

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

If you have any questions about this alert or would like to discuss this topic further, please contact your Foley attorney or the following individuals:

**Stephen I. Burr, Author**

Boston, Massachusetts  
617.342.4038  
sburr@foley.com

**Craig P. Wood**

Los Angeles, California  
213.972.4555  
cwood@foley.com

**Kenneth R. Appleby**

Boston, Massachusetts  
617.342.4091  
kappleby@foley.com

## What Have We Learned From TIC Workouts?

In its six years of existence, the tenant-in-common (TIC) industry has had a strong record of delivering on its promises of deal performance. However, with the general economic slowdown and the problems in the real estate debt market, some challenged transactions are beginning to surface. These problems can be caused by many factors. Three recent examples highlight the kinds of problems that can arise:

1. The bankruptcy of the single tenant of a large industrial facility
2. The bankruptcy of the sponsor, master lessee, and property manager entities
3. The failure of the property to perform as expected due to specific market conditions

Of course, these and many other causes of distress are not unique to the TIC industry; they are common to the whole national commercial real estate industry, which has proven cyclical in nature.

So what is unique about the TIC workout? The crucial distinction of the TIC workout from the typical commercial real estate workout is the number of parties involved and the Internal Revenue Service (IRS)-designed lack of control of any particular party over the borrower/property owner. TIC investors are by design in a structure where none of them can control decision-making. This is not a crucial problem when everything is going well, and an effective, well-capitalized master lessee or property manager is in place with the power to make day-to-day decisions. However, if the performance of the property declines, whether due to vacancy, default, or bankruptcy by tenants, and/or the master lessee or property manager proves untrustworthy or is in financial distress, small problems can become big problems in a hurry.

If a property is in distress, the first indication is typically that the return to the investors declines, whether in the form of rent under a master lease or net operating income. It is critical to take meaningful action at this initial stage, as the decline can rapidly progress from failure to pay rent to failure to pay debt service.

What should investors, broker-dealers, and registered representatives do when the return to investors declines? Here are a few steps to take:

1. **Hire competent counsel.** Any workout of a TIC transaction on behalf of investors requires the immediate engagement of counsel with experience in TIC transactions and ideally with experience in TIC workouts. This is much easier said than done, as there are fewer than 10 law firms nationally with meaningful TIC experience, and less than half that number with meaningful workout experience. The problem is exacerbated by the fact that the normal clients of these firms are TIC sponsors, so conflicts are a serious problem. Once conflict waivers are in place, determining who the client is (i.e., one TIC, some of the TICs, all of the TICs) is excruciatingly complicated and needs to be well documented. Finally, a substantial retainer will be required, typically requiring the first of what could turn out to be a series of capital calls. All of this will take an inordinate amount of time when time is scarce.

2. **Appoint persons to act.** The first action of the TICs and their counsel must be to empower a small number of them, ideally no more than three, to act for all of the TICs. This can be done by the grant of irrevocable, durable powers of attorney. It is optimistic to expect unanimous consent of the TICs to anything at this point, but if such powers of attorney can be gathered from at least a majority in interest of the TICs, the appointed TIC "attorneys" can make most decisions. Competent tax counsel must review such arrangements to ensure that the powers of attorney do not turn the TIC structure into a prohibited partnership.

3. **Read the TIC agreement carefully.** Every TIC offering includes a TIC agreement, a non-partnership agreement crafted to comply with Rev. Proc. 2002-22. This agreement is a roadmap for many of the actions required of TICs in a workout, including:

- a. Basic decision-making — What decisions must be unanimous and what decisions require a majority?
- b. Dispute resolution — Is there a buy-out mechanism for recalcitrant TICs?

- c. Capital calls — Are capital calls contemplated? Are there protections for contributing TICs against defaulting TICs? Can the master lessee, the property manager, or individual TICs make loans and receive repayment on a priority basis?

If the provisions do not fit comfortably with the circumstances of the TIC workout, or if there are serious differences of opinion among the TICs, making significant decisions, particularly time-sensitive decisions, can be difficult.

4. **Decide whether to involve brokers/securities representatives.** The question of whether to get the brokers/securities representatives involved is a double-edged sword. Despite problems with the investment, many investors still look upon their representatives as crucial advisors whose advice they will still follow. However, other investors may be furious with their representatives, or there may be suitability claims. All of this puts the investors and their representatives in a quagmire of real or perceived conflicts. On balance, their participation generally is valuable, but conflicts need to be considered carefully and the attorney-client privilege carefully maintained.
5. **Deal with sponsors and affiliates effectively.** In some workouts the sponsor and its affiliates, including the master lessee and the property manager, clearly are either part of the problem or so distracted as to be a hindrance, not a help. On the other hand, if the problem truly is one of property underperformance due to underlying market conditions, removing the master lessee and/or property manager can do more harm than good. In particular, most loan documents prohibit changing master lessees or property managers without lender consent. Removal also can disrupt relationships with vendors and tenants. Finally, such removal may produce unintended control or tax consequences. Be particularly wary of terminating master leases as opposed to simply replacing the master lessee.
6. **Communicate with other third parties.** Constant communication with lenders, tenants, and vendors is critical during

## ABOUT FOLEY

Opportunities in the fast-growing and ever-evolving TIC industry abound — as do potential regulatory hurdles and legal pitfalls. As a leader in the TIC industry, Foley's TIC attorneys can help you maximize success through our experienced legal counsel in Private Placement Memoranda for TIC and Delaware Statutory Trust Offerings; TIC offering; Circular 230 compliant "should" tax opinions; TIC real estate acquisitions; nationwide financing representations; and sophisticated, third-party due diligence reports.

## Foley.com

*Foley & Lardner LLP Legal News Alert is intended to provide information (not advice) about important new legislation or legal developments. The great number of legal developments does not permit the issuing of an update for each one, nor does it allow the issuing of a follow-up on all subsequent developments.*

*If you do not want to receive further Legal News Alert bulletins, please e-mail [info@foley.com](mailto:info@foley.com) or contact Marketing at Foley & Lardner LLP, 321 N. Clark Street, Suite 2800, Chicago, IL 60610 or 312.832.4500.*

any workout. If communication is absent, slow, or incorrect, third parties will assume the worst. Most lenders, particularly servicers of conduit loans, assume that it is inherent in TIC structures that their borrowers cannot make timely, prudent decisions, and foreclosure will be required. This is one reason it is critical to retain competent counsel and appoint properly authorized representatives at the first sign of trouble.

7. **Involve personal tax advisers to explain tax effects.** Almost always, workouts will have at least the potential for significant negative tax consequences for the TICs, including recapture, phantom income, and so forth. These issues must be understood and explained, at least at a conceptual level. Each TIC investor will have his or her own specific tax issues, so continued involvement of their personal tax advisers is crucial.

### Delaware Statutory Trusts (DSTs)

The discussion above applies to traditional TIC offerings. Of course, there are relatively fewer DST offerings in the marketplace. However, if a DST offering turns into a workout, it will have its own specific challenges beyond what is common in a TIC offering.

These are just a few of the lessons that those active in TIC workouts have learned, generally through challenging and frequently distressing circumstances. It is critical for the TIC industry that sponsors, broker-dealers, registered representatives, investors, lenders, and other third-party service providers rapidly improve and streamline the workout process. Failure to do this could lead to a crisis of confidence that would be damaging to the future of the TIC industry.