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REAL ESTATE

Rise and Fall of a Real Estate Market Niche

The future is uncertain for TICs, the brainchild of a San Diego attorney that grew into a multibillion-dollar industry segment before collapsing in the downturn

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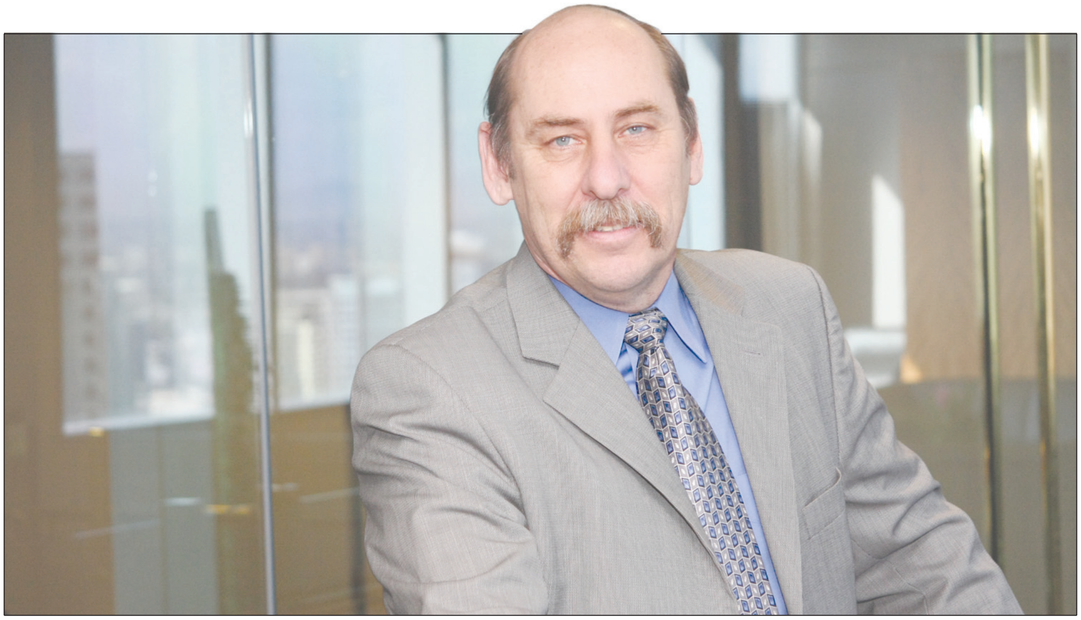

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Luce, Forward, Hamilton & Scripps partner Darryl Steinhause

It all started one night in 1994. San Diego attorney Darryl Steinhause was talking to an investment fund manager friend with a client who wanted to invest $1 million and get the benefits of a "like-kind exchange" to defer massive capital gains taxes.

Since investment funds aren't eligible for those tax breaks, Steinhause's friend William O. Passo, a lawyer who founded Passco Cos., which owns more than 11 million square feet of real estate, suggested that he try to come up with a solution.

Steinhause, a San Diego partner with Luce, Forward, Hamilton & Scripps, had an idea: What if he could get the IRS to sign off on a structure in which a group of investors with a lot of cash could invest in real estate, each with an undivided interest, and have it treated as an exchange under Section 1031 of the tax code?

"I hit the books and thought a lot and looked at case law and did a lot of analysis," Steinhause said, "and came up with a structure I thought worked."

Steinhause's firm issued a legal opinion on the fractionalized investment model in 1995 and started doing deals. In 2002, the IRS sanctioned the arrangement, and the modern tenant-in-common industry was established.

The market niche grew beyond its California roots to peak in 2006, with a record 341 deals worth $3.6 billion traded across the nation.

By 2009, however, TICs were gasping for air, with the number of deals that year falling to 71 with $229 million in total equity, according to Utah-based real estate research and mortgage services firm Omni Real Estate Services.

Despite being pummeled along with the rest of the real estate market in the financial meltdown, Steinhause and other lawyers say TICs could come back in the next several years after the real estate market recovers.

"My view is that, as soon as properties start to sell again and there's profit again, we'll see tenant-in-common interests again," Steinhause said.

Other lawyers aren't so optimistic, predicting that, while a handful of TIC deals are trickling across their desks, the niche industry as a whole doesn't have a future.

"I don't think if banks recover, that will resurrect the TIC industry," said Craig P. Wood, a partner at Foley & Lardner in Los Angeles. "I think lending institutions have come to realize there are too many inherent risks."

TIC deals picked up steam so quickly last decade, attorneys said, because the maximum of 35 investors who exchange their funds into large real estate projects don't have to be hands-on owners, which particularly appealed to older investors seeking to reduce the headaches that often accompany property ownership.

Unlike a typical 1031 Exchange, in which a single owner defers capital gains taxes by reinvesting proceeds of a real estate sale into similar property, the IRS rule Steinhause helped pass in 2002, Revenue Procedure 1002-22, stated that property owned by multiple people also fell under the tax-deferred exchange policy.

A 53-year-old University of Wisconsin Law School graduate who also has an MBA and an LLM, Steinhause had been crafting partnership offerings at Luce Forward for a decade when he pitched his legal change to the IRS in 1994.

He said he didn't know what to expect at first.

"I was surprised. Most people thought a tenant-in-common structure with multiple owners would be treated like a partnership, which meant you couldn't use it for purposes under a 1031," Steinhause said. "But after the IRS put out the revenue procedure, it just exploded."

As TICs expanded into every real estate investment type, Steinhause and his firm worked on a series of massive TIC deals last decade. Those included the largest ever, the 2003 sale of the Puente Hills Mall in Industry to Passco, which involved 34 tenant-in-common investors and a limited liability company that funneled $56 million into the $148 million deal for the 1.2 million-square-foot shopping center.

"That one was very complex because it involved so many different tenants," Steinhause said. "Every issue of the loan was looked at carefully by the lender and lender's counsel."

In 2007, NNN Realty Advisors, which at the time was one of the largest sponsors of TIC securities with nearly $3 billion in equity investments, surprised the real estate industry by acquiring Grubb & Ellis, one of the more prominent real estate services firms in the nation, in a reverse merger.

As TICs gained momentum, the industry was divided over whether the transactions were securities and guided by securities laws or whether they were real estate transactions. That was resolved in favor of securities by the Securities and Exchange Commission in January 2009, but by then the TIC market hardly resembled itself.

The industry had been rocked by major deals that went bust, including Oregon-based Sunwest Management, which persuaded 1,300 investors to become separate groups of tenant-in-common investors to back its nationwide chain of senior living homes. The SEC sued the operation in early 2009 and forced it into receivership, contending its executives were commingling the funds. Investors lost millions.

Thousands of TIC investors also were left holding the bag following the collapse of DBSI, a nationwide real estate investment company that went bankrupt in 2008. DBSI filed a bankruptcy plan this July offering to pay 20 cents on the dollar for the $800 million in outstanding claims.

As the market plummeted amid the financial crash, the Tenant In Common Association, the national trade group representing the industry, reorganized and changed its name last year to the Real Estate Investment Securities Association. The group now serves a broader contingent of investors, including real estate investment trusts and partnerships.

The change, according to Craig Porter-Rollins, a former member of REISA's board of directors, "sped up when the tenant-in-common industry was starting to fall on hard times."

Porter-Rollins, chief executive officer of investment advisory firm LJCooper Capital Management in Utah, said with tighter investment rules in the wake of the crisis, TIC deals "have a lot more due diligence, and more research is being done on properties."

"I don't think the industry will go away, but I do think it is evolving," Porter-Rollins said.

According to Wood, a limited niche in which TICs continue to go forward is in apartment and other multifamily deals. That's because multifamily is virtually the only residential housing sector in which government-sponsored financing from Fannie Mae and Freddie Mac has remained robust. "There is available financing these days through Fannie and Freddie. Theoretically, a buyer can buy apartments and finance it that way," Wood said.

Wood said he doesn't see the TIC structure as a "particularly financeable model over the long term."

"Tenancy-in-common sponsors have come to realize how unwieldy an investment deal it is," Wood said. "There's unbelievable brain damage you have to go through to unwind a TIC if the property has problems.

"It's not impossible," he added, "but it's extremely difficult."

On the other hand, Brian Weinhart, a name partner at Steckbauer Weinhart Jaffe in Los Angeles, expects TICs to make a comeback, but said it will take at least three to five years.

"Until the real estate market starts to significantly appreciate, there won't be much appetite for TIC deals," Weinhart said.

Investors now are dealing with a host of maturing TIC loans with few refinancing opportunities, Weinhart said.

Securing bank modifications of such loans is a rough process, he said, because IRS rules require unanimous consent among tenants-in-common on a property.

"This is especially true in large projects where there may be dozens of TIC investors," Weinhart said.

Jeffrey P. Woo, special counsel with Sedgwick, Detert, Moran & Arnold in San Francisco, said some investors are cautiously re-entering the TIC market.

"We're starting to talk to developers about projects, and there's some renewed interest," Woo said. "It seems like the market is starting to come back."

Steinhause said many former broker-dealers who worked on TIC transactions - those who buy and sell securities - have moved on to other types of investments, such REITs and Delaware Statutory Trusts, or DSTs.

In fact, Steinhause said a lot of his work now involves structuring DSTs, which, similarly to TICs, involve multiple investors in a project and allow for 1031 benefits.

But unlike TICs, DST investors are considered one unit, and they can't attempt to modify a loan once it's finalized.

As a result, banks are more willing to finance DSTs, Steinhause said.

When TICs make a comeback, Steinhause said "we'll see a big difference in who is still out there.

"Back in 2004, I said the industry had to look out because it was expanding so quickly. I said you couldn't just have a pickup truck and a dog and believe you were a TIC sponsor," Steinhause said. "The ones that will survive will be the strong real estate companies, and they'll come back to tenant-in-common deals that investors will look at."