On November 10, 2008, DBSI Inc. (“DBSI”), as well as dozens of special purpose entities that were affiliates of DBSI (each, a “Master Tenant,” and collectively with DBSI, “Debtor”) filed a Chapter 11 Bankruptcy in the United States Bankruptcy Court for the District of Delaware (collectively, the “DBSI Bankruptcy”). DBSI was one of many tenant in common syndicators (“TIC Syndicators”) that generated its revenue through the creation of tenants in common real estate transactions, in which the TIC Syndicator would acquire an interest in a commercial real estate property and sell off fractional interests of the real estate to multiple (up to 35 per transaction) tenants in common (“TICs”).

The DBSI Bankruptcy has impacted hundreds of TICs, lenders, and other creditors. Even if a lender is lucky enough to have escaped a “direct hit” from the DBSI Bankruptcy, due to the credit crunch and the related decline in real estate values, now is the time to re-evaluate loans made to TICs to determine what, if anything, can be done to better protect the lender’s interest.

**Structures of TIC Transactions**

TIC transactions have enjoyed great popularity due to the ability of small investors, the TICs, to defer taxes on a sale of real property by replacing the sold property with an undivided fee interest in a new property and pooling such
interests in order to generate sufficient funds to acquire the replacement property. To receive the full advantage of the
tax deferment rules, the TICs’ ownership of the new property must be structured to avoid re-characterization as a
partnership for tax purposes (which would trigger an immediate tax on the sale). A tenant in common agreement
(“TIC Agreement”) provides a mechanism for the TICs to manage day-to-day decisions at the property level and
establishes a structure based upon the retention of a master tenant or property manager. The tax lawyers theorize that
if the TICs are removed from making such decisions by appointing the master tenant or property manager, they are
more apt to avoid being characterized as a partnership. Typically, the master tenant and property manager are affiliates
of the TIC Syndicator and receive ongoing fees from the TICs for providing these services.

DBSI structured its transactions with a master lease model in which the TICs became the landlord and the Master
Tenant became the tenant of the replacement property under a master lease. Master Tenant controlled the property,
and the TICs (sometimes as many as 35) were not involved in any leasing or other decisions in the ordinary course of
operating the property. Master Tenant then leased the property and became the landlord of the tenants (actually
subtenants) at the property. Master Tenant collected rent, paid operating expenses (including debt service on any
mortgage loan), and paid itself a fee (which it upstreamed to DBSI), with any net amounts being disbursed to the TICs
as their return on investment. Master Tenant also engaged an affiliate of DBSI to be the asset manager at the property
(which typically engaged another property manager to be the actual on-site manager).

Some TIC Syndicators structure their transactions, as DBSI did, with the master lease model, while others structure
such transactions without the use of the master lease, thus avoiding the additional layer of tenancy at the property that
intervenes between the direct contractual relationship of the TICs as owners of the property and the actual tenants of
the property. Under the property management model, the TICs authorize and appoint the manager to enter into the
leases at the property on behalf of the TICs. The property management arrangement is typically a two-tier
management structure in which the TICs enter into an asset management agreement with a manager affiliated with the
TIC Syndicator, and the affiliated manager then enters into a sub-management agreement with a third-party property
manager that is the on-site manager of the property collecting rent and paying operating expenses.

In either structure the master tenant and affiliated manager provide an extra layer of management that allows the TIC
Syndicator to collect additional fees.

**Master Lease Structure Issues**

One of the reasons that some lenders have been wary of tenant in common transactions is due to the possibility of each
of the TICs commencing bankruptcy, leading to serial bankruptcy filings; but ironically, the DBSI bankruptcy has
revealed certain problems with this structure when the TICs do not file at all, but, instead, the master tenant files
bankruptcy. The bankruptcy of a **master tenant** causes the leases that the master tenant entered into as the landlord
(with the subtenants, the actual occupants of the property) to become property of the master tenant’s bankruptcy estate,
**although the TICs themselves, as the actual owners of the property, did not file bankruptcy.** Until the automatic
stay that is effective upon bankruptcy commencement is lifted, neither the TICs nor the lender can directly collect rent
from the subtenants (which provide the cash flow for the property). In addition, if there has been a default under the
loan, the lender is prohibited from foreclosing upon its interests until it can obtain relief from the automatic stay.

Some actions that can be taken to better protect the lender in these situations are set forth below. Lenders should re-
evaluate the applicable loan documents and the status of the property, and as modifications, requests for extensions, or
defaults arise, the lenders should take the opportunity to make these improvements, if possible:

- The lender should confirm that when the loan was originated, the master tenant assigned to the lender its interests
  in the master lease and, most important, the subleases (in addition to the standard mortgage and assignment of
leases received from the TICs as the owners of the property), because if it did not, the lender does not have a lien on the subleases (which as the source of cash flow and payment of debt service, provide the primary collateral for the loan). If no bankruptcy proceeding has been filed, the lender may require the additional assignment from the master tenant if not previously received at the loan origination. Although this assignment may later be subject to a possible preference or fraudulent transfer claim in the master tenant’s bankruptcy, it is worth curing the defect now and hoping that a bankruptcy filing will not occur until the applicable statutes of limitation have expired.

- In order to clarify the contractual relationship between the TICs and the subtenants, and the subtenants’ recognition of lender’s security interest in the leases, an estoppel (or subordination, non-disturbance and attornment agreement, “SNDA”) should be obtained from each subtenant providing that the subtenant will attorn to (a) the owner of the property (the TICs), and (b) the lender. Such agreement should also provide a statement from the subtenant clarifying that it agrees that the rejection in a bankruptcy proceeding of the master lease or the sublease shall not be deemed to be a material breach or otherwise treated as an event that would allow the subtenant the right to terminate its lease. These provisions create a direct contractual relationship between the subtenant, TICs and lender. If there are no clear attornment provisions, it might be more difficult to provide evidence to the tenant that notwithstanding the bankruptcy of the master tenant, it is required to remain in possession and pay rent in accordance with its lease, whether or not the master tenant, TICs, or lender is the party acting as landlord under the lease. Depending upon the applicable loan documents, the lender might be able to request the estoppel or SNDA at any time during the term of the loan. In addition, depending upon the provisions of the loan documents, the lender may (and should) have an approval right over each new lease entered into during the term of the loan (and modifications to existing leases). If lender’s approval rights of leases are limited, lender should require an amendment to the loan documents to provide a broad ability to approve each lease. As these approval requests are received, the lender should require the attornment language to be inserted into the actual leases. Lender might also want to consider whether the loan should become recourse (or be subject to a recourse carve-out) to the TIC Syndicator (as well as each TIC) if a lease is entered into or modified without the lender’s approval.

- The lender should re-evaluate the recourse provisions contained in the loan documents and determine how such provisions might impact certain actions and inactions of the master tenant and each of the TICs, including the filing of a bankruptcy proceeding. Upon such evaluation, the lender may find that the standard “springing recourse” provision contained in the loan documents is only triggered by a bankruptcy proceeding filed by a TIC (rather than the master tenant).

- The master lease may contain provisions that help clarify the relationship between the TICs and the tenants at the property. The lender should review the master lease to confirm that (a) upon a termination of the master lease or a rejection of the master lease in bankruptcy, all of the leases automatically revert to the TICs as the owner of the property, (b) the lender has the right (in addition to the right of the TICs) to terminate the master lease, (c) the lender (in addition to the TICs) has a right to request information with respect to the property, all leases, and tenants, and (d) the lender has the ability to respond in its own name or in the name of the TICs to a rejection by the master tenant of the master lease in connection with a bankruptcy of the master tenant (such ability should include the right, with an accompanying broad power of attorney, to file and prosecute, to the exclusion of the TICs, any proofs of claim, complaints, motions, applications, notices and other documents). Further, if the TICs were to file bankruptcy and attempt to reject the master lease, the lender will want the ability to determine if the master lease should be rejected or if the lender will require the TICs to assign the lease to the lender.

- The loan documents probably provide that the termination of the master lease without lender’s prior approval causes an event of default. This provision should be modified to also provide that a rejection of the master lease in bankruptcy is also an event of default.
If a cash flow shortfall occurs at the property during the term of the loan, when there are so many passive investors involved, it is very difficult to require and enforce capital calls from the TICs. Some TIC Syndicators (DBSI being one example) require reserves to be deposited at the origination of the loan (rather than just monthly reserves throughout the term of the loan) from the TICs to be held by the master tenant (or property manager, if applicable) to be available for re-tenanting and for replacements and repairs at the property during the term of the loan. The lender should take a security interest in these reserves and control their disbursement. As more fully discussed in the next Section, the master tenant might not have the same interests in maintaining the property as an actual owner of the property.

If a lender has any leverage at all, now is the time to require modifications to the documents to incorporate the items outlined above.

**Property Management Structure Issues**

If a transaction is structured with a TIC Syndicator as the property manager rather than as the master tenant, there are still likely to be complications for the lender (and the TICs) if the TIC Syndicator files bankruptcy. The management contract is property of the TIC Syndicator’s bankruptcy estate, and at least one court has held that a lender’s acts to dispossess a debtor-property manager violates the automatic stay applicable during bankruptcy, even if the property manager has no leasehold or ownership interest in the property. In re Colonial Realty Co., 122 B.R. 1 (Bankr. D. Conn., 1990). A foreclosure of the lender’s interests could directly or indirectly cause the lender to gain “control” over the rights of the property manager in the management agreement, with the result that the lender would be required to obtain relief from the automatic stay before filing its foreclosure action, seeking the appointment of a receiver, or attempting to collect rents from the borrower’s tenants. Id. Although this decision seems not to prohibit the lender from foreclosing or taking other actions that do not have the effect of ousting the property manager, it can be difficult for the lender to walk a fairly fine line in this regard and the lender still must obtain stay relief if it is ever to rid itself of a property manager who is unnecessary and wasteful even if competent.

Further, structuring the TIC transaction through a property management agreement rather than a master lease does not eliminate the additional layer of management at the property (and probably an additional layer of cost) by a party that is not an owner of the property and is not the borrower under the loan. Such party might not be providing the same level of attention to the property as an owner with its equity investment tied up in the property. Because of this inherent lack of oversight by an actual owner of the property, the lender will want to confirm that it has certain rights with respect to property management, and should take a more active role in servicing and monitoring.

A few rights that the lender will want to confirm are contained in the loan documents and property management agreement are that (i) it has the right to approve the leases (and modifications to leases) at the property, (ii) it has the right to terminate the property management agreement, (iii) it either has a security interest in the reserves that might be held by the property manager, has sufficient reserves that it is holding, or it has the right to require additional reserves to be deposited during the term of the loan, (iv) it has a security interest in the property management agreement, and (v) the payments due to the property manager are subordinate to all payments due to the lender (which should be triggered automatically upon a loan default). In addition, the lender might want to require that the property manager provide a non-recourse carve out guaranty with respect to liability for certain of its actions, including liability for any losses sustained by the lender if the property manager commences a bankruptcy proceeding. And to incentivize the TICs to take an active role and discipline their property manager, the Lender might also want to modify the loan documents to include additional events of default due to (a) the commencement of a bankruptcy proceeding by the property manager, (b) termination or modification of the property management agreement without lender’s approval, and (c) rejection of the property management agreement in bankruptcy.
Because the TICs are typically passive investors, they rely heavily upon the TIC Syndicator, through its management of the property, to maintain the property, properly resolve tenant issues, complete and monitor tenant improvements, and actively market any vacancies at the property. The lender will need to be familiar with the leases and any lease issues, and if it has a broad right to approve all leases at the property, this will be helpful. The lender should take full advantage of the opportunity this provides to monitor its collateral. A lender should also have the right to terminate the management agreement if the property is being mismanaged or a certain debt service ratio is not maintained.

Although the TICs as the owners of the property remain the landlord under the leases under the property management model (rather than the intervening master tenant), as with the master lease model, if any TIC files bankruptcy, it would cause the property (including all leases) to become subject to the bankruptcy estate. Typically, there is a springing recourse guaranty that might deter the TICs from filing bankruptcy, but it is an inherent risk that cannot be further mitigated.

**Multiple Ownership Issues**

One basic problem with the TIC structure is that there can be a large number of TICs, each of which has an interest in the property, and each of which could cause chaos if it tried to actively manage the property. As discussed above, the goal of the master lease and property management structures is to achieve centralized management within the confines of the IRS requirements for income tax deferral. To satisfy IRS criteria (as interpreted by tax advisors), the TIC Agreement generally will require unanimous consent from the TICs for certain actions, such as changing the management structure, replacing the property manager or master tenant, or modifying the loan documents. Obtaining unanimous consent for these changes may be extremely difficult, especially following a bankruptcy of the master tenant, a termination of a master lease, or a termination of a property management agreement.

If the lender has the ability to do so, it should require the TICs to modify the applicable documents to make management at the property and dealings with the TICs more centralized. Beneficial modifications to the loan documents include:

- Providing that so long as notice is sent to all TICs, a TIC’s failure to respond within 10 days is deemed approval of the matter set forth in the notice.
- Providing that notice sent to one designated TIC is deemed notice to all TICs (rather than requiring that notice be sent to all TICs).
- Permitting a designated TIC to negotiate the loan documents and bind all TICs to such provisions.
- Permitting a majority vote of the TICs (rather than a unanimous vote) to make certain determinations at the property.
- Requiring that, in addition to the master tenant (or manager), the TICs have the obligation to make the debt service payments, ongoing repairs, tenant improvements and capital improvements, and requiring that any reserves remain sufficient to satisfy such obligations.

In addition, if the loan is not performing and lender determines that the foregoing modifications are insufficient, lender could require that the TIC structure be abandoned and the TICs be “rolled up” into a newly formed special purpose partnership or limited liability company whereby each TIC conveys its interests in the property to such entity (which entity then becomes the sole owner of the property and borrower under the loan). If sufficient time has passed since the TIC structure was formed such that the TICs’ tax advisor determines that the TIC structure can be abandoned without an impact on the tax that was previously deferred by the TICs, the TIC structure could be converted into a limited partnership or limited liability company model that provides the TICs and the lender with more flexibility and ease in restructuring the loan and managing the property.
Many of the issues discussed herein are beneficial to the TICs, as well as a lender. The TICs, as owners of the property, may be amenable to modifications that might protect them against certain actions (or inaction) of TIC Syndicators. Following an event of default, the lender might have more flexibility (subject to the TICs’ tax advisor’s approval) to require more stringent changes.

As the number of modifications, extensions, and defaults increase, lenders should seize upon these opportunities to enhance their loan documents in accordance with the foregoing recommendations. Once the credit crunch ends and lending resumes, tenancy in common transactions may become popular again, but the structure of such transactions might change based on the lessons learned during this economic crisis.

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