$1.50 VOL. 38 NO. 17 www.ocbj.com APRIL 27-MAY 3, 2015

ORANGE COUNTY BUSINESS JOURNAL

RUTAN

RUTAN & TUCKER, LLP

Pardon Our Partition

Financing Commercial Real Estate Held by Tenancies-In-Common

by Bob Hagle, Partner, & Sarah Kruszona, Associate, Rutan & Tucker

What are Tenancies-in-Common?

A tenancy-in-common (a "TIC") is not an entity, but rather a form of ownership where two or more parties, as co-tenants, own direct, undivided interests in real property. Although in some ways the relationship among co-tenants in a TIC is similar to that of limited partners in a limited partnership or among members of a limited liability company, a key distinction is this direct ownership interest in the underlying real property by the TIC investors rather than by the partnership or limited liability company. The TIC structure is utilized by TIC investors to facilitate tax deferral available through so-called "1031 Exchanges," which provide for federal capital gains tax deferral on the sale of certain investment property when an investor uses the sale's proceeds to purchase a "like-kind" investment property.

Even though each co-tenant only owns a percentage interest in the property, each is entitled to possession of, and profits derived from, the entire property, no matter how small the ownership interest. The right to possession, along with the other rights and obligations of each co-tenant, are subject to the rights and obligations of the other co-tenants. Like a general partnership, a formal written agreement is not required for a TIC. Nonetheless, when forming a TIC, most real estate investors enter into a written agreement to, among other things, (i) memorialize the rights and obligations of each party, (ii) assist in documenting compliance with Internal Revenue Code requirements for a 1031 Exchange, and (iii) facilitate the financing of real property.

Lender Concerns and Possible Solutions

The TIC structure may create several underwriting concerns or hurdles for lenders seeking to provide financing secured by the real property. If properly addressed, none is insurmountable.

Over-Valuation

TIC investors sometimes may be willing to overpay for an interest in real property if the economic advantage in deferring capital gains tax through a 1031 Exchange outweighs the purchase price premium, or where the

Bob Hagle

Bob Hagle is Co-Chair of the Banking and Finance Group at Rutan & Tucker and is a partner in the firm's Real Estate Section. Mr. Hagle has extensive experience representing lenders and borrowers in a broad range of finance transactions, including asset-based, real estate, receivables financing, mezzanine financings, loan workouts and debt restructurings. Mr. Hagle also has substantial experience in bankruptcy reorganizations, out-of-court workouts and debtor/creditor rights and remedies. He can be reached at 714.662.4621 or bhagle@rutan.com.

Sarah Kruszona

Sarah Kruszona is an Associate in the firm's Real Estate Section, where her practice includes representing lenders, borrowers and developers in many aspects of real estate transactions, including real estate secured financings, sales and acquisitions, title review and due diligence analysis. She can be reached at 714.641.3467 or skruszona@rutan.com.

$1.50 VOL. 38 NO. 17 www.ocbj.com APRIL 27-MAY 3, 2015

ORANGE COUNTY BUSINESS JOURNAL

investor may be up against the deadline to identify replacement property to qualify for the 1031 Exchange. Obviously overpayment, left unchecked, could lead to an overvaluation and over-leveraging of the real property. Lenders typically mitigate this risk by requiring an independent appraisal of the property as a condition to financing and sizing of the loan.

Multiple Bankruptcy Filings

Because TICs by their very nature involve multiple property owners encumbering their interests in the property, the resulting potential bankruptcy risk is compounded and, if realized, subjects the lender to the automatic stay, potential restructuring of its debt and other undesirable consequences. The risk of bankruptcy filings arising from unrelated business interests of co-tenants may be mitigated by structuring the TIC so that each co-tenant is a special purpose entity (“SPE”) with its TIC interest being its sole asset (and with each SPE entity owned solely by the respective investor, resulting in the SPE being treated for tax purposes as a “pass-through” entity). The single member SPE structure will not jeopardize the investors’ 1031 Exchanges and the SPE ownership helps avoid the investment property becoming infected by an investor’s unrelated reversal of fortune.

Partition

Finally, one of the more concerning aspects of a TIC, at least from a lender’s perspective, is a co-tenant’s right to partition. Partition is the right to have property divided into separately owned parcels according to each co-tenant’s percentage interest. Partition typically is initiated by one or more co-tenants filing an action after becoming dissatisfied with some aspect of the TIC arrangement. Practically speaking, a physical partition of real property can be complicated, or in some cases impossible. When physical partition of the property is impractical, courts will order the sale of the entire property and divide the proceeds among the co-tenants. Either result is problematic for a lender.

If a TIC property is partitioned into multiple parcels, any mortgage on the property prior to partition survives and encumbers the partitioned parcels. However, while a lender would retain its lien on each parcel, the parcels would no longer be operated in a unified fashion by common management (which could negatively affect project performance), undercutting the lender’s assumptions when underwriting the loan. Likewise, having its collateral being subject to a court-ordered sale could frustrate the lender’s expected return and increases the risk of disruption of the operating asset’s performance during the pendency of the legal proceedings. These potential adverse consequences arising from the right of partition may be mitigated in both the TIC agreement amongst the co-tenants and the loan documents between the lender and co-tenants as co-borrowers.

With respect to the TIC agreement, although the right to partition generally exists as a matter of law, co-tenants may waive that right. Waiver of partition typically will be respected by courts if waived on a limited basis. (If the waiver is open-ended, its enforceability may be attacked as an invalid “restraint on alienation”, i.e., contrary to a general public policy against prohibiting owners of real property from freely transferring their interest.) Lenders may require that a TIC Agreement contain a provision explicitly waiving each co-tenant’s right to partition for so long as a loan secured by an interest in the property remains outstanding (or words to that effect).

With respect to the loan documents, the loan agreement may include a covenant that a co-tenant (each of which shall be a co-borrower) will not commence an action of partition and, to give lenders a remedy should a co-tenant violate this covenant, may further provide that the filing of an action for partition is an event of default. Further, if the loan is a limited or non-recourse loan with an indemnity from responsible parties for so-called “bad boy” acts, lenders may seek to include, as an additional lender indemnified claim, any losses from a violation of the covenant not to seek partition.

Conclusion

With some advanced planning and early involvement of lender’s counsel, issues presented by tenancies-in-common need not be deal-killers to a real property-secured loan.