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Breaking Up Is Hard to Do: Partition and Possible Land Mines (or What to 'Mind') for Lenders and Tenants-in-Common


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Can you play nice and share a piece of real estate? Sharing is hard enough, but imagine jointly owning an investment property with your brother when he decides that he would like to sell and then retire in Hawaii. While your brother would like to cash out his investment for the sun and sand, you live in the building, operate your business in the ground floor commercial space and never want to sell the building that you inherited from your parents. What if you cannot amicably resolve the dispute?

A partition action provides a remedy to any person or entity who co-owns property with another (not in the form of an LLC or partnership) and who wishes to segregate and terminate common ownership interests in the same parcel of property. Partition actions are a unique option of last resort when diverging interests are at odds and, if possible, should be avoided with proper real estate planning. Under N.Y. Real Prop. Acts. Law ("RPAPL") § 901, a partition remedy is available to any person who is a joint-tenant or tenant-in-common under New York real property law. A tenancy-in-common and joint tenancy is a form of ownership where two or more parties, as co-tenants, own directly, undivided interests in real property. Ideally, the co-owners of the property will have planned in advance, through a written agreement (a TIC Agreement), how to effectuate a division or sale of the property, or will amicably come to an agreement as to how to fairly divide or to sell the property. The distinction between a joint tenancy and a tenancy-in-common is that, in a joint tenancy, the survivor of the property inherits the interest of the other, while in a tenancy-in-common, the interest will pass through to the issue, heirs or devisee of the decedent tenant-in-common.

Where an agreement or voluntary disposition is not possible, the parties must file a partition action to obtain a ruling from a court to unravel the co-ownership interests that are at odds. There are two ways to effectuate a partition of real estate in New York: (i) a partition in kind, which physically divides the property so that each party owns a portion of property as the sole owner, and (ii) a partition by sale, where the property at issue is sold at auction and the co-owners divide the proceeds in proportion to their ownership rights. In New York, a partition by sale is far more common because the property in dispute typically cannot be physically or equitably divided, as many properties consist of a single tax lot with one improved structure, and even seemingly similar properties, like condominium units in the same building, will often have differences (*i.e.*, views, layouts) that make division impractical.

While joint ownership and the tenant-in-common structures are common, they do present certain risks for the individuals involved and any potential mortgage lenders, including the risks posed by a partition action, unresolved disputes between TIC Owners, and owners losing their equity in the property. If a tenant-in-common property is partitioned into multiple parcels, the lender, as long as all tenant-in-common owners are party to the loan, will retain its lien on each parcel between its borrowers and guarantors, but each parcel would no longer be operated in a uniform fashion under common management. The value of each individual parcel may also vary or be less than its original appraised value. Similarly, if the mortgaged property is subject to a partition action and subject to a court-ordered sale, the proceeds of the sale may be less than the lender's loan or expected return and increase the risk of disruption of the property's performance during the term of the legal proceedings, particularly if the tenants in common are not cooperating in management.

For lenders, it is undeniable that tenancy-in-common ownership structures present obstacles, although many of the obstacles can be mitigated through the implementation of comprehensive tenancy-in-common agreements and well-crafted loan documents. Because of the significant consequences to the collateral if the property were partitioned, a lender typically will require the co-tenant borrowers to waive their right to partition for the term of the loan. The waiver of the right to partition should be affirmed and codified in the tenant-in-common agreement, or similar agreement if applicable, and affirmatively waived in the loan documents. As added precaution when drafting loan documents, a breach by the borrower of its covenant to waive its right of partition should not only be a default under the loan documents but also included as a non-recourse carve-out, such that a violation would give rise to recourse liability against both the borrower and any guarantor. In addition, the waiver of the right to partition should be filed of record in the applicable recording office to reflect that the interests under the agreement are subordinate to the lender's mortgage. The lender should also require that the borrower's attorney provide a legal opinion addressing enforceability of the partition waiver contained in the tenant-in-common agreement and the loan documents.

In most cases, all co-owners will be party to the loan documents and both individually and jointly liable for the obligations to repay under the loan documents. This requirement is needed due, in part, to RPAPL §929, which provides that "after actual partition the lien of a creditor having a lien on an undivided share or interest in the property, who is or is not made a party, shall attach only to the share or interest assigned to the party upon whose share or interest the lien attached…" Having all co-owners as signatories to the loan documents provides added protection for the lender to ensure they have a lien on the entire collateral, even if partitioned.

An additional issue to be addressed is how the interests are separated if one party agrees to buy the other out in a settlement of a partition action. If the subject property is encumbered by a loan and all TIC Owners are jointly liable, although the co-owners may agree on the terms and price for one individual to remain an owner of the property and purchase the equity interest of the departing person, the agreed sale would result in a default under the loan, unless the lender provides consent for the separation of ownership. If the lender does not consent, the TIC Owners are still both jointly liable to the lender under the terms of the loan and responsible for repayment of the loan, and can be sued in a foreclosure action after a default under the loan. The departing co-owner technically has no connection to the property after the partition (if an equity purchase) but is still obligated under the loan, unless otherwise released from its obligations and guaranty under the loan by the lender.

To mitigate the lender's risk of the intertwined financing of TIC Ownership, the lender should take particular care in reviewing the TIC agreement and prevent or limit resale of the TIC Ownership interests under the loan documents. The loan documents will typically contain transfer provisions restricting change of ownership (guided by a threshold percentage of ownership change) without the lender's consent, or even a "due on sale" provision that prohibits TIC Ownership interests from being sold without the lender's consent. In cases where TIC Owner can transfer their interests, lenders obligate that the new TIC Owner assume the obligations and liabilities of the departing TIC Owner under the loan documents.

For joint owners of real estate, there are also many risks and potential abuses of the partition action that often target owners that are unsophisticated in real estate matters and/or economically disadvantaged. Through legislation, many states enacted the Uniform Partition of Heirs Property Act ("UPHPA"). Since introduction of the UPHPA in 2010, versions of the UPHPA have been enacted in 21 states, including New York, and similar bills are currently being considered in other states. In the State of New York, the UPHPA, codified in RPAPL § 993, the forced sale of inherited property goes through a different process than the typical partition process, which is designed to help families that own "heirs property" as tenants-in-common that have been targeted by real estate opportunists looking to acquire property at below market prices. "Heirs Property," as defined under RPAPL § 993, "means real property held in tenancy-in-common which satisfies all of the following requirements as of the filing of a partition action: (i) there is no agreement in a record binding all of the co-tenants which governs the partition of the property; (ii) any of the co-tenants acquired title from a relative, whether living or deceased; and (iii) any of the following applies: (A) twenty percent or more of the interests are held by co-tenants who are relatives; (B) twenty percent or more of the interests are held by an individual who acquired title from a relative, whether living or deceased; (C) twenty percent or more of the co-tenants are relatives of each other; or (D) any co-tenant who acquired title from a relative resides in the property." Before New York enacted UPHPA, partition law in the State of New York left co-tenants' heirs subject to being taken advantage of by creative real estate investors. In New York, under the UPHPA, once the court classifies the inherited property as Heirs Property, the other co-owners are given due process protections such as notice, appraisal, the opportunity (or right of first refusal) to buy out the share of the other co-owners who filed an action for partition and if the other tenants-in-common chose not to exercise their right and a sale is required, a commercially reasonable sale supervised by the court to ensure all parties receive their fair share of the proceeds at market value.

When property is owned as a tenancy-in-common, particular care should be exercised to address this nuanced ownership structure to protect against and mitigate the risks attendant to common law and statutory rights of partition.