Tim Lupinacci is a shareholder in the Birmingham, Ala., office of Baker, Donelson Bearman, Caldwell & Berkowitz, PC. Contact him at 205-244-3835 or tlupinacci@bakerdonelson.com.

I Knew You Were Trouble

Effective strategies to address defaulting tenant-in-common borrowers

The continuing economic malaise highlights growing trends of defaulted commercial loans based on the form of financing vehicle used in the lead-up to the Great Recession. During the past couple of years, our team has seen an increase in bankruptcy filings by individual tenant-in-common owners who are part of a larger financing vehicle with multiple other TIC parties. Given the structure of most TIC transactions, a defaulting TIC borrower creates numerous unique issues. As a result, the strategies for protecting the bank's interest in collateral differ from traditional commercial real estate defaults and bankruptcies.

A 2002 tax law change resulted in the development of TIC investments as "like kind" exchanges under section 1031 of Internal Revenue Code. The TIC vehicle has many differences from other ownership forms, including the fact that each co-tenant has an assignable interest in real property, giving rise to the "like kind" exchange application. The TIC owner has many unique legal rights such as unity of possession under distinct legal title. Because the TIC owner holds an undivided interest in the entire real property, a bankruptcy filing by one of the multiple TIC owners triggers the protections of the bankruptcy automatic stay as to the entire property. The bankruptcy filing enjoins any pending foreclosure proceeding or ongoing recovery litigation as to the borrower entity.

At the outset of analyzing a financially distressed TIC transaction, it is critical to understand the terms of the TIC agreement, applicable state law and the offering memorandum. The TIC agreement is the operative document by which each of the TICs has rights vis-à-vis other TIC members. Often the TIC agreement prohibits an individual TIC from acting as agent for the remaining TICs, incorporates a buy-sell procedure or other call/purchase options as to any individual TIC member's interest in the project, and requires certain approval levels for action to be taken by the borrower (e.g., unanimous consent of TIC owners to change property manager). Applicable state law, such as partition, may implicate additional concerns regarding the relationship of the TIC parties and the underlying real property. The offering memorandum typically is prepared by a sponsor trying to put together the TIC transaction seeking TIC members. The offering memorandum often is a source of important information about the structure and ownership as the bank plans its strategy to deal with a defaulted situation.

At the outset of a TIC borrower loan default, there are complicating issues of notice and service. Although the underlying loan documents may appoint a sponsor or representative for notice purposes, it is best practice to get all TICs to sign a prenegotiation agreement that includes their notice address. While financial institutions differ on the use of PNAs in defaulted commercial loans, a PNA that gets all of the TICs to the table at the outset of discussions about the defaults is useful. If the TICs have appointed a designated representative to negotiate with the lender, the PNA should authorize specifically the representative to discuss the matter with the lender. In addition, the representative should sign the PNA. If the first notice of default under the loan documents is a bankruptcy filing by one individual TIC, the PNA is not a useful avenue.

Several unique bankruptcy issues are implicated on one TIC owner filing bankruptcy to stay a foreclosure or other remedial action. These include identifying the property that is included within the bankruptcy estate, which would be limited to the individual TIC owners' ownership interest in the property. As to the individual TIC, there likely is little ongoing revenue, no employees and no real operating business. It is merely the passive ownership of a minority interest in a piece of real property. However, the bankruptcy does stay the action against the property as a whole given the TICs undivided interest in the same.

Another unique issue involving an individual TIC owner is the ability to use cash collateral. The bankruptcy code prohibits a debtor's ability to use cash generated at the property that is subject to a lender's lien unless the lender consents or the court orders otherwise and provides the lender adequate protection

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of its interest. In the TIC owner case, however, there is limited "cash collateral" generated (really only potential distributions from the TIC borrower entity).

Fortunately, the bankruptcy code provides financial institutions with various tools to aggressively protect its position. The bankruptcy code permits a party in interest to file a motion to transfer the venue of the bankruptcy case to the location where the property is located. Although this is discretionary to the judge, we have been successful in getting the bankruptcy transferred to where the property is located as being in the best interest of creditors. This permits local creditors and a local judge who understands the local dynamics to be involved.

In addition, the lender may determine in the first instance to file a motion to dismiss the bankruptcy case as a bad faith filing. The bankruptcy code provides certain indicia of bad faith in a bankruptcy filing, which includes the lack of a valid reorganizational purpose, that the matter involves only a two-party dispute (lender and TIC borrower since there typically are limited other creditors) and that the individual TIC owner has no revenue or business operation to support a reorganization. Although it is a high burden to get a bankruptcy case dismissed at the outset of a case, the TIC financing structure provides a strong argument based on analyzing the factors courts look to in dismissing chapter 11 bankruptcy cases. An alternative to dismissal is for the court to grant relief from the automatic stay to permit the foreclosure to proceed. One of the strong arguments on both fronts is that an individual TIC owner can never confirm a plan of reorganization for the variety of reasons outlined above (e.g., no income, no employees, no business, no equity in the property, no cash flow).

One other unique area of bankruptcy law involving TIC borrowers is the ability of a TIC owner to sell not only its interest, but also the entirety of the project under section 363(h) of the bankruptcy code. There are certain requirements that must be met to take advantage of this provision; however, it does provide the lender an exit strategy if a purchaser for the real property is found. Section 363(i) of the bankruptcy code provides protection to the remaining TIC owners by incorporating a right of first refusal. The bankruptcy code also protects the lender in such a sale by permitting the lender to credit bid its debt at the sale under Section 363(k).

Another interesting nuance of the TIC financing structure is the risk of serial bankruptcy filings by the various TIC members. Because the members of each TIC limited liability company may reside in multiple jurisdictions, TIC owners, if they are well organized, well informed and well funded, may take advantage of the geographic diversity of the multiple owners by filing serial cases in inconvenient jurisdictions far removed from the real property securing the loan. If the first TIC case is dismissed, the lender can seek *in rem* relief from the automatic stay in any subsequent TIC bankruptcy filing as an abusive, serial filing.

While the TIC structure is a tax-driven vehicle, it creates innumerable issues to a lender facing a defaulted loan. It is important for the lender to develop a well-informed action plan on a TIC bankruptcy filing in order to take advantage of the bankruptcy code's protections for secured lenders. Although the TIC debtor creates unique issues, there are tools at the lender's disposal to protect and preserve the collateral securing the TIC loan. BN