TENANT-IN-COMMON

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Legal News: Tenant-in-Common is part of our ongoing commitment to providing legal insight to our clients and our colleagues.

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Ten Tips for Reading a TIC Offering PPM

Of all of the obstacles to encouraging investors to consider investing in tenant-in-common (TIC) offerings, perhaps the most challenging is the nature of the offering document itself, the Private Placement Memorandum (PPM). Stretching to 100 pages or more, this document is so complex that very few investors ever read the entire document, much less understand it. Some investors wind up relying on an explanation of the deal from their investment advisor, or becoming so discouraged that they decide that paying the taxes is the better alternative.

Why is the PPM complicated? Perhaps the most important reason is that the generally accepted purpose of the PPM is to protect the "sponsor," the person making the offering, and only secondarily to inform the investor. This results in at least 50 pages of the 100 page document being nothing but qualifiers, assumptions, boilerplate "risk factors" and discussion of obscure issues of no relevance in 90 percent of the likely results of the offering. Beyond that, it is far easier and less risky to include complete copies of complex documents than to summarize the contents of such documents in any detail, so a 50 page PPM may have 100 pages of exhibits.

When I read a PPM, I try to focus on a few key issues before I read the whole document. I write out a list of key questions that I want answered. Based upon those answers I decide whether I even want to read the PPM. This approach can save a lot of time and help you not get lost in the overwhelming length and detail of the PPM. Here are 10 such key questions that would apply to the traditional real estate TIC offering PPM:

Who Is the Sponsor?

This information generally is found about half-way through the PPM under the heading "Sponsor." There should be a description of who the principals are and their level of experience in real estate generally, and in real estate syndications, including TIC offerings, specifically. If the principals do not have a track record of raising, and more importantly returning, investors' dollars, it should raise your level of caution.

Is There a Managing Broker-Dealer?

If there is one, their logo typically is displayed on the bottom of the first page of the PPM. The managing broker-dealer is a securities-licensed firm that supervises the offering and has something such as its reputation to lose if the investment does not work out well. The managing broker-dealer plays a coordinating role between the sponsor, the retail representatives, and the investors. It also frequently conducts due diligence as well as obtaining third-party due diligence reports on the sponsor and the specific investment. The managing broker-dealer functions as a check and balance on the sponsor. Many TIC offerings are done without a managing broker-dealer, which is a negative factor as then there is no one checking on the reasonableness of the sponsor's claims.

Compensation of Sponsor

There typically is a table entitled, "Compensation of the Sponsor and Affiliates" buried two-thirds of the way into the PPM. This tells the investor what the sponsor is making from the transaction and when. One of the flaws of the TIC structure as blessed by the Internal Revenue Service (IRS) is that it makes it difficult to align the interests of the investors and the sponsor by putting the sponsor's compensation at the back-end based upon performance. Pay particular attention to what the sponsor paid for the property: If he bought it last month for $12,000,000 it may be reasonable in a TIC structure to sell it to the investors with a markup to $13,500,000 to cover costs, but not a markup to $15,000,000 so that he can clear $1,500,000 in profit immediately upon closing.

Sources and Uses

This table, frequently captioned "Estimated Use of Proceeds," typically appears right after the "Risk Factors." It tells you how the sponsor is using the investors' money. Creation of adequate reserves is a good thing. Excessive closing costs are a cause for caution, as it increases the need for appreciation of the property to get the investors' principal back.

Bonus Rent

If the structure contemplates a master lease, turn to the "Summary of the Master Lease" section, typically towards the end of the PPM just before the tax discussion. If the property is successful and generates income over what is necessary to pay the yield to the investors, is the sponsor paying that to the investors, or at least sharing it? There is nothing wrong with the sponsor having some stake in the improved performance of the property, but there also is nothing wrong with sharing that with the investors.

Recourse Liability

Mortgage lenders to TIC offerings generally provide "non-recourse" debt, that is, the investors are not personally liable for the debt. However, the TIC investors typically are required by the lender to sign a document referred to as a "Non-Recourse Exception/Carve-out Indemnity" or "TIC Guaranty," which can give them personal liability for the entire debt in some circumstances. The description of this contingent liability is normally in the "Acquisition Terms and Financing" section about half-way through the PPM. Make sure that any personal liability is limited to intentionally wrongful acts.

Appraisal

PPMs generally summarize the results of any appraisal rather than describe it in detail. Can you tell what the assumptions were? Is the value "as-is" or "as-stabilized" (i.e., contingent on future events)? What are the credentials of the appraiser? This information typically is found in a section entitled, "Valuation".

Business Plan

If the property is a stabilized, fully-valued asset, there may not be much of a plan necessary. But if the property is a turn-around, or so-called value-added situation, a description by the sponsor of how it intends to accomplish the turn-around is important. Check the "Business Plan" disclosure, typically contained in the "Description of the Property" section after the "Estimated Use of Proceeds" table.

Projections

Projections are dangerous for both the sponsor and the investor, but they typically are included, usually in one of the last exhibits to the PPM, and barely even mentioned in the main body of the PPM. While not to be relied upon, you should still review the projections to check for unrealistic assumptions, including no increase in operating expenses, no capital improvement costs, or dramatic declines in vacancy. This will tell you more about the honesty of the sponsor than it will forecast what will really happen in the future, but knowing whether the sponsor is honest is a critical piece of information.

Tenant-in-Common Agreement

The Tenant-in-Common Agreement, which is the closest thing to an equivalent of the partnership agreement that investors are used to, usually is summarized in the PPM with the other legal documents and attached as an exhibit. Check out the capital call provisions. Could you be required to increase your investment amount? What happens to you if you do not/cannot come up with the money — dilution or personal liability?

If you can get through the above list of 10 key points without encountering major obstacles, then reading the full PPM is probably warranted. Otherwise, do not waste your time.