

# Lending to TIC Owners - the Trends, the Risks, the Rewards

## OVERVIEW

1. What is TIC ownership?
2. Why do owners choose TIC ownership, especially in multifamily housing?
3. The basics of 1031 tax-deferred exchanges.
4. What are the historic risks to Lenders from TIC Borrowers?
5. Why should Lenders today look to integrate TIC properties into their portfolios?
6. Minimizing Lender risks with a TIC Borrower structure.
7. Questions.

### Presented by:

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## 1. What is TIC ownership?

Tenancy-in-common, or TIC, ownership is shared ownership of all rights and liabilities related to the ownership of property. It has the following characteristics:

- a. There is no limit to the number of potential TIC owners.
- b. Each TIC owner holds an undivided interest in the whole property.
- c. Each TIC owner is entitled to shared possession of the entire property with all other TIC owners.
- d. Each TIC owner has the right to access a proportionate share of the rents and profits of the property.
- e. Each TIC owner has the right to transfer its interest without the consent of other TIC owners.
- f. Each TIC owner has the right to demand a judicial partition, or division, of the property (either by a division in kind, if the property can be easily divided, or a forced sale of the property with division of the proceeds).
- g. As long as the owners adhere to particular IRS rules, a TIC is **not a partnership.**

**2. Why do owners choose TIC ownership, especially in multifamily housing?**

TIC ownership allows investors to enter much higher priced markets than were available to them as individual investors, while still taking advantage of 1031 Exchange tax deferral.

**Example:**

a. Mr. Able-Taxpayer:

- owns a farm held for investment, currently valued at \$1M.
- intends to sell the farm in a 1031 Exchange in order to defer the tax he owes on the increased value of the farm.
- plans to purchase a new multifamily investment property.
- seeks a mortgage at 80% LTV to purchase the multifamily investment property.
- as a sole owner, must limit his search to properties with an appraisal value at or under \$5M ( $\$1M / 20\% = \$5M$ ).

b. If Mr. A purchases a property as a TIC owner with only one other investor seeking a property exchange, and they invest equally in the property, Mr. A expands his search opportunities to properties with an appraisal value at or under \$10M.

c. Mr. A is able to expand his search criteria by \$5M for every fellow TIC investor he is able to bring on board for this investment project, and none of the investors will pay taxes on the gains from the sale of their existing properties if they each invest all of the \$1M they receive from the sale of the first property into the purchase of the new multifamily property as TIC owners (within the prescribed time periods and rules of Section 1031).

d. Therefore, the TIC ownership structure allows Mr. A and his fellow investors to significantly increase the leverage of their interests and expands the types and price ranges of real property in which they might invest.

### 3. The basics of 1031 tax-deferred exchanges.

(a) Section 1031(a) provides for the *non-recognition* of gain or loss from a property if the taxpayer engages in a *like-kind exchange* of property: land can be exchanged for land.

(i) Both the *relinquished property* and the *replacement property* must be used in a trade or business, or as an investment (multifamily properties almost always fall into one of these categories).

(ii) An interest in a partnership is not of *like-kind* with any other property, but generally any investment or trade or business real estate can be exchanged for any other investment or trade or business real estate.

(iii) In 2002, the IRS issued a Revenue Procedure (Rev. Proc. 2002-22) that clarifies how a TIC ownership of a property can avoid being classified as a partnership and how the owners can take advantage of Section 1031 Exchanges.

(iv) Up to 35 TIC co-owners of one property are permitted under Section 1031 (this limitation bumps up against securities law).

(b) Basic steps for a 1031 Exchange:

(i) Party owning a *relinquished property* adds language to its sale agreement that allows the sale to happen as a 1031 Exchange.

(ii) At the closing of the *relinquished property*, the buyer of the *relinquished property* and a “qualified intermediary” (often a title company, but other companies can serve as qualified intermediaries) enter into an exchange agreement.

(iii) The exchange agreement:

(1) sets up the exchange on paper;

(2) indemnifies the buyer of the relinquished property from liability for participating in the exchange; and

(3) causes the qualified intermediary to hold the net sale proceeds from the sale until the purchase of the *replacement property*. This prevents the seller from receiving cash for real estate, which would void the tax deferral. Instead, through the use of the qualified intermediary, the seller receives real estate for real estate.

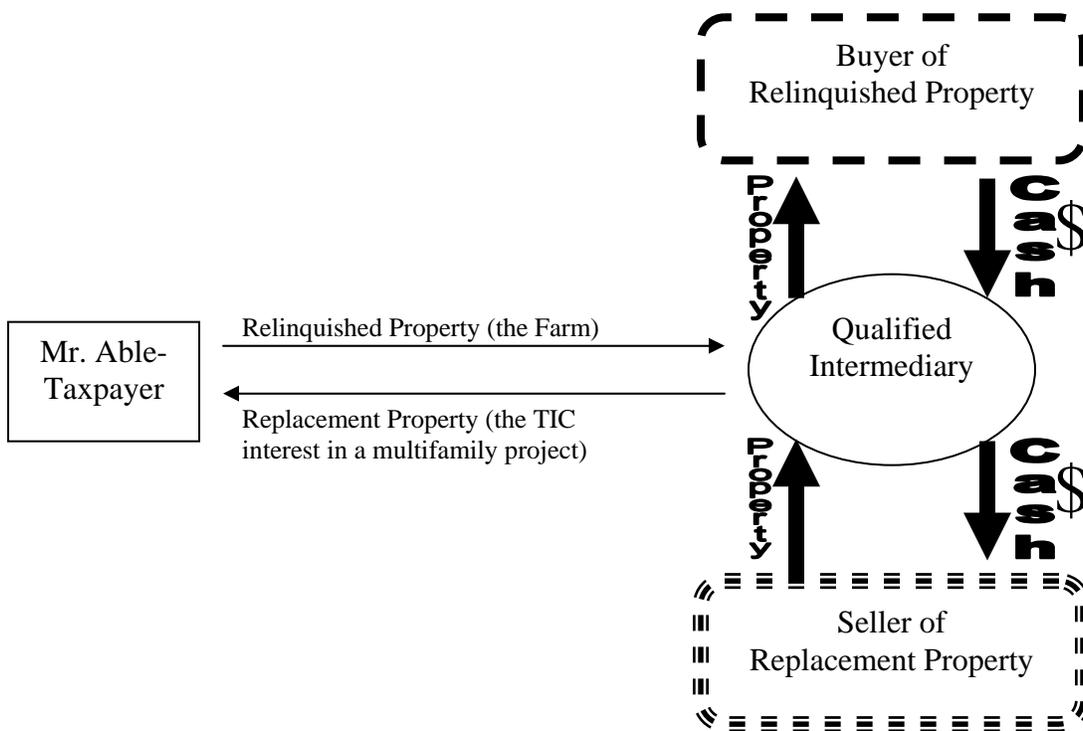
(iv) Within 45 days of the closing of the *relinquished property*, the exchanger (the seller) must provide the qualified intermediary with notice identifying the property the exchanger wants to use as the replacement property. **TIMING ISSUE**

(v) The closing on the *replacement property* must be completed within 180 days of the sale of the *relinquished property*. **TIMING ISSUE**

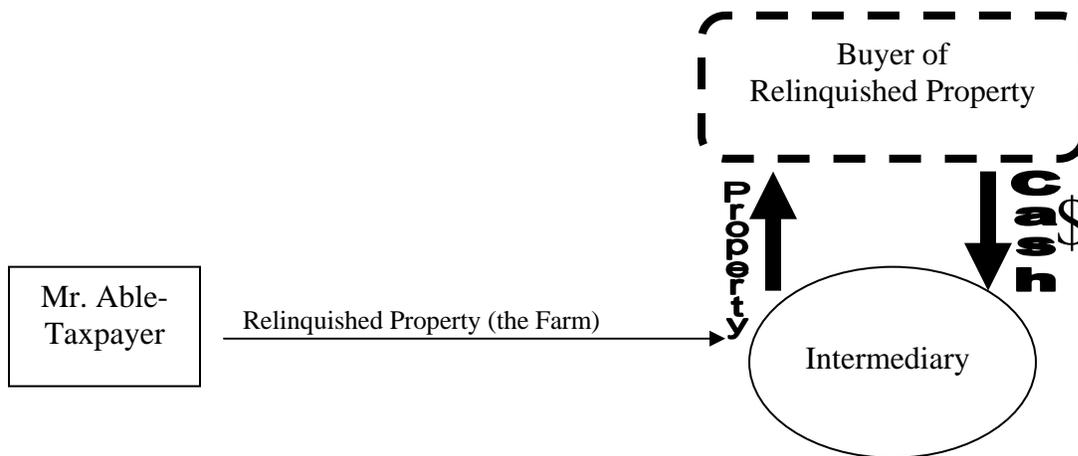
(vi) Part of the exchange agreement with the qualified intermediary has a “direct deeding” clause that allows the sellers and buyers to omit the qualified intermediary from the chain of title. The qualified intermediary operates as a necessary straw man in this process, so that the *relinquished property* is conceptually *exchanged* for the *replacement property* and thus falls under Section 1031, and no tax is paid on any capital gain on the property sold.

**A Simultaneous Exchange with Intermediary**

**(Mr. Able-Taxpayer exchanges his Farm for TIC interest in a Multifamily Project)**

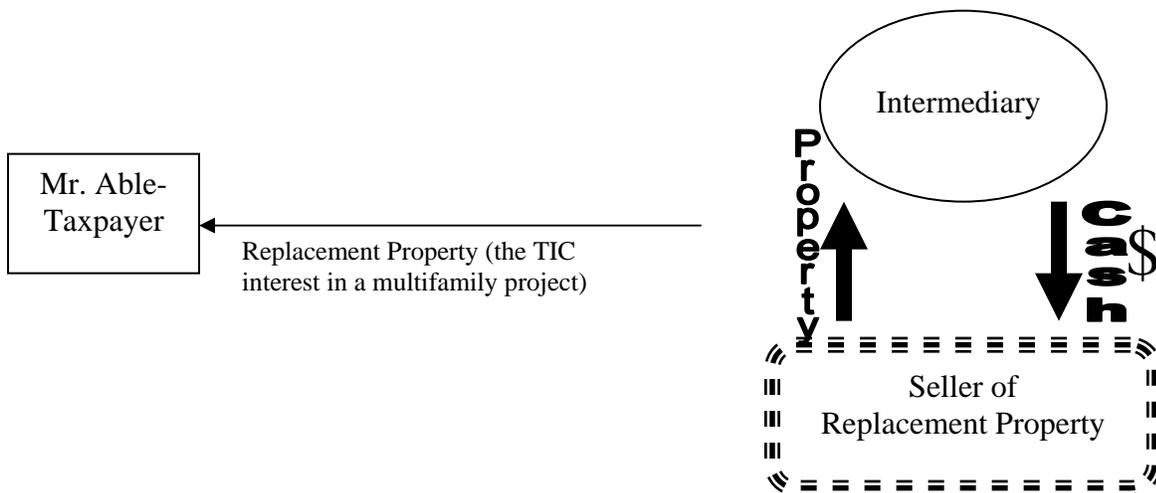


**A Deferred Exchange with Intermediary**  
**(Mr. Able-Taxpayer exchanges his Farm for TIC interest in a Multifamily Project)**



**NOTE:**  
Mr. A must identify the Replacement Multifamily TIC Property within 45 days of the sale of his Relinquished Farm, or Mr. A loses the benefit of the 1031 Exchange.

**NOTE:**  
There can be no more than 180 days between the first and second parts of this Exchange (including the 45 days for identification of the replacement property), or Mr. A loses his Section 1031 tax-deferred benefits and has to pay taxes on his Farm.



**4. What are the historic risks to Lenders from TIC Borrowers?**

- (a) **Bankruptcy.** Bankruptcy by one TIC owner can imperil the security interest. Because the TIC owner holds an undivided interest in the property, his creditors can levy directly against the real property, even though it is owned by other TIC owners as well.
- (b) **Death.** Death of one TIC owner can imperil the security interest.
- (c) **Right of Management.** The right of all TIC owners to manage the property can disrupt effective management of the security interest (if multifamily property or other business property). One of the TIC requirements to prevent it from being treated as a limited partnership is that all the tenants in common have equal management rights.
- (d) **Partition and Sale.** Forced partition and judicial sale of the property can imperil the security interest.
- (e) **Divergent Interests.** Differing interests and goals of multiple borrowers can imperil the security interest.
- (f) **Inadequate Maintenance.** Shortfalls in funding to maintain property due to failed capital calls can imperil the security interest.

**5. Why should Lenders today look to integrate TIC properties into their portfolios?**

- (a) In 2004, the amount of equity raised for TIC investments in real property totaled approximately \$1.7 billion (more than doubling the 2003 total).<sup>1</sup>
- (b) 2005 saw approximately \$3.2 billion in TIC equity investments, again, nearly doubling the prior year's total.<sup>2</sup>
- (c) The reported 2006 numbers show a slight slow-down in the growth of TIC equity investments, but at \$3.5 billion, the industry is still posting strong annual numbers.<sup>3</sup>
- (d) Even presuming the moderation in the trend continues, leverage of 80% on top of such equity investments creates a mortgage opportunity that is conservatively in excess of \$300 billion.<sup>4</sup>

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<sup>1</sup> Fass, Peter M., *Tenancies-in-Common Interests and § 1031: Part 1*, 235 NYLJ 3, 3 February 2006.

<sup>2</sup> Rosta, Paul, *Shakeout City, Reformation Awaits Maturing Tenant-In-Common Industry*, Commercial Property News, April 1, 2007, page 20 (based on reports from Omni Brokerage, Inc.).

<sup>3</sup> Id.

<sup>4</sup> Calculated using a projected \$4 billion in TIC investments for 2007.

**6. Minimizing Lender risks with a TIC Borrower structure.**

(a) **Risk--Overvaluation of Underlying Real Estate.** With the explosion of 1031 Exchanges and the 2002 Revenue Procedure's blessing on TIC participation in the exchanges, there is a market incentive for TIC owners to pay excess of market value for a property because there is a tax advantage component to the price.

**Minimize**--vigilantly value properties that secure a loan to a TIC.

(b) **Risk--Lack of Structure in TIC Owners' Relationship.**

**Minimize**--require all TIC Borrowers to enter into a TIC Agreement (also called a Co-Ownership Agreement), if they have not already done so, in order to establish operating provisions between the TIC owners that will provide predictability of actions for Lender. Among Some important issues the TIC Agreement should address include:

- (1) an election by TIC owners not to be treated as a partnership under the Tax Code in each TIC owner's individual tax return and an indemnity for other TIC owners if any owner fails to so elect;
- (2) agreement that no TIC owner is authorized to act as an agent for, or on behalf of, any other TIC owner or the TIC as a whole;
- (3) agreement by all TIC owners to adhere to the covenants of the agreement, including the execution of necessary documents, payment of each owner's pro rata share of expenses, contributions for recourse payments on any recourse mortgage loan, satisfaction of all cash calls needed by the project;
- (4) agreement by all TIC owners to joint and several liability for all loan obligations; and
- (5) statement that all income, losses, costs, and expenses will be shared proportionally among TIC owners.

(c) **Risk--Forced Sale of Property Due to TIC Owner Partition.** State law grants TIC owners the right to partition the TIC property. Most often, property cannot be physically divided among TIC owners, so a forced sale and division of the proceeds results.

**Minimize**--require TIC owners to execute a waiver of their partition right in *both* the Loan Agreement and the TIC Agreement. This is consistent with 1031 Exchange requirements, so long it is a Lender requirement and it is consistent with customary lending practices.

**Protect**--make the act of any TIC owner filing a petition for partition an Event of Default.

**Protect**--ensure that the TIC Agreement between the owners contains a built-in first right of offer as between TIC owners to prevent partition.

**Protect**--if the loan is non-recourse, require a non-recourse carve-out for the violation of a covenant not to seek partition.

(d) **Risk--Multiple and Serial Bankruptcy Filings.** Since each TIC owner owns an undivided interest in the real estate, each TIC has the ability to file for bankruptcy protection, which could interfere with Lender foreclosure actions. Also, TIC owners can, in theory, schedule serial bankruptcy filings to interfere with Lender's access to the property.

**Minimize**--individually underwrite each TIC owner.

**Protect**--require that each TIC be a bankruptcy-remote entity (Example: Mr. Able-Taxpayer can still qualify for Section 1031 Exchange tax deferral if he sells the farm that was held in his name, but takes title to the new TIC interest in the replacement multifamily property as the sole member of a bankruptcy-remote limited liability company that is a disregarded entity for federal tax purposes).

**Protect**--if the loan is non-recourse, require a non-recourse carve-out for any losses resulting from the bankruptcy of any TIC owner.

**Protect**--if the loan is non-recourse, non-recourse carve-outs should be guaranteed by all TIC owners, as well as by any applicable project sponsor.

**Note**--serial bankruptcy filings are a remote and theoretical risk; for an excellent discussion on the bankruptcy risks associated with tenant-in-common ownership, I recommend David R. Kuney's paper on the topic, *Tenants-in-Common in Commercial Real Estate Transactions: Assessing the Bankruptcy Risks*.

(e) **Risk--Lack of Centralized Management.** Under state law, each TIC owner has the right to occupy and manage the property, which could create inconsistencies in management and cause a disruption of cash flow from the property.

**Minimize**--require an approved management contract be put into place for the project.

**Minimize**--require that the approved management contract renew automatically unless terminated.

**Protect**--limit the TIC owners' abilities to change management during the term of the loan without Lender's prior consent.

**Protect**--consider the use of a lockbox arrangement for the centralized collection of rent and the payment of expenses (include notice and consent from each TIC owner in the loan documents).

(f) **Risk--Unexpected Capital Calls for the Property.** The TIC structure does not provide a ready means for TIC owners to raise additional capital needed for the operation of a property.

**Minimize**--require the TIC Agreement to address capital call procedures and provide for a right of purchase for any TIC owner who meets the delinquent capital call of another TIC owner.

**Protect**--establish up-front or automatic funding of all reserves to minimize need for capital calls and provide ready access to capital for required projects.

(g) **Risk--Liens Imposed by One TIC Owner Against Another.** A TIC owner may have the right to impose a lien against the interests of another TIC owner that has not performed its obligations under the TIC Agreement or other obligations.

**Minimize**--require TIC owners to covenant that they will not file liens against fellow TIC owners' interests.

**Protect**--make the filing of a lien against another TIC owner's interest that is not released within 30 days (or a similar period) an Event of Default.

(h) **Risk--Enforceability of Required TIC Provisions.** In order to meet Section 1031 requirements, all TICs must exist under applicable state law, so the enforceability of certain risk-minimizing requirements should be opined to by local counsel.

**Minimize**--Require Borrower's counsel to include the following items in his legal opinion in addition to Lender's standard requirements:

- (1) enforceability of the TIC Agreement;
- (2) enforceability of the waiver of partition provisions in the TIC Agreement and the loan documents; and
- (3) enforceability of the waiver of partition in the event of bankruptcy of the prospective partitioning TIC owner.

### **Risk--Additional Underwriting Considerations.**

**Minimize**--your Lender clients should adhere to the following additional underwriting and closing requirements to minimize the risks and challenges associated with lending to TIC owners:

- (1) Perform lien searches for all TIC owners; if the TIC owner is a disregarded entity, perform lien searches on both the entity and the 100% member of the entity;
- (2) Require all TIC owners to execute all loan documents;
- (3) If a TIC Agreement is already in place, require all TICs to amend and restate their TIC Agreement to incorporate the requirements of the loan;
- (4) Establish a manageable limit for the allowable number of TIC owners per project for underwriting and logistical management purposes;
- (5) Require all TIC owners to expressly waive suretyship rights and defenses in both the TIC Agreement and the Loan Agreement; and
- (6) Anticipate and prepare TIC borrowers for higher-than-average legal fees due to the increased due diligence and documentation requirements.

### **7. Questions.**

I welcome your questions and comments. Please email me at [davenportf@ballardspahr.com](mailto:davenportf@ballardspahr.com).

### **8. Thanks.**

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