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Breaking Them In:
Educating
New Lenders
About TICs



Ten Things You
Need to Know
About the New
SEC Form D

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Breaking Them In: Educating New Lenders About TICs

By: Robert W. Hughes, Esq.*

The last twelve months have seen the virtual collapse of the commercial mortgage-backed securities (CMBS) lending market, which for many years was the financing of choice for tenant-in-common (TIC) syndications. This has led, or at least contributed to, a slow down in the TIC industry, and has generated significant interest in identifying alternative financing for TIC transactions. Many lenders have little prior experience with TICs, and so must be educated about the unique characteristics and requirements of TIC transactions.

Unquestionably, the best time to educate the lender is during the negotiation of the loan application. Waiting until further along in the deal creates significant risk of delays, and may place the entire deal in jeopardy.

This article identifies several important issues to consider when negotiating loan applications with lenders unfamiliar with TICs. These issues can be summarized in an addendum attached to the loan application.

1. Identify the Borrower.

- Clearly state that the borrower will be the various tenant-in-common co-owners of the property that take title to the property pursuant to terms laid out in the loan application.
- If the transaction will have two steps (i.e., seller conveys the property to an initial purchaser entity (the "Acquisition Entity"), which then conveys tenant-in-common interests to the TICs), then identify the name of the Acquisition Entity, state that it will be the initial borrower, and state that each TIC will then assume the loan pursuant to a separate assumption agreement.
- Alternatively, if it is a one-step transaction (e.g., a refinance by the TICs or an acquisition in which the seller conveys the property directly to the TICs, which all sign the loan documents directly at closing), then say that.
- Specify that, even though each TIC may be required to be a Delaware limited liability company (LLC) that is a special purpose, bankruptcy-remote entity (SPE), no TIC entities will be required to have independent managers or directors. Further specify that the investors that own the TIC LLCs need not be Delaware LLCs, or be SPEs, or have independent managers or directors. While such requirements in a non-TIC environment are generally minor, acceptable burdens, incorporating them into a TIC transaction can be expensive and confusing.

2. Outline the TIC transfer process. Most lenders are not used to the idea of allowing transfers of property interests. The loan application must specifically permit transfers of TIC interests and related loan assumptions, in accordance with a procedure laid out in the loan application:

- Specify the maximum number of TICs allowed, ideally 35 (not including the Acquisition Entity).
- Permit TICs to be brought into the deal at closing.
- If the sponsor wants to be able to bring TICs into the deal after closing, then clearly permit that. State the maximum number of post-closing TICs that may be brought into the deal, and specify the period of time after closing during which new post-closing TICs may be brought in (often 60-180 days, at a minimum).
- State the applicable fees for bringing in TICs post-closing. Clearly state that no transfer fee (often 1% of the loan) will apply; instead, limit the fees to reimbursement of lender's legal fees or to a low per-TIC administrative fee (often \$1,000 to \$2,500). Try negotiating a cap on per-TIC administrative fees for groups of 5 or more TICs that close simultaneously.

- If the sponsor intends to sell off all of the TIC interests (and not retain any direct ownership interest in the deal), then the loan application should clearly permit that. Lenders often anticipate a retained interest but do not identify this requirement until late in the game. Thus it is critical to get this issue resolved before the loan commitment is issued.
- Describe the procedure, required documents, timing, and criteria for lender's approval of TICs. Try to make the process as objective as possible (to provide comfort that the lender will not arbitrarily reject or delay approval of TICs).

3. Address other transfer issues.

- If the sponsor wants to have one TIC in the deal in which LLC membership interests may be bought and sold without lender's consent and without transfer fees, then state that.
- Provide for estate planning transfers by TICs, without lender's consent and without transfer fees.
- State that when an investor is an entity (i.e., not an individual), transfers of direct and indirect ownership transfers in the investor entity may take place without lender's consent and without transfer fees.
- Allow for some number of substitute TICs at any time during the loan term, subject to lender's review and reasonable restrictions (such as prohibitions on any TIC other than the Acquisition Entity holding more than 20% undivided interest in the property).

4. Specify whether there will be a master lease or a property manager.

5. Clarify guaranty issues.

- If the lender requires one or more principals of each TIC to execute an environmental indemnity and/or a non-recourse carve-out guaranty, then try to limit each TIC principal's liability to liability resulting from the acts of its TIC.
- Avoid general guaranties (i.e., guaranties of some or all of the loan, as compared to guaranties of specific bad acts under a non-recourse carve-out guaranty). They may jeopardize the investors' Section 1031 like-kind exchanges, particularly where the only guarantor is the sponsor.

6. Provide for buy-outs for partitioning or bankrupt TICs. Specify that even though the loan documents may have a waiver of partition, the borrowers have the right to cure, in accordance with the tenants-in-common agreement, any attempted partition or any TIC bankruptcy by having other TICs buy out the offending TIC. If such buy-out is completed within some period of time (specify the time: typically 60 to 90 days), then the bankruptcy or attempted partition will not be deemed to constitute a default under the loan.

7. Limit required opinions. Specify that no formation, existence, authority, or other opinions will be required with respect to any entities other than the TIC LLCs (i.e., no opinions will be required with respect to investors that are entities). Similarly, try to avoid substantive non-consolidation opinions, because they may be expensive and difficult to obtain for the TICs.

8. Provide for mezzanine financing. If mezzanine financing is desired, state that it is permitted and outline how it will be structured. For example, if the mezzanine debt will be secured by a pledge in the ownership interests of the Acquisition Entity only (and not with pledges of the TIC LLCs), then state that. Many lenders have an aversion to the use of mezzanine debt. Accordingly, it is critical to determine the need for and structure of any required bridge debt and to secure the lender's approval well in advance.

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Ten Things You Need to Know About the New SEC Form D

By: Eric C. Perkins, Esq.*

Form D is a federal notice form required to be filed with the Securities and Exchange Commission ("SEC") in connection with Regulation D private placements of securities. The SEC utilizes the data provided in Form D filings to: (i) evaluate the effectiveness of Regulation D exemptions, (ii) analyze the private placement market in general, and (iii) serve as guidance for subsequent rulemaking activities. After several years of deliberation, the SEC has approved a new (and improved) Form D, including a new electronic Form D filing system that went "live" on September 15, 2008. Highlights of the new Form D are summarized below.

- 1. Transition Period.** The new Form D made its formal debut effective September 15, 2008. Issuers may either submit Form D filings with the SEC electronically via the Electronic Data Gathering, Analysis, and Retrieval system ("EDGAR") or may continue filing paper copies of either the new Form D or a "temporary" Form D (i.e., the old version) with the SEC until March 15, 2009, when electronic filing becomes mandatory. Copies of both forms and related guidance can be found at <http://www.sec.gov/info/smallbus/secg/formdguide.htm>.
- 2. The New Form D is more Practical and User-Friendly.** The new Form D is more condensed than its predecessor. The new Form D solicits more "check the box" responses and eliminates requirements to provide estimates of multiple categories of expenses and uses of offering proceeds.
- 3. Electronic Form D Filers must use EDGAR.** To file Form D electronically, issuers must utilize EDGAR, which will require issuers to obtain a filer identification number (referred to as a "Central Index Key" or "CIK" number) and a login password ("CIK Confirmation Code" or "CCC" number). Detailed instructions for electronically filing Form D can be found at http://www.sec.gov/info/edgar/edmanuals913_d.htm. Real estate sponsors that form offering-specific issuer entities will have to navigate this process for each offering.
- 4. CRD Numbers of Selling Broker-Dealers and Registered Representatives must be Listed on the New Form D.** This information was not required on the "old" Form D, and while this requirement will increase the time it takes to complete Form D, issuers should have easy access to this information, either from their selling group or via <http://brokercheck.finra.org>.
- 5. Multiple Issuer Offerings may now be Combined on one Form D.** Some real estate sponsors structure their programs such that multiple securities (e.g., tenant-in-common interests and limited liability company membership interests)

are packaged together and offered simultaneously. Such programs are generally considered to have two issuers and, before now, would have required two separate Form D filings. The new Form D addresses this issue and provides for multiple issuers to utilize a single Form D.

- 6. Form D Filings will be more Accessible than Ever.** Electronically filed Form Ds will be searchable via EDGAR, making the information disclosed on Form Ds more readily available to the public than ever.
- 7. Form D Formally Recognizes Tenant-in-Common Securities.** Item 9 of the new Form D requires a "check the box" response identifying the type of securities being offered. For the first time, one of the listed categories is "tenant-in-common securities." This gesture of recognition by the SEC represents a degree of symbolic validation of the securitized tenant-in-common ("TIC") industry. From a practical perspective, it will become relatively easy to track the TIC industry through EDGAR's searchable database of Form D filings.
- 8. Date of First Sale Required on New Form D.** Under Rule 503 of Regulation D, an issuer must file Form D no later than fifteen (15) days after the first sale of securities in the subject offering. The date of first sale is a required item of disclosure on the new Form D. The instructions to the new Form D clarify that the date of first sale is "the date on which the first investor is irrevocably contractually committed to invest, which, depending on the terms and conditions of the contract, could be the date on which the issuer receives the investor's subscription agreement or check."
- 9. NASAA Developing a One-Stop Electronic Filing Platform for Blue Sky Notice Filings.** Efforts are underway to develop an efficient "one-stop" filing platform for electronic Form D notice filings at the state level. The North American Association of Securities Administrators Association ("NASAA") is spearheading this effort. Issuers can monitor NASAA's efforts at www.nasaa.org.
- 10. Consequences of Noncompliance.** At the federal level, the consequences of noncompliance with Form D filing requirements remain the same. Failure to timely file Form D with the SEC does not result—in and of itself—in the loss of the Regulation D exemption, but it may result in an issuer being precluded from relying on a Regulation D exemption for future offerings. As before, intentional misstatements or omissions of fact on Form D constitute federal criminal violations under 18 U.S.C. 1001.

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