

Real Estate Loan Workouts and Restructurings for Tenant In Common Owners

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A FREEBORN & PETERS WHITE PAPER

ABOUT THIS WHITE PAPER:

This White Paper explains the specific challenges that can emerge in a Tenant in Common Structure (TIC) and outlines the key steps TIC Owners can and should take to protect their interest in an underperforming property.

Those involved in real estate investments are aware of, and often frustrated with, the tax burdens associated with the sale of investment properties. Therefore, when the Internal Revenue Service offered some relief in the form of the tenant in common ownership structure for use in tax-free like kind exchanges in 2002¹, the structuring of deals using the tenant in common structure (“TIC Structure”) became increasingly widespread. Over time, experience has taught us that a variety of burdens come along with the tax benefits associated with the TIC Structure, especially when the property is underperforming. By understanding the various issues that can arise uniquely in a TIC structure, TIC owners are better positioned when attempting to turn around an under-performing property.

Overview of the TIC Structure

In a typical TIC Structure, up to 35 unrelated investors may purchase ownership interests in income producing commercial real estate and take title as co-owners through separate single-member limited liability



¹ See Section 1031 of the Internal Revenue Code of 1986, as amended, and Rev. Proc. 2002-22.



companies (each limited liability company, a “TIC Owner”). At the same time that the investor purchases their undivided fractional ownership interest in the property (a “TIC Interest”), the investor, through the TIC Owner, also enters into various other agreements with affiliates of the company that sold the TIC Interest to the TIC Owner (the “TIC Sponsor”). For example, in what is commonly known as the “Asset Management TIC Structure,” TIC Owners enter into an asset management agreement with an affiliate of the TIC Sponsor. Under the “Master Lease TIC Structure,” TIC Owners enter into a Master Lease with an affiliate of the TIC Sponsor. In both instances, the TIC Sponsor affiliate is typically a newly formed limited liability company. Under the asset management agreement with the TIC Owners, the Asset Manager affiliated with the TIC Sponsor receives a monthly asset management fee that is typically a percentage of gross receipts. Thus, under the Asset Management TIC Structure, the TIC Owners’ monthly return is based upon the flow-through of cash from the property after payment of debt service, operating expenses and funding of reserves. Under the Master Lease TIC Structure, the affiliate of the TIC Sponsor (the “Master Lessee”) is obligated to pay expenses related to the operation of the property and an amount of Master Lease rent to the TIC Owners as specified in the Master Lease. Thus, unlike the Asset Management TIC Structure, in the Master Lease TIC Structure the TIC Owners’ return would be based upon the rent set forth in the Master Lease rather than flow-through of cash after payment of debt service, operating expenses and funding of reserves.

Dealing with the TIC Structure for an Underperforming Property

Underperformance can be caused by factors beyond the control of the TIC Sponsor or the TIC Owners. For instance, the bankruptcy of a significant tenant, over-development of similar properties near the property or a general economic downturn in the geographic area around the property can cause a property to underperform. Over the last 24 months, there have been allegations by TIC Owners that properties’ underperformance was caused by a lack of attentiveness by the Asset Manager as a result of internal cost cutting necessitated by the TIC Sponsor’s inability to bring new TIC deals to be marketed. If a property is underperforming, the TIC Sponsor will seek to raise funds through a capital call from the TIC Owners. If the TIC Owners perceive that the TIC Sponsor is not being sufficiently attentive to the situation or if the TIC Owners cannot obtain a clear understanding of the financial condition of the property from the information supplied by the TIC Sponsor, raising funds through a capital call might be difficult. In these circumstances, many TIC Owners will feel the need to examine whether another party should be brought in to replace the TIC Sponsor. Pursuing this course of action, however, raises many issues that will need to be resolved in order for the TIC Owners to successfully replace the existing TIC Sponsor with another Asset Manager or Master Lessee.

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Obtaining Information Can Be Difficult

In many TIC Structures, the investors who acquire the TIC Interests are unrelated to one another and their sole point of contact is through the TIC Sponsor. In some cases, the investors will only know the identity of the other owners by reference to the name of the special purposes entity that was formed in connection with each owner’s acquisition of the TIC Interest (i.e., the TIC Owner).

To take action independent of the TIC Sponsor, the investors must first organize themselves and establish a way to communicate with one another. The next task is to gather objective financial information about the property and its operations. This generally includes contact information for the tenants occupying the property and information regarding the status of various leasing activities.

In the case of an underperforming property, the difficult tasks of establishing lines of communication among the TIC Owners and of obtaining relevant information about the property are typically done in the context of a pending loan default. The TIC Owners need to conduct fact-finding (e.g. identifying all investors) in order to be in a position to address the corrective action that is needed to avoid default and foreclosure.

Additional Hurdles Can Be Created by the TIC Documents and the Loan Documents

Once the TIC Owners have organized themselves and gathered information about the property, the next issue that is typically raised (in the case of an underperforming property) is determining who is available to replace the TIC Sponsor as the Asset Manager or Master Lessee. Even where a potential replacement candidate can be quickly identified, completing this process will require the TIC Owners to overcome several hurdles that are imbedded in the TIC Structure.

In a typical TIC Structure, the TIC Owners enter into a Tenant In Common agreement and, in some cases, a separate call agreement (collectively, the “TIC Documents”). The provisions of the TIC Documents are designed to address the tax requirements of Revenue Procedure 2002-22. As a result, the decision making provisions of the TIC Documents are somewhat cumbersome. For example, in order to comply with the requirements of Revenue Procedure 2002-22, many TIC Documents provided that the decision to amend the Master Lease or to enter into a new or amended asset management agreement required the unanimous consent of the TIC Owners. This unanimous consent requirement can be problematic if the principals of the TIC Sponsor own TIC Interests in the troubled property, or if some of the TIC Owners cannot be located.



Even where unanimous consent can be obtained, the loan agreements (for property owned through a TIC Structure) may contain provisions that can make it difficult to remove a nonperforming TIC Sponsor. In a typical TIC Investment, the owners of the TIC Interest are not liable under the loan beyond their investment in the underlying real estate (e.g., nonrecourse). However, in a typical TIC Investment, both the investors (individually) and the principals of the TIC Sponsor have exposure to springing recourse liability under the so-called “nonrecourse carve outs.”

One typical nonrecourse carve out is the termination of the Master Lease or Asset Management without the advance written consent of the lender. Thus, even if the TIC Owners can obtain unanimous consent to terminate the existing agreement with the affiliates of the TIC Sponsor, they cannot terminate the existing asset management agreement or Master Lease unless they can also obtain the written consent of the lender to do so.

Issues Related to Lender Communications

As a practical matter, obtaining lender consent can be a difficult task. In many cases, the loan documents will typically designate the Master Lessee or Asset Manager as the sole person who is authorized to contact the lender. As a result, the lender will not communicate with anyone (other than the TIC Sponsor) without written authorization from the TIC Sponsor.

The inability to communicate with the lender creates significant problems for the TIC Owners if the property is underperforming and default under the loan is imminent. Accordingly, TIC Owners must be prepared to take the appropriate actions to open these lines of communication, either by negotiating with the TIC Sponsor to obtain its cooperation or through other avenues.



Specific Issues with the Master Lease TIC Structure

The use of the Master Lease TIC Structure raises additional issues in the context of a troubled TIC Sponsor. Under the Master Lease TIC Structure, the Master Lessee enters into leases with the tenants in its own name. The Master Lease also provides that all payments related to the property, other than debt service, will be paid by the Master Lessee. In many cases, contracts for the operation of the property are also held in the name of the Master Lessee rather than in the name of the TIC Owners. In contrast, under the Asset Management TIC Structure, the Asset Manager typically enters into leases and other contracts on behalf of the TIC Owners.

If the TIC Sponsor is facing financial difficulty and a transfer from the existing TIC Sponsor to a new Asset Manager or Master Lessee cannot be achieved, additional complications arise under the Master Lease TIC Structure if the TIC Sponsor seeks (or is forced into) bankruptcy protection. Specifically, cash generated by a property that is subject to bankruptcy protection may be held by the bankruptcy estate under supervision of the Bankruptcy Court, rather than distributed to the TIC Owners pursuant to the Master Lease. Additionally, there is also a risk that the termination of the Master Lease through the bankruptcy, without a specific assignment of the tenant leases, could give the tenants grounds to seek to renegotiate the terms of their leases.

Keys To a Successful TIC Restructuring

As noted above, the tax-oriented requirements of the TIC Structure create significant hurdles to resolving the various issues that arise in connection with an underperforming property. Additional issues are created if the TIC Sponsor's actions contributed to the property's underperformance. In order to place the TIC Owners in a position to take corrective action and save their investment in the property, each of the issues identified above must be addressed. Each situation involving a troubled TIC property is unique because of the specific circumstances of the property itself, and the sophistication of the TIC Owners and the TIC Sponsor. As a result, there is no "cookie cutter" approach that can be adopted to resolve these issues.

In many situations involving distressed properties owned through a TIC Structure, repositioning the property will require the recapitalization of the property. The tax-oriented restrictions of the TIC Structure can make this recapitalization difficult if less than all of the TIC Owners are willing to contribute their pro rata share of the additional funds. Accordingly, in a workout situation, the TIC Owners may be required to examine whether they need to adopt an alternative structure to facilitate the workout. In some distressed property situations caused by the actions of the TIC Sponsor, the conversion of the TIC Structure to a multi-member limited liability company or contribution of the property to an UPREIT may be viable options for such a structure.

The Future of TIC Property Workouts

The TIC Structure was not designed with a distressed property structure in mind. Knowing where these structural shortcomings arise, however, can help TIC Owners take the steps necessary to turn the property from an underperforming property into a performing property. In many cases, the TIC Sponsor will undertake specific actions to provide as much transparency as possible to the TIC Owners on the operation of the property. A limited number of TIC Sponsors who have experienced loss of revenue from the inability to sell TIC Interests have cut back their operations to the point where they can no longer properly manage their existing TIC properties. If TIC Owners in these circumstances want to take the steps that may be necessary to pursue a workout with the lender, they must move quickly.





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