

QUESTIONS AND ANSWERS ON TENANCY IN COMMON

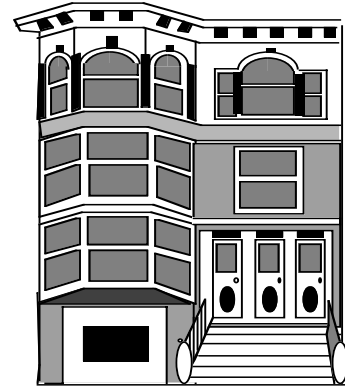
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WHAT IS A TENANCY IN COMMON (TIC)?

Tenancy in Common is a form of group ownership and can best be understood through comparison to the condominium. In a condo, the portions of the property inside the apartment walls are owned by individuals, and everything else is owned by a group. In a TIC, the entire property is owned by a group. A detailed written agreement describes each TIC owner's rights and duties.

WHY HAVE TICs BECOME SO POPULAR?

San Francisco severely restricts both new condo construction and conversion of older buildings to condos, keeping the cost-per-unit of condos much higher than the cost-per-unit of apartment buildings. In addition, TICs often can be converted into condos after a period of owner-occupancy. (See our article entitled "Condominium Conversion In San Francisco" for information about conversion.)

HOW ARE TICs STRUCTURED?

In most TICs, a "relative value percentage" is assigned to the areas (dwelling, parking, storage, deck etc.) that each owner will occupy. Factors that affect relative value percentage include size, level within the building, light, views, and general condition. The percentages are typically determined through an appraisal process conducted by either the prospective co-owners, a real estate agent, or a licensed appraiser. A common approach is to value each unit as if it were a condominium. Recent sale prices for comparable condominium units can be used as a basis for this valuation. Once the condominium values are established, they are added together and each is divided into the total to yield the percentages.

After purchase, each owner occupies and maintains his/her assigned areas. The costs of maintaining shared areas, and most other building expenses, are divided according to relative value percentage. Each owner can sell his/her interest at any time. If the building is converted to condominiums, each owner receives his/her assigned areas as a condo.

Frequently, a prospective TIC owner will have a small down payment but ample income, or a large down payment but limited income. This problem can be overcome by making each owner's percentage share of the loan different from his/her percentage share of ownership. Provided that the total of a particular owner's down payment and loan share equal his/her share of the building cost, this type of arrangement is equitable.

When the relative value percentage approach is not appropriate, a real estate attorney can help the co-owners develop an appropriate structure. The primary goals should be maintaining simplicity, minimizing group decisions, and maximizing marketability.

ARE TICs LEGAL?

On August 8, 2001, San Francisco enacted legislation to slow owner-occupancy of rental housing. Since the City could not prohibit group-buying or owner-occupying, they attempted to discourage this behavior by making it more risky. Traditionally, TIC Agreements give each owner the exclusive right to occupy his/her assigned unit so that one owner could not "invade" another owner's home. The new law attempted to make these exclusive occupancy arrangements illegal and unenforceable on the theory that the co-owner unit invasion risk will deter group owner-occupancy. On January 10, 2003, the law was found unconstitutional and entirely invalidated. Given the evolving nature of the situation, and the possibility of an appeal, buyers and owners should check with the authors for recent developments before making commitments based on information in this article.

WHAT ARE THE STEPS IN A TIC FORMATION PROCESS?

Group members first evaluate each other's financial statements, and undertake the building inspection and loan application processes which are common to all real estate purchases. Accepting the financial statements, approving the building condition, and obtaining a satisfactory loan should all be preconditions to a group's obligation to buy a building.

An attorney experienced in TIC formation should raise and explain the many important issues associated with group ownership, and help assess the advantages and disadvantages of various approaches. Through this process, the group members thoroughly develop and test their ability to get along, solve problems, and make decisions. They also create the framework and spirit necessary for successful response to unforeseen future events.

The attorney prepares a comprehensive written agreement that is specifically tailored to the group's personalities and needs. Each participant may then have the draft agreement reviewed by his or her own attorney and accountant, and bring the comments of these outside experts before the group for discussion and further revision of the agreement.

WHAT IS INCLUDED IN A TIC AGREEMENT?

The following is a partial list of issues a TIC agreement should cover:

- Division of the property into "individual" and "group" spheres with regard to usage rights and maintenance responsibilities;
- Description of the owners' financial obligations including initial deposits, reserve accounts, mortgages, taxes, common area maintenance and other expenses;
- Formulas for determining each owners' monthly payment in advance and periodically adjusting the amount;
- Management of the property including accounts receivable, accounts payable, regular reporting, maintenance and janitorial;
- Rules governing usage of the property by the owners (e.g. pets, noise, floor covering) and enforcement provisions;
- Meeting and decision making procedures;
- Provisions defining when a default has occurred and describing remedies;
- Policy in the event of death or bankruptcy;
- Sale of interests, group approval of prospective purchasers, and rights of first refusal; and
- Dispute resolution.

A thorough and comprehensive agreement includes numerous additional issues. Use of a "boiler plate" or standard form agreement does not facilitate the necessary level of group discussion or understanding, and consequently creates a higher probability of a subsequent disagreement. Should a dispute develop, everyone ultimately loses.

Even a well-prepared TIC agreement should be used only in the event friendly relations among group members break down. While it is useful to have owners' rights and duties well defined, relying on the agreement to dictate a response to actual events is unwise. Even the best agreement will rarely anticipate all circumstances, and applying a formulaic response that does not quite fit the

situation may not reveal the best course of action. Such an approach encourages group members to adopt firm positions based on agreement interpretations, and an impasse may develop. A better strategy is to rely first on discussion. The goal should be to develop a consensus that all owners can accept even though some may believe that the agreement dictates a more personally advantageous decision. If a consensus cannot be reached, the TIC Agreement can provide a final resolution.

HOW ARE DECISIONS MADE?

In most TIC groups, each owner has one equal vote, and routine decisions are made by a majority. Major items such as sale or refinancing of the building, and expensive non-emergency repairs or improvements generally require unanimity.

HOW ARE EXPENSES PAID?

Building expenses are divided into "individual expenses" and "group expenses". Individual expenses include maintenance and improvements to unit interiors, personal property insurance, and separately metered utilities; they are paid directly by the individual owners. Group expenses include mortgage payments, building insurance, property taxes, maintenance and improvements to common areas, and shared utilities like water and trash removal; they are paid through a group bank account using a monthly assessment system. Under this system, each owner makes a single monthly payment to the group account. The monthly payment is based upon the total of the owner's share of each of the anticipated group expenses. To add predictability and protect against default, even semi-annual and annual expenses, like property taxes and insurance, can be included in the owners' monthly payments.

HOW ARE TICs MANAGED?

TICs often have a manager (usually a group member) who is responsible for collecting monthly payments, paying bills, keeping books, and arranging repairs. The group meets periodically with the manager to determine the anticipated expenses including mortgage payments, taxes, insurance, utilities and replenishment of reserves, and then establish each owners' monthly payment.

CAN A TIC OWNER SELL HIS/HER OWN INTEREST?

TIC interests can be sold at any time for any price the market will bear, provided the group approves of the qualifications of the purchaser. In San Francisco, TICs have rapidly achieved acceptance and popularity, and their relatively low price has caused them to re-sell briskly. Marketability is enhanced if, by resale time, the group has a track record of solving its problems and paying its bills, greatly decreasing the buyer's risk.

HOW ARE TIC RESALES FINANCED?

In most instances the TIC will not refinance the property when a single owner sells. Instead, the buyer will join the other owners as a borrower on the existing loan, and will assume the seller's percentage of the outstanding loan balance under the TIC agreement. To accommodate this arrangement, it is important that purchase money loans for TICs be assumable. Moreover, to minimize the fees and inconvenience sometimes associated with loan assumption, it is beneficial to obtain a loan that allows a "partial assumption" — a substitution of a buying partial owner for a selling partial owner. When allowed, partial assumptions are generally much less expensive than full assumptions, and do not involve re-qualification by the entire owner group.

If the TIC interest being sold has dramatically appreciated in value, there will be a large difference between the sale price and the seller's percentage of the outstanding loan balance. If the buyer does not have a large down payment, the seller will need to (i) accept some of the down payment as a note payable in the future and secured by the property, (ii) increase the size of the existing loan (if allowed by the lender and the TIC agreement), or (iii) arrange to refinance the property. Most TIC agreements have detailed rules governing these processes.

DOES A TIC PROVIDE THE SAME TAX BENEFITS AS OTHER REAL ESTATE?

Owner-occupants may deduct their mortgage interest and property taxes, and often may avoid capital gains tax on resale. Owner-investors declare their income and expenses, including depreciation, and may undertake a tax-deferred exchange.

HOW DO RENT CONTROL LAWS AFFECT TICs?

Notwithstanding the efforts of tenant activists to ban TIC ownership, TICs are more popular than ever. But recent changes in San Francisco's rent control laws have further restricted the ability of TIC owners to occupy their new homes if tenants are present. Only one "Owner Move-In" eviction per building is allowed, and this type of eviction is limited to situations where the tenant is not a protected elderly, disabled or terminally ill person. The evicting owner must hold a 25% ownership interest and meet a variety of other qualifications. Where more than one eviction is necessary,

the tenant is protected, or the owner does not qualify under "Owner Move-In" rules, all tenants in the building can be evicted under the "Ellis Act", but subsequent rental of the property is restricted. All of these laws are complex and anyone contemplating a TIC purchase of a tenant-occupied building should seek legal advice before buying.

WHAT OTHER LEGAL RESTRICTIONS APPLY TO LARGER TICs?

The California Department of Real Estate (DRE) has recently taken the position that it is illegal to form a TIC in buildings of five or more units unless the building has received a form of DRE approval called a "Public Report". This position conflicts with the opinion of many attorneys who believed that a Public Report was not required for groups of 5-10 provided two simple DRE forms were signed and filed. Until the courts decide whether a Public Report is actually required, it will be risky to form

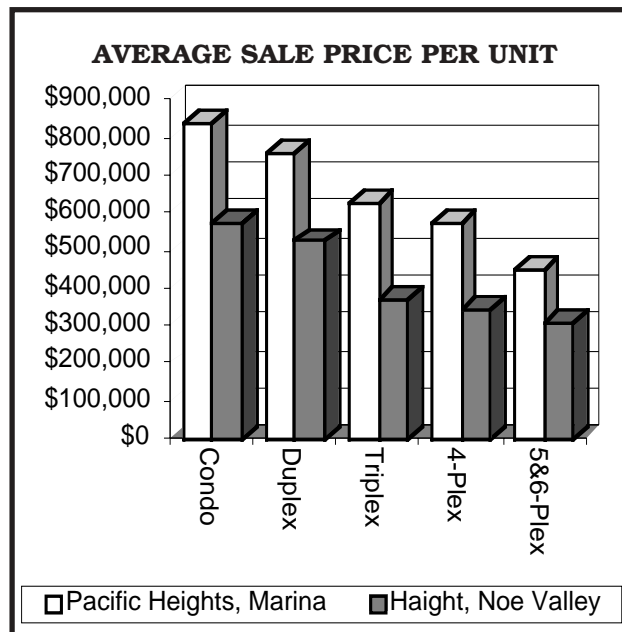
a TIC in buildings of five or more units without a Public Report, and sellers should consider obtaining one. Fortunately, the DRE has stated that a Public Report is not required for resale of an interest in an existing TIC, even if the TIC has never had a Public report. The DRE is now issuing Public Reports for new TICs for the first time. Please consult an attorney regarding the latest developments in this area.

ARE TICs RISKY?

All co-ownership forms (TICs, condominiums, cooperatives, partnerships, etc.) involve the risks of sharing use of property with others and relying on them

to fulfill their obligations to you. The level of risk depends on the portion of the property that is co-owned, and the size of the obligations that are shared. For example, condo owners co-own relatively little of the building (e.g. structural elements, systems, common areas), and share relatively few obligations (e.g. maintenance and insurance of the co-owned areas, staff salaries), making the risk relatively low. Thus while condo owners need to worry about such issues as whether their neighbors will be capable of group decision making, be considerate in their use of the common areas, and pay their home owners' association dues, they need not worry about whether their neighbors will make mortgage payments.

The extra risk of TIC ownership arises because the owner group is collectively responsible for all obligations of ownership. If a TIC owner fails to make a monthly payment and a mortgage default results, the lender



could foreclose on the entire building causing all of the other owners to lose their homes and possibly their equity.

The following steps minimize the risk of TIC ownership:

- A complete investigation into the background and qualification of potential co-owners;
- An exhaustive evaluation of the property and financing;
- Creation of a customized TIC agreement that every member of the group fully understands;
- Using a monthly assessment system for payment of group expenses;
- Establishment of a default reserve fund; and
- Strong procedures to enforce the TIC agreement.

WHAT IF AN OWNER FAILS TO MAKE A PAYMENT?

If the group determines that the non-paying owners' situation is temporary, they may make a loan from the group reserve account. Otherwise, depending on their agreement, the group may employ a variety of harsher options including eviction, forced sale, and foreclosure.

HOW CAN I GET INVOLVED IN A TIC GROUP?

Your first decision will be whether to join an existing TIC group by buying a single TIC interest that is available for sale, or to participate in a "new" TIC as one of the founding members. Joining an existing TIC group is usually more expensive but involves less risk because the group will already have developed a "track record" of successful decision making and regular monthly payments. An existing group may also be farther along in the process of qualifying the building for conversion to condominiums.

If you opt for a "new" TIC, you will have three possible ways to proceed:

- Assembling your own group of family or friends, then working with a qualified Realtor to locate a building. After you find a building that the whole group likes, you will need to agree on the assignment of percentages and units.
- Joining an individual or group that is in the process of buying a building, but has an available unit. A Realtor can help you find such an individual or group and then evaluate the qualifications and suitability of the potential co-owner(s).
- Working with a Realtor to find a multi-unit building, creating a fair ownership structure, then locating co-owners for the other units.

ABOUT THE AUTHORS AND THE FIRM

The firm of Goldstein, Gellman, Melbostad, Gibson & Harris, LLP, formed in 1986, has extensive experience in real estate litigation and transactions. The firm's practice includes real property sales and exchanges, general land use, buyer/seller disputes, landlord/tenant disputes, estate planning and probate.

D. Andrew Sirkin, of counsel to the firm, is a recognized expert in co-ownership forms including condominiums, TICs, equity sharing and co-housing. He is an accredited instructor with the California Department of Real Estate, and frequently conducts co-ownership workshops for attorneys, real estate agents, corporations, and prospective home buyers. His first book, *The Equity Sharing Manual*, was published by John Wiley and Sons in November 1994, and his most recent book, *The Condominium Bluebook*, was published by Piedmont Press in January 2001. Mr. Sirkin has been working with TIC groups since 1986, and has prepared TIC agreements for over 1500 clients. He has written three companion articles to this one. They are entitled "Owner-Occupancy and Ellis Evictions", "Condominium Conversion in San Francisco", and "Unmarried Couples and Property Ownership". Copies are available from the firm free of charge. Mr. Sirkin can be contacted via email at DASirkin@earthlink.net.

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