TENANT-IN-COMMON

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## The New Wave of Hotel Equity Syndication — The Tenant-in-Common Offering

The past five years of low interest rates and gradual economic recovery have created a boom market in the buying and selling of commercial real estate. Owners have been extremely active sellers despite the concern that selling property requires either finding a replacement property and doing a like-kind exchange, or paying substantial capital gains taxes. Five years ago, the Internal Revenue Service (IRS) opened the door to a technique that made it easier to defer capital gains taxes. That solution is embodied in the newest form of real estate equity syndication: a tenant-in-common (TIC) offering.

What did the IRS do in 2002? The IRS issued Revenue Procedure 2002-22, which provided standards for determining whether an arrangement for owning real estate by individuals constitutes a tenancy in common or a partnership. The distinction is crucial, as a seller trying to do a like-kind exchange cannot use the proceeds to buy an interest in a partnership that owns real estate. What the IRS did in Revenue Procedure 2002-22 was describe standards that could act as guidelines for buyers trying to avoid partnership treatment.

The result of the issuance of Revenue Procedure 2002-22 was the development of a commonly accepted structure for doing private placements of TIC interests through complex, private-placement memoranda that include “should” tax opinions. This is the structure that is now commonly referred to as a “TIC offering.” Such offerings are limited under Revenue Procedure 2002-22 to 35 investors. Broker-dealers selling the offerings have in turn met resistance marketing TIC interests with minimum investment amounts per investor higher than $500,000. The result has been that the typical TIC Offering seeks to raise $10 to $20 million in equity, with an average deal size, assuming 60 percent leverage, of $15 to $35 million.

Notwithstanding these limitations, from its birth in 2002, the TIC offering industry grew to approximately $4 billion in equity raised in 2006. Where did this money come from? Prior to the issuance of Revenue Procedure 2002-22, it has been estimated that as much as $30 billion or more in proceeds from commercial real estate transactions each year became subject to capital gains taxes because sellers were unable to find suitable exchange property. The TIC offering industry stepped into that $30 billion void.

Over the past two years, TIC sponsors — the real estate companies doing the offerings — have been under increasing pressure to find new real estate assets to syndicate, particularly stabilized, income-producing assets that can be bought at a price that will allow payment to investors of an initial return of close to eight percent on their equity. One of the asset classes that has been identified as potentially attractive is stabilized, limited-service hotels in strong markets. Only a handful of such transactions has been completed to date, but there appears to be a significant appetite among TIC investors for this type of product brought out by either sponsors who have strong hotel acquisition and management experience or sponsors who retain experienced third-party managers.

The arrival of TIC offerings into the world of buying and selling hotels has caused some concern among owners, franchisors, and management companies, who are uncomfortable selling to or working with up to 35 previously unrelated accredited investors. Ways to deal with these concerns are now being found. Here are some examples:

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## Owner/Sellers

Some of the initial attempts of TIC sponsors to acquire hotels for syndication involved the use of the proceeds of the offering to acquire the property. Owner/sellers quickly discovered that the TIC offering process was far too prone to delays to be relied upon, even if the TIC sponsor was offering a more attractive price than other potential buyers. As a result, a new cadre of "mezzanine" lenders has sprung up who will finance the portion of the equity necessary to close the acquisition, allowing the sponsor to complete the offering at a more realistic pace post-acquisition. This also is far preferable from the perspective of TIC investors, who previously were faced with closing risk-matched against set-in-stone IRS deadlines for completing their exchanges. The bottom line is that no owner/seller should agree to sell to a TIC sponsor who is planning on conducting the offering prior to the acquisition closing without a significant risk premium built into the price.

## Franchisors

The challenge for franchisors is how to assure that the funding obligations of the franchisee are met. There are three levels of protection built into current TIC structures that can provide some comfort:

### Master Lease

For TIC offerings on hotels to pass muster from a tax perspective, it is critical that the business of operating the hotel be separated from the ownership of the real estate. The TIC investors want to (and must, from a tax perspective) own only the real estate, not operate the hotel. This separation is achieved typically through a lease, referred to as the master lease, from the TIC investor to an affiliate of the TIC sponsor. From a franchisor's perspective it is critical that a master lease have a term that extends beyond the term of the franchise agreement. The master lessee, not the TIC investors, becomes the franchisee. It is important that the master lessee is controlled by experienced, reputable principals with hotel operating experience and a reputation for honoring their obligations under hotel franchise agreements.

### Reserves/Capitalization/Guaranties

As the franchisor is looking primarily to the master lessee, that entity should be required to maintain customary reserves as well as have a net worth and liquidity beyond reserves that will allow it to meet its funding obligations under the franchise agreement.

### Capital Call

While no one wants to contemplate initiating a capital call among the TIC investors to meet the owner's funding obligations under the franchise agreement, the right to trigger such a capital call should be present in the TIC documents and available as a resolution if the problem cannot be solved by the master lessee.

## Management Companies

TIC offerings may prove to be a boon to third-party hotel management companies. Not all TIC sponsors want or are qualified to manage hotel properties. TIC sponsors and investors will need experienced third-party managers. The keys from the manager's perspective are much like the keys from the franchisor's perspective: make sure that there is a quality, well-capitalized master lessee to function as owner under the management agreement, and that there are capital call provisions in the agreement among the TIC investors if all else fails.

## Conclusion

Are TIC offerings complex and confusing? Certainly. Do they provide access to low-cost equity for hotel owners and operators? Certainly. Do they provide opportunities for franchisors and management companies? Absolutely. For these reasons, despite the complexity, expect significant penetration of the TIC industry into the hotel industry, at least the limited-service, flagged segment.

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Opportunities in the fast-growing and ever-evolving TIC industry abound — as do potential regulatory hurdles and legal pitfalls. As a leader in the TIC industry, Foley's TIC attorneys can help you maximize success through our experienced legal counsel in Private Placement Memoranda for TIC and Delaware Statutory Trust Offerings; TIC offering; Circular 230 compliant "should" tax opinions; TIC real estate acquisitions; nationwide financing representations; and sophisticated, third-party due diligence reports.

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