



Commercial Real Estate/Multifamily Finance Board of Governors (COMBOG)
LOAN ORIGINATION COMMITTEE

Quarterly Informational Conference Call
Thursday, June 2, 2005
3:00 p.m. – 4:30 p.m.

TENANTS IN COMMON (TIC)
CONFERENCE CALL SUMMARY

Guest Speakers:

Daniel Huffenus, Partner, Katten Muchin Rosenman LLP
James Shevlin, Principal, Allied Capital Corporation
Nathan Stearns, Director – Structured Products, LaSalle Bank N.A.
and Vice Chair, MBA Loan Origination Committee

Background

TIC structures are when two or more persons own a direct, undivided interest in real property and each has ownership rights as to the whole property.

For IRS purposes, TIC structures can have up to 35 participants – husbands and wives may count as one participant, even if each person sets up a separate entity. The TIC structure can not be set up like a limited partnership with a controlling party; each participant needs a direct ownership interest in the real estate. Unanimous consent is required for all important actions taken by the TIC.

This type of ownership is not new, but prior to IRS guidance issued in 2002 that laid out guidelines for when the IRS would recognize the TIC structure, it was not common for commercial real estate. Now TIC structures are often selected as a vehicle to syndicate interests in real estate and to take advantage of tax deferral treatment. A taxpayer may defer taxable gain associated with the sale of investment real estate, by acquiring a replacement investment property with sales proceeds in what's called a "1031 exchange", so named for the particular Tax Code provision allowing for this deferral.

Increasingly, purchasers of commercial real estate are pooling their individual sales proceeds and purchasing percentage interests in larger commercial properties. Many CMBS lenders report as much as 10% of their volume as TIC 1031 exchange transactions or having a TIC structure on the real estate title. It is estimated that \$2-\$4 billion was invested by TIC structures last year and this year the number may double.

Lender Concerns

So what's the fuss?? TICs present lenders, servicers and investors with some interesting challenges.

For example, each TIC is a separate property owner and, therefore, a separate borrower on the loan – this can be rather unwieldy. There can be difficulties dealing with diverse interests of unrelated, unsophisticated TIC investors, especially with today's more complex real estate transactions.

There are also concerns about the value in the property - industry participants have complained that TICs investors sometimes pay too much for properties because they've already received most of the "economics" in the form of the tax deferral. Some feel that the TIC investors are only interested in the financial side of the deal and have little understanding of real estate fundamentals.

There have been instances where TICs require more extensive loan administration because, among other things, there are frequent transfers of TIC interests (especially when not all TICs are in place at closing).

Also, under property law, a TIC generally has the right to partition the property (i.e. to force a sale and division of the proceeds), and under section 363 of the Bankruptcy Code, the bankruptcy of one TIC could enable the trustee in bankruptcy to sell the entire property, even if owned together with many other TICs.

Mitigants

TICs do have some benefits. TIC structures can have more equity in the transaction; they also may have a higher debt service coverage (DSC) requirement, lower loan to value (LTV) and more reserves collected.

As lenders, there are some specific steps you can take to mitigate the risk and reduce the administrative burdens of working with TIC structures:

- Need a "sponsor" who can "manage" the property and the TIC investors (at the same time, must be careful not to violate IRS requirements).

 - Include in the TIC Agreement that one person/entity is the designated sponsor
TIC/property manager for notices

 - Include in the TIC Agreement that the sponsor gains agreement from the other
TIC investors and is then authorized to work with the lender as the authorized
voice of the investors

 - Review the buyout rights on dissenting TIC

- Want the sponsor to have "skin in the game".

 - Require sponsor equity

 - Require sponsor carve outs

 - Master Lease where sponsor is Master Lessee

Concern over lack of sophistication among TICs.

Require Accredited Investors

Conduct some level of diligence on TIC principals

Require "qualified" property management or master lease

Request a legal deposit from each TIC investor for any future legal costs

Concern over potential for serial bankruptcies delaying enforcement of remedies.

Recourse carve outs for voluntary bankruptcy

Waive rights to place liens on the property

Also, keep in mind that all properties types and all TIC structures may not work together.

Securities Law

Normally, one doesn't consider interests in real estate to be securities; however, certain attributes of TIC offerings in the 1031 exchange context (e.g., pooling of Exchanger funds, third party management of property and marketing of interests based on profit expectations) – each of which is independently innocuous -- raise significant securities law concerns.

Why be concerned? If TIC structures are securities, offer and sale of TIC interests have to be registered with SEC and/or States, or an exemption from registration is needed. If one violates the registration requirements, rescission actions are allowed. Securities anti-fraud cases may arise from material misstatements or omission in offering materials. Intermediaries selling TIC interests may be deemed securities brokers or dealers requiring broker-dealer licensing -- use of unlicensed brokers can create liabilities, as well as criminal liability.

The Issue: Are TIC interests' securities? Short answer under federal guidance: probably in most all circumstances. In individual states: the answer is less clear.

- A. Definition of "Securities" under Tax Code and Securities Law overlap but are not the same – Securities Law is very broad by comparison: Tax Code's is fairly narrow.
 1. Can be real estate for tax purposes and still be securities for Securities Law purposes.
 2. Policy goal of federal securities law is to protect investors: disclosure is emphasized and regulation of financial intermediaries who owe a fiduciary duty to their customers (e.g., securities brokers).
 3. State securities law (blue sky laws) focuses much more on consumer protection – merit regulation of offerings – as well as regulation of industry participants. (state laws appeared to be aimed at those who "would sell building lots in the blue sky in fee simple")
 4. Tax Code's goal is the raising of revenue.

- B. Section 2(a) (1) of the Securities Act of 1933 definition of “security” – Supreme Court says the definition “embodies a flexible . . . principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits.”
1. [definition], includes “investment contract”
 - a. Howey Test: The Supreme Court’s 1946 decision in SEC v. W.J. Howey Co.: “An investment contract for the purposes of the Securities Act means a contract, transaction or scheme whereby a person invests their money in a **common enterprise** and is led to **expect profits solely from the efforts of the promoter or a third party**, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise.”
 - “The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.”
 - “Immaterial whether there is a sale of property with or without intrinsic value”
 - Howey involved land sales contracts for warranty deeds to parcels of citrus groves under 10-year service contracts (entitling investors to an allocation of net profits). Held: Land sales contract together with service arrangement constituted and “investment contract.”
 - b. Common Enterprise: horizontal = commonality among other investors; or vertical = commonality under the property and management services arrangement
 - c. Expectation of Profits: profits in the sense of income or return, either fixed or variable. See SEC v. Edwards Supreme Court (2004) Passive appreciation of property value is not at issue, it is “capital appreciation resulting from the development of the initial investment.”
 2. SEC Interpretations: Triple Net Leasing (2000) No-Action Letter 1031 exchange of property for replacement properties covered by triple net leases (fixed rent not linked to net profitability of underlying property) to promoter – either single property or as TIC interests – SEC disagreed that exchange transaction did not involve a security)
 3. In re Union Home Loans (report and order stating that sale of promissory notes secured by deed of trust, coupled with management services and providing investors a specified percentage return on investment)
 4. NASD March 2005 Notice to Members: When TIC interests are offered and sold together with other arrangements, they generally would constitute investment contracts and thus securities under federal securities law.

- C. Can the TIC Interest Offering be structured to avoid securities law issues? No direct rulings, but some players argue that if the sponsor has no future involvement in the property (i.e., no property or asset management role) that they are not selling a security. This concept has worked on NNN leased deals and/or properties master leased to a third party.
1. Securities Registration Exemption: Section 4(2) and Rule 506
 - a. Rule 506 & Preemption of State Registration
 - b. General vs. Limited Solicitation
 - Pre-existing, substantial relationship
 - c. Form D – SEC and State Notice Filings & Fees
 - d. Failure to perfect exemption – Right of Rescission
 2. Broker-Dealer Issues
 - a. “Effecting” securities transactions
 - b. Issuer exemption
 - c. Use of Private Placement Agents
 - d. Suitability Issues
 - e. Penalties/sanctions -- rescission

State of Delaware – Delaware Statutory Trusts

The IRS recognizes the use of the Delaware Statutory Trust (or DST) structure for investors in 1031 exchanges. The DST acts as a single entity and similar to a limited liability company, has the pass through tax benefits. The IRS does have restrictions around these trust structures. The IRS states “an investment trust with a single class of ownership interests, representing undivided beneficial interests in the assets of the trust, will be classified as a trust if there is no power to vary the investment of the certificate holders.”¹

The IRS describes the DST – “Delaware law provides that a Delaware statutory trust is an unincorporated association recognized as an entity separate from its owners. A Delaware statutory trust is created by executing a governing instrument and filing an executed certificate of trust. Creditors of the beneficial owners of a Delaware statutory trust may not assert claims directly against the property in the trust. A Delaware statutory trust may sue or be sued, and property held in a Delaware statutory trust is subject to attachment or execution as if the trust were a corporation. Beneficial owners of a Delaware statutory trust are entitled to the same limitation on personal liability because of actions of the Delaware statutory trust that is extended to stockholders of Delaware corporations. A Delaware statutory trust may merge or consolidate with or into one or more statutory entities or other business entities.”²

¹ Information gathered from an IRS bulletin on DTC structures and 1031 Exchange from the IRS website at http://www.irs.gov/irb/2004-33_IRB/ar07.html. (August 16, 2004).

² *Id.*

Questions:

1. Can TICs waive the right to partition in their TIC Agreement and still satisfy IRS requirements if the waiver is required by a Lender?
 - Yes, if required by the lender, this waiver is allowed.
2. Can a TIC structure assume a single-borrower deal that's already been securitized?
 - Yes and no – the structure needs to be looked at closely.
 - Look at the loan level documents at the lockbox, reserve collection, tenant improvements language
 - The loan documents may also state that there is no ability to transfer interest in the borrowing entity
 - Look at the debt service coverage requirements
 - Do some additional due diligence – look at the TIC investors' credit information, net worth, look for any bankruptcy or lawsuits
3. Do Lender's require TICs to post an additional capital reserve?
 - Lenders are looking for as much equity in the deal as possible – typically you are not going to let an 80% LTV on a TIC (especially if the TIC overpaid for the property)
 - So far, TICs have paid any additional reserves required – they are not walking away from deals. If they need additional funds, they find more participants to join the TIC
4. Do Lenders accept TIC deals with more than 35 TICs?
 - IRS mandates the amount of TIC investors to 35
 - Some lenders have seen 35 investors – a question of risk tolerance
 - DST allows for an unlimited number of investors, although most are not over 100
5. What financial benefits are driving TIC investors and who are they?
 - Smaller owners, who have owned real estate for lots of year and are looking to step up into larger or more complex properties
 - Parties with excess cash flow, but do not want an active role in real estate
 - Parties looking for tax deferral options
6. What do lenders look for in a sponsor and how much "skin in the game" is expect on the part of the sponsor?
 - Lenders are looking for equity or involvement in the asset management and the property
 - Sophistication levels of the TIC investors vary greatly
7. What due diligence do servicers look for in post-closing transfers of TIC interests?
 - Understand the structures
 - There can be problems if there is a death or bankruptcy – lenders should carve these rights out and get them waived
 - Get a tax opinion on 1031 exchange to ensure the TIC structure is acceptable