



LENDER CONCERNS WITH TICs

Background of TICs

Commercial mortgage loans are often made to multiple borrowers as joint-owners, or tenants-in-common (“TIC”). There are basically two kinds of TIC transactions: those completed with a small number of often related tenants (“non-syndicated TICs”), and those with a large number of unrelated investor tenants, brought together by a Wall Street house or syndicator (“syndicated TICs”). This discussion will focus on non-syndicated TICs.

TIC ownership structure has been around for many years, but until recently it was not often used in commercial real estate transactions for which the preferred forms of ownership have traditionally been partnerships, corporations, and limited liability companies. The current popularity of the TIC is primarily tax driven. Section 1031 of the Internal Revenue Code provides for the non-recognition of gain or loss of taxpayer exchanges of like kind properties. A borrower cannot use an interest in a partnership, limited liability company, or corporation for a tax deferred exchange. TIC interests in real property qualify for a like kind exchange under section 1031 since TIC interests are a direct interest in real property. In 2002, the IRS issued Revenue Procedure 2002–22, which sets forth guidelines for deciding if an undivided fractional interest in rental real property is an interest in a

business entity and thus whether an exchange of such interests qualifies as a like kind exchange.

The IRS has set forth a series of 15 requirements for TICs to qualify as replacement property, among them is:

- ▶ Each owner must own title to the property.
- ▶ There can be no more than 35 co-owners.
- ▶ Co-owners retain the right to approve the hiring of any manager and the sale or disposition of the property.
- ▶ Each co-owner has the right to transfer their fractional undivided interest without any approval.
- ▶ Co-owners may dispose of their interest as they see fit without any approval.

Lender’s Concerns

When making loans to TICs, lenders and lenders counsel need to exercise additional caution.

Overvaluation of the real estate asset. Since it is sometimes difficult for a borrower to locate an appropriate non-syndicated TIC



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interest, there may be a tendency for TICs to overpay for property. Lenders need to be vigilant in the appraisal process to insure against this possibility.

Partition issues. The right to partition the property is granted to TIC owners under state law. If the property cannot be divided proportionally (which is the case with virtually all improved real property) the courts will order a forced sale of the entire property with the proceeds to be divided among TICs in accordance with their respective interests. This risk can be avoided by requiring TICs to execute a waiver or subordination of the partition right, which is permitted by TIC tax regulations so long as it is required by a Lender consistent with customary lending practices¹. To enhance this protection, some lenders require that there be non-recourse carve-outs for a violation of the covenant not to seek partition. In any event, the act of filing for partition should be an event of default of the loan documents and the TICs should have a built-in right of first offer to prevent partition.

Risk of multiple bankruptcy filings. A lender needs to avoid a scenario where TICs file bankruptcy and forestall the lender's foreclosure actions. To reduce this risk each TIC should be individually underwritten; should be a bankruptcy remote special-purpose entity with an independent director; there should be recourse liability for any losses that the lender suffers as a result of a bankruptcy filing by a TIC; and bankruptcy filings by a TIC should be considered a non-

recourse carve-out for a limited guaranty such as other bad acts.

No Centralized Management. Lenders may consider management contracts with an unrelated management company that cannot be amended or altered during the term of the loan and/or lock-box arrangements with up front or automatically funded reserves for regular management functions.

Additional Capital Requirements. Lenders may consider up front or automatically funded reserves for regular management functions.

The TIC Agreement and Recordation. Lender's may wish to require their own form of TIC Agreement for TICs to execute. Attached is a Lender Form of TIC Agreement. This form should be recorded along with the mortgage.

¹ IRS Revenue Procedure 2002-22 section 6.06