FRIDAY, MAY 5 1:30 p.m. – 2:30 p.m.

TICS - DO THEY GIVE YOU TICS

PROGRAM CHAIRS:

Norman M. Arnell
Stinson Morrison Hecker LLP, Kansas City, MO

Nancy Leary Haggerty
Michael, Best & Friedrich, LLP, Milwaukee, WI

SPEAKERS:

Norman M. Arnell
Stinson Morrison Hecker LLP, Kansas City, MO

Nancy Leary Haggerty
Michael, Best & Friedrich, LLP, Milwaukee, WI

Todd LaSala
Stinson Morrison Hecker LLP, Kansas City, MO

TICS- DO THEY GIVE YOU TICS?

A NEW USE OF AN OLD CONCEPT

BUT WHAT ARE THE RISKS?

THE ADVANTAGES, THE RISKS AND ALTERNATIVES

ABA REAL PROPERTY, PROBATE AND TRUST LAW SECTION

17TH ANNUAL SYMPOSIA

FRIDAY, MAY 5, 2006

1:30 pm

SAN DIEGO, CA

PRESENTERS

NORMAN ARNELL
and
TODD LASALA
Stinson, Morrison, Hecker, LLP, Kansas City

NANCY LEARY HAGGERTY
Michael, Best & Friedrich, LLP, Milwaukee

I. Introduction.

The formal written materials included below are intended to give you a quick background on real estate tax exchanges allowed under Section 1031 of the Internal Revenue Code ("1031 Exchanges"), and a summary of the advantages and risks of exchanging those real estate interests into "Tenant in Common" or "TIC" interests. In our presentation, this committee will present a typical scenario of the premise identified below, and talk through the considerations involved, from the point of view of the investor, the promoter of the TIC exchange, and the position of the attorney for the investor who is weighing the advantages and risks.

II. The Premise for the Oral Presentation.

Since the middle ages improvement has been the mantra of Western civilization. Transportation, health care, communication and whatever else you might conjure have been improved.

The trend extends to conveyance and investing in real estate. Just 200 years ago, where were the condos, the co-ops, the time-shares.

However, one of the newest trends is an old friend, tenancy-in-common, except not between friends and close associates, but as co-investors in large projects not thought of in medieval England. Overlying this rediscovery is the income tax, driving many to attempt to reinvest, rather than take proceeds of a sale in cash.

This new use of the estate of tenancy-in-common has many added refinements, designed to afford the benefits of direct ownership without being considered a partner or part of some undivided joint ownership estate, which might limit freedom of choice or have unfavorable tax or other consequences.

Let us explore the situation of George Mitchell, a fictional name. George has held some investment property for over ten years and is considering a purchase offer. If the transaction closes he will have a cash profit of about $500,000, and some depreciation recapture taxable as ordinary income. George would like to invest all his proceeds in a larger investment property, without paying taxes and not personally undertaking any significant indebtedness.

George now discovers that inflation in property valuation has made desirable shopping centers, office buildings and other such investment properties very expensive.

Now George hears of John Deal (also fictional) who is promoting investments on a large new shopping center in a desirable location on a concept George is not familiar with. Mr. Deal is seeking multiple owners, each with a comparatively small investment. With a sufficient cash payment down, Mr. Deal believes he can get a loan with no personal responsibility and he is telling his investors that they will each own an undivided portion of the center as a tenant-in-common, with the freedom to deal with their undivided interest as a direct owner. Of course, Mr. Deal will have an interest as tenant-in-common (and future income through Deal Management Company managing the property).

Mr. Mitchell is intrigued by the proposal and contacts his law firm. He wants to know the potential benefits, and burdens, he might encounter in the proposed arrangement.

His firm decides to let two of its members discuss the issue with Mr. Mitchell, each taking one side. For such discussion they may touch upon, but will not deal with, the intricacies of tax law since Mr. Mitchell may want to use some after tax funds if he decides not to sell the property on which he has received a proposal.

III. Background on 1031 Exchanges.

The idea of using the provisions of Section 1031 of the Tax Code to defer capital gains on the sale of long-invested real estate is well established. Frankly, it is so well-established, that many sellers (also called an "Exchanger") of real estate, which is called the "Relinquished Property" in a 1031 Exchange, automatically assumed they should exchange into a new property, called the "Replacement Property" in a 1031 Exchange, without going back to basics to determine whether the situation warrants it.

The procedures and forms for 1031 Exchanges have become simple and streamlined, providers of the exchange services abound, lenders understand the process, and the exchange agreements contain standard indemnities so the fear of risk in the exchange transaction is limited, although such risks are still present.

For those who are not familiar with 1031 Exchanges, a party owning a Relinquished Property, adds language in the sale agreement of that property, allowing the sale to happen as a 1031 Exchange, as long as the buyer of the Relinquished Property is indemnified from liability. At the time of the closing of the sale of the Relinquished Property, that Seller, the Buyer and a "Qualified Intermediary" usually the title company in the transaction, enter into a standard Exchange Agreement, which sets up the "exchange" on paper, indemnifies the Buyer of the Relinquished Property from any liability for participating in the exchange, and causes the Qualified Intermediary to hold the net sale proceeds of the Relinquished Property until the closing of the purchase of the Replacement Property. Within 45 days after the sale of the Relinquished Property, the Seller of that Relinquished Property must notify the Qualified Intermediary of the property that Seller wishes to identify as the intended Replacement Property, and the closing on the purchase of the Replacement Property must be completed within 180 days after the sale of the Relinquished Property. Part of the Exchange Agreement with the Qualified Intermediary contains direction for "direct deeding" so that, notwithstanding the existence of the exchange, the Seller of the Relinquished Property deeds the Relinquished Property directly to the Buyer of that property, and similarly, the Replacement Property is directly deeded from the seller of that property to the buyer of the Replacement Property. In this way, the other parties to the exchange are not in the chain of title. This is a simplification of the many details of how loans, boot and the naming of Replacement Properties are handled by the IRS Code, and each deal needs to be researched on its own.

IV. Problems With 1031 Exchanges.

A. <u>Low Capital Gain Tax Rates.</u> While the procedures have simplified, and the risks have simply been accepted, classic 1031 Exchanges don't work in all situations. First, the capital gain tax rate has fallen in recent years to as low a level as has existed in years. For this reason, in the last year or two, some sellers are just deciding to pay the capital gains tax on the sale of property, while the rate is low, and not be encumbered with the obligations and risks of a 1031 Exchange.

B. High Prices of Replacement Property. The news media recently has exposed the "real estate bubble" in prices of residential real estate. However, within commercial real estate circles, there is also a bubble of high prices for Replacement Properties, driven up by parties to a 1031 Exchange who are factoring their capital gains tax savings into the purchase price of a Replacement Property, and paying multiples of cash flow that many investors say no longer "make sense."

C. Finding Replacement Property. If the seller of a Relinquished Property wants to incur no more debt, and wants to not put in fresh capital, it is very difficult to find a Replacement Property that is acceptable, within the given geographic area, in the price range, and with the specific strict timing needed to qualify for an exchange. For this reason, many sellers who do want to sell in an exchange, look for, and even contract for, a Replacement Property before they finalize the sale of the Relinquished Property, to be certain the correct property is available for them.

D. Identity of Investors. One of the strict requirements of a 1031 Exchange is the requirement that the owner of the Relinquished Property, and the purchaser of the Replacement Property, be identical. Although possibilities exist to dissolve or form entities on either end of the exchange, which are "Disregarded Entities" under the IRS Code, and to cash out some investors while keeping others in, doing so reduces the likelihood of finding just the right Replacement Property at just the right price at just the right time. In many cases, where there are investors in the Relinquished Property who are of different ages or interest, some want to reinvest their money, and some want to cash out, either because the need the money, because they no longer want to be partners with the old group, or they want to invest the money in a different way.

E. Timing of Purchase. Even if an appropriate Replacement Property can be found, the time it takes to do the due diligence and work through the entitlement process with local governments on the Replacement Property, not to mention the construction timing for new buildings or substantial remodeling of existing buildings, often eliminates some properties which would be desirable, but for the timing issues. If the intended Replacement Property deal falls through, after the 45 day notification and before the 180 day closing, even if there is enough time to find and close on another Replacement Property within the 180 day exchange period, if that property was not appropriately named in the 45 day notice, the exchange fails.

V. The TIC Solution.

A. Structure. This is the reason for which the TIC structure was created. In a TIC deal, a TIC promoter or "sponsor" finds or builds a property, usually a large development, and makes available undivided Tenant In Common interests in that development, into which a Seller of Relinquished Property can exchange into. This arrangement provides a ready market of property interests into which the Exchanger can exchange, in the same name as the Relinquished Property was held, and with these interests readily available when the Exchanger's timing requires. Each investor is a Tenant in Common as to the other investors. The TIC deal typically also includes a professional management agreement, so that the individual investor does not need to personally manage the project. Such an investment opens a wider number of options into which the Exchanger can exchange, and allows the purchase of a fractional interest in an institution-grade property. Most elementally, TICs can qualify as "like kind" property in a 1031 Exchange under the IRS Code. Rather than each Exchanger looking for its own solely-owned property, the TIC structure allows a Sponsor to "pre package" investment groups. The major selling points for this type of investment is that it allows an investor to have access to institution-grade investments which are much too large for that investor to afford alone, and allows the investor to be relieved of the active management of the properties.

B. The Documents.

The Sponsor of the TIC finds the real estate investment, finds the mortgage lender, and typically creates the package of identical documents which the Tenants in Common will sign. The basic documents usually include a Tenant In Common Agreement, which governs the rights of the co-owners as to each other, and often a "Call Agreement" which allows other Tenants in Common to purchase other owner's interests under certain circumstances, and a Property Management Agreement by which a professional property manager manages the Replacement Property. Some TICs are sold with a formal Offering Memorandum, which includes formal budgets, tax opinions, Indemnity Agreements for payments made under recourse provisions of the Mortgage Loans, and other documents to create structures which cap liability. I have seen one set of documents which required each Exchanger to create a single-purpose bankruptcy remote entity, which would be a disregarded entity under the IRS Code, in which they purchase their interest. In other deals the Replacement Property was subject to a Ground Lease, in which the Ground Lessor had the right to keep all profits from the ownership and management of the property except for a particular income stream to the TIC investors, but also had to absorb some of the unforeseen costs. Although the IRS Code and Regulations promulgated thereunder have certain requirements which are needed to prevent the TIC investors from being considered as partners, there are many variations on the theme.

C. The Tenants in Common Agreement. A Tenant in Common Agreement is the agreement which governs the relationship among the TIC investors. It identifies that the TIC investors are governed by local law' definition of tenancy in common, and contains an election to be excluded from Subchapter K of Chapter 1 of the IRC, with respect to the joint ownership of property and an election to not be treated as a partnership. Each TIC agrees to elect this treatment under their own tax return, and indemnifies the other TIC owners from liability for their failure to do so. Each TIC agrees it shall not be authorized to act as agent for, or on behalf of, any other TIC or the group of investors. Each TIC is given the right to receive all income, losses, costs and expenses in proportion to that owner's stated interest. Each TIC agrees to take the actions required by the agreement, including executing needed documents, being responsible for a pro-rata share of expenses, contributions if the mortgage loan on the property is a recourse loan, and for cash calls needed by the project. If any TIC does not comply with these terms, or does not meet the cash call required, any of the other TICs has the right, but not the obligation, to meet that cash call, and the TIC who makes the payment is entitled to reimbursement, with a healthy amount of interest, and if not repaid, has the right to purchase the defaulting TIC's interest in accordance with the Call Agreement. The Defaulting TIC usually assigns all rights to receive distributions as collateral for these payments.

Although day to day management of the property is given to a professional property manager, the TICs retain the right to approve a refinancing, sale or disposition of the property, or the creation or modification of a blanket lien, and the right to lease the property, except for leasing allowed under the Property Management Agreement is limited. The major decisions require unanimous approval of the TICs. Hiring a replacement manager requires unanimous approval, and is often limited in time. For other matters, 51% consent needed.

Each TIC has right to sell or mortgage its TIC interest, but this right is expressly made subject to whatever limitations are in the mortgage loan, which usually prohibit it. Such sales of TIC interests are also subject to Rights of First Refusal, and Rights of First Offer, to other TICs and sometimes to the Sponsor, which are contained in the documents.

The TICs retain a right of partition, but again, subject to the lender's rights and terms, and subject to the obligation to first offer to the other TICs the right to purchase that interest at Fair Market Value. There are often obligations to arbitrate or mediate any differences of opinion about what that value is, before any lawsuits are filed.

Similarly, if the owner of a TIC becomes bankrupt, this agreement allows other TICs to buy out that TIC interest. Each TIC agrees to not engage in any activity which would violate the TIC Agreement, and is obligated to indemnify and pay the costs and attorneys fees if violating any provisions.

Obviously, these provisions are intended to create a self-help situation to override any adverse consequences to the group as a whole, which is created by the individual situation of an individual TIC.

D. <u>The Call Agreement.</u> The Call Agreement gives other TICs the right to purchase the interest of any TIC who either: i) does not pay any property expenses or cash calls required by the TIC Agreement; or ii) does not consent to an agreement requiring 100% assent, when 80% of the total TICs agree. The TIC interest is purchased at fair market value, less the pro-rata share of any encumbrances against the property. Again, this agreement provides a self-help solution to overcome deadlocks, and to act as a "force along" agreement in case of a hold out TIC. The agreement provides that the bankruptcy, death, dissolution, liquidation, termination, incapacity or incompetency of a TIC shall not cause the termination of the Call Agreement.

E. <u>The Property Management Agreement.</u> The Property Management Agreement is usually tailored to the type of property being managed, whether with one large, long term tenant, or multiple tenants, such as for an apartment building. The length of the agreement, and the amount of control given to the manger, seems to depend on whether the TIC investor group is small and composed of institutional investors, or unrelated small investors. It often will have a period of automatic renewals.

F. Asset Management Agreement. If the TIC investor group is diverse, there is sometimes an Asset Management Agreement which provides, for a fee, the management of the Tenancy in Common, including filing required documents. This agreement has been used to provide fees to an affiliate of the Sponsor, and in which the Asset Manager defers its fees until the TICs have received a stated cumulative return, and the rest of the return is paid to the Asset Manager to the extent of available net cash flow. The Asset Manager may also receive a brokerage fee on the sale of the property.

G. Overall Summary of Advantages. Much has been made of the fact that the "baby boomer" generation is at an age where they would like to receive investment-quality returns in real estate without the work of actively managing them. The other large selling point is that this vehicle "levels the playing field" because it allows smaller investors access to larger, more lucrative ventures. The market started with office properties, but is now expanding into a variety of uses, even actively producing oil and gas properties. At least one Sponsor sells the idea as a way of selling off farm or ranch land which needs active management, while retaining the cash flow from that management to retain the family ownership of farm or ranch buildings which have sentimental value to the second or third generation of a family. The TIC could also diversity and own several properties, and a Sponsor can often arrange to have a new Replacement Property waiting when this initial property is sold, to allow the investor to continue to roll over the investment.

Although there clearly are risks to purchasing a TIC interest, if an investor does his or her due diligence up front, and understands the property which is the subject of the investment, if that is a stabilized property with a steady cash yield to the investors and a low loan to value ratio, there should be little need for additional cash calls. Some of the largest sponsors sell TIC interests as securities in accordance with SEC regulations, which provides a better explanation of the potential risks of the project. Typically the professional manager is required to provide year-end tax information in a timely and user friendly manner. The Call Agreement is intended to blunt some of the larger dangers of traditional tenancy in common, by allowing a TIC to be bought out whose bankruptcy, death or wish to sell, could otherwise cause a partition of the property. Many of the TIC transactions use either an Asset Management Agreement, a Master Lease, reserve accounts or other interim vehicles to smooth over cash flow issues.

V. "YES, BUT": THE VERY REAL RISKS OF TICS AND THE UNTESTED PROVISIONS OF THE AGREEMENTS.

A. Unlimited Liability. The very nature of tenancy in common is that each co-owner of real property owns an undivided interest in the whole property. Naturally, this means that each co-owner has unlimited rights to use and enjoy the whole property, but consequently, each co-owner also has unlimited liability. Accordingly, creditors of any one co-tenant may enforce their rights against the others. As TIC sponsors advertise and promote their products to potential owners, it is highly unlikely that they point out the unlimited exposure that such clients may take on when they purchase a TIC interest.

Such exposure can be and should be mitigated within the context of the TIC agreement so that the various property owners indemnify one another to the extent of such owners' TIC interests. For example, a TIC owner with a nine percent (9%) share in a tenancy in common property should indemnify the other co-owners of the property up to its 9% share of any liabilities incurred by the TIC. However, such indemnifications are only as good as the other parties to the TIC agreement. Accordingly, clients who are considering ownership of a TIC interest should conduct meaningful financial due diligence on the other TIC owners (not to mention the property) before purchasing a TIC interest.

Additionally, clients considering ownership of a TIC interest should also consider the formation of a single-asset entity to hold such interest. Many individuals are purchasing TIC interests in their individual capacity. These individuals, and other entities with multiple assets, may be exposing themselves to far more liability than they should by virtue of their purchase of a TIC interest. Accordingly, lawyers should advise their clients about the risks created by TIC ownership and in many cases should encourage such clients to form single-asset entities to hold their clients' share of a TIC interest. Ownership of a TIC interest in the form of a single-asset LLC may also be beneficial to the other TIC owners as well. For example, the other TIC owners who have interests in that property may prefer a single-asset LLC owning a particular share of the TIC versus an individual so that the other TIC owners may avoid entanglements created by either death or bankruptcy of an individual TIC owner.

B. <u>Will the TIC be Subject to One Loan or Several</u>? Many lenders will not allow for separate loans to the individual TIC owners. Such lenders will require one blanket lien on the property so that in the event of a default they can foreclose on the entire property and not just one TIC owner's proportionate share of the TIC. Notwithstanding the fact that a TIC property is likely to be encumbered by one loan, most of the principal borrowers in the TIC are likely to be single-asset LLCs, which will therefore necessitate the need for guaranties. Accordingly, institutional lenders may be more willing to consider limiting the guaranties of a loan in percentages that correspond to the different TIC borrowers' pro-rata ownership percentages.

As a practical matter, the payments of principal and interest to a lender create a number of issues for the various TIC owners. In a TIC property that has adequate cash flow, it is simple enough to provide that the manager for the TIC shall pay all debt service before funding reserves or distributing profits. However, debt service issues are more complicated when a property is faced with shortfalls. Most well-drafted TIC agreements will include well thought out provisions about how the various TIC owners answer cash calls and considerations about what happens in the event that any one or more TIC owners fail to provide capital when the same is needed to make debt service payments. Included for your reference is the following provision from a sample TIC agreement that allows other TIC owners to cover such a shortfall created by a non-paying TIC owner and remedies in the event that the non-paying owners does not refund such advances:

> *<u>Financing of the Property</u>. The TICs hereby agree to finance the acquisition of the land and construction of the improvements constituting the Property by entering into the loan documents with First National Bank of 1031 ("Bank") as described on Exhibit "D" attached hereto. Each of the TICs shall be liable for the debt (the "Loan") described in the loan documents described on Exhibit "D" in proportion to their respective Proportionate Share in the Property. The TICs hereby agree that the Manager shall, to the extent sufficient revenues are available from the Property in the Operating*

Account, pay to Bank the scheduled payments on the Loan on or before such payments become due (the "Loan Payments") as a Property Expense under the terms of the Management Agreement. However, each of the TICs hereby agrees that if the Manager does not have sufficient revenues from the Property in the Operating Account to pay such Loan Payments (a "Loan Payment Shortfall"), Manager shall request in writing from the TICs a payment of the amount of the Loan Payment Shortfall (a "Loan Payment Shortfall Notice"), and each of the TICs shall deposit its Proportionate Share of the Loan Payment Shortfall in the Operating Account within five (5) business days of such Loan Payment Shortfall Notice. Failure of any TIC to pay its Proportionate Share of a Loan Payment Shortfall within such five (5) business days shall be deemed a "Capital Call Default" as set forth in Section 8 below.

<u>Capital Call Defaults</u>. In the event of a Capital Call Default hereunder, written notice of such Capital Call Default shall be delivered to the TIC in default (the "Defaulting TIC"). In the event of a failure of the Defaulting TIC to cure the Capital Call Default within five (5) days of written notice, the non-defaulting TICs shall have the following remedies:

a. <u>Self Help</u>. A non-defaulting TIC may contribute such funds and then (a) the Defaulting TIC shall reimburse the non-defaulting TIC upon written demand the amount of any such payments plus interest thereon at the rate of the greater of ten percent (10%) per annum or the maximum rate allowed by law until paid, and (b) if the Defaulting TIC fails to reimburse the non-defaulting TIC as set forth in (a) above within fourteen (14) days of such written demand, the non-defaulting TIC shall have the right and option to purchase all of the Defaulting TIC's undivided interest in the Property for an amount equal to fifty percent (50%) of the Defaulting TIC's initial cash or equity contribution toward the acquisition and construction of the Property.

b. <u>Other Remedies</u>. The TICs agree that the remedies against a Non-Paying TIC provided for herein are in addition to any other remedies that may otherwise be available, to the extent allowed by law.

B. <u>Does This TIC meet the IRS's 1031 Requirements</u>? The primary reason for the newfound interest in tenancy in common as an ownership structure is the ability to quickly find adequate Replacement Properties within the limited 45 day identification period required in 1031 exchanges. In many respects, TICs are ideal for this purpose because there are a number of TIC sponsors marketing replacement properties and a party who has just sold a property can typically purchase an interest in a TIC that will perfectly accommodate the dollars such party just received from the sale of the exchange property. The IRS has looked at this type of transaction closely in an effort to determine whether the purchase of such interest would qualify as replacement property for 1031 purposes or instead constitute partnership interests, which would not be eligible for tax-free exchange under § 1031(a)(2)(D) of the IRS Code. The IRS has subsequently issued revenue procedures and letter rulings which clarify its positions and requirements for TIC to qualify as replacement properties, and not be viewed as partnership interests.

The requirements for a TIC to qualify as a replacement property are generally as follows:

(i) The TIC co-owners must hold title to the property as a tenant in common under applicable local law;

(ii) The number of co-owners cannot be more than thirty-five (35) persons or parties;

(iii) The TIC cannot act as a partnership in any respect, (*i.e.*, file a partnership or corporate tax return, conduct business under a common name, or otherwise hold itself out as a partnership or other entity).

(iv) The TIC owners must retain the right to unanimously agree on certain decisions, including the hiring or a manager for the TIC, sale, disposition or refinancing of the property, creation of loans and leases; and

(v) The TIC owners must retain the rights to alienate their interests in the property, provided however, that certain restrictions to transfer partition or encumber the property may exist, including rights of first refusal and options to purchase.

The tax limitations and requirements on a TIC for purposes of a 1031 Exchange are extensive and beyond the scope of these materials or this presentation. However, it is important to note that a real estate lawyer who is drafting a TIC agreement or a management agreement for a TIC on behalf of a client that is trying to preserve the tax benefits of a 1031 by purchasing an interest in a TIC as a replacement property must consult a tax expert who has familiarity with these issues.

C. How Do I Get Out of This Thing? As mentioned above, a TIC must provide a co-owner of TIC property with the ability to transfer its interest in the TIC. However, most well-drafted TIC agreements provide for rights of first refusal that benefit the other TIC owners when one party decides that it wants to sell its interest. The following is an example of such a provision for your reference, but there are many different ways to draft such a provision, depending upon the various interests of the parties:

> *Right of First Refusal. In the event that a TIC receives a bona fide offer from a third party to purchase all or any portion of the undivided interest of said TIC in the Property, which offer the TIC is willing to accept, or if a TIC shall make a bona fide offer to sell its undivided interest in the Property to a third party, and such party has accepted the offer (either one, a "ROFR Offer" and the TIC making or receiving such offer the "Offering TIC"), then the Offering TIC shall promptly notify the other TICs (each a "Remaining TIC") in writing (the "ROFR Offer Notice") of the terms and conditions of the ROFR Offer including, without limitation, the price and the identity of the third party making the offer or to whom the offer is being made. In the event that the Offering TIC receives or makes an ROFR Offer to sell its undivided interest in the Property in written form, the Offering TIC shall attach a copy of the written ROFR Offer to the ROFR Offer Notice. The remaining TICs then shall have thirty (30) days after receipt of the ROFR Offer Notice to elect to purchase the undivided interest of the Offering TIC in the Property on*

the same terms and conditions as contained in the ROFR Offer Notice. If a Remaining TIC or the Remaining TICs elect to exercise the Right of First Refusal or elect to decline to exercise the Right of First Refusal, they shall do so in writing to Offering TIC (the "Exercise Notice") with a copy to any other Remaining TICs. If one or all of the Remaining TICs elect to exercise their Right of First Refusal, the closing of the sale to one or all of the Remaining TICs shall occur within sixty (60) days after the Offering TIC receives the Exercise Notice. If none of the Remaining TIC exercise the Right of First Refusal in the time and manner set forth herein, the Remaining TICs shall be deemed to have waived the Right of First Refusal as to the transaction contained in the ROFR Offer Notice, and the Offering TIC shall have the right to sell its undivided interest in the Property to the proposed third party purchaser on substantially similar terms and conditions contained in the ROFR Offer Notice. Any other proposed transaction with a different purchaser than that specified in the ROFR Offer Notice or any transaction on terms or conditions that are not substantially similar with those set forth in the ROFR Offer Notice shall revive the Remaining TIC's Right of First Refusal with regard to the Property. For purposes of this Section, the purchase price of a transaction shall be deemed to be "substantially similar to the terms and conditions of the ROFR Offer Notice" if the same is greater than, or no more than five percent (5%) less than the purchase price set forth in the ROFR Offer Notice.

Additionally, most state laws will provide a TIC owner with a statutory right to sue for partition of the property. TIC agreements may also attempt to limit or qualify a party's right to partition a TIC property. An example of such a provision is:

7. <u>Right of Partition</u>. Subject to the provisions set forth in this Section 7, the TICs hereby agree that any TIC and any of its successors in interest shall have the right, while this Agreement remains in effect, to file a complaint or institute any proceeding at law or in equity to have the Property partitioned in accordance with, and to the extent provided by, applicable law. The TICs acknowledge and agree that partition of the Property may result in a forced sale by all of the TICs.

7.1 <u>Offer Obligation</u>. The TICs agree that, as a condition precedent to filing a partition action, the TIC filing such action ("Petitioner") shall first make a written offer ("Offer") to sell its undivided interest to the other TICs (the "Other TICs") at a price equal to the Fair Market Value (as defined below) of Petitioner's undivided interest, less the cost of sale, prepayment fees or penalties or other costs that would apply in the event the Property was sold on the date of the Offer. The Other TICs shall be entitled to purchase the Petitioner's interest in accordance with their Proportionate Shares in the Property. In the event that any TIC elects not to purchase its Proportionate Share of the Petitioner's interest, the other TICs shall be entitled to purchase additional interests based on their Proportionate Shares in the Property.

7.2 <u>Fair Market Value (One Appraisal)</u>. The TICs hereby agree that the Manager shall choose a "Qualified Appraiser" who is reasonably acceptable to the TICs, such TICs shall have five (5) days to object to the proposed appraiser *and if no objection is raised, such appraiser shall be deemed "reasonably acceptable", and such Qualified Appraiser shall make a determination of the Fair Market Value of the Petitioner's interest in the Property as of the date of the Offer. Such determination shall be made and submitted to the Petitioner and the Other TICs in writing (the "Written Appraisal") within thirty (30) days after the date of the Offer. If neither the Petitioner nor the Other TICs deliver a written objection to the Written Appraisal to the other party (or parties) within ten (10) days of the Written Appraisal, then the same shall be conclusively deemed to be the "Fair Market Value" for purposes of this Section 7 and binding upon the parties. If either party timely objects to the Written Appraisal by delivering notice to the other party (or parties), then the "Fair Market Value" shall be determined as set forth in Section 7.3 below.*

7.3 Fair Market Value (Additional Appraisals). In the event that either party timely objects to the Written Appraisal described in Section 7.2 by delivering notice to the other party (or parties), then the "Fair Market Value" shall be determined as set forth herein:

7.3.1 The Petitioner shall choose a Qualified Appraiser and the Other TICs collectively shall also choose a Qualified Appraiser, and the Qualified Appraisers shall make a determination of the Fair Market Value of the Petitioner's interest in the Property as of the date of the Offer. Neither of the Qualified Appraisers described in this Section 7.3 may be the same Qualified Appraiser selected in Section 7.2 above. Such determinations shall be made and submitted to the other party (together with the information forming the basis for such determination) in writing (the "Written Appraisals") within seventy (70) days after the date of the Offer. The two Qualified Appraisers shall then meet to try to mutually agree upon Fair Market Value, which mutual agreement shall be binding upon the parties.

7.3.2 If the two Qualified Appraisers do not agree as to the Fair Market Value as set forth in Section 7.3.1 within eighty five (85) days of the date of the Offer, then the two Qualified Appraisers shall promptly jointly select a third Qualified Appraiser and if the two Qualified Appraisers are unable to agree upon the identity of the third Qualified Appraiser within five (5) days, the third Qualified Appraiser shall be selected by the most senior officer of the local chapter or branch of the Association. Within thirty (30) days after his appointment, the third Qualified Appraiser shall select one of the two initially submitted appraisals as the Fair Market Value and such selection shall be binding upon the parties.

7.3.3. The fee of the two original Qualified Appraisers shall be paid by the party appointing such Qualified Appraiser. The fee of the third Qualified Appraiser, if any, shall be paid by the party whose *determination of Fair Market Value is not selected by the third Qualified Appraiser.*

7.3..4 The term "Qualified Appraiser" as used in this Section 7 shall mean an appraiser who is independent, licensed and a member of the Association, with at least ten (10) years experience appraising commercial properties in the [Name of City] metropolitan area. For purposes hereof, the "Association" shall be the American Institute of Real Estate Appraisers or its successor, or if there shall be no successor, a professional organization having a function, standards and qualifications similar thereto.

Conclusion

Although the explosion of the TIC ownership may be attributable to 1031 of the Internal Revenue Code, it is not the only driver, since investment can be made by parties who are seeking investment of funds for a return, not just for shelter of a gain.

The TIC industry is apparently here to stay, but there is no substitute for careful analysis of the deal and the documents to protect your client and each deal will have its own issues, beyond the scope of the major points covered above including, but not limited to: the requirements of the Mortgage Lender; whether insolvency will render useless the documentary protections created for the deal; the risks of environmental problems; the effect of local law on both ownership and tax consequences.

Thus, one size in TICs does not fit all and the attorney and client both need to exercise the full scope of due diligence for acquisition of property, as well as in review of documentation.

FRIDAY, MAY 5 **1:30 p.m. – 2:30 p.m.**

WHAT'S IT WORTH? THE VALUATION OF REAL PROPERTY IN LITIGATION

PROGRAM CHAIR:
Michael Rikon
Goldstein Goldstein Rikon & Gottlieb, P.C., New York, NY

SPEAKERS:

Mark D. Capasso
Cushman & Wakefield, Los Angeles, CA

Eric P. Haims
Jerome Haims Realty, New York, NY

Michael Rikon
Goldstein Goldstein Rikon & Gottlieb, P.C., New York, NY