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Working capital and operating reserves: The emperor borrows the TIC's clothes

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As a due diligence law firm that has analyzed securitized tenant-in-common (TIC) offerings numbering in the hundreds over the past five years, we have seen the various developments, and the varying treatment by TIC sponsors and their counsel, regarding the designation, holding and application of reserves. Notwithstanding efforts by many broker-dealers, registered representatives, due diligence law firms and clients to require that reserves in all forms be accountable, many TIC sponsors and their law firms fail to specify not only the specific purposes for many reserve accounts, nor the accountability thereof, but now are leading the charge to collect even more money from investors that does not purchase real assets but rather is paid back to investors over time. This article defines existing reserve accounts, examines the potential rationales for collecting working capital reserves, and concludes that working capital reserves should not be a substantial component of a prudently structured TIC offering.

A brief discussion of typical reserve accounts and structure on existing TIC offerings is in order. There are several reserve dollar "buckets," or accounts, that are traditionally set up and funded either at closing of the real estate acquisition and/or on a monthly basis. The first type of account is always included and is easily calculable. The lender will require a reserve account for payment of real estate taxes and insurance premiums for the asset. Although commercial real estate loans do not have to follow Real Estate Settlement Procedures Act (RESPA) guidelines, many commercial tax reserve accounts are calculated and funded on the same basis. As taxes are generally paid in semi-annual installments, the lender will estimate the real estate taxes due and payable for the annual period following closing and reassessment, collecting the half-year installment next then due, plus a one or two-month cushion. Regarding insurance, a full annual premium is generally collected and paid at closing with an additional 1/12th or 2/12th of the annual premium. Thereafter, the lender collects a prorated portion of the taxes and insurance premiums on a monthly basis. These reserves are almost always held by the lender in a TIC offering.

Reserve accounts are also generally allocated to capital improvements and tenant retention. Usually tenant improvement and leasing commissions (TI/LC) are combined into one reserve account, and project capital improvements are included in another. With respect to the TI/LC reserve, multiple parties, including, but not limited to, the sponsor, the mortgage broker, the lender, and the due diligence underwriter, analyze the rent roll turnover, condition of existing improvements, market rate allowances for attraction of new tenants and retention on lease renewal, and estimate the appropriate reserve figures. Most often, the TI/LC reserve will be controlled in two "buckets," one held by the lender based on its underwriting and the 10-12 year property condition assessment, and the other held exclusively by the sponsor (in hopefully a segregated account), to ensure that there will not be any underfunded TI/LC costs throughout the projected holding period. There are legitimate reasons for a sponsor to hold these excess funds; for example, in a supply-constrained market with low vacancy and negligible deliveries of new space to the market, landlord concessions at $10/per s/f for tenant improvements may increase to $18-20 as the market slows. Therefore, there is a rationale for holding back TI/LC reserves beyond lender-mandated amounts in the mortgage loan commitment or note.

The newest and most troubling reserve category is the "working capital" or operating reserve. John Maynard Keynes posited that working capital, or purposefully held cash, should be used for three purposes in an operating business:

1. Speculation or opportunistic investment, e.g. purchasing inventory at discount.
2. Holding cash as a precaution for short-term liquidity needs, ie. contractual obligations.
3. Routine transaction needs, the providing of the firm's products or services.

While some TIC offerings may, unfortunately, truly be characterized as speculation, it is the author's opinion that such speculation was not what Keynes had in mind. As the unrealistic assumptions and buried profit that have stressed various TIC offerings from the date of closing start to materialize, it appears that many sponsors, rather than delivering the bad news that, in many cases, they knew would develop, would rather raise "working capital" or "operating" reserves and not, as it were, face the music with TIC investors. The best characterization of the use of excessive working capital reserves would be the vacation of a material amount of space by one or more tenants, an optimistic plan by the TIC sponsor to replace the tenancy within a short period of time (e.g. 60-90 days), and expend the working capital funds after six months of remarketing the project space. On the other hand, some sponsors argue, and reasonable minds could agree, that a working capital reserve equal to thirty days of normalized project operating expenses and one month's PITI payment would be prudent. This approach would be consistent with Keynes' short-term liquidity approach. If "it's real estate and real estate has risk," then a healthy market with lean and transparent offerings should be allowed to function with the investment performing on its underlying NOI merit, not artificially supported economics.

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