consideration is the level of ownership, if any, that will be required of the borrower sponsor's TIC and whether or not lender will permit any other TIC to have a greater interest. These determinations will generally be functions of the facts of the transaction. At least some of the national tenancy in common sponsors do not like to retain any equity in their deals. From the lender's perspective this may be acceptable on lower leverage loans where lender is very comfortable with the real estate. In such a structure, the importance of underwriting all of the TICs is magnified. Such a structure would not seem to be appropriate where lender is relying upon the reputation or expertise of the borrower sponsor and where the real estate fundamentals are not quite so good. In these situations, lenders may require the borrower sponsor to participate in the deal on an equity basis (as opposed to merely as a property manager) and may want to provide that no other TIC has an economic interest greater than that of the borrower sponsor's TIC. These restrictions provide some assurance to lender that borrower sponsor shall remain interested and in control of the transaction.

New TICs

Whether the maximum number of TICs to be permitted is ten or some other number, fairly often in syndicated transactions the sponsoring entity will not have all of the TIC investors in place by closing. As a result, the sponsor will require some period of time (e.g., 90 days) from after the closing during which transfers of tenant in common interests by the sponsor's TIC to new TICs are permitted. To avoid dealing with a new party not familiar with the structure and possibly having to obtain rating agency confirmation of no downgrade, qualification or withdrawal in connection with any such transfer, sponsors often request that lender agree to hold and not securitize the loan during the transfer window. The foregoing transfer right is a often a major issue for the sponsor and may have to be accepted by lender in order to obtain the deal.

Such a transfer right can be effected as an exception under the loan documents to lender's transfer restrictions. Such an exception could provide that lender would not withhold its consent to a transfer of a tenancy in common interest by the sponsor's TIC to a new TIC, provided that:

- the new TIC's key principals satisfy lender's underwriting requirements for TICs (borrower may request that these requirements be specified in the loan documents),
- the new TIC satisfies lender's SPE requirements,
- the transfer to the new TIC will not result in a violation of any restrictions imposed by lender as to the maximum number of TICs or the minimum amount of tenancy in common interest to be retained by the sponsor's TIC,
- the new TIC joins in the execution of the loan documents or assumes the same under an assumption agreement acceptable to lender,
- the new TIC joins in the execution of the tenancy in common agreement and the property management agreement or assumes the same under an assumption agreement acceptable to lender,

- lender receives all requisite legal opinions (e.g., enforceability, and if required, Delaware single member and non-consolidation),
- lender receives a date down endorsement identifying new TIC as one of the tenant in common owners of the property and reflecting new TIC's assumption of the mortgage on a joint and several basis,
- all of lender's fees and costs, including legal fees, are paid (an assumption fee may also be imposed, although this may be resisted by borrower sponsor), and
- the transfer is completed within the specified period (e.g., 90 days) after closing.

Securities Caveat

Regardless of whether all of the TICs in a syndicate style transaction are admitted before closing, the nature of these transactions and the way that they are marketed pose some additional concerns for lenders. The sponsor essentially offers the tenancy in common interests to accredited investors as privately placed securities. Whether or not TIC interests technically constitute securities is not addressed here and is not necessarily a concern for the lender. Lender should, however, review the offering materials and ensure that they do not identify the lender. Although not desirable, if sponsor has already identified lender as a potential lender in the offering circular, lender can probably accept this, provided that no assurances are made in the offering materials that a loan will be made, and that such materials do not describe any contemplated loan term inaccurately or in any manner that is misleading. Although lender should avoid providing any securities law advice whatsoever to borrower, it should identify for borrower any material factual inaccuracies that it might note in the offering materials. Failure by borrower to correct such inaccuracies by a supplement to the offering circular (without being asked to do so by lender), should give the lender pause.

Despite a hands off approach, there is always some risk that a disgruntled investor searching for a deep pocket will name lender in a suit should its investment go awry. To provide itself with some protection against this possibility, lender should obtain a representation and covenant in the loan documents that no securities laws have been or shall be violated in connection with the offering of the tenancy in common interests and that all offering materials are accurate and do not omit any material information. Violation of the representation or the covenant should be an event of default and should be personally recourse to the borrower sponsor. Lender should also verify that the general indemnity provided to it under the loan documents is broad enough to cover any such claims.

Delaware Business Trusts

It is worth noting that some tenancy in common syndicators are exploring using Delaware business trusts in lieu of tenancies in common to acquire commercial real estate on behalf of multiple Section 1031 exchange investors. These structures have their own issues and uncertainties, including uncertainty with respect to tax deferred treatment. If such structures work, they may well provide a cleaner alternative to the tenancy in common structure and lenders should keep attuned for further developments in this market.

Unsettled Tax Status

Although the New Guidelines provide some guidance as to transaction structures that will be acceptable to the Service, the New Guidelines are not talisman and do not address all of the potential issues that could affect the ability of the exchange transaction to qualify for gain recognition deferral under Section 1031. If the Service elects to review any Section 1031 exchange involving tenancy in common interests that it has not blessed in advance by private letter ruling or otherwise under the New Guidelines, and determines that the underlying tenancy in common is a partnership for tax purposes, then the full amount of any capital gain that existed on the relinquished property would be recognized. The sole member of the TIC owning such tenancy in common interests would be liable for such tax. Structuring by borrowers to avoid such a result should become easier over time as the standards and acceptability of various structures are clarified through private letter rulings requested in connection with actual transactions. Although understanding the TIC borrower's tax needs is valuable to a lender in negotiating the loan structure and documentation, the tax issues raised by Section 1031 exchanges involving tenancies in common are for borrower to determine, and lender and its counsel should be careful not to offer any tax advice to borrower.

In the event that tax liability is imposed upon a TIC's sole member, the SPE structure of the TIC should protect lender. Liability for the tax would rest with the TIC owner and not the TIC itself, because the TIC owner (and not the TIC) had the gain on the relinquished property. Any tax lien that may arise due to non-payment of any such tax liability would encumber the TIC owner's membership interest in the TIC and should not attach to the TIC's interest in the real estate. Even so, any event imposing significant tax liability upon the owners of one or more TIC borrowers will stress the structure and increase the likelihood of default. This tax risk should be taken into consideration by lenders when underwriting proposed tenancy in common transactions.

Conclusion

There are a fair number of Section 1031 tenancy in common transactions in the market, and the numbers appear to be growing. Although these transactions

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present some additional risks for capital market lenders, most can be eliminated or ameliorated with sound structuring.

[1] If the parties do not take title in specific percentage interests, it is presumed that each party has an equal TIC interest. See 20 Am. Jur. 2d Cotenancy and Joint Ownership § 127 (1995).

[2] See 20 Am. Jur. 2d Cotenancy and Joint Ownership §§ 31, 41, 42 (1995). One cotenant may not, however bind cotenants to a contract without the authority of other cotenants. See id. §§ 101-105.

[3] See generally 59A Am. Jur. 2d Partition § 86 (1987).

[4] See 59A Am. Jur. 2d Partition § 8 (1987).

[5] See 26 U.S.C. § 1031(a) (Supp. 2002).

[6] The term "exchange" may conjure images of two property owners swapping deeds and keys. The majority of Section 1031 exchange transactions are done through a "qualified intermediary" (a "QI"). The relinquished property is sold with the sales proceeds being paid directly to the QI. The QI uses those proceeds to acquire the exchange property for the exchanger (the seller of the relinquished property). The exchange may be simultaneous or deferred. In a deferred exchange, the QI holds the proceeds of the sale of the relinquished property until the exchange property is identified and purchased. The exchanger has 45 days from the sale of the relinquished property to identify the exchange property and up to 180 days from such sale to close upon the purchase of the exchange property.

[7] Rev. Proc. 2002-22, published on March 19, 2002.

[8] See Rev. Proc. 2002-22 § 6.09. Typically the tenancy in common agreement will provide for proportional liability among the TICs. All TICs are borrowers under the loan documents, however, and with respect to lender are jointly and severally liable on a non-recourse basis. This dichotomy is customary. Although not entirely free from doubt, it should not be construed as non-compliant with the New Guidelines, at least in the context of non-recourse debt.

[9] See 11 U.S.C. § 363 (h),(i),(j) (1993).

[10] See Business Entities; Defined 26 C.F.R. § 301.7701-2 (2001).

[11] 59A Am. Jur. 2d Partition § 4 (1987).

[12] 59A Am. Jur. 2d Partition § 113 (1987).

[13] 59A Am. Jur. 2d § 62 (1987).

[14] See Rev. Proc. 00-46, 2000-44 I.R.B. 438; Rev. Proc. 01-3, 2001-1. I.R.B. III; Rev. Proc. 02-3, 2002-1 I.R.B. 117.

[15] Rev. Proc. 2002-22 §§ 3 and 4.

[16] See Commissioner v. Culbertson, 337 U.S. 733 (1949); Tech. Adv. Mem. 78-32-007 (Apr. 29, 1978); Rev. Proc. 2002-22 § 6.06.

[17] Rev. Proc. 2002-22 § 6.06.

[18] At some point, it begins to look more like a "trade, business, or venture" where the investors are merely dividing the profits, which, under tax law, creates a partnership. See, Classification of Organizations for Federal Tax Purposes, 26 C.F.R. § 301.7701-1(a)(2). See also Rev. Rule 75-374, 1975-2 C.B. 261; Priv. Ltr. Rul. 81-17-040 (Jan. 27, 1981).

[19] Rev. Proc. 2002-22 § 6.05.

[20] See Rev. Proc. 2002-22 § 6.05. Although the Revenue Procedure appears to require the approval of each TIC to every individual lease, it may be permissible where the asset will have continuing, relatively uniform leasing activity (e.g., in the case of multi-family housing) for the TICs to grant the property manager authority to enter into leases on approved forms and on terms consistent with approved guidelines. Whether the Revenue Procedure will be interpreted broadly or narrowly in this regard will be determined as requests for individual rulings are made.

[21] Rev. Proc. 2002-22 § 6.02. See Terence Floyd Cuff, Creative Tax Planning for Real Estate Transactions; Everything You Wanted to Know About Like-Kind Exchanges-Year 2001 Developments, SG034 ALI-ABA 507, 518-22 (2001).

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