TENANT-IN-COMMON

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JUNE 22, 2007

Legal News Alert: Tenant-in-Common is part of our ongoing commitment to providing up-to-the minute information about pressing concerns or industry issues affecting our clients and our colleagues.

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The TIC Workout

Since the promulgation of Revenue Procedure 2002-22 the tenant-in-common (TIC) offering industry has grown to approximately $5 billion in annual equity raised. Although accurate statistics are hard to come by, perhaps as much as $10 billion in equity has been raised since 2002, spread across more than 1,000 offerings.

Given the volume of TIC transactions, the number of materially underperforming TIC transactions (i.e., transactions where the return to the investors is materially below what was projected) appears remarkably low. Some of this is no doubt attributable to the generally favorable market conditions for commercial real estate over the past five years. It has only been five years, with most of the transactions done in the past three years, so many of the TIC investments are still in early stages. As well, most TIC transactions are based upon stabilized, income-producing property, utilizing a fairly low level of debt (in the 50 to 70 percent range), so by their nature they are fairly conservative investments.

Although none of the above factors limiting problem TIC deals has changed, with the passage of time a few workout situations have surfaced. Should the underlying conditions in the commercial real estate market worsen, more workouts would be likely.

To some extent, the possibility of having to work out TIC investments has been in the minds of sponsors, lenders, broker-dealers, registered representatives, and investors from the inception of the industry. The concern was that any workout would be very cumbersome and complex given the number of interested parties. While there is certainly some basis for the concern, working out a TIC investment is not impossibly complicated. As with any workout it involves understanding the concerns and goals of all interested parties as well as a lot of patience. Here are a few basics:

Who Are the Interested Parties?

Any TIC workout will involve the sponsor and the TIC investors. If the sponsor is still involved in the deal, whether as a TIC investor itself or through an affiliate as master lessee, asset manager, or property manager, it should not be difficult to get them actively involved. If the sponsor has no continuing interest in the transaction, it may be more difficult to get their attention. Reminding them that investors will make future investment decisions in part based upon how the sponsor works through problems might help.

Other potential interested parties include the lender, the tenants, the managing broker-dealer (if any) and, in some situations, third parties with an interest in the property such as the franchisor in a hotel transaction.

What Type of Workout Is It?

There are many reasons why transactions become distressed, but generally speaking they fall into one of two categories:

The "Bad Boy" Workout

In this situation, the sponsor either misstated or omitted to state material facts in the private placement memorandum (PPM), or has failed in its obligations post-closing, whether as master lessee or property manager. The TICs are largely on their own and need to act quickly and decisively. The biggest problem is to get all of the TICs to work together. If a managing broker-dealer is involved, it should be able to provide contact information for the other TIC investors. Although a managing broker-dealer's interests may not be completely aligned with the investors they should be willing to help in a bad boy workout situation just to protect their own interests.

The "Things Happen" Workout

If the workout is not the result of misrepresentation or mismanagement, the sponsor should be willing and, indeed, anxious to work with the TIC investors to resolve the situation. These workouts can run the gamut from bankruptcy of a major tenant, unexpected capital expenses, unusual conditions in a submarket — such as hurricanes increasing the cost of property insurance in Florida — to environmental concerns.

Raising Money

Most workouts require additional capital or financial forbearance as a part of the solution. Potential sources of such relief are:

Deferral of Fees

If the sponsor retains an interest through an affiliate that is earning fees, that affiliate should be willing to defer at least a portion of its fees. It may not amount to a lot, but sharing the pain makes a good impression on the investors.

Lender Forbearance

If the ability to pay debt service in full is in doubt, or debt service is using up cash flow that needs to be reinvested in the property to attract or stabilize the tenant base, the senior lender may be willing to forebear — allowing the borrower to defer payment of debt service for some reasonable period of time.

Refinancing

Amending or refinancing the existing senior debt to add credit availability for cash needs such as capital or tenant improvements, leasing commissions, and environmental remediation, among others, is always a possibility — particularly if the initial loan to value ratio was moderate and the underlying value of the property is still strong. However, as much of the senior debt on TIC transactions is fixed-rate debt from conduit lenders who sell into securitized pools, refinancing may be impossible or cost-prohibitive.

Subordinate Debt

Rather than refinance, the senior lender may be willing to offer a subordinate line to deal with specific costs such as tenant improvements, or may be willing to permit another lender to provide subordinate debt subject to an intercreditor agreement.

Capital Calls

The typical TIC agreement (attached as an exhibit to the PPM and signed at closing) provides a capital call mechanism. Key elements to focus on are: Who can trigger a capital call and for what purpose, what percentage of the TICs have to approve the capital call and, if one of the TICs does not pay its share, can it be diluted and/or will its principal (a TIC typically being a single-purpose limited liability corporation (LLC) owned by one individual) be personally liable for the capital call?

Member or Master Lessee Loans

If all else fails, the TIC agreement may allow a TIC to lend money into the transaction, to be repaid with a return on a priority basis. Similarly, if there is a master lease there occasionally is a provision allowing the master lessee to lend money into the transaction, to be repaid prior to future investor distributions.

Specific Issues

Do You Terminate the Master Lease?

If the master lease is a drain on the value of the property, or the master lessee is ineffective, the TICs may want to consider terminating the master lease. Two cautions: first, the loan documents may prohibit the TICs from terminating the master lease without the consent of the lender. The lender may want to preserve the master lease if for no other reason to allow it to talk to the master lessee rather than 35 TICs. Second, the master lessee typically is the focal point of control. Assuming that this is a "Things Happen" and not a "Bad Boy" workout, it may not be advisable to remove that focal point.

Selling the Property

The TICs always have the right to sell the property. Sometimes a property may not be able to support the investment return to the TICs, but in today's seller's market it might yield a net price upon sale that fully returns the TICs' principal. Selling may be a much simpler resolution than restructuring.

Breaking Deadlocks

Many decisions such as selling or refinancing the property require unanimous consent of the TICs. Typically the tenant-in-common agreement will provide that if a certain percentage of the TICs, typically 80 percent, wants to take action and the remaining 20 percent or less does not, the consenting TICs have a fair market value call right.

Who Represents Whom?

The sponsor will have its own legal counsel, frequently but not always the counsel who prepared the PPM and closed the transaction. That counsel does not represent the TICs and its fees generally are not properly chargeable to the TICs. In any event, particularly in a "Bad Boy" workout, the TICs should have their own counsel and work out payment arrangements among themselves.

DST

This discussion is directed at traditional TIC offerings, not Delaware Statutory Trust (DST) offerings. Working out a DST transaction poses unique challenges.

Taxes

Make sure that any changes in a TIC structure are blessed by a competent TIC tax lawyer.

Conclusion

As this discussion demonstrates, TIC workouts have the potential to be complicated, if for no other reason than the number of parties involved. However, that complicating factor also can be a positive. If the workout is not a "Bad Boy" workout, there is an experienced real estate company — either the sponsor or a sponsor-affiliate — involved that has a financial stake in the transaction as well as up to 35 sophisticated real estate investors, most of whom presumably have meaningful financial resources. Given that TIC transactions involve stabilized income property, the workouts should not generally be of the "lose your entire investment" variety, so patience and cooperation should allow a successful resolution.