What to Do with Troubled TICs? Considerations for Lenders

Lenders may be able to reform loan documents and enhance their position with tenant-in-common borrowers in the aftermath of the economic downturn.

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Between 2002 and 2008, the commercial real estate industry witnessed an explosion in the popularity of real estate investments in tenant-in-common (TIC) structures. The impetus for this remarkable increase in popularity was an IRS revenue procedure issued in 2002.

The procedure gave comfort to investors and financial advisors that capital gains earned from selling real estate could be reinvested into TIC interests in revenue-producing properties, with no recognition of capital gains under the like-kind exchange rules of Internal Revenue Code Section 1031. Investors pooled assets with others to invest in TICs, owning everything from apartment buildings to office towers. The rapid growth of the industry, riding on the front edge of the real estate bubble, was fueled by TIC sponsors and syndicators who offered investors their services to identify co-investors and provide documentation to create and manage the TIC structure. In many situations, they offered a guaranteed return on the investment.

The relative dearth of practical, judicial, or legislative guidance on TICs as a modern real estate investment tool led to a wide array of TIC structures, governed by widely varying documentation. Equally uncertain was how lenders should protect themselves against various issues specific to the structure.

Over the last several years, commentators have suggested various structures and provisions that TIC lenders should include in their TIC loan documentation to provide the optimum level of protection. However, given the lack of established practices for TICs and the rapid expansion of the industry, it is likely that many lenders currently do not enjoy the benefit of these protective measures. Further, many loans to TICs were negotiated and managed through sponsors. As these sponsors failed during the economic downturn, many lenders and investors were left with unanswered questions and serious issues with their TIC properties.

As defaults occur and loan maturities approach, lenders may now have an opportunity to reform loan documents and TIC structures to help good TIC assets become better loans, enhancing the functionality of the borrower and the security of the lender.

This article provides a brief background on the development of modern TICs, along with a discussion of some important points for lenders who have outstanding loans on TIC assets syndicated and managed by failed or bankrupt sponsors. Also offered are some general considerations for lenders who may have the opportunity to reform TIC loan documents or master leases.

IRS Revenue Procedure 2002-22

The tenancy-in-common structure has been around for centuries and, until recently, had not deviated far from its common-law ancestry. In a traditional tenancy in common, each co-tenant

owns an undivided interest in the property. The law of the jurisdiction controls certain aspects of their relationship, such as when an individual co-tenant can seek a partition of his or her interest, when co-tenants may seek to oust a fellow tenant, and how the co-tenancy interest passes in marriage, divorce, and death.

Similarly, for decades, the IRS has offered taxpayers the ability to defer capital gains through like-kind exchanges. However, investors seeking to reinvest capital gains from the sale of real estate through an IRC Section 1031 exchange generally would not invest those gains through a TIC structure. The reason was uncertainty over whether the structure would be recognized by the IRS as an investment in real estate or as an investment partnership, the latter failing to achieve nonrecognition of gains.

In 2002, the IRS addressed this issue with IRS Revenue Procedure 2002-22. The procedure sets forth 15 conditions under which the IRS will consider a request for a ruling that an undivided fractional interest in real estate (a TIC interest) will be recognized as such in a like-kind exchange, and not as an investment in a business partnership. The procedure, however, does not create a "safe harbor" or set forth substantive rules on how to structure a TIC to ensure nonrecognition of gains in an exchange.

Despite the lack of concrete guidelines from the IRS on how to safely structure a TIC, over the last several years sponsors and investors have widely accepted Revenue Procedure 2002-22 as a blueprint for structuring 1031-friendly TICs and have incorporated as many of the 15 conditions into their TIC structures as possible. There is ample commentary on these 15 conditions and the nuances of each, but for the purposes of this article the following conditions, quoted from the procedure, are most pertinent to the discussion below:

- Each co-owner must hold title to the property (either directly or through a disregarded entity) as a tenant in common under local law.
- Any sale, lease, or re-lease of a portion or all of the property, any negotiation or renegotiation of indebtedness secured by a blanket lien, the hiring of any manager, or the negotiation of any management contract (or any extension or renewal of such contract) must be by unanimous approval of the co-owners.
- A co-owner may issue an option to purchase the co-owner's undivided interest (call option), provided that the exercise price for the call option reflects the fair market value of the property determined as of the time the option is exercised. For this purpose, the fair market value of an undivided interest in the property is equal to the co-owner's percentage interest in the property multiplied by the fair market value of the property as a whole.

These three conditions are of particular interest to lenders with TIC borrowers.

Failing Sponsors

A central concern for lenders in the current TIC environment is the insolvency of TIC sponsors. Many sponsors played multiple roles within the TIC structure through various affiliated entities, often as the syndicator, the lessee under a master lease, the property manager, and, in some cases, a co-investor. In the last 18 months, many of the country's largest TIC sponsors have

gone into bankruptcy,[1] leaving investors and lenders scrambling to find replacement sponsors and to reform deals.

The majority of sponsors syndicated TIC interests under a "master lease" structure, wherein investors unanimously approved a single master lease to an entity controlled by the sponsor and received guaranteed returns as "rent" under the lease. Returns were commonly guaranteed at 6.5 percent and some were as high as 12 percent annually.[2] For a healthy fee, the sponsor acted as property manager for the master tenant and had the authority to negotiate and sign leases and to manage the underlying property without much oversight from TIC investors. Sponsors retained the right to pool profits from all of their properties to pay returns, thus insulating their liability on underperforming assets with profits from well-performing assets and fee revenue. In addition to the management fees, the sponsor would often collect fees for syndicating investors, for finding and negotiating loans, and for disposing of the property.

The recent turmoil in the real estate marketplace created the perfect storm for TIC sponsors: shrinking profit margins or operating losses on properties, falling property values, and zero transaction volume to generate fee revenue. Many sponsors have defaulted on return obligations and some have failed completely. Most notoriously, Boise-based DBSI Inc. and its many subsidiaries filed for bankruptcy in November 2008. Their bankruptcy filing listed debts in excess of $100 million, with each of their top 50 creditors an individual TIC investor. That bankruptcy alone affected more than 8,200 investors and hundreds of properties. Many parties have had to step in to deal with the departure of DBSI — to sell or buy their associated properties, find replacement property managers, and negotiate necessary loan modifications to reflect the sponsor's failure.

Not all lenders will have to deal with issues related to the sheer scale of the DBSI bankruptcy, but the issues involved in the loss of the sponsor are largely the same for all TICs: lack of investor knowledge about the property or its tenants, lack of communication and organization among the co-tenants, and the need to revise the property's master lease and loan documents to reflect the new realities of the TIC structure. Of course, all of these issues must be resolved within the promulgated confines of Revenue Procedure 2002-22. For lenders currently dealing with TIC sponsors that are in or near bankruptcy, the following issues should be of utmost importance to ensure their TIC assets continue to perform.

Asset Management. Asset management should be a top priority for lenders when a TIC sponsor fails. In many cases, a sponsor-syndicated TIC may include co-tenants from all over the country, if not from all over the world, who have likely never seen the underlying asset. A typical master lease (as discussed below) granted the sponsor broad authority to manage the property independently, leaving investors in the dark as to the day-to-day operation of the asset. If the sponsor fails, the lender cannot realistically look to the co-tenants to promptly and competently take over management of the asset.

Revenue Procedure 2002-22 requires unanimous co-tenant approval for the selection of a property manager or the execution of blanket-lien loan documents on the property. As sponsors signed up eager investors, obtaining unanimous consent among co-tenants was merely a hurdle. Today, however, getting unanimous approval may be difficult, if not impossible. To

address the unanimous approval issues, many lenders and co-tenants negotiated call agreements into their governing and loan documents by which each TIC investor (or all of them collectively) had the right to purchase the interest of a holdout investor if 80 percent (or some majority) of the other co-tenants were in agreement.[3] Even with a call agreement in place, a holdout investor may gain substantial leverage if the other co-tenants are unwilling or unable to come up with the additional capital to purchase his or her interest.

If a call agreement was not negotiated in the original agreements, it should be considered at renegotiation, but getting holdouts to agree to a revised master lease and loan documents may be difficult. When negotiating with TIC borrowers, whether regarding a loan, master lease, or property management agreement, the lender should be keenly aware of the legal requirement of unanimous approval. There will have to be a delicate balancing of interests between the co-tenants, most likely orchestrated by the lender. These discussions can be a litmus test for the lender to determine the long-term plan for an asset.

If co-tenants are unresponsive or become embroiled in a prolonged debate over these issues, or if there are obstructionist TIC investors who appear to be using the call agreement as a leverage strategy, this may indicate major problems down the road, and a quick exit strategy may be the best plan. On the other hand, if the co-tenants are well organized and focused on the well-being of the asset, this may be an opportunity for the lender to reform the deal and keep the loan performing.

Communication. Communication with the co-tenants will be key to a successful reorganization of a TIC following the failure of a sponsor. Generally, the sponsors serve as the conduit between these parties, so the lender may not have a relationship with, or even proper contact information for, the co-tenants.

If there is not already a point person for contact between the lender and the co-tenants, one should be identified immediately. For the DBSI bankruptcy, each group of co-tenants identified a single contact person who then served as the primary conduit for dissemination of information to the other investors. In the master lease and loan documents, this person should be identified explicitly, with a provision stating that notice to the contact person is deemed notice to all investors. The TIC contact person should be explicitly burdened with an obligation to pass information to his or her fellow co-tenants, and failure to do so should not be a failure of the lender or the property manager to provide notice.

The co-tenants also should be encouraged to choose one legal counsel to represent the interests of the entire group. While there is potential for internal conflicts in some situations, the lender doesn't want to be in the position of negotiating with a league of attorneys, each representing the interests of individual investors. The lender should discourage the selection of an attorney who currently represents a particular co-tenant. If the co-tenants insist on such an arrangement, there should be a written agreement stating the attorney's primary duty to the co-tenants as a group.

The co-tenants' ability to agree on a contact person and legal counsel is another litmus test by which the lender can determine how to proceed with a particular loan. If the co-tenants cannot

agree on the appointment of these essential players in the restructuring of the TIC, the lender may want to exercise foreclosure or receivership options as soon as possible.

Bankruptcy Concerns. Even the most prudent lenders could not have contemplated the complicated implications of the recent large-scale bankruptcies of major TIC sponsors. When a sponsor files for bankruptcy, all of the subleases and agreements executed by its affiliated entities may become property of the bankruptcy estate and thus are protected by the automatic stay. This could also include all of the any subleases executed by a sponsor-affiliated property manager or a master tenant, so long as the entity is part of the bankruptcy filing.

When a TIC sponsor files for bankruptcy protection, the lender will want to actively monitor and participate in the bankruptcy proceedings to ensure that the bankruptcy court does not reject the underlying subleases. The mechanics of dealing with these bankruptcy issues are beyond the scope of this article, but lenders should immediately employ competent bankruptcy attorneys and professionals to ensure that their economic interest in their TIC properties is protected.

The Upside of the Downfall

If there is a silver lining to the clouds looming over the TIC industry, it's that the current turmoil may provide lenders with the opportunity to reform their loan and governing documents for TICs and improve their security in those assets. As TIC borrowers seek to replace sponsors or extend maturities, lenders can seize on that opportunity to build into their documents certain protections that they may not currently enjoy. As lenders go through this process, the following are important points to consider.

Master Lease and Management Documents. The replacement of the sponsor as the master tenant and property manager will require the negotiation of a new master lease and property management agreement. This may be a perfect opportunity for the renegotiation of the lender's rights under those agreements.

As mentioned earlier, Revenue Procedure 2002-22 requires that a lease of all or any portion of the TIC property be approved by all of the co-tenants, as must the selection of a property manager or the execution of a property management agreement. That could be a very onerous burden when operating and leasing a multi-tenant asset. Because of this, many sponsors employed a “master lease” structure for TIC properties by which each of the co-tenants agreed to lease the entire property to a “master tenant” (generally a party affiliated with the TIC sponsor). The master lease provided the master tenant with the authority to sublease and manage the property within negotiated parameters, thus allowing the master tenant to operate the property without getting unanimous co-tenant approval for leasing and business decisions.

Similarly, sponsors could get unanimous approval for a master management agreement for the property and empower the property manager to name submanagers for daily management of the asset. If the TIC sponsor has gone bankrupt or otherwise walked away from the asset, TIC investors and replacement sponsors or property managers will need to renegotiate these documents.

In the negotiation of the arrangements, lenders should realize that generation of fee revenue for the TIC sponsor was often a driving factor behind complicated submanagement and sublease structures. The lender should strive to keep the TIC structure as simple as possible and set forth the relationship between the replacement sponsor, the master tenant, the actual tenants, the property manager, the TIC investors, and the lender in a manner as transparent and coherent as possible. While being mindful of potential lender liability issues associated with exercising too much control, the lender should ensure that the following protections are included in any revised documentation:

- **Lender should have approval rights over all leases signed at the property.** While this provision is generally included in loan documents covering any sort of rental property, it is particularly important on a TIC property owing to the relative freedom with which sponsors have managed TIC properties in the past. It also is recommended because of the high probability of absentee ownership among TIC investors. At the very least, the lender should approve of a lease form attached to the master lease that may be used for smaller spaces, but any deviations from the form and all leases signed for large tenant spaces should be approved by the lender. The lender also should have reasonable approval rights on renewals or extensions of leases already in place on the property.
- **Rents under the master lease and each sublease should be assigned to the lender.** Prior to the failure of high-profile TIC sponsors such as DBSI, a lender's primary concern was an assignment of the proceeds and "rent" under the master lease, which represented the real value of the collateral. Today, however, the master tenant is just as susceptible to failure as the individual TIC investors, if not more so. Lenders should require an assignment of *all* rents generated by the property to ensure that they have access to revenue from the property in the event that the master tenant defaults on its obligations.
- **The master tenant should pledge its interest to the lender.** Similarly, the master tenant interest should be pledged to the lender. If the sponsor and its master tenant go into bankruptcy or otherwise default under the master lease, this would give the lender the ability to foreclose that interest and step in, if only temporarily, to manage the property.
- **The lender should require SNDAs from the master tenant and each subtenant.** A subordination, nondisturbance, and attornment (SNDA) from the master tenant alone will not be enough to protect a lender in the event the sponsor goes under. Each subtenant should be required to execute an SNDA that recognizes the rights of the TIC investors and/or the lender to step in as the landlord if the sponsor goes into bankruptcy — and acknowledges that, in the event of a foreclosure by the lender or bankruptcy of the TIC or the master tenant, the tenants will stay in place under their lease agreement.
- **The lender should be able to terminate the master lease.** Both the lender and the TIC investors should have the ability to terminate the master lease. As discussed above, however, before exercising the right to terminate, all parties should be in agreement on a transition plan to a new master tenant or property manager and interim management of the asset.

- **Reserves.** In the current market, successfully obtaining capital calls from every TIC investor may be impossible. It is inevitable, however, that an income-producing property will need capital injections from its TIC investors, even if just for brokerage commissions and tenant improvements. If the initial master lease or loan documents did not contemplate the establishment of capital reserves for the property, they should be established as part of a TIC restructuring. The lender should retain a security interest in *all* monies deposited into the reserve account.
- **Subordination and fees.** The master lease and all subleases should be expressly subordinate to the lender's lien, and all fees paid to the sponsor or property manager, in any capacity, should be subordinate to the interests of the lender. Fees to the sponsor should be carefully monitored, particularly fees earned on the front end of the transaction. Lenders should negotiate provisions in the master lease and loan documents that prohibit or defer fees if the loan is in default, or in the event that the TIC is unable to maintain certain debt covenants (loan-to-value, debt service coverage ratio, etc.).[4] This protects the lender against leaking cash on a nonperforming loan and provides incentive for the sponsor to maximize the profitability of the asset.

Sponsor Bankruptcy. In addition to the assignment of rents and SNDAs discussed above, if the sponsor has not already filed bankruptcy or been replaced, the lender should require the sponsors to sign a springing guaranty by which the lender would be indemnified for losses connected to the sponsor's subsequent bankruptcy filing. The potential expense of the guaranty will reduce the risk of bankruptcy, but if the entity files despite the guaranty, the lender will want to take prompt steps to initiate enforcement.

Some commentators have suggested that lenders should require the TIC investors to also sign carve-out guarantees making losses suffered by the lender due to the sponsor's bankruptcy recourse to the investors. While this provides a comfortable backstop for lenders, it may be a very untenable position to take in the current TIC environment. If lenders have sufficient leverage with their TIC investors, however, it may be considered.

Investor Bankruptcy. In addition to concerns over the sponsor's bankruptcy, lenders face the possibility of insolvency of their individual TIC investors. The bankruptcy of any single co-tenant could result in a partition of that interest or, in some situations, a forced sale of the entire property. Lenders also are at risk of suffering through a "serial bankruptcy" in which investors put their ownership entities into bankruptcy in succession, thereby using the automatic stay to postpone indefinitely any action against the property by the lender. If certain protective provisions related to bankruptcy are not included in the original loan documents, they should definitely be considered as part of any loan reformation or renewal.

Prudent lenders should require that TIC interests be held in a bankruptcy-remote, single-member limited liability company (SMLCC). While this is an essential protection in the event of an individual co-tenant's bankruptcy, it may not be possible if investors transferred the property to themselves personally instead of through a disregarded entity. As part of any TIC loan renewal, lenders should also require that TIC investors execute a carve-out guaranty that makes the loan recourse to the investor in the event that their ownership entity goes into voluntary or involuntary bankruptcy.

These steps may not prevent the filing of a bona fide bankruptcy by a co-tenant, but they will prevent co-tenants from filing frivolous bankruptcy proceedings merely to delay or inhibit the lender's actions against the property. To prevent the likelihood of a forced sale or partition by the bankruptcy trustee, the call agreement should be triggered by bankruptcy filings for any co-tenant, which would allow the other co-tenants to purchase the interest at the same price as would be offered by the bankruptcy estate.

Again, however, if the entity is already in bankruptcy, the co-tenancy agreement will be considered an executory contract terminable by the bankruptcy trustee. As with the bankruptcy of a sponsor, the lender should be actively involved in the bankruptcy proceeding of any TIC investor to ensure that the co-tenancy and loan agreements are not terminated or modified by the trustee.

To further protect against potential co-tenant bankruptcies, the lender can require that each SMLLC include the lender as a "springing member" of the entity.[5] The springing member can be given a noneconomic interest in the entity and would have the right to vote only on certain decisions, such as whether to file bankruptcy. Because the springing member holds a noneconomic interest, the entity may still be disregarded for tax purposes. The springing member may also be an effective way to protect the co-tenant entity from control by a bankruptcy trustee claiming to ascend to the rights of an individual investor vis-à-vis a single-member interest in the LLC.[6]

SMLLCs, springing guarantees, and springing members may not be surefire measures to protect lenders against the various bankruptcy risks inherent to TICs, but these protections do provide lenders some control and recourse in the event a co-tenant goes under. They should be considered in any renegotiation of a TIC loan.

Unique Problems, Unique Opportunities

While there are many issues particular to the TIC structure, lenders who are aware of these particularities can effectively protect themselves in lending to TICs through renegotiated master leases, precise loan documentation, and a thorough understanding of the issues.

The financial pressures of the current market may provide a unique opportunity for lenders to leverage the credit crunch to improve their positions with new sponsors and current TIC borrowers and, if possible, extend well-structured loans to TICs in need of replacement financing. When navigating these waters with TIC sponsors and borrowers, lenders should be prepared to negotiate each of the points described here and employ competent professionals to effectively draft documentation particular to the TIC structure.

TICs present lenders with a unique set of issues, but in the next few years, they may also present lenders with a unique opportunity to capitalize on lending to TIC borrowers.

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Notes

[1]See, for example, Alex Frangas, “DBSI Failure Shows Spread of Turmoil in Real Estate,” *Wall Street Journal*, November 17, 2008, p. C-1.

[2]*Ibid.*

[3]Nancy Leary Haggerty, Norman Arnell, and Todd LaSala, “Tenancy-in-Common Ownership for 1031 Exchanges: The Risks with TICs,” *Probate and Property*, American Bar Association, January–February 2007.

[4]*Ibid.*

[5]Kevin Thomason, “How to Keep the TICs from Biting,” Practising Law Institute, *Tax Law and Estate Planning Course Handbook Series, Tax Law and Practice*, PLI Order No. 14290, May–June 2007.

[6]*Ibid.,* p. 481, citing *In re Albright,* 291 B.R. 538, 541–542 (Bankr. D. Colo. 2003).