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# Common Cause

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**Last May, Passco facilitated the sale** of City of Industry, Calif.'s Puente Hills Mall via a tenant in common transaction. Thirty one investors, mainly 1031 exchangers, put up an average of $1.5 million each to acquire the $148 million mall. More and more such deals are looming on the horizon.

It is no secret that the 1031s have expanded with the advent of the tenant in common ("TIC") exchange, in which a number of investors pool their money to buy a property. The burgeoning TIC industry has more than doubled in size during the past two years.

Not surprisingly, the number of 1031 exchange tenant in common companies has increased from just a few firms to more than 30 nationwide, with new groups actively entering this fast-growing sector as a result of favorable IRS revenue procedures issued in early 2002. Although not technically a safe harbor, IRS Rev Proc. 2002-22 sets out guidelines to submit for a private-letter ruling request using a TIC ownership structure.

Industry growth has significantly increased the number of CMBS loans sold with a TIC structure, causing rating agencies, such as Moody's and Fitch, to offer further guidelines.

Several components are required, including.the formation of a "bankruptcy remote" single purpose entity ("SPE") single member LLC for each TIC, to mitigate the risk of bankruptcy. The SPE must be owned directly or indirectly by the principals of the property owner.

Furthermore, the organization documents require that the SPE engage only in the business of owning and operating a single property and not have any other assets other than those related to its interests in the property and not merge its assets with any another entity. The owner of the SPE must covenant to take no action to cause the SPE to voluntarily file for bankruptcy. Also, depending on the loan size, usually $20 million or more, the lender may require a non-consolidation opinion that addresses the concern that a bankruptcy court would order the consolidation of the assets and liabilities of the SPE with the other TIC SPE's, thereby disregarding the separate entities and pooling their assets.

Many CMBS lenders impose limits on the number of tenant in common co-owners — generally from 20 to 35. Just a few years ago, the few lenders in the business, only allowed a dozen or so investors. The change has increased investor awareness and contributed to the dramatic growth of single ownership property.

With more TIC investors, greater sums can be raised. Sponsors can now buy institutional properties in the $100+ million range never contemplated a few years ago when typical acquisitions were $10 to $15 million.

Here is how the process works. Passco, the company, purchases all the property and sells prorata ownership interests to the investors. The TICs take title subject to a tenant in common and a property management agreement along with their prorata share of the debt against the property via a loan assumption agreement.

The question of who signs the respective “bad boy carveouts” is the subject of lender negotiations. In most cases, the guarantees with respect to the non-recourse or “bad boy” carveouts, such as fraud, waste, misappropriation of rents, etc. are divided between the sponsor and the TIC owners (on a prorata basis) based on obligations and acts within their control, with all parties sharing environmental liability on a joint and several basis. In other words, the lender does not hold any individual TIC borrower responsible for bad acts that are not their own bad acts.

**STRICTER STANDARDS**

The lending industry is concerned about unsophisticated investors who are not financially strong or who don't have enough experience to evaluate the economics of a transaction. Lenders are also concerned that these investors are so motivated to defer taxes they may be willing to overpay for a property.

To mitigate these concerns, lenders are now applying more stringent underwriting standards with an in-depth review of credit history and financial capacity so that “accredited investors” make up the majority of the borrowers. Passco, requires all TICs to be accredited. Lenders are also requiring diligent sponsorship underwriting and hard lock box arrangements. Sponsor companies, like Passco, must have acceptable financial capacity, liquidity, track record and management experience. Higher upfront and on-going reserves combined with lower loan to purchase prices are becoming typical in sizing for CMBS loans.

Lastly, the TIC structure must adequately address the lenders requirements, the IRS tax code and SEC requirements for securities (the management agreement creates a security under state and federal law). Lenders seek to consolidate as many ownership powers in the hands of the company, which is perceived to have the most control over the management and future performance of the property. Issues such as the right of partition, management control and serial bankruptcy filings for instance will continue to invoke lender scrutiny as the TIC business continues its rapid evolution.

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