
TRENDS IN REAL ESTATE AND TITLE INSURANCE

Tenancy in Common Emerges, Posing Challenges

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IN AN AGE of special purpose entities, bankruptcy remote entities, check-the-box filings, and securitized real estate, there has been a re-emergence of property ownership by tenancies in common, a throwback to an earlier era. While tenancies in common certainly offer investors new opportunities, they also raise important issues for both owners and lenders that need to be considered.

In March 2002, the Internal Revenue Service (IRS), in Revenue Procedure 2002-22, issued clear guidelines for obtaining a ruling as to whether the ownership of a particular tenancy in common interest qualifies for a §1031 tax-free exchange. For owners who have held title to property for a long time, and have a low taxable basis, this type of treatment enables them to realize upon the value of their assets without a current large taxable gain.

By helping open up tenancy in common investments to §1031 exchanges, the IRS has effectively given an opportunity to the smaller investor who sells property for a

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modest amount, and was thereby limited to smaller purchase opportunities, to purchase an interest in a far more valuable property. Furthermore, given the over-heated real estate markets and the disparity of supply and demand for real estate assets, the Revenue Procedure stimulates supply by providing sellers with greater flexibility for their exit strategy and enables motivated purchasers to unlock real estate opportunities.

What is the effect of the Revenue Procedure and what is involved in an ownership by a tenancy in common? The IRS has long taken the position that a person or entity owning an interest in a real estate joint venture does not qualify for the benefits of §1031. However, the IRS had made it clear that an ownership interest as a tenant in common could so qualify. The Revenue Procedure assists in dealing with the numerous questions and issues raised by taxpayers seeking direction on how to qualify as a valid tenancy in common under §1031.

The Revenue Procedure sets out the IRS guidelines for structuring the tenancy in common and tenancy in common agreements in order to obtain a ruling. At the heart of the guidelines is the concern that the investor be truly an owner of real estate rather than an investor in a business venture or partnership. Accordingly, the Revenue Procedure

requires, inter alia, that each tenant retain voting and consent rights, have freely transferable interests and share proportionately in profits/losses generated by the property and in any debt secured by a mortgage on the property.

General Principles

A tenancy in common is an estate in real property which is described in the Estates, Powers, and Trust Law of New York (EPTL), §6-2.1, as one of the "estates as to the number of persons owning an interest therein," which is classified as a tenancy in common. Section 6-2.2 of the EPTL provides that a disposition of property to two or more persons creates a tenancy in common unless expressly declared to be a joint tenancy.

Under New York common law, the key element of tenancy in common is that each has an undivided possessory right in the entire property. Beyond these elements, and the right to partition, as discussed later, there is no statutory provision by which parties who are tenants in common in the same property hold their interests. For these reasons, parties who hold title to real property as tenants in common should have an agreement between them, which spells out the relationship between them.

By comparison, both limited part-

nership and limited liability company entities are recognized creatures of statute. Partners or members own an interest in an entity, not in the real property. The statutes provide for management of the entity by a general partner or managing partner. Such managing partner manages the day-to-day affairs of the entity subject to votes of the limited partners or members, as provided in the governing agreement.

In both a limited liability company and limited partnership, a managing partner or member has the ability to bind the entity, subject to obtaining the consents of the other partners and members in accordance with the governing agreement. Because the partners or members in these entities hold interests in the entities and not in the real property, their interests cannot be exchanged under the Revenue Procedure.

Partition

One of the basic rights of a tenant in common, not found in most other ownership structures, is the right to seek partition. In New York this right is codified under §901 of the Real Property and Proceedings Law. Such action enables any of the tenants in common to compel a partition of the property or a sale of the property where partition cannot be made without prejudice to the owners. Under the Revenue Procedure, each tenant in common must retain the right to partition without the agreement or approval of any third party. However, the Revenue Procedure provides that restrictions may be put on partition rights where it is required by a lender and it is "consistent with customary commercial lending practices." Tenants in common may and should waive the rights

to partition against each other. It is critical this waiver complies with both the applicable common law and the Revenue Procedure.

It is well-established under New York case law that a court will recognize and uphold an agreement by a party not to seek partition. *Chew v. Sheldon*, 214 N.Y. 344 (1913), *Leonardo v. Leonardo*, 297 A.D.2d 416 (3d Dept., 2002), *McNally v. McNally*, 129 A.D.2d 686 (2d Dept. 1987). However, courts have stated that the restriction period must be for a specified period and of a reasonable duration. *Luvera v. Luvera*, 119 A.D.2d 810 (2d Dept.

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1986), *Levy v. Herson*, 127 Misc.2d 634 (Sup. Ct. 1985). However, they do not spell out what constitutes a reasonable duration.

Agreements

Tenancy in common agreements will look much like agreements for a limited partnership or limited liability company. One tenant in common will be the day-to-day manager of the property, dealing with any tenants of the property as well as any lender. However, the Revenue Procedure's guidelines as to the voting and control rights which each tenant must retain, including rights pertaining to leasing and the hiring of a manager, must be complied with. The agreement should

also set out the purpose of the venture and the obligations of the parties. Unlike a limited partnership or limited liability company, each party will file tax returns for its own tenancy in common interest.

In addition, as discussed below, the agreement should require that (i) any party desiring partition must first offer to sell its interests to the other tenants and that (ii) the other tenants are required to purchase such interests.

Tax Structuring Issues

When purchasers of property structure a transaction to accommodate a tenancy in common structure, they are adding a variable to what would otherwise be an entity of purchaser's choosing. In addition to carefully structuring the method of getting some portion of current cash to the seller, the purchasers must integrate the tenant in common in a way that limits the tenant in common's ability to make decisions and also ensures that a tenant in common's bankruptcy filing will not disrupt the purchaser's plans for the property.

The seller should consider having more than one tenancy in common interest, so that it can enter into more than one 1031 exchange. The purchaser will have to plan for this in its structure and also consider, for tax purposes, how long the seller must wait before an exchange can be made. Such a structure will require sophisticated counsel.

Tips for Lenders

Because lenders are accustomed to (and from a servicing perspective, often only equipped to) dealing with a single borrower, it is important that a tenancy in common loan involving multiple borrowers be streamlined.

Each tenant in common must be a party to any loan documents under the Revenue Procedure as well as for the benefit of the lender.

The loan documents and the tenancy in common agreement should be written to allow the lender to deal only with the appointed manager. Notice requirements should be satisfied by notifying only such party. In addition to these administrative issues, the lender should make sure that it is named as a third party beneficiary under the tenancy and management agreements. Furthermore, under the loan documents, each tenant in common should be treated separately in terms of representations, covenants and other guaranties, as appropriate.

In order to deal with the bankruptcy risk inherent in a transaction with multiple borrowers, Standard and Poor's guidelines provide (i) each borrower/tenant should be a bankruptcy remote special purpose entity (SPE) and (ii) non-consolidation opinions should be provided for each tenant in common. However, some investors may hold interests in entities which may not have sufficient flexibility to convert into an SPE. Remember, entities that become tenants in common will often have been in existence long before SPE requirements came into being. How then does a lender protect itself? One thing a lender can do is obtain a recourse carveback guaranty from a creditworthy guarantor and make certain that such guaranty covers any bankruptcy filing, in addition to covering other steps which may be taken by a tenant in common to prevent enforcement of the loan documents.

As noted earlier, a lender must build protections against partition into its loan documents. The loan documents

should strictly prohibit bringing a partition action while the loan is outstanding; otherwise the prospect of a forced sale would loom perpetually through the term of the loan. Such restriction should also be covered by a recourse carveback guaranty by each tenant in common.

Second, the lender must be sure that as part of both the tenancy agreement and the loan documents, any party desiring partition is required to offer to sell its interests to the other tenants and those tenants are required to purchase such interests. The Revenue Procedure expressly permits a first offer requirement. Finally, because of the uncertainty surrounding such restrictions under the common law and the Revenue Procedure, a legal opinion should be required from borrower's counsel concerning its enforceability. The opinion will most likely be a reasoned one. The foregoing complies with Standard and Poor's guidelines for tenancy in common transactions.

With respect to the permissibility of the waiver of partition under the Revenue Procedure, there is little direction given by the IRS or case law. However, it would seem that a lender would be on solid ground taking the position that such waiver is consistent with customary lending practices. Regardless, a legal opinion, even a reasoned opinion consistent with the above analysis, should be required.

Regulatory Issues

In the post 9/11 era, government legislation has had a dramatic impact on lenders' policies and requires that lenders do adequate due diligence on their borrowers. Each tenant in common should be separately analyzed for compliance

with a lender's policies.

Any loan agreement should contain, at the least, some language stating that each tenant in common, any guarantor, and their respective affiliates are not and shall not become a person with whom the lender is restricted from doing business under regulations: the Office of Foreign Asset Control (OFAC) of the Department of the Treasury (including, but not limited to, those named on OFAC's Specially Designated and Blocked Persons list); under any statute, executive order (including, but not limited to, the Sept. 24, 2001, Executive Order Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism); or under other governmental action relating to terrorism financing, terrorism support and/or otherwise relating to terrorism. Some lenders add ongoing covenants and indemnities relating to OFAC to ensure ongoing compliance.

Conclusion

While the Revenue Procedure offers investors broader opportunities to defer realization of taxable gain on the sale of real property as well as to exchange those interests into other real property interests, it also presents new challenges to both owners and lenders. By considering all of the issues and following the guidelines, the risks posed by tenancies in common can be adequately mitigated.

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