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TICS - WHAT ATTORNEYS NEED TO UNDERSTAND

Frederick Rosenberg

Tenancy In Common – known as TICs - is a form of concurrent ownership of property in which two or more persons simultaneously possess undivided interests in property. TICs s can be created by deed, will or operation of law. They have been around since the Magna Carta without much controversy, except where Section 1031 of the IRS Code is involved.

Section 1031 provides for a transfer of taxable basis in an exchange for like-type properties thereby deferring taxes. Prior to 2002, the IRS characterized a tenancy-in-common as a security in the ilk of a limited partnership and, therefore, TICs did not qualify under Section 1031 for like-kind exchanges. This was remedied in IRS Revenue Procedure Ruling 2002-22 in which, under prescribed conditions, a tenancy in common was determined to be a direct ownership and not a security for 1031 purposes and, therefore, TICs would qualify for 1031 like-kind exchange.

IT IS A SECURITY!

The first confusion about the IRS letter ruling is that it appears to conflict with *S.E.C v Howey,*[1] in which the U. S. Supreme Court adopted a definition of a security that included an "Investment Contract," which, under the '33 Act, encompasses TICs. In 1946, the Supreme Court stated in *Howey*:

> An "investment contract," as used in the Securities Act, means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from efforts of promoter or a third party, it being immaterial whether shares in enterprise are evidenced by formal certificate or by nominal interests in physical assets employed in enterprise.

Is a TIC merely a real estate transaction subject to traditional caveat emptor real estate principles, or is it a security that is subject to the Securities Act of 1933 as well as the Securities Exchange Act of 1934, which affords substantial investor protections and imposes industry duties not found under local real estate law and practice?

Take care not to confuse the IRS letter ruling or Tax Opinions in which TICs are not securities for 1031 purposes with the rules that apply to selling

1. *S.E.C v Howey*, 328 U.S. 293, 66 S.Ct. 1100 (1946).

securities under the 1933 and 1934 acts. While a TIC is not a security for 1031 purposes, it is indisputably an "Investment Contract," a security under the 33 Act, which explains why these matters are litigated primarily in FINRA Arbitration and must be analyzed according to Securities Laws.

HOW IT SEEMS TO WORK IN MOST, BUT NOT ALL, CASES

In a TIC, a sponsor and its affiliated companies structure a real estate purchase in which a property is purchased by an affiliate, marked up with fees and promotions of 25% +/- on average and then sold off as TIC units to 35 investors. The investor forms a single- purpose LLC that in turn purchases the TIC, receives a deed and executes the Management and TIC Agreements drafted by the sponsor. The sponsor and its affiliates effectively retain control of the property and promise both an income stream and return of principal. Each investor assumes a pro-rata share of a non-recourse first mortgage on the property, typically an amount 150%-200% of their capital contribution. Distributions to investors are typically guaranteed by a Master Lease or otherwise supported by the sponsor's credit assurances.

Following the 2002 IRS Revenue Procedure, Investors could defer gains on exchanged property by "exchanging" the gross sales amount into a TIC, the principal attraction of a TIC. For example, an Investor originally paid $200,000 for a property with a current market sale of $1,000,000. The gain, $800,000, would generate a tax liability of $160,000 at 20% federal and state rates. There is $300,000 of debt on the property meaning the investor would net out $700,000 before taxes. Regardless of the debt, the Investor is compelled to invest the gross sales amount, $1,000,000, to defer the tax, including replacement of paid off debt with cash or similar recourse debt. This presents a nettlesome problem for investors seeking to exchange real estate with substantial recourse debt.

WHY A TIC IS A SECURITY PURCHASE

In *Howey*, the Supreme Court made clear that it is *immaterial* "whether shares in enterprise are evidenced by formal certificate *or by nominal interests in physical assets employed in enterprise.*" Consequently, where the investors' purchases are part of a common enterprise, their TIC purchases are Capital Contributions to the enterprise**,** not personal real estate investments. The sale of TICs must, therefore, be in compliance with the '33 and '34 Acts and that means that broker/dealers must abide by FINRA's rules

and rulings including having a reasonable basis for a recommendation. FINRA Notice to Members (NTM) 03-71 laid out, as far back as 2003, what should be expected in the sale of a Non-Conventional Investment (NCI). TICs were specifically addressed in NTM 05-18, reinforcing NTM 03-71, and both Notices are referenced again directly in NTM 10-22 with regard to private placements.

WHAT IS DUE DILIGENCE?

Due Diligence is the underwriting process required to meet the Reasonable Basis suitability requirement of Rule 2310. It should be orderly and properly focused. Throughout the process, there will be:

1) Red Light issues that must be resolved before proceeding further,
2) Red Flag issues that add risk in a cumulative way and require caution or remediation and
3) Green Light issues that require no further examination.

Non-conventional investments (NCIs) are business ventures funded with private equity from passive investors. The fact that these ventures are packaged as securities merely adds an additional layer to the due diligence investigation. All private equity has unique underwriting areas related to the specific business activities and financial condition of its sponsors. Analyzing that information requires specific analytical skills and experience unrelated to securities registration issues. Absent those skills, the analysis will be incomplete and the risks will be inadequately evaluated.

The Loan Agreement in a TIC typically places significant and continuing reliance on the sponsor and its affiliate's financial condition as identified in the representations, warranties, and cash flow covenants of the Agreement. The financial entanglements identified by the Loan Agreement in a TIC commonly identify potential default risk for the investor far greater than the operational risks associated with the purchased property; those risks are foreseeable and quantifiable. Where substantial reliance on the sponsor exists, an experienced private equity analyst must focus on conducting a thorough credit and cash-flow analysis of the sponsor and its affiliates, hopefully supported by audited financials. Failure to assess the creditworthiness of the sponsor has foreseeable consequences under the Loan Agreement. Given most sponsor financial entanglements, it is a grave weakness in the underwriting process to green light a TIC without assessing known credit risks that set the stage for later problems.

Audited financials must also provide an assessment of the adequacy of the sponsor's internal systems and controls that protect Investors against

foreseeable occurrences, such as commingling, defalcation, diversion, theft, title encumbrances, and process errors. "Controls" are the signature policies, reporting, signing authority, bonding, borrowing authority, chain of command, reviews and reporting, legal opinions, and exceptions policies. This area of investigation is the most basic in due diligence. Turning over millions of dollars and substantial portions of a customer's net worth to a sponsor that is unwilling to provide the maximum protections against foreseeable problems is a Red Light that cannot be ignored. Furthermore the costs of a thorough audit are relatively insignificant when compared to the funds raised and the fees and promotions earned. Each sponsor should be fully capable of providing verified up to date financials and no Private Equity review could continue once there is a determination of inadequate systems and controls that leave investors vulnerable to loss.

Finally, every offering requires an evaluation of the "sources of repayment," distributions, collateral valuation, and credit weaknesses. Understanding the sources of TIC distributions is crucial. Audited financials must be "spread" and analyzed for credit risk and cash flow. Analysis of borrowing, collateral covenants, and sponsor cash flows from new offerings must be assessed in addition to assessing operational income from the property. Predictably, large, highly leveraged sponsors can suffer substantial financial reversals that can trigger defaults in relatively short periods even while the investor's property interest is still performing on the underlying loan. Could financial failures elsewhere in the sponsor's portfolio trigger default for investors? These areas of investigation and analysis are totally unrelated to securities disclosure or compliance but essential to identify financial weaknesses that add risk to the Investment. Without understanding the risks, no recommendation can be said to have *reasonable basis*.

For a private equity investor, the reasonable basis question is whether the $160,000 (see example above) in tax deferral warrants taking on the substantial risk and encumbrance of a TIC. Investing in a TIC is with pre-tax dollars and the investor must contribute the entire $1 million. However after promotions and markups, the investor sees on average only $750K at work in contrast to the $840,000 remaining after taxes. And with the TIC, the $160K tax liability still continues. Regardless of the gain, if it is $800K ($160k in taxes) or $100K ($20K in taxes), the investor must roll over the entire $1 million into the TIC to qualify for 1031 treatment.

Next comes a more nettlesome issue. On the $1 million 1031 exchange, the actual real estate purchase requirement is only $1 million, yet with a TIC, regardless of the recourse nature of the debt, the investor will be purchasing $1.8 to $.2.6 million in leveraged real estate, two to three times the amount needed for 1031 purposes. Analytically, since 1031 is fully satisfied with the

first million exchanged, any excess real estate purchased generates no 1031 deferral whatsoever, thereby negating the rationale for taking on the additional risk in the first place. A review of the Investor's IRS form 8824 filed in the year of the exchange should provide some information about the new basis versus the original basis.

Another onerous consequence of NCI and specifically TIC investments, is permanent Credit Impairment. A TIC is a highly leveraged security that is replete with various party agreements, loan agreements, representations and warranties, sponsor guarantees, and co-tenant liabilities and other encumbrances that disqualify a TIC as collateral for a loan. Since most TIC investors invest a substantial portion if not most of their net worth and typically are nearing or at retirement age, collateral value and credit availability becomes significant. The investor who purchases a $1 million TIC, permanently and instantly loses $1 million of credit availability offered by readily available non-leveraged investments, market securities, and conventionally owned real estate. The severe consequence of this credit impairment should be evaluated prior to any recommendation for one or multiple TICs, and then only after a determination of the tax deferral and duration of impairment.

This brings us to yet another perplexing question. I have read dozens of TIC PPMs and have no doubt that the speculative warnings are real and that catastrophic loss is a foreseeable possibility. And yet the projected returns are modest at best, 4-5% over the safe rate for a few years under perfect conditions. Are the relatively modest returns of TICs and the tax deferral sufficient basis to recommend a TIC? I've spent several years analyzing and reviewing hundreds of ppms and private equity proposals and from a Private Equity perspective, an investor should reasonably project a multiple return on any investment with a foreseeable risk of catastrophic loss and extended capital impairment. By analytical standards a TIC has speculative risk without the expectation of speculative return, essentially making it unsuitable as a speculative recommendation. Whether the modest projected returns warrant the potential for catastrophic outcomes is a fundamental question to be answered before a recommendation can be made.

THE SIGNIFICANCE OF CREDIT RISK

Since all TIC investors must assume a pro-rata share of the underlying debt, one place to focus on in a TIC analysis is the Loan Agreement with the primary lender, paying specific attention to the covenants, representations and warranties, conditions of default, conditions of non-recourse, and

conditions of transfer or assumption of the debt. The primary loan is negotiated by the sponsor or affiliate and commonly identifies the sponsor's financial conditions, guarantees, and management covenants tied directly to the underlying financing, many unrelated to the performance of the TIC real estate. Most Loan Agreements have carve-outs from non-recourse liability that impose personal liability on a sponsor or principals for defined the "bad boy" acts and misrepresentations. TIC purchasers should also understand that their loan is risk paper that will be sold off and pooled into CMO's making the lender underwriting suspect.

When a TIC purchaser assumes a share of the loan, all a sponsor's liabilities, representations and warrantees, and financial covenants are also assumed while the sponsor still remains on the loan. What are they? TIC investors must execute a Loan Assumption Agreement directly with the Bank that memorializes terms and conditions, but which often fails to provide copies of the sponsor's guarantees, reps, and covenants that impact default risk. Most Assumption Agreements require the investor to assume proportionate liability for covenant breaches and defaults and even under rare conditions, personal liability if they engage in any defined conduct. That's a Red Light to recommending a TIC.

The consequence of failing to analyze properly the credit entanglements and Agreements is foreseeable. TIC sponsors are commonly integrated, both vertically and horizontally, and typically have raised hundreds of millions of dollars in multiple offerings over several years. The problem is that multiple offerings and businesses mean multiple credit facilities, loans, guarantees, covenants, reps and warranties, and multi-tasking personnel responsible for conflicting interests. A default in any of the sponsor's offering, or a general weakness within the sponsor finances or affiliated businesses could trigger defaults across the entire portfolio even among performing assets, including the investor’s TIC. In point of fact, it is not unusual to find that in most TIC defaults the underlying property is still performing operationally at a level sufficient to meet monthly debt service before investor distributions despite the condition of the real estate market.

What this comes down to for due diligence analysts is that the credit structure of the sponsor needs thorough evaluation to determine foreseeable investor vulnerability. There is substantial reliance on the sponsor's financials both by the investor and the primary lender collateralized by the property. Vulnerability arises from weakness in the sponsors' credit facilities unrelated to the real estate transaction underlying the offering. It means that in large part, the viability of the offering primarily depends on the credit quality of the sponsor and its financial entanglements not the real estate.

SOURCE OF REPAYMENT:

Due Diligence analysis must also focus on the sources of repayment to the investor and all the factors related to that objective. TIC Distributions have been sourced to operating income, debt, new investor capital, master lease payments, paid-in reserves, seller rental guarantees and financing, or a combination of those alternatives. It is paramount to evaluate each distribution source in the context of risk and return, and audited financials provide the source of verified numbers that can be spread and analyzed. Unfortunately most TIC sponsors offer nothing but out of date, unaudited financials at best and those are rarely analyzed adequately, if at all. Any unwillingness or excuse by a sponsor failing to obtain audited financials however, should be a Red Light, especially given the magnitude of the sponsor's equity-raising, fees, and markups when compared to the relatively modest cost of an audit.

Equally important, audits will also provide opinions on the adequacy of a sponsor's internal systems and controls that protect clients from defalcations, diversions, theft, commingling, self-dealing, collateral impairment, and the like. The issue is whether it is foreseeable given the operating environment, controls, systems, and management, that customer investments go unprotected and subject to default or diversion. The larger and more complex a sponsor grows, the greater the capacity for problems and the greater the need for adequate controls. This outcome has been born out in many failed TICs where the sponsor is found to have been engaged in Ponzi activities or other illegal or improper commingling or self dealing that would have been preventable or avoidable were adequate systems and controls demanded and implemented. It is true in many cases that defalcation, commingling, bankruptcy, theft, or diversion occurred after the investment, but the opportunities for abuse must be addressed by structuring investments with adequate controls that anticipate problems and dissuade and deter sponsors from jeopardizing the investors' capital through illegal or risky practices.

SALE LEASEBACK

A TIC investment structure is effectively a sale-leaseback of property. Sale leasebacks are normally common with high-credit-worthy tenants. For example, a company such as Kmart will sell its real estate to an investor who is induced by the credit worthiness of the seller to purchase the property and master lease it back to them. The investor avoids operational and market

risks while Kmart gets the accounting benefit of an operating lease. The investor risk depends solely on Kmart's credit worthiness because the market risk is assumed by the master lessee. For the investor it makes no difference if the property is ever profitable, as the market risk remains at all times with Kmart.

TICs are sold as fixed income alternatives to passive income oriented investors with a tax benefit. They are functionally equivalent to sale leasebacks and consequently, Due Diligence must focus on the credit underwriting or ignore the principal risks. The real estate is no more than collateral to be liquidated at the end of the lease term.

MASTER LEASES:

One structure often used in TICs is a sponsor Master Lease of the entire property. The purpose of a Master Lease is to provide investors with a comfort level on the safety of their promised distributions. In a Master Lease, the Master Lessee (sponsor affiliate) agrees to absorb all the market and operational risks, and agrees to pay a fixed rent regardless of profitability or market conditions. In return, the investors pay on average 25%+/- in promotions. TIC investors are less interested in the real estate than they are with the income stream promised by the Master Lessee and the tax deferral. Here too, it is the Master Lessee that takes on the Market and Operational Risks not the investors who paid for that assurance with substantial fees and markups. Still, in most litigation Respondents typically rely on the "Market Loss" defense, when ironically, it is specifically the market risk that the Master Lessee contractually assumed from the investor. Finally, it is common to find covenants in the Loan Agreement making removal or replacement of the Master Lessee a condition of default and adding another entanglement.

Not all TICs are master leased to the sponsor, however, which makes evaluation of the credit risks somewhat more problematic. Once again the place to start a review is with the underlying loan agreement. Most Agreements contain references to sponsor guarantees if any, either in the definitions or within the body of the loan agreement. And virtually all Assumption Agreements make the investor a party to the guarantees, warranties, representations, and covenants. Often the lending bank has obtained from the sponsor and its affiliates signed and identified guarantees and commitments and the investors typically stand in the shoes of the sponsor/guarantor. Consequently reading and evaluating all the consents, guarantees, and covenants referenced in the Agreements is paramount for

risk evaluation. Commonly many ancillary documents are not included in the PPM or other investment documentation and must be requested and reviewed in advance of recommending the investment. The lender may also have cross collateral agreements with the sponsor and require debt coverage ratios relating to the sponsor's total credit facilities that also are not transparent to the inexperienced due diligence investigator.

Where there is substantial reliance on the sponsor's financial strength, the credit worthiness of the sponsor must be evaluated professionally and that requires an audit with full credit analysis. Most brokerages marketing TICs lack capable credit-trained personnel and consequently their due diligence efforts are simply unable to identify or evaluate the actual credit risks in most NCI offerings, which as it turns out are substantial and consequential.

DISCLOSURE OF SECURITIES RISKS

TICs are typically offered in private placements with an accompanying memorandum offered under section 506 of Regulation D. Sections 502 and 506 of Regulation D require no disclosure to Accredited Investors, but full disclosure to non-accredited investors. Consequently, sponsors limit offers to qualified, Accredited Investors only. Most sponsors prepare substantial placement memoranda that identify the real estate in detail and which contain sections on property management, deal structure, risks, and the like. While most PPMs are amply caveated with disclaimers as required by securities laws, disclaimers do not suffice for analysis. No amount of disclosure can make an unsuitable recommendation appropriate, nor does Disclosure equate to Due Diligence. With TICs, there often are substantial credit issues and financial considerations that impact default outside of the TIC but which require evaluation regardless. It is Private Equity experience that is required to identify not only those risks, but to assess the probability of default and to determine the adequacy of the systems and controls prior to recommending an investment.

In general as with any private equity consideration, a BD has no choice but to reject any offering until the sponsor can comply with the audit request, implement effective systems and controls, and produce for analysis all relevant documents, guarantees, credit facilities, contracts, and offering materials that impact the loans and default risk. These are obvious Red Light concerns. Third party due diligence is also an option if the credit issues are adequately identified and addressed, but in my experience third party due diligence for TICs is simply inadequate, focusing instead on real estate risk, PPM disclosures, Tax Opinions, and valuation, none of which is relevant to

the investor's primary risk, a decline of the sponsor's financial condition that triggers a default, or internal controls that are inadequate to protect investors.

SOURCE OF REPAYMENT

Theoretically, the source of repayment for both the debt and investor distributions should come solely from the net operating income of the underlying real estate, but that is a rarity indeed. TICs permit sponsors to borrow short term both for distributions and working capital secured by the real estate. That is problematic. Also, TIC sponsors often rely on the mark-ups and fees from new investor money on subsequent offerings, or seller guarantees with which to fund a substantial portion of its current cash flow including guarantee obligations if needed. Paid in reserves may also be used for distributions, essentially returning the investors money. Distributions funded out of paid-in reserves, seller guarantees, borrowings, or new investor capital distort the distribution curve and often mislead as to past performance. Without a complete cash flow analysis, hopefully based upon audited financials, no due diligence analyst is able to opine on the risk of the TIC. The outcome is foreseeable.

Most due diligence by Independent BD's marketing TICs typically fails to underwrite the systemic risk that arises when a sponsor and its subsidiaries are making identical commitments on a half billion dollar portfolio of properties over several years multiplying default risk and potentially placing financial stress on the sponsor. A default anywhere could arguably trigger a cascade of defaults across all the sponsor's credit relationships.

In my observation, the majority of TIC failures were a consequence of sponsor over-leveraging and financial stress, and not TIC property operations directly. Were the syndication market to cool down for any reason and new money no longer be available, a sponsor's cash flow and financial stability could deteriorate precipitously, triggering default under the loan covenants. The same could occur if the CMO market could no longer absorb the sponsor's mortgages and financing dried up. The probability of those occurring is foreseeable and only an appropriate analysis of the sponsor's cash flow can avoid taking excessive risk. This means that absent new money or substantial reinvestment by existing investors, many sponsors would not have the financial strength to meet their continuing obligations to existing investors and the bank and that spells disaster for investors regardless of the property's performance. These risks need to be underwritten properly on a Private Equity basis before recommending the investment.

The fact that substantial investor risk is tied directly to the sponsor's credit worthiness is the most overlooked aspect of TIC's. Instead, PPMs typically spend pages upon pages on appraisal information, occupancy rates, and cash flow projections, leaving the impression that a TIC is actually a direct Real Estate investment when substantively it is an extension of credit to a large integrated syndicator/sponsor collateralized by real property. *Howey* makes it clear that "it matters not whether shares in enterprise are evidenced by formal certificate or by nominal interests in physical assets employed in enterprise", e.g. real estate. The individual investor has no control over the asset whatsoever, does not arrange financing or negotiate loans, and is a passive investor with no intention of ever holding title without sponsor assurances. It compares in no way to a direct purchase of a fee simple interest in any property.

Under ideal conditions property operations should serve as the principal if not sole source of investor repayment. Were the sponsor's financials to decline significantly, it could trigger a default under the covenants of any loan agreement resulting in a foreclosure or forced liquidation and leaving investors with a significant loss under existing market conditions.

Unfortunately, Tenancy in Common is the worst, most onerous form of common ownership for syndication. Unlike limited partnerships or LLCs, TIC owners are personally liable to upwards of 34 other co-tenants and may very well be liable pro-rata for any co-tenant's default.

In some cases liability may not even be limited to the TIC interest. Without a general partner or managing member, property decisions must be by vote, usually unanimous, including decisions on the removal of property management, selling one's unit, etc. The bankruptcy of one TIC owner could trigger defaults on the loan Agreement and Assumption Agreement, partition is impossible without triggering a loan default, and the sponsor's property management is a condition of the loan, meaning the sponsor's control is seen as essential to underwriting and loan approval. There may also be broader credit facilities to the sponsor along with other guarantees and contractual agreements. Investors or their single purpose LLCs are primary on both the deed and the loan, which affects their credit directly and yet ties their fortunes to 34 other persons unknown and unfamiliar to the investor. In the context of 1031 tax deferral, a TIC structure suffers from complexity and restriction, which brings into question whether the tax deferral is balanced by risk. This too should be considered before making a recommendation.

VALUATION OF A TIC

TICs have three values:

1) *Notional Value* - the par value upon which distributions are calculated;
2) *Implied Value* - the value of a TIC unit as a pro rata allocation of the equity in the real estate without discount for market risk; and
3) *Market Value* - the amount one could expect to receive from a willing buyer in the marketplace.

Commonly in litigation, the parties offer real estate appraisals that establish Implied Value, but such calculations fail to discount for the inherent risks and complicating factors related to the market value of the TIC security. For example, even if the property were under contract for sale, the time to closing, the legal complications, the uncertainty about terms of the sale and payout, and the probability of the sale falling through over time would still demand a discount from Implied Value to calculate Market Value if there were no other considerations

It is the Market Value of the security by which to measure damages, which in many TIC cases is zero. The complex relationship of the parties to the TIC, the detailed agreements referenced in the loan agreement, the credit risk, the covenants, warranties, hold harmless agreements, and covenants are all impediments to valuation. For these reasons, Implied Value matters little to an individual TIC owner. Regardless of whether the property is appraised at $12 million or $16 million there is no effective way to realize any value in the market place or exercise any contractual right that could. Furthermore, continued ownership at Implied Value carries unacceptable risk and uncertainty.

By contrast, consider a junk bond selling at a substantial discount from par in order to induce investors with a return comparable to the risk. If the coupon on junk bonds is 6-7% but market risk adjusted return is 12%, the bond sells at a substantial discount to adjust for risk and to raise expected returns. The same principal applies to TICs.

Market valuation relies on the discount for uncertainties, illiquidity, encumbrances, and risk. By comparison, a portfolio of high yield instruments provides return, diversification, marketability, and liquidity. An after-tax junk bond portfolio can offer nearly the same level of return without the credit impairment and illiquidity, and without having to assume proportionately all the debt, covenants, and representations and warranties required for the purchase of 2.5-3 times more real estate than is required.

Despite the fact that Market Value of the TIC is the most relevant, it is routinely ignored in litigation in favor of Implied Value based upon the real

estate. Mere valuation of the real estate equity unfortunately is a far cry from the Market Value of the TIC. The reasons are obvious. By the time the investor proceeds in litigation, the TIC is typically in default, even if the property is performing. A subsequent investor interested in purchasing the TIC has to go over the following hurdles:

1. Assumption of debt on loan with pro rata acceptance by the primary lender;
2. Impairment of credit;
3. Assumption of the sponsor's representations, warranties, covenants, and guarantees;
4. An uncertain outlook as to litigation and bankruptcy or insolvency;
5. Uncertainty as to when, if ever, proceeds will be available;
6. An insolvent sponsor;
7. The absence of adequate internal controls within the TIC management;
8. The execution of the Tenant In Common Agreement with 35 strangers and surrendering control; and
9. Forecasted returns that are inadequate compensation for the risk at par value.

CONCLUSION

There is a distinction between securities Disclosure and Due Diligence that often appears to go unrecognized within the independent brokerage community when analyzing and recommending Private Equity investments. That distinction is exemplified in TICs where BD due diligence focuses more on the securities disclosures than on competently assessing the risks of the offering prior to a recommendation.

Disclosure is neither a free pass from due diligence nor a defense to an unsuitable recommendation, even when that recommendation comes in the form of a placement memorandum to an accredited investor. No recommendation can be made without a reasonable basis and delivering a PPM to any investor without Reasonable Basis would violate NASD Rule 2310, and its successors FINRA Rules 2109 and 2111.

In short, no customer/investor assumes the risk that the broker simply does not know what he or she is talking about.

- Due Diligence is the duty of the brokerage firm prior to making a recommendation, not the investor after the recommendation.

- Due Diligence is not a matter of "good faith," but of competence in risk assessment
- No amount of disclosure will make an unsuitable recommendation suitable.
- Good faith is not a defense to negligence or to a breach of contract.
- Private equity investors are entitled to expect competence, especially when brokerage firm expertise is reasonably relied upon.

TICs commonly wind up in default even when the property is performing. The reasons for a default varies, but besides market conditions, sponsor covenant or guarantee breaches, poor management, commingling of asset, and deferred maintenance could all be the precipitating factors that impact the sponsor's performance and financial condition. Where the property is in foreclosure, it is essential to review the foreclosure complaint or bankruptcy filings to determine if market conditions or other avoidable factors were to blame. It would be unconscionable if adequate internal systems and controls could have prevented loss or defalcation and protected assets from creditors and litigants, but were never properly instituted. When audits and proper credit analyses could have shown overstretched and overcommitted sponsors, insolvency and default become a foreseeable risk with avoidable consequence.

END NOTES:

1. As an analyst I have yet to find any Reasonable Basis to recommend a leveraged syndicated TIC to any investor. The risks are too great, projected returns are too small, and the tax deferral illusory.
2. My focus in this article has been on Private Equity due diligence as the first line of analysis. Collateral analysis is essential, but resolving the credit issues comes first.
3. TIC real estate serves principally as collateral securing credit extensions to the sponsor by the investor. The real estate purchased is a Capital Contribution, no more, no less, and carries none of the attributes of fee simple interests.
4. Most TICs are financing transactions, sale leasebacks, not traditional real estate deals. Proper credit analysis cannot be ignored.

Recommended: If you want to familiarize yourself with credit issues, I would recommend the Office of the Comptroller of the Currency (OCC) Handbook on "Rating Credit Risk." It can be downloaded free.[2]

Due Diligence Documents: Pre Recommendation

a. Assignments and Investor consents
b. Loan Agreement
c. Loan Assumption Agreement
d. Lender's Appraisal
e. Management Agreement
f. Master Lease
g. Mortgage
h. Notes executed
i. PPM
j. Purchase Agreement
k. sponsor's Financial Statements
l. sponsor's Guarantees
m. Tenant In Common Agreement

Litigation Analysis Documents: Post Investment:

n. Foreclosure complaint
o. Bankruptcy findings
p. Title search

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2. See Examining Credit Risk, Page 21-28, OCC Handbook, "Rating Credit Risk," April 2001.