TENANT-IN-COMMON

Legal News Alert™

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Legal News Alert is part of our ongoing commitment to providing up-to-the minute information about pressing concerns or industry issues affecting our TIC clients and colleagues.

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Tenant-in-Common Offerings Survive in Challenging Times

Over the past five years, tenant-in-common (TIC) offerings have become an accepted form of structured investment for like-kind exchange investors. In each of 2006 and 2007, well over $5 billion in real estate investor equity has been placed in these structures, representing over $10 billion per year in total deal size. Although the majority of these investors are still west of Mississippi, each year produces more TIC investors in the Northeast.

The characteristics of a TIC offering are fairly simple. A real estate company, or "sponsor," conducts a securities private placement offering to as many as 35 accredited investors for a fractional interest in a designated piece of real estate. They are not partners in a partnership; rather, a loosely affiliated group of direct investors in a piece of real estate. Each investor receives a deed of his undivided interest and signs the mortgage (on a non-recourse basis). Properly structured under Revenue Procedure 2002-22 (Rev. Proc.), a TIC offering allows investors to qualify for like-kind exchange treatment through buying a small percentage of a larger (and presumably better quality) piece of real estate than they could buy if they simply purchased a replacement property by themselves.

Has the TIC offering proved to be a desirable and reliable investment vehicle? The answer is a resounding yes. Since the Rev. Proc. was published by the Internal Revenue Service (IRS) in 2002, some $20 billion in investor equity has been placed in these investments through over 1,000 offerings and involving over 20,000 investors. These investors typically are baby boomers now entering their 60s who no longer want to be involved in speculative real estate investments or real estate that they have to actively manage. They have capital gains realized from the sale of appreciated real estate, and they want to defer the resulting capital gains taxes until the taxes are actually eliminated for their heirs by the step-up in basis upon their death. They are looking for passive, secure, cash-flowing real estate investments.

Because of the restrictions of the Rev. Proc. and the nature of TIC investors, the TIC offerings to date have been conservative, low-risk investments. The properties typically are stabilized income properties, including multi-family, fully-leased suburban office, or grocery-anchored retail with low leverage (typically 50-60 percent of the fully loaded acquisition price), which produce an initial cash return to investors ranging from six to eight percent, and a projected internal rate of return (IRR) on disposition in the low double-digits.

Given the conservative structure, most TIC offerings have performed exactly as projected or better. Although accurate statistics are difficult to find in this "private placement" environment, it appears that the vast majority of TIC offerings are performing at or above projections, and only a handful of those that are below projections are to the degree that would raise the specter of foreclosure by the lender.

Of course, the good track record of TIC offerings must be attributed in part to the positive commercial real estate market from 2002 to 2006. Projects for 2007 and 2008 are predicted to be more challenging. A few more TIC offerings, although still a very low percentage, have become distressed. The most telling effect of the current market conditions is a slowdown of the pace of TIC industry growth. This slowdown is due, in part, to fewer sales of appreciated real estate by potential investors, and more costly and restrictive debt terms, which have resulted in razor-thin margins for TIC sponsors. This slowdown does not appear to be based upon investor concerns about the viability of TIC investments.

One restraining factor on the growth of the TIC industry has always been investor concern that even if a workout was unlikely, if the worst scenario came true and a workout was required, it would be exceptionally difficult to produce a successful resolution given the involvement of so many different "stakeholders," — lenders, sponsors, master lessees, property managers, broker-dealers, registered securities representatives, and up to 35 accredited investors. The most pressing concern relates to the fact that the 35 investors who own the property presumably do not otherwise know each other or even know how to reach each other. Coupled with that are the Rev. Proc.-generated restrictions in the TIC agreement the investors all sign at closing, which require a majority or even unanimous decision by the investors before taking such critical actions as renegotiating or replacing the debt, replacing the property manager, triggering capital calls, or selling the property.

All of this seems an ominous and potentially serious impediment to the otherwise increasing acceptance of TIC investments. However, real-world experience has shown that with a few TIC workouts, the challenges generally have proved manageable. When a few simple guidelines are followed, TIC workouts do not have to be more difficult than any other commercial real estate workout. Here are some of the guidelines:

Communication

At the first sign of trouble, the TIC investors need to be organized and start communicating. This can usually be coordinated by the sponsor/master lessee or by the managing broker-dealer. Of course, this may be impractical if the sponsor/master lessee is incompetent, dishonest, or in bankruptcy, or if there was no managing broker-dealer. Experience suggests that it is unusual for all of these conditions to exist — the problem that needs to be worked out is generally some unexpected event such as the loss of a tenant rather than, for example, misappropriation by the master lessee. There also typically is a managing broker-dealer. At the first sign of declining performance, some or all of the TIC investors should insist on the creation of an e-mail mechanism, which allows them to communicate with each other as well as the sponsor/master lessee and the managing broker-dealer.

Improved Reporting

During any period of underperformance, both the frequency and the depth of property level reporting must be increased and must be generated in a fully transparent manner.

Delegation of Authority

If the situation is, or gradually becomes, more serious — for example a potential default with a lender or a clear need to replace the master lessee — the TIC investors must delegate authority to a small group of investors — ideally no more than three. This small group, pursuant to powers of attorney, can take all actions on behalf of investors other than those actions where the authority must be exercised by the TIC investors themselves under the Rev. Proc.

Hire Experienced Advisors

As the situation deteriorates, hiring legal counsel experienced in both TIC offerings and workouts may become necessary. This will require some group of investors to step forward and raise a retainer. There typically are mechanisms in the TIC agreement allowing those who contribute to recover from those who do not.

Remove the Master Lessee

If the master lessee is incompetent, dishonest, or distracted by other circumstances, it may be necessary to terminate the master lease or arrange for its assignment to another more reputable TIC sponsor. A word of caution: Any change in the status of the master lease or the identity of the master lessee without the lender's consent may trigger an event of default.

Stay Close to the Lenders and Tenants

It is critical that the confidence of the lender and any tenants be maintained. Communication with them, by persons authorized to speak on behalf of the TIC investors, is critical.

Be Patient

Take the actions that are necessary, but do not force the action out of fear of inaction. Real estate moves in cycles. If you hunker down, keep the lender current and the tenants happy, make decisions on a timely basis, maintain the integrity of the structure under the Rev. Proc. so the like-kind exchange benefits are not compromised, and wait for the market to rebound, a big problem should gradually turn into a minor annoyance.

TIC offerings are here to stay. Because of their conservative nature, it is unlikely — even in difficult market conditions — that there will be a material increase in workouts, or that any substantial portion of the workouts that do crop up will turn into catastrophic events.