Tenancies-in-Common: An Old Dog Performing New Tricks©

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"Tenancy-in-Common" – the mere mention of the phrase causes the typical businessperson's eyes to glaze over with boredom. The lawyer, on the other hand, breaks out in a cold sweat as he or she flashes back to memories of law school and discussions of arcane types of property ownership that invariably involved the ceremonial exchange of a twig, clod of dirt or other *livery of seisin*. For the commercial lender, the reaction is often even more extreme, shuddering as they struggle to determine who their borrower is and what their collateral may look like at the end of the day. Given that enthusiastic introduction, one may ask why anyone would bother putting pen to paper about such a topic.

A tenancy-in-common is a form of real property ownership among two or more *tenants-in-common* (which we will refer to in this article as "co-tenants"). Although each co-tenant has only a percentage ownership in a parcel of real property,[1] each co-tenant has the right to use the entire property. (As an aside, it is important to note that, despite the use of the "tenant" moniker, a tenancy-in-common has nothing in common with a lease of real property in which there is a landlord-tenant relationship.)

The relationship among the co-tenants is, in some respects, similar to that among the equity owners in an entity (e.g. limited partners in a limited partnership or members in a limited liability company) that owns a parcel of real property. The critical differences are that, unlike the limited partner or limited liability company member, each co-tenant has a direct ownership interest in the property and, absent an agreement to the contrary, each co-tenant has the legal right to use the entire property as each co-tenant may choose.

Still, the question remains why do we care about co-tenancies in the world of modern commercial real estate? The short answer can be found in that source of clarity and brevity, the U.S. Internal Revenue Code (the "Tax Code") and some relatively new guidance promulgated by the Internal Revenue Service (IRS).

Commercial real estate investors increasingly desire to avail themselves of the tax deferral benefits of Section 1031 of the Tax Code—the so-called "1031 Exchange." If an investor desires to exchange a property for a more expensive like-kind property for which the investor does not have sufficient resources, the investor must join with other investors to raise the necessary equity to acquire the new property. Because of the conditions contained in Section 1031–specifically, the direct ownership requirement–these investors are forced to turn to the tenancy-in-common.

By way of example, Investor One has owned a commercial office building for several years and now wants to sell the property. Because of the substantial appreciation in value, Investor One is facing a significant income tax liability. To defer this tax liability by taking advantage of Section 1031 of the Tax Code, Investor One, on the advice of One's accountant, has decided to purchase a "replacement property." Investor One has identified another commercial property that it wants to acquire to replace One's current property, but the net proceeds from the sale of the current property, together with One's other resources, will not be sufficient to enable One to acquire the replacement property.

Through One's contacts and various brokers, Investor One locates Investors Two, Three and Four, each of which are interested in purchasing an interest in the new property. Satisfied with the group of Investors that have been assembled, Investor One assumes that it has hit a home run. Investors One, Two, Three, and Four discuss forming a limited liability company to own the new property, with each Investor acquiring an interest in the limited liability company equal to their respective equity contributions.

Unfortunately for Investor One, the accountants and the tax lawyers remind Investor One that in order to take advantage of the 1031 Exchange rules, Investor One must have a direct ownership interest in the replacement property rather than an indirect ownership interest through the contemplated limited liability company. Because of the need for additional equity funds, Investor One cannot

close the deal without the contributions of Investors Two, Three and Four. The deal appears to be on the verge of foundering.

Investor One's lawyer then suggests structuring the transaction as a tenancy-in-common, in which Investor One would have a direct ownership interest in the new property, and Investors Two, Three and Four would either have a direct ownership interest in the property individually or they would create a separate entity that would own the remaining interests in the property, in either case as co-tenants with Investor One.

"Great," exclaims the principal of Investor One. But then, with a somewhat perplexed look on his face, queries, "what's a tenancy-in-common and will my lender go for it?"

Hence, the renewed interest in this not-so-common – at least in the commercial real estate context – form of real property ownership and the *raison d'etre* for this article. What is it and will the lender go for it?

1031 Exchanges

Before exploring the world of tenancies-in-common, we should first provide a basic primer on the 1031 Exchange and how the Section 1031 requirements relate to tenancies-in-common.

The 1031 Exchange, also called a "like-kind exchange" or a "tax-deferred exchange," involves the deferral of federal income taxes on gains realized on the sale of certain types of business and investment property. If an investor is able to defer federal income tax on gains that would ordinarily be payable on the sale of appreciated property, the investor keeps more of the sale proceeds and so retains more of the equity in his or her investment. These retained funds make it possible for the investor to make a bigger subsequent investment in a replacement property.

Section 1031(a)(1) of the Tax Code states that, "No gain or loss shall be recognized on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of **like-kind** which is to be held either for productive use in a trade or business or for investment" (emphasis added). It is significant to recognize that the term "like-kind" refers to the *nature* of the property that is "held for productive use in business or for investment," not the *use* of the property. Thus, for example, a retail center may be exchanged for an apartment building, an office complex or even raw land. Most real property and personal property can qualify for Section 1031 tax deferral, as long as such property is used in a trade or business or held for investment. Moreover, an investor can sell one or more properties and acquire one or more properties; the number of properties does not have to be the same.

Very few 1031 exchanges actually occur as two-party, simultaneous exchanges. As a result, an investor will typically sell its property, with the help of a "qualified intermediary" and then, within a certain period thereafter, acquire replacement property, again with the assistance of a qualified intermediary. There are strict time restrictions that are applied to the identification and acquisition of replacement properties.[2] When an investor sells a property – the "relinquished property" – the investor has no more than 45 days from the date of the sale to identify like-kind property – the so-called "replacement property" – and one hundred eighty days from the date of the sale of the relinquished property to close on identified replacement properties.[3] If these deadlines are missed, the gain on the sale of the relinquished property will not be deferred and will be taxable at the applicable income tax rate.

1031 Exchanges and Co-Tenancy

In the past, there was significantly more uncertainty as to how to structure a co-tenant interest to ensure that the IRS would consider it a like-kind real estate interest suitable for a 1031 Exchange. One of the reasons for this uncertainty was the concern that a co-ownership of property, such as a tenancy-in-common, could be viewed by the IRS as an entity, separate from its owners, under federal tax law. If the owners of a tenancy-in-common interest are considered as a separate entity for tax purposes, then the co-owners themselves would be treated as having acquired interests in an entity rather than direct interests in the property and thus, none of the co-tenants would be entitled to tax deferral under Section 1031.

In early 2002, in an attempt to bring some certainty to the issue of whether a co-tenancy will be treated as an entity for tax purposes, the IRS issued Revenue Procedure 2002-22, a guideline that helps taxpayers and investors determine whether the IRS will treat certain tenant-in-common interests in rental real property as like-kind real property eligible for a tax-deferred exchange under Section 1031. The Revenue Procedure specifies the conditions under which the IRS will consider a request for a ruling that a co-tenancy interest in rental real property is not an interest in a business entity. Effectively, this Revenue Procedure describes the conditions under which the IRS will respect a co-tenancy arrangement for federal tax purposes.

The issuance of the Revenue Procedure, although not a safe harbor without obtaining a private letter ruling, and not the only way to achieve a deferred 1031 Exchange involving a co-tenancy interest, has given investors additional comfort that their co-tenancy transaction will be treated as a tax-deferred exchange, assuming compliance with the Revenue Procedure. The more significant of the Revenue Procedure guidelines include:

1. Each of the tenants in common must own an interest in the replacement property, either directly or through an entity which is disregarded for tax purposes, such as a single member limited liability company. Thus, title to the property as a whole may not be held by an entity recognized under local law.

2. The number of co-tenants is limited to no more than 35 persons.[4]

3. The co-tenants may not aggregate in any type of business entity or hold themselves out as any type of business entity.

4. The co-tenants may not file a partnership or corporate tax return.

5. The co-tenants must retain certain voting rights, and may not delegate certain of their authority to others of the co-tenants.

6. In general, a co-tenant must have the right to alienate its co-tenant interest. That is, the co-tenant must have the traditional right of partition of the property. The IRS will, however, consider a ruling request where the right to transfer the tenant-in-common interest is restricted pursuant to a "customary lender's restriction on alienation."

7. The co-tenants must share proportionately in all revenues and costs associated with the replacement property. Also the co-tenants must share indebtedness secured by a blanket lien in proportion to their undivided interests. The co-tenants' activities must be strictly limited to those customarily performed in connection with the maintenance and repair of rental real property.

8. All leases of the property must be bona fide leases for federal tax purposes.

9. Any debt on the property must not be from a related person or a co-tenant, a sponsor, or manager or lessee of the property.

One other point to be made before turning to our discussion of tenancies-in-common is that some of the items certain to be on the lender's wish list with respect to loans involving tenancies-in-common are at odds with the requirements of the Tax Code, the related Treasury Regulations and the guidance offered by Revenue Procedure 2002-22.

Tenancies-in-Common

Generally, with very few exceptions, commercial real estate investors cannot rely on equity alone. Without the capital resources of lenders, most real estate acquisitions could not be completed. Accordingly, although a tenancy-in-common may be assembled in a manner that will satisfy the IRS, if such a structure cannot also be cobbled together in a way that satisfies the lenders and, in the case of commercial mortgage-backed securities (CMBS), the buyers of CMBS certificates, there will be no deal.

At the outset, it is important to recognize that real property law, perhaps more so than any other body of law, is unique to each state. When analyzing tenancies-in-common, it is therefore critical to review the laws of the jurisdiction in which the property is located.[5] We believe, however, that there are enough similarities among the states such that the basic concepts will resonate in all jurisdictions.

Our discussion in this article will be a *seriatim* presentation of certain fundamental legal issues which lenders must analyze in order to determine what requirements will be imposed on tenancy-in-common borrowers. This discussion will also provide insight into the lender's reluctance to approve a borrower structure that includes a tenancy-in-common.

Right to Possession; Ouster; Use

A tenancy-in-common is a form of "co-tenancy" which, in turn, is a term generically used to designate an *undivided* interest in real property owned by several parties.[6] In other words, a co-tenancy is "one estate and the **rights of the co-tenants are identical and coextensive**. The co-tenants own the property by one joint title and in one right, and thus have one common freehold" (emphasis added).[7] Each co-tenant has an equal right to possess and occupy the entire property and, with respect to each other co-tenant, no co-tenant has the right to exclusive possession of the property. These concepts have a somewhat Zen-like quality to them (the sound of one co-tenant clapping) or perhaps better put, having one's cake and eating it too. All of this immediately highlights a central problem for the commercial real estate lender. If each co-tenant borrower has the right, as a matter of law, to use and occupy the entire property that secures the loan, but no co-tenant borrower may exclude the other co-tenants from possession of the property, it is problematic for the lender to determine what it really has. Moreover, without a comprehensive agreement, the legal relationship among the borrowers appears fraught with uncertainty and risk.

A corollary concept to the right to possess the entire property is the concept of "ouster." An ouster is a situation in which one co-tenant improperly excludes another co-tenant from the use and possession of the property. In such circumstances, the excluded co-tenant is entitled to recover from the excluding co-tenant the excluded co-tenant's share of a reasonable rental value for the property. Similarly, absent an agreement to the contrary, if the property is leased to a third party, each co-tenant is entitled to receive its pro rata share of the rental payments generated by the property.

On the other hand, unless there has been an actual ouster, the mere fact that a co-tenant is not in occupancy will not entitle the non-occupying co-tenant to the payment of rents and profits from the property from the occupying co-tenant. The tenant out of possession may, however, offset a reasonable rental value against claims by the possessory co-tenant for contribution for interest, taxes, insurance, and loan obligations paid. If you are still paying attention, it should be clear why lenders cringe at the thought of a tenancy-in-common.

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Now that we have established that each co-tenant has the right to use and occupy the entire property, let us consider what the co-tenants may do with the property and what their respective obligations are regarding the property. Subject to the rights of the other co-tenants to use and occupy the entire property, each co-tenant may use and occupy the property as it chooses. There is not, however, an obligation to actually use or improve the property. Accordingly, if a co-tenant elects to improve the property without an agreement with the other co-tenants, it does so at its own cost and risk. For example, if a co-tenant decides, without the agreement of the other co-tenants, to build a building on the property, that co-tenant may not seek contribution from the other co-tenants for the construction costs. On the other hand, because the building will likely enhance the value of the property, a non-contributing co-tenant must relinquish any claim to both the increased value of the property and any rental income generated by the improvements.

At this juncture, it is important to note that we have been discussing a pure, legal tenancy-in-common relationship that is governed only by applicable statutes and common law principles, without regard to any separate agreement among the co-tenants. The likelihood of such a relationship arising in the commercial real property context is highly unlikely. If, however, an agreement entered into among co-tenants were found by a court to be inadequate in some aspect, the court would be required to look to the applicable statutes and common law for guidance in resolving the dispute. Thus, the need for a comprehensive and complete agreement among co-tenants (a "Tenancy-in-Common Agreement") should be apparent.

Because each co-tenant has a direct ownership interest in the property, most lenders will also require that each co-tenant be a co-borrower under the loan, with joint and several liability for the entire loan. For obvious reasons, this is a prudent requirement. Moreover, in a conduit loan, because of the requirements of the national rating agencies that will rate the CMBS pool in which the loan will be securitized (the "Rating Agencies"), the need to have each co-tenant be a borrower is an absolute necessity.

Right to Contribution

An issue related to the use and improvement of property held by a co-tenancy is the right of a co-tenant to seek contribution from the other co-tenants for their pro rata share of the operating and maintenance expenses of the property. For example, if one co-tenant pays the taxes on the entire property, the paying co-tenant has the right to receive pro rata contributions from the other co-tenants. If the other co-tenants fail to pay such amounts, a lien on the non-paying co-tenants' interest in the property arises in favor of the paying co-tenant. Similarly, if one co-tenant makes payment on account of a secured debt that is for the mutual benefit of all co-tenants, the paying co-tenant is entitled to an equitable lien against the non-paying co-tenants' interest in the property. It is important to distinguish these expenses, which are generally always payable by all co-tenants, from the costs of improvements which may have been constructed without the approval of each co-tenant, for which there is no corresponding right to reimbursement or contribution.

Right to Sell or Transfer

Given that each co-tenant has an unfettered right to occupy and use the entire property, it should come as no surprise that each co-tenant also has the right to sell its interest in the property without any requirement that the other co-tenants approve or even receive notice of such a sale. Similarly, each co-tenant has the right to grant liens on its interest in the property. The selling or lien-granting co-tenant may, however, only sell or encumber its own interest in the property, so the other interests in the property remain unaffected. For example, if a 30% co-tenant sold or encumbered its interest in the property, the acquiring party or lienholder, as applicable, would only have rights with respect to the 30% interest so sold or encumbered. There would be no legal effect on the remaining 70% co-tenancy interests. Each co-tenant may grant to third parties only the rights that such co-tenant has in the property and the party acquiring such an interest merely steps into the proverbial shoes of the granting co-tenant. Nonetheless, the issue for both co-tenants and lenders is the fact that without a contractual relationship to the contrary, a co-tenant has broad transfer rights under the law.

Passive occurrences (e.g., judgments against a particular co-tenant) may also result in conveyances or encumbrances on the property. In addition to the legal effect of a transfer or encumbrance, one must also consider the practical effect when one party in a co-tenancy relationship is suddenly replaced by a new player. The incoming co-tenant may have entirely different interests and ideas about how the property should be utilized and managed. Again, unlike the new equity member in an entity that owns a commercial property, the co-tenant has a *direct* ownership interest and

corresponding rights to do with that property as the co-tenant pleases, subject, of course, to the rights of the other co-tenants.

A related example is the foreclosing judgment creditor that may have a completely different view of how the property should be owned and operated. Indeed, the typical foreclosing creditor is likely irate at the failure of the debtor to perform and wants to rid itself of the collateral as soon as possible. The usual result in such a scenario is that the collateral is promptly sold to the highest bidder. The interests of the winning bidder may not be aligned with those of the remaining co-tenants.

The point to be considered here is that in a multiple borrower scenario–and a co-tenancy relationship by definition has multiple parties–there is a greater likelihood that the acts of any one co-tenant may have an adverse impact on the ability of the other co-tenants to use the property in the manner that may have otherwise been agreed upon.

Partition

The last general legal issue to be highlighted with respect to tenancies-in-common is that of "partition." It is appropriate that this is the final issue that we discuss, because an action for partition terminates the co-tenancy.

A leading real estate law treatise succinctly describes the process as follows:

> Partition is the procedure for segregating and terminating common interests in the same parcel of property. The term "partition" may refer to a judicial decree or a voluntary agreement of the parties.
>
> The process does not involve a transfer of title; the parties already have the title, and their common title is merely being divided. A partition segregates and terminates the common interests in a parcel of property, but it does not create or convey new or additional interests and there is no change in title between the common owners...The partition changes the rights of the co-tenants from common possession of the entire property into individual rights of exclusive possession of some portion of the property for each co-tenant.[8]

In short, an action for partition, although not creating new real property interests, separates the existing, unified estate into separate and distinct parcels. After the partition, each erstwhile co-tenant has the right to exclusive possession of some portion of the property, as determined by the court or by agreement among the parties.

Generally, unless the co-tenants have waived their rights to partition, or there exists some other unique circumstance that makes the remedy inappropriate (e.g., estoppel or other equitable defense), the right to partition is essentially absolute. Practically speaking, however, most commercial properties cannot be physically partitioned; consider, for example, an apartment building. Accordingly, because a physical partition is not possible, the partition will be effected through a court ordered sale of the property with the net sale proceeds divided among the co-tenants according to their percentage interests.

The specific requirements for, and in an action for, partition go beyond the scope of this article. The existence of the right of partition, however, has self-evident adverse implications from the lender's perspective. Although the lender retains its lien on the entire property, where that property has been physically partitioned, it is highly likely that it may no longer be operated in a unified fashion. The almost inevitable result of such partition is that the nature of the property and the income stream is materially and dramatically different from that originally underwritten by the lender. A forced sale has its own set of unpleasantries for the lender.

Because of the significant consequences to the collateral if the property were partitioned, most lenders simply require the co-tenant borrowers to waive their right to partition for the term of the loan. In the conduit lending arena, the waiver of partition is an absolute requirement of the Rating Agencies. Thus, each co-tenant must affirmatively waive its partition right and also covenant in the loan documents and in the Tenancy-in-Common Agreement, or a related agreement, not to commence an action for partition. Additionally, Lender needs to be a third party beneficiary of the waivers contained in the Tenancy-in-Common Agreement, and the waivers need to be placed of record in the land records. Often, because of Rating Agency requirements, a legal opinion must be delivered addressing the enforceability of the waivers and, where available, a title endorsement or affirmative insurance of the waivers.

While the general view is that waivers of partition are enforceable, the authors are not aware of any case law on the issue in the context of a conduit loan requirement. As additional protection for the lender, and as a disincentive to any co-tenant to challenge the waivers or breach its covenant, lenders should and typically do make the violation of the covenant not to seek partition a default under the loan documents, giving rise to the lender's usual remedies (e.g., foreclosure, etc.). The violation of this covenant is often included by lenders, and at least one of the major B-piece buyers prefers that this be included, in their litany of non-recourse carve-outs, such that a violation would give rise to recourse liability against both the borrower and the guarantor.

Unfortunately, requirements that are ultimately reasonable from the lender's perspective do not always translate into viability under the Tax Code. Indeed,

Revenue Procedure 2002-22 suggests that co-tenants must retain the right to partition the property. The Revenue Procedure further provides, however, that lender-required waivers that are consistent with customary commercial lending practices are acceptable. Recalling the dramatic and adverse consequences for the lender in the event of a partition, one could reasonably argue that any lender-required waiver of the right to partition should be considered consistent with customary commercial lending practices.

The relatively plain language of the Revenue Procedure and the reasonableness of the lender's requirement notwithstanding, some borrowers, through their tax counsel, have nonetheless expressed reluctance to completely waive the right of partition. Responding to this concern, in addition to adding the event of default and recourse carve-out noted above, lenders have occasionally permitted borrowers to address this issue by including in their Tenancy-in-Common Agreement a provision requiring that the partition-seeking co-tenant sell its interest in the property to the remaining co-tenants at fair market value, determined based on an appraisal process.

This approach, in theory, addresses the lender's concerns with respect to the physical division of the property and the failure of the property to be operated in a unified fashion. Moreover, considering that many, if not most, commercial properties cannot be physically partitioned, this method is one that would likely be embraced by the courts. At least one of the national Rating Agencies has, however, indicated that it is not an acceptable solution to the partition issue, noting that it "leaves open the possibility of partition if the other tenants are unwilling or unable to buy out the tenant seeking partition."[9]

With so many potential pitfalls, the tenancy-in-common seems an unlikely candidate for a commercial mortgage lending relationship. One might be tempted to ask the question, why would any lender even consider lending to a tenancy-in-common. At the risk of sounding glib, we respond to that query with the answer that old-time bank robber Willie Sutton gave when asked why he robbed banks: "Because that's where the money is!"

In other words, increasing numbers of commercial borrowers are seeking to avail themselves of the benefits of Section 1031 and therefore, have a legitimate need to use the tenancy-in-common. If lenders want to make loans to these borrowers, lenders will have to work within this structure. Although it is undeniable that tenancies-in-common present unique circumstances, many of the obstacles can be mitigated through the implementation of a comprehensive Tenancy-in-Common Agreement and well-crafted loan documentation.

Other Lender Issues

Multi-Borrower Structure; Complexity

In addition to the legal issues, there are a variety of other lender concerns that arise as a result of having the multi-borrower structure that is present in a tenancy-in-common. The practical reality is that many, if not all, of these issues are present in any situation where the borrower has multiple equity members, each with an ability to control how decisions are made. Because of the direct ownership aspect of the tenancy-in-common, these issues are generally more difficult to resolve in the tenancy-in-common context. Obviously it is easier to deal with one borrower than with multiple borrowers, and the complexity of these issues increases as the number of co-tenants increases towards the maximum permitted (i.e., 35) under the Revenue Procedure guidelines.

The issues presented by a multi-borrower structure range from the more mundane (e.g., to whom must notices be sent) to the thornier problems that arise where the lender must foreclose on the property or, perhaps worse, where one or more of the co-tenants file a petition for protection under the U.S. Bankruptcy Code. Certain of these concerns can be addressed in either the loan documentation or the Tenancy-in-Common Agreement. With respect to other issues related to the multi-party nature of the transaction, however, no amount of drafting will change the reality of this risk and, accordingly, such issues can only be addressed by the lender in the pricing and sizing of the loan.

Simply stated, the greater the number of borrowers that are involved, the greater the likelihood is that something will go wrong. There may be a dispute between one or more of those borrowers, or one of the borrowers may have a judgment entered against it, or one or more of the borrowers may fail and, as a result, file a petition for relief under the U.S. Bankruptcy Code or other insolvency law. This is a fact that cannot be denied, nor can it be drafted around.

A portfolio lender, having somewhat greater flexibility, may simply elect to take these risks at face value, and incorporate them into the pricing of the loan. In other words, do nothing with respect to the structure and simply accept the co-tenant borrowers in their current configuration, whether they be entities or individuals.

Where a conduit lender is involved, making a loan that is destined for securitization, or in the case where the lender is simply more conservative, the judgment and bankruptcy issues will be addressed, arguably somewhat theoretically, with a requirement that each co-tenant borrower be a single purpose entity, formed solely for the purpose of owning its co-tenancy interest in the property. Depending on the nature (i.e., conduit or portfolio) and credit policies of the lender, the specifics of the single

purpose entity may include a variety of other requirements such as a lengthy list of "separateness covenants" inserted in the borrower's organizational documents.

Conduit lenders generally require a newly formed, single purpose entity borrower. Because of the Tax Code's direct ownership requirement, Section 1031 of the Tax Code will require that the newly-created borrowing entity be disregarded for tax purposes. In other words, the taxpayer must be able to treat the newly formed entity as non-existent. This quandary is typically addressed through the formation of a single-member limited liability company. The current state-of-the-art in the conduit lending industry requires that such an entity be formed in Delaware, and that Delaware legal counsel render opinions with respect to certain aspects of the viability of the structure.

A discussion of the specifics of these issues is not relevant to the tenancy-in-common concerns that we are discussing in this article and, accordingly, are not addressed in this article. On the positive side, we note that the typical single purpose entity requirements and separateness covenants may mitigate some lender tenancy-in-common concerns by establishing parameters within which the co-tenants must operate as legal entities.

Decision-Making

A simple, but often overlooked issue in multi-borrower deals is the designation of a party that will be responsible for decision-making and interaction with the lender on a day-to-day basis in connection with issues arising with respect to the administration of the loan. This is typically addressed in both the loan documents and in the Tenancy-in-Common Agreement, wherein the co-tenants are required to designate an "agent" for purposes of interacting with the lender. The lender should further require that, without the prior, written approval of the lender, the co-tenants may not change the designation of the agent. Thus, for purposes of sending notices and dealing with ordinary course administrative matters (e.g., lease approvals), the lender or its servicer will only be required to interact with one borrower party. Considering the demands made on the servicers of commercial mortgage loans, the inclusion of this simple provision is of critical importance. Assuming that the borrower parties trust each other, the appointment of the agent can also simplify matters for the borrowers.

Lenders should, however, be cautioned that there are limitations on the authority of the designated agent to act on behalf of the co-tenants; some of these limitations are of a legal nature, while others fall more into the common sense category. For example, a provision that granted an agent the authority to act on behalf of an entity without requiring that the applicable corporate, partnership, or limited liability company approval formalities be satisfied with respect to such decisions would likely be held unenforceable. Thus, amendments to loan documents entered into by the agent on behalf of each of the co-tenant borrowers, without a specific grant of authority with respect to such amendment, would likely not result in an enforceable legal document. In such circumstances, given the need for a specific grant of authorization, the prudent practice is to have each co-tenant borrower execute the relevant documents.

Similarly, in a default situation, the notice requirements of the applicable jurisdiction may require notice to each co-tenant (i.e., each borrower) notwithstanding the agency designation contained in the loan documents or the Tenancy-in-Common Agreement. Moreover, even in those situations where notice to the agent is clearly valid, there may be circumstances where a notice to all borrower parties is warranted.

The designation of one co-tenant as the agent for the other co-tenants for ordinary course administrative matters will, nonetheless, greatly simplify the administration and servicing of the loan, and should always be included in the loan documentation and in the Tenancy-in-Common Agreement.

Tenancy-in-Common Agreement

Although each co-tenant owns a direct interest in the property, the relationship between the individual co-tenants is similar to the relationship among the equity owners in an entity that owns a commercial project. Thus, the co-tenants must agree upon how typical equity issues will be resolved (e.g., allocation of profits and losses, need for additional capital, financing, sale and operation, dissolution and termination). Therefore, it is imperative that the co-tenants enter into a comprehensive Tenancy-in-Common Agreement. The prudent lender will require that virtually all of the issues that are discussed in this article be addressed with specificity in the Tenancy-in-Common Agreement.

Because the Tenancy-in-Common Agreement must address both typical multiple equity owner type concerns and co-tenancy issues, the document will be, by necessity, more complex than a typical limited liability company operating agreement or partnership agreement. Moreover, because the co-tenants will, themselves, be legal entities, in addition to the Tenancy-in-Common Agreement, the parties will also have organizational documents (e.g., operating agreements, partnership agreements, etc.) with which to contend. Accordingly, tenancy-in-common borrowers are well advised to begin preparing these documents early on in the loan closing process.

A final point to consider with respect to the Tenancy-in-Common Agreement is, because of the critical importance of the Agreement, the loan documents will contain a restriction prohibiting the co-tenants from amending or modifying the Tenancy-in-Common Agreement without

the prior approval of the lender. This prohibition highlights the need for the co-tenants to carefully consider the Tenancy-in-Common Agreement before presenting it to the lender and the lender's counsel for review.

Roll-Up

Most co-tenancies in the commercial property context are driven by the desire of one or more of the co-tenants to take advantage of the benefits of Section 1031 of the Tax Code. The IRS has not, however, issued specific guidance with respect to the length of time that an exchanging party must hold its interest in the new property in order to qualify as a Section 1031 exchange. Tax law practitioners have reached a variety of conclusions with respect to the requisite holding period ranging from the seemingly absurd conclusion that holding title for a mere moment on the real property records of the county where the property is located is sufficient to a perhaps more prudent conclusion that having a direct ownership for at least one year and a day will satisfy the IRS requirements.

For all of the reasons outlined in this article, a one-borrower structure is far more preferable to most, if not all, commercial lenders. Similarly, many borrowers are not terribly enamored of the multi-party structure, except where it is absolutely necessary for either tax or business reasons. As a result, lenders occasionally require, and borrowers occasionally request the right, to "roll-up" the tenancy-in-common structure after an agreed-upon holding period has expired.

Whether lender-required or borrower-requested, the loan documents should be drafted with sufficient detail so that all parties will understand the timing, documentation, and other requirements, including who is going to pay for the roll-up. Typically, the roll-up will require the transfer of the co-tenant interests to one of the existing co-tenant entities, with a corresponding grant of equity interests to the outgoing co-tenant entities. Alternatively, a new entity may be created that will take title to the property and grant equity interests to each of the outgoing co-tenant entities. In any case, this will then require either an acknowledgment by the remaining co-tenant entity that it is the sole borrower, or a formal loan assumption by the newly created entity with respect to the loan obligations. Because the roll-up will involve a transfer of title to the single entity that will be the borrower, lenders will require endorsements to their title insurance policies, which becomes another cost item that must be considered in documenting the roll-up provisions. Additionally, any guarantors or indemnitors should be required to re-confirm their obligations under the applicable guaranties and indemnity agreements.

Specificity in the loan documents with respect to the roll-up is beneficial and important for both borrowers and lenders. Where the loan is made by a conduit lender, the loan will likely have been securitized by the time of the roll-up, and, thus, subject to the strictures of the Tax Code's real estate mortgage investment conduit (REMIC) requirements, the need for detail and specificity is of even greater importance.

Rating Agency Issues

As one would expect and hope, the Rating Agencies have weighed in with their own concerns with respect to tenancies-in-common. The reader is encouraged to read the Moody's Report (see footnote 9) and also the tenants-in-common provisions of the current Standard & Poor's U.S. CMBS Legal and Structured Finance Criteria. Both publications offer thoughtful, insightful and useful guidance on tenancy-in-common requirements and discussions of why the issues are viewed by the Rating Agencies as significant. Although the publications are, for obvious reasons, focused on loans destined for securitization, the discussions in both pieces are also relevant to the portfolio lender considering making a loan to a tenancy-in-common borrower.

In addition to the issues already discussed in this article, the Rating Agencies have expressed concern about the following:

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1. True property values being less than the price paid by the co-tenants. In other words, co-tenants may be willing to pay a premium for the property to obtain the tax deferral benefits of Section 1031 of the Tax Code. An investor without similar tax needs may perceive the value of the property as significantly less. Accordingly, the Rating Agencies are concerned that the purchase price in a co-tenancy deal is not a true indicator of fair market value.

2. The potential for serial bankruptcy filings by the co-tenants to frustrate the lender's ability to foreclose on the property. Presumably this risk is mitigated by the (a) single purpose entity covenants and (b) presence of a non-recourse carve-out guaranty, triggered by the filing of a bankruptcy petition by any co-tenant.

3. Lien rights among co-tenants (i.e., the ability of one co-tenant to impose a lien on the interest of another co-tenant for failure to perform some obligation) and options among co-tenants to acquire the interest of the other co-tenants. This issue is generally resolved by requiring, in both the loan documents and in the Tenancy-in-Common Agreement, that each co-tenant waive its lien rights and subordinate any option rights until the loan has been paid in full. Similarly, the Rating Agencies also require that any other remedies of the co-tenants and any rights of the co-tenants against each other be fully subordinated to the lender's security instrument.

Conclusion

Good, bad or ugly. No matter how you characterize tenancies-in-common, they are going to be a regular part of the world of commercial real estate. The deferral of capital gains is a huge incentive for any real estate investor and, unless and until the laws change, the tenancy-in-common would appear to be the only way for commercial real estate investors to be able to take advantage of the favorable tax provisions of Section 1031 in deals where multiple investors are involved.

While tenancies-in-common present their own unique set of complexities and headaches, and often require creative legal drafting, not to mention patience on the part of both borrowers and lenders, we believe that it is possible to structure these deals so that everyone wins. Obviously, the proof of the pudding is in the eating, and in the case of commercial real estate, we may have to wait and learn from a few deals that go bad.

For the industry to continue to grow and thrive, and for borrowers to continue to have meaningful access to capital, all sides must be flexible and continue to take risks. Certainly, there is still a great deal that is unknown. Both lenders and borrowers, however, have done and will continue to do an admirable job of working with the thorny issues of the tenancy-in-common. ❑

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[1] *For simplicity's sake in this article, we will assume that all of the property discussed is a fee interest in one parcel of real property. In other words, we will not discuss ground leases or other more complex types of interests in real property.*

[2] *Internal Revenue Code § 1031(a)(3).*

[3] *The U.S. Treasury has promulgated regulations that address the identification of alternate and multiple replacement properties.*

[4] *Husbands and wives are considered as one person.*

[5] *The laws considered in this article are those of the State of California.*

[6] *Other types of co-tenancies include joint tenancies, tenancies in partnership, condominiums and cooperatives; none of which will be discussed in this article.*

[7] *Miller & Starr,* California Real Estate, *Third Edition, 2000, Section 12.1.*

[8] Ibid. *Section 12.14.*

[9] *Moody's Investors Service,* Special Report, *August 18, 2003, "CMBS: Tenants-in-Common Becoming More Common."*