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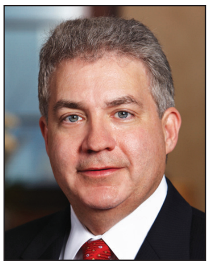
Feature

By Gary W. Marsh and David E. Gordon

Lender Strategies for Dealing with Commercial TIC Bankruptcies



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Commercial tenant-in-common (TIC) bankruptcies can be particularly vexatious and costly to a secured lender. TICs can subject a lender to multiple bankruptcy filings affecting the same real property, each giving rise to an automatic stay and bringing to a halt the lender's exercise of its legitimate rights and remedies with respect to its collateral. Worse, an aggressive and well-organized group of TICs that are savvy about the venue provisions of the Bankruptcy Code will often organize and time their chapter 11 cases in order to file serial bankruptcies in various jurisdictions throughout the U.S., greatly increasing the cost and delay to their secured lender.

This article explains the unique features of the commercial TIC loan structure and the high level of bankruptcy risk, as well as the cost, that it imposes upon lenders. This article also explains how lenders can mitigate these risks and reduce the cost of dealing with a TIC bankruptcy. If the proper strategies are employed, a lender can efficiently obtain permanent, *in rem* relief from the automatic stay and title to its collateral despite the infirmities of the TIC loan structure.

Overview of the TIC Loan Structure

TIC investments became increasingly popular in the earlier part of the last decade, particularly in 2002, when the Internal Revenue Service (IRS) promulgated detailed rules governing such investments.[1] TIC deals are attractive to investors who have gains from one or more prior real estate investments and want, for tax purposes, to defer recognition of the income from those gains. Through a § 1031 exchange, investors can postpone paying taxes on their gains by reinvesting the proceeds of their prior investment into a similar, qualifying investment, such as by purchasing a TIC interest in commercial real property.[2]

Increased demand for investment opportunities that qualified for this advantageous tax treatment spurred the creation of various real estate syndication networks throughout the nation offering TIC investments. TIC syndicators would locate an attractive opportunity to acquire commercial real property, promote the opportunity nationwide to individual investors, and then organize the acquisition of the property to be held by the various investors as TICs. Many of these TIC investments were financed not only through rolled-over money from the TIC investors' prior real estate deals, but also through secured financing extended to the TIC owners to help fund the acquisition. While the extension of secured TIC loans appeared at one time to be a viable and profitable business for lenders, recent experience has shown that the fundamental structure of such deals exposes the secured lender to an unanticipated and often unacceptable level of bankruptcy risk.

A TIC interest is a unique form of real property interest that poses unique challenges in the chapter 11 context. In a limited liability company (LLC) or other traditional real property investment vehicle, the real property would be owned by the LLC or other entity, and membership interests or equity in the entity would be sold to the individual investors. The investors would infuse capital into the entity in exchange for their interests in the entity, the entity would borrow the remaining needed funds from the lender, and the lender would then take a mortgage on the real property purchased by the entity. In the event of default and bankruptcy, the secured lender would be faced with one borrower/owner entity with which to contend, and a typical single-asset real estate (SARE) case would ensue.

1 *See* Revenue Procedure 2002-22.

2 26 U.S.C. § 1031.

In a TIC investment, however, each TIC holder is the direct owner of an undifferentiated share of the entire real property. So if, for example, 20 persons or entities invest in a single commercial real property as TICs, each investor owns an undivided TIC interest in the entire property. If the loan goes into default, the lender has not just one borrower-owner to contend with, but 20. Even worse, because each TIC owner holds an undivided interest in the entire real property, a bankruptcy filing by one of the 20 TIC owners creates an automatic stay protecting the *entire* property and halting the lender's foreclosure efforts.

Even if the lender defeats the first TIC owner's bankruptcy case and obtains relief from the automatic stay, there are still 19 other TIC owners to contend with, each of whom can file for bankruptcy before the foreclosure sale is consummated and once again block the sale. Moreover, applicable IRS regulations permit the TIC interest to be owned by a pass-through entity, such as a single-member LLC, while still allowing the individual investor to enjoy of the applicable tax attribute. If the 20 TIC owners are all LLCs, as is common, then each of them can dictate the venue of their particular chapter 11 case to be (1) where the property is located, (2) in their state of organization or (3) in their principal place of business, generally where the owner of the LLC (the individual TIC investor) resides.[3] While the property will be located in the same jurisdiction for all of the TICs, a TIC's states of organization and principal places of business may span across the country. The TIC owners, if they are well organized, well informed and reasonably well funded, will take advantage of this situation by filing serial bankruptcy cases in inconvenient jurisdictions across the U.S. in order to delay foreclosure or to pressure the lender into a settlement.

Finally, many TIC loans, especially those where the TIC owners are single-member LLCs, are nonrecourse loans that are not guaranteed by the individual investors. As such, the TIC owners have little incentive to do anything other than file serial bankruptcies across the U.S., forestalling the lender's foreclosure efforts indefinitely and imposing massive costs and inconvenience on the lender. In short, if the TIC owners are well organized and willing to fight, a TIC deal that goes into chapter 11 can prove to be a complete nightmare for a secured lender and it can last for years.

Strategies for Defeating TICs

The expense and delay associated with commercial TIC bankruptcies can be mitigated through the pursuit of a two-step legal strategy specifically tailored to the TIC structure: (1) defeat the first TIC bankruptcy by combining the traditional secured lender approach to a SARE bankruptcy case with additional arguments centered on aspects of the TIC structure that require immediate relief from stay or dismissal of the case, then (2) seek and obtain *in rem* relief from the automatic stay pursuant to § 362(d)(4) of the Bankruptcy Code in the ensuing subsequent TIC bankruptcy case. Once a secured lender obtains *in rem* relief pursuant to § 362(d)(4), the automatic stay is lifted as to the *collateral itself* such that no future bankruptcy filing by any of the other TIC owners will give rise to an automatic stay and the secured lender will be free to foreclose notwithstanding any additional bankruptcies.

Defeating the First TIC Bankruptcy

A secured lender should generally treat the first TIC bankruptcy like any other SARE chapter 11 case. The lender's initial strategy should be to seek relief from the automatic stay for cause characterizing the case as a bad-faith filing under the *Phoenix Piccadilly*[4] factors and relief from the automatic stay pursuant to § 362(d)(2), because the debtor has no equity in the property and the property is not necessary for an effective reorganization. If the automatic stay is still in place after 90 days and the debtor files a plan and disclosure statement, the lender should amend its motion for relief from stay to include a request for relief under § 362(d)(3), arguing that the plan does not have a reasonable possibility of being confirmed within a reasonable amount of time because it is inherently unconfirmable. The lender should also object to the disclosure statement on the same grounds. While the foregoing strategy is typical of the strategy that a lender would pursue in any generic SARE case, certain aspects of the TIC ownership structure, if effectively explained to the bankruptcy court, make this strategy even more likely to succeed in the TIC context.

While the TIC structure provides for easy (and repeated) invocation of the protections of the automatic stay to protect the underlying real property, it is not particularly amenable to chapter 11 restructuring. In fact, certain aspects of the TIC structure make confirmation of a chapter 11 reorganization plan virtually impossible. By explaining these elements of the TIC structure and its impact on a debtor's reorganizational prospects to the bankruptcy court, a lender can often swiftly convince the court that any reorganization is impossible and that the case should be dismissed, the stay should be lifted, or and the plan and disclosure statement should be rejected.

Since an individual TIC owner owns only a fractional interest in the entire real property, and the rest of the property is owned by other TIC owners who are not debtors in bankruptcy,[5] this fundamental, structural element has major ramifications for the TIC owner's chances of reorganization. In order to restructure its own debt obligations, the TIC owner must also restructure the obligations of the nondebtors and affect the secured lender's interest in property that the TIC owner itself does not own. Section 524(e) of the Bankruptcy Code, however, states that a debtor's discharge does not affect the liability of nondebtors for property that is not property of the estate. Section 524(e) has been strictly interpreted by most bankruptcy courts to prohibit confirmation of plans that provide for nondebtor discharges or that restructure indebtedness on property that is not property of the bankruptcy estate.[6] Because the individual TIC owner who filed for bankruptcy cannot restructure the obligations of the other TIC owners or affect the secured lenders' rights with respect to their property, a reorganization is largely impossible absent the secured lender's consent.

3 28 U.S.C. § 1408.

4 *See In re Phoenix Piccadilly Ltd.*, 849 F.2d 1393 (11th Cir. 1988).

5 While the other TIC owners could theoretically all join together as joint debtors in a single administratively consolidated chapter 11 case, thereby remedying the defects created by only a fraction of the property being in bankruptcy, a joint filing would also negate the TIC owners' advantage in being able to file multiple serial bankruptcy cases. If 100 percent of the TIC owners filed jointly, the case would simply be a standard SARE case with no risk of multiple re-filings in different venues.

6 *See, e.g., In re Am. Hardwoods*, 855 F.2d 621, 626 (9th Cir. 1989).

The fractional ownership interest of an individual TIC owner also carries other important implications. As a practical matter, given that the TIC owner will only own a fraction of the property but be obligated on the entire secured indebtedness, it is virtually certain that the TIC owner will lack equity in the property for purposes of obtaining relief from stay under § 362(d)(2). This also means that the secured lender will have a large deficiency claim that will control the unsecured creditor class, preventing the TIC owner from obtaining an impaired consenting class under § 1129(a)(10). Given these infirmities, the debtor will never be able to confirm a plan, so the bankruptcy court must eventually grant relief from stay or dismiss the case.

Obtaining *In Rem* Relief

Obtaining relief from stay or dismissal of the first TIC bankruptcy will not end the matter. Typically, the lender will re-initiate the foreclosure process under applicable state law, and prior to the lender's completion of that process, one of the other TIC owners will file its own chapter 11 case, often in an inconvenient venue. This second filing will once again give rise to an automatic stay that is protecting the property. The lender's foreclosure efforts will be halted, and a new SARE case will ensue.

Rather than once again going through the costly—and ultimately futile—process of defeating the second TIC bankruptcy using the aforementioned strategies, the secured lender should seek lasting and permanent relief. In order to obtain such relief, the lender must obtain *in rem* relief from the automatic stay under § 362(d)(4).

Congress added new § 362(d)(4) to the Bankruptcy Code as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) in an attempt to reduce abusive filings.[7] Pursuant to § 362(d)(4), a bankruptcy court can grant *in rem* relief from the automatic stay when a bankruptcy case has been filed as part of a scheme to hinder, delay or defraud creditors and involves multiple bankruptcy filings. To grant relief under § 362(d)(4), a court must find that a bankruptcy filing "was part of a plan or program of action to postpone and get in the way of and to defraud creditors, that was connected to or included more than one or numerous bankruptcy filings that affected the subject property."[8]

As originally enacted in 2005, § 362(d)(4) required a showing that the bankruptcy case had been filed as part of a scheme to hinder, delay and defraud creditors. As part of the Bankruptcy Technical Corrections Act of 2010, Congress modified § 362(d)(4) to provide that *in rem* relief is appropriate as long as there are multiple bankruptcy filings as part of a scheme to hinder, delay or defraud creditors. This amendment signals congressional intent that relief be granted liberally under § 362(d)(4) any time there is a pattern or practice of multiple filings affecting the same property, because any bankruptcy filing will necessarily hinder or delay a secured creditor, and the creditor is not required to demonstrate an intent to defraud.

Relief under § 362(d)(4) is binding on the property itself and applies not only on the debtor, but to every nondebtor, co-owner or subsequent owner of the property that is afforded notice of the motion seeking *in rem* relief. When a secured creditor obtains an order granting *in rem* relief, the creditor should immediately record the order in the appropriate real property records for providing notice of interests or liens under state law. Once recorded, the order is binding for two years, meaning that any subsequent bankruptcy filing affecting the property by any other person or entity will not give rise to an automatic stay for the two-year period.[9] Therefore, § 362(d)(4) gives the secured creditor ample time to complete the foreclosure process and brings the TIC owners' strategy of multiple bankruptcy filings to a halt. In short, *in rem* relief from stay pursuant to § 362(d)(4) provides the secured creditor with lasting relief from the automatic stay and the ability to finally obtain title to its collateral.

Conclusion

TIC loans are fraught with bankruptcy risk. If a lender is asked to make a loan on commercial real property owned by a TIC syndicate, the lender should demand that the individual TIC owners execute "bad boy" guarantees, providing that they will be personally liable on the indebtedness in the event of a bankruptcy filing. Without such a guarantee, the individual TIC owner has little incentive to do anything other than engage in a strategy of serial bankruptcy filings. If a lender or other entity is considering purchasing a TIC loan, they should make sure such guaranties are in place. If there are no guaranties, the buyer should insist that the loan be priced to compensate for the high level of bankruptcy risk and cost associated with the transaction. Finally, if a secured creditor already owns a TIC loan with no personal guaranties in place, they should prepare for a long, expensive fight that they will eventually win if the proper strategies are employed. abi

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7 *See In re Abdul Muhaimin*, 343 B.R. 159, 166 (Bankr. D. Md. 2006) (citing H.R. Rep. 109-31(I) at 69 (2005)).

8 *Abdul Muhaimin*, 343 B.R. at 169.

9 11 U.S.C. § 362(b)(20).