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"Adapting Tenancy-in-Common Structures to SPE Requirements"

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In CMBS conduit loan transactions, borrowers may present the lender with a structuring challenge, such as when their tax advisor suggests the use of a tenancy-in-common (TIC) structure to accommodate a like-kind exchange under IRC §1031. Thus, rather than having one entity that would typically adopt single purpose entity (SPE) provisions into its organizational documents, the lender is presented with anywhere from 2 to 20 (or more) individuals and/or entities that will be "co-borrowers" as tenants-in-common.

A TIC structure presents special concerns: (i) how to deal with multiple TIC borrower parties in bankruptcy; (ii) how to address each TIC party's rights of partition; and (iii) how to manage contacts between the lender and multiple TIC borrower parties. In order to mitigate the risks posed by the TIC structure, lender's counsel should require the following:

Each TIC party must be an SPE; typically this will be in the form of a single member limited liability company (LLC), which generally may be ignored for federal income tax purposes. Thus, if the initial co-tenant were an individual, he/she could create a single member LLC to be the TIC party for the proposed loan, and that should satisfy IRC §1031 constraints that require that the property be owned by the co-tenant for tax purposes.

Each TIC party must enter into a TIC management agreement with provision for each of the following:

1. Appoint one TIC party as the manager/representative for all TIC parties;

2. Authorize the manager/representative TIC party to be the sole contact and notice party on behalf of the other TIC parties for purposes of the loan;

3. Authorize the manager/representative TIC party to act on behalf of all of the TIC parties in dealing with the lender concerning the loan;

4. Stipulate that the property may not be partitioned; and

5. Provide that if a TIC party becomes a debtor in a bankruptcy proceeding, any one or more of the other TIC parties shall have the right to purchase the bankrupt TIC party's interest at fair market value based on an independent appraisal - this is designed to lessen the potential negative impact of the trustee's power of sale pursuant to Sec. 363(h) of the Bankruptcy Code.

In addition to addressing bankruptcy concerns, some of these provisions are designed to make servicing less burdensome and avoid the possibility of failing to notify all required parties or having to secure multiple consents or responses to various matters.

Failing to properly structure and document a TIC loan will affect the SPE characterization of the loan and may impact pricing. Even with these mitigants in place, TIC loans may be viewed less favorably than loans having more typical SPE structures, and, accordingly, the lender may consider charging a slight spread increase to the borrower.

Note: When using SPE forms, some of the restrictions and covenants will need to be modified to account for the fact that there are other co-tenant SPE borrowers. For example, the covenants not to commingle funds or guaranty the debts of others would not apply as to the other TIC parties. Accordingly, the modification can be stated as follows: "Except with respect to each of the other Co-Tenant owners of the Property," This allows for the multiple TIC party structure and is consistent with the overall view that the lender is not concerned about consolidation of the TIC owners of the property with each other, since they should not have any business or operations apart from their ownership interest in the property.

While the foregoing structure makes the TIC loan more palatable to the lender, it should not be construed as tax or other advice to the borrowers, who instead must rely on their own tax advisor to assure compliance with IRC §1031 and related regulations.

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Single Member LLCs. In general, the use of the single member LLC as borrower has grown, particularly with the IRS issuance of the 'check the box' rules for electing treatment as a partnership for federal income tax purposes. The single member LLC generally is acceptable to rating agencies, lenders and CMBS investors. Delaware is the jurisdiction with the most favorable statute and provides the greatest flexibility. LLCs may be member or manager managed, and the A&K form SPE provisions should apply here as well.

There have been a number of developments under the Delaware LLC Code in the last few years that may make it appropriate for additional terms in the LLC agreement if a single member LLC is being used, especially with a large loan where a level 5 SPE (i.e., full SPE criteria with independent director/manager and non-consolidation opinion) is required. Please contact me if you are presented with a single member LLC borrower for a large loan.