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Tenants-In Common in Commercial Real Estate Transactions: Assessing the Bankruptcy Risks

"It is not bad faith to seek to gain an advantage from declaring bankruptcy--why else would one declare it?"

In re James Wilson Assocs, 965 F.2d 160 (7th Cir. 1992).

By David R. Kuney [1]

Commercial real estate loans are increasingly being made to groups of investors or co-owners who hold the fee interest to real property under the common law form of ownership known as tenancy-in-common. (This aggregation of co-owners is referred to as a "TIC" and the individual co-tenant as the "TIC Owner"). The TIC vehicle has significant differences from other forms of ownership, such as limited partnerships and limited liability companies. One of the key differences is that each co-tenant has an assignable interest in "real property," as opposed to having an interest in personal property. For that and other reasons, the TIC is said to make possible the use of "like kind" exchanges by individual TIC Owners under Section 1031 of the Internal Revenue Code (the "IRC"). [2] A second major difference, in terms of what happens in a distress context, is that the fee is owned by separate owners, none of whom have unfettered legal title or control over the fee. Since a TIC is not a true legal entity, but a group of separate entities,

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[2] This permits TIC Owners to sell or trade their interests and defer recognition of gain for tax purposes. Thus, ownership in the form of a TIC increases the liquidity of an investment and defers gain recognition.

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it may be the only form of ownership of commercial real property where less than all of the fee owners would be debtors or debtors-in-possession in a filing under Chapter 7 or 11 of the U.S. Bankruptcy Code (the "Code"). Like Ichabod Crain, would the TIC debtor be a headless horseman in bankruptcy? [3]

This articles examines some of the possible bankruptcy related risks that might arise if one or more of the co-tenants files for bankruptcy. The primary focus is on whether the bankruptcy risk of lending to a TIC is qualitatively different than lending to other conventional forms of entities, such as the limited liability company. The conclusions suggested in this article are as follows: first, there is some bankruptcy and enforcement risk associated with the use of the TIC form of ownership merely from the absence of an established body of case law dealing with commercial real estate bankruptcies (although there is a substantial amount dealing with former spouses as co-owners). Second, one of the principal devices which is used to mitigate the risk of bankruptcy, namely, a buy-out right in favor of the co-tenants or the sponsor, may be challenged as unenforceable under traditional executory contract law principles found in section 365 of the Code. Third, the combined statutory right of the debtor to sell the interests of its co-owners, and the reciprocal right of the co-owners to purchase the interest may provide for substantial protections to co-owners and mortgage lender. Likewise, the mortgage lenders right to credit bid whenever the co-tenant exercises a sale right should also provide substantial protection. Fourth, TICs may be more bankruptcy remote than other ownership entities because the TIC may be more vulnerable to traditional bankruptcy remedies, such as relief from the automatic stay or motions to dismiss, because of fundamental economic barriers to reorganization, including lack of cash flow and operating capital.

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[3] Washington Irving, The Legend of Sleepy Hollow (1819).

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Nature of a Tenancy in Common

A tenancy in common is a form of property ownership in which "two or more persons are entitled to real property in such manner that they have an undivided possession or right to possession in such property but several interests." [4] Each tenant in common, regardless of its percentage ownership, has an equal right to possession. There is no right of survivorship among tenants in common, and interests held as tenants in common are freely alienable. "Therefore, a tenant in common may sell, assign, or devise by will or otherwise his or her interest in the tenancy in common without the consent of the other tenants in common." [5] In short, each tenant owns a direct, undivided interest in the whole property.

A TIC has certain legal characteristics that create legitimate concerns over credit risk and bankruptcy risk. Part of the credit risk arises from the fact that each co-tenant can file its own bankruptcy (see below) and hence a lender is faced with a daunting task of monitoring and evaluating as many as 35 separate entities within the TIC. [6] Another credit risk may arise from the fact that a judgment lien against any one co-tenant would be a lien against the fee interest held by the entire TIC. This is because each co-tenant owns an interest in real property, and thus a judgment lien attaches directly to the TIC's real property interest (unlike a judgment lien against an individual partner). See In re Laborde, 231 B.R. 162 (W.D.N.Y. 1999) (after a divorce, ex-husband and ex-wife each held one half tenancy in common interest in a residence. Several banks obtained judgment liens after the divorce on the one-half tenancy in common interest of the ex-husband); see also Hall v. TWS, Inc., 113 P.3d 1207 (Alaska 2005) (after the

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4 In re Sturman, 222 B.R. 694 (Bankr. S.D.N.Y. 1998).

5 Id. (citing Clarkson Co. Ltd. v. Shaheen, 533 F. Supp. 905 (S.D.N.Y. 1982)).

6 There may be concerns that the ultimate owner of the TIC interest may be substantively consolidated with the TIC, but that topic is beyond the scope of this paper.

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dissolution of a mining partnership, each former partner held tenancy in common interests in mining claims previously owned by the partnership. The court held that a creditor who obtained judgment after the dissolution against a former partner may foreclose on the former partner's tenancy in common interest in the mining claims.); Greenhouse Realty, Inc. v. St. George, 151 A.D.2d 7 (N.Y. App. Div. 1989) (holding that, where a creditor held a judgment lien on husband's interest in tenancy by the entirety, after divorce, tenancy by the entirety becomes tenancy in common and the lien is attached to the tenancy in common interest created by the divorce).

Conversely, limited partners or members of a limited liability company do not own an equity interest in real property; rather they own personal property. Partners are considered to be "tenants in partnership." [7] Generally, a partner has an equal right with the other partners to possess specific partnership property for partnership purposes. However, a partner has no right to possess such property for any other purpose without the consent of the other partners. [8] Generally, a partner's right in specific property is not assignable except in connection with the assignment of the rights of all of the partners. Some states, such as New York, specifically forbid assignment by one partner to a third party unless all partners join or consent. Because of this, a partner's interest in partnership property is not subject to attachment or execution except to satisfy a claim against the partnership. [9] Furthermore, creditors of individual partners cannot attach the partnership property.

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[7] See e.g., Cutler v. Cutler, 165 B.R. 275 (Bankr. D. Ariz. 1994) (construing the rights of a general partner under Arizona law, which corresponds to the Uniform Partnership Act).

[8] Sturman, 222 B.R. at 710.

[9] Id.

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Partition

A frequently cited risk associated with TIC real estate financing is that one or more of the TIC Owners will exercise the common law right of partition. Partition, in one form, permits each tenant to take a separate title to a separate parcel of real property:

> Partition is the method used to terminate joint tenancies and co-tenancies in property by division of the interest. Partition may be voluntary or it may be effected by judicial action at the instance of one or more of the joint tenants or co-tenants. When partition takes place, each joint tenant or co-tenant takes title to a specific portion of the property separately. . .
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> In re Powell, 325 B.R. 6 (Bankr. N.D. Ala. 2005).

Partition results in each tenant being given separate title to a separate parcel, provided that physical division is practical. However, when dealing both with a marital home, and with a single commercial real estate property, such as an office building, physical division is likely to be highly impractical. Thus, under the common law, where a physical division is not practical, partition results in a sale of the entire property, with the proceeds being distributed to each tenant on account of their respective ownership interest. "The right to partition the property is granted to TIC owners under state law. If the property cannot be divided proportionately (which in virtually all cases of improved real estate it cannot), then partition is often the result, which requires forced sale of an entire property, with the proceeds divided among the TICs in accordance with their respective interests."[10] One commentator describes the function of partition as follows:

> One of the hallmarks of a "tenancy-in-common" interest is the right of partition. Under TIC ownership, each TIC Owner owns an undivided percentage in the whole. However, the right of partition

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[10] Cheryl P. Armata, Financing Tenants in Common Projects, 22 No. 5 Prac. Real Est. Law 17 (Sept. 2006); See generally 20 Am Jur. 2d Cotenancy and Joint Ownership, §§31, 41, 42 (2006).

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> (at least theoretically) gives each TIC Owner the right to wholly own (without other owners) a smaller portion that correlates to such TIC Owner's percentage of the whole. This "right" is the right of a TIC Owner of real estate to cause a "partition" of the co-owned property so that each owner has a totally separate asset that is, for all purposes, independent of the assets owned by all of the other owners. This is usually impractical and/or legally impossible (if, for instance, the commonly-owned property is a multi-unit apartment building or the zoning laws have a minimum size for a property). In such situations, the alternative remedy is to force a sale of the entire property and then divide the net proceeds.

Alvin L. Arnold, Real Estate Transactions - Structure and Analysis with Forms, RETSA § 2:98 (April 2007).

Tax Advantages of TIC Ownership

It has been suggested that the current popularity of the use of the TIC is tax driven and relates to the provisions dealing with like kind exchanges.[11] The use of the TIC structure facilitates the ability of co-owners (the tenants) to use section 1031 of the IRC to enter into a "like kind" exchange, in which the owner of real property exchanges its interest in one parcel for an interest in another, (which may include cash as part of the consideration) and with the gain on the sale being deferred by an adjustment in the basis of the new property. Current tax provisions do not permit an owner to do the same when property is owned by a limited liability company or a limited partnership because those interests are considered to be personalty and not realty.

Previously, an impediment to the use of the TIC form of ownership had been the uncertainty whether TIC ownership would be recognized as a valid form of ownership by the IRS, as opposed to an interest in a business entity, such as a partnership or limited liability company. This was apparently resolved in 2002 when the IRS issued Rev. Proc. 2002-22.[12]

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[11] See Jon S. Robins, Financing Tenants in common Property in Capital Markets, Real Estate Finance Journal, Summer 2002, p. 23. ("Robins").

[12] Rev. Rul. 2002-22, 2002-1 C.B. 733, 2002 WL 417295 (IRS RPR)("Rev. Proc. 2022-22").

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According to some, "this revenue procedure establishes guidelines for the issuance of private letter rulings confirming that a TIC structure would be recognized by the IRS. The guidelines are not technically a safe harbor and they do not represent the only way to achieve TIC treatment…"[13]

In distinguishing between an interest in an entity and a tenancy-in-common, the IRS has stated that the "central characteristic of a tenancy in common. . . is that each owner is deemed to own individually a physically undivided part of the entire parcel of property. . . These rights generally provide a tenant in common the benefits of ownership of the property within the constraint that no rights may be exercised to the detriment of the other tenants in common." Rev. Proc. 2022-22, (citing 7 Richard R. Powell, Powell on Real Property, §§ 50.01-50.07 (Michael Allan Wolf ed. 2000)).

Since the issuance of Rev. Proc. 2022-22, Moody's has noticed an increase in the use of the TIC structure in the deals that its rates and in the general interest of the CMBS industry.[14] The IRS ruling permits up to 35 co-tenants.

Typical Financing Structure for a TIC Loan

It has been generally recognized that there are at least two common forms of TIC financing transactions today. In "syndicated" transactions, there is typically a "sponsor" who "packages co-ownership interests for sale by acquiring property, negotiating a master lease on the property, arranging for financing" and then seeks investors. Rev. Proc. 2002-22. Other forms of co-tenancy may simply involve one or two co-developers of a rental property.

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13 See Sally J. Gordon, Commercial Securitization for Real Estate Lawyers. Real Estate Finance in the Capital Markets: Risks and Rewards, SK077 ALI-ABA 393, 396 (2005) (hereafter, "Gordon").

14 Id.

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In a typical TIC loan structure, each TIC Owner is jointly and severally liable for the loan and the mortgage. The TIC Owners may have an agreement (the "TIC Agreement") among other things, to delegate management to a third party manager.[15] The TIC may also enter into a master lease with a master lessee who enters into occupancy leases with occupancy tenants, and who is given various management responsibilities. A TIC Agreement may also provide for the rights of other tenants to purchase the interest of a co-tenant, if the tenant files for bankruptcy. The delegation of management powers to a third party may be problematic at some level. For example, the IRS has stated that a factor which may influence a court's decision that an entity is a partnership is where there are "limitations on the co-owner's ability to sell, lease or encumber either the co-ownership interest or the underlying property, and the manager's effective participation in both profits (through the remarketing fee) and losses (through the advances). Id.

A waiver of the right of partition is frequently included in the TIC Agreement. This too must be somewhat circumscribed because of the tax issues. The IRS has stated that each co-owner must have the right to transfer, partition, and encumber the co-owner's undivided interest in the property without the agreement or approval of any person. Id. However, "restrictions on the right to . . . partition. . .that are required by a lender and that are consistent with customary commercial lending practices are not prohibited… Moreover, the co-owners, the sponsor, or the lessee may have a right of first offer (the right to have the first opportunity to purchase the co-ownership interest) with respect to any co-owners' exercise of the right to transfer the co-ownership interest in the Property." Id.

[15] A sample provision might state as follows: "The Master Lessee shall have the sole and exclusive right to manage, operate, maintain and lease the Property; provided, however, that the Master Lessee may employ a third party Property Manager, as agent for the Master Lessee pursuant to the Master Lease Agreement, to manage, operate, maintain and lease the Property."

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The TIC Agreement may also create indemnification claims among the co-owners. However, a right of indemnification means that any TIC which files for bankruptcy may thus have 34 other contingent claims against it for indemnification, thus making the TIC less bankruptcy remote in the sense that it is no longer a two party dispute, and there are numerous classes of creditors.[16]

The Bankruptcy Risks of the TIC

What would happen if one or more of the co-tenants of the TIC filed for bankruptcy where the TIC owned commercial real property, and a mortgage lender held a first lien on the entire fee interest? Few if any reported cases deal with the rights of the other co-tenants when one tenant files for bankruptcy, and the property is subject to a mortgage.[17]

There is only a limited amount of commentary on the bankruptcy risks.[18] One of the more often cited articles is by Moody's Investor Service ("Moody's"), which identifies several major concerns,[19] including: (a) the possibility of a forced sale of the property under section 363(h) of the Code; (b) the risk of partition, and, (c) the risk of serial bankruptcy filings by other co-tenants.[20] Are these the only risks and when and how would they arise in a TIC Owner's bankruptcy case? In contemplating a possible TIC Owner bankruptcy, the following questions might arise:

- What is the impetus for filing? What is the context in which this issue might arise?

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16 Presumably, any indemnification claims would be considered "contingent claims" and could be disallowed under 11 U.S.C. § 502(e).

17 But see, In re Locke, 180 B.R. 245 (Bankr. C.D. Cal. 1995)(dealing with whether a co-tenancy agreement is an executory contract).

18 Almost all of the reported cases deal with the more frequent situation of a husband and wife who own real property as tenants by the entirety, and who then divorce, which by law, creates a tenancy in common.

19 Gordon, supra note 13.

20 See e.g., In re Kassover, 28 Fed.Appx. 100 (2d Cir. 2002).

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- Is the TIC an "entity" that can file for bankruptcy?
- Would any of the typical remoteness devices such as the use of an independent director or springing guarantees be effective?
- How would the automatic stay operate? Is there a risk of serial filings and serial invocations of the automatic stay?
- Once the bankruptcy is filed, can the other TIC Owners buy out the TIC Owner upon a filing, or is there a risk that the TIC Agreement is an executory contract which can be rejected?
- Could a Chapter 11 or Chapter 7 trustee sell the interests of the co-owners? Do they have a right of first refusal under section 363(i) of the Code?
- Could the TIC Owner which filed for bankruptcy reject the master lease under Code section 365?
- Could a TIC confirm a plan of reorganization which involved a restructuring of the mortgage debt and even use the cram down provisions?

These issues are addressed below.

Financial Stress and the Impetus to File Bankruptcy

When is it likely that a TIC Owner might wish to invoke the protections offered by Chapter 11 of the Code? In order to identify some of the more likely risks, we might hypothesize that the TIC Owners own a commercial office building in downtown Washington, D.C. The TIC Owners have entered into a master lease for the entire office building (the "Master Lessee"). The Master Lessee has entered into four sub-leases with occupancy tenants (the "Occupancy Tenants"), these being a group of four major law firms, each of which was supposed to lease one fourth of the building. Two years into a five year term loan, two of the four law firms close, and are judgment proof. The rental income falls to one half of the projected rental income, and there is a payment default under the mortgage loan. No other occupancy tenants are immediately available. Assume that there is a justifiable or good faith basis to seek bankruptcy protection.

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Another impetus might be the case where one of the TIC Owners has a judgment entered against it. Unlike a partnership or limited liability company, this judgment is a lien against the real property interest. See In re Laborde, 231 B.R. 162; see also Hall v. TWS, Inc., 113 P.3d 1207. A lender would presumably seek to guard against this by having the TIC execute separateness covenants stating it will not permit nor incur any indebtedness (other than normal operating expense). Unfortunately, in our hypothetical the TIC Owner permitted a judgment to be entered against it.

The mortgage lender proposes to enter into a forbearance agreement with the TIC Owners but requires that they each fund the mortgage shortfall during the period of forbearance. A dissident group of TIC Owners (or a single TIC Owner) rejects the work out proposal and file for bankruptcy (the “TIC Debtors”). The automatic stay springs into existence and at least momentarily stops the foreclosure. The other TIC Owners do not file for bankruptcy (the “TIC Non-debtors”).

Remoteness Devices: Springing Guaranties and Independent Directors

A threshold issue would be whether an individual TIC Owner would be precluded from filing by the use of an independent director, assuming that the co-tenant is itself a limited liability company. Whether the use of such directors is feasible given the number of TIC Owners in a single transaction, and the potential expense involved, is unclear. Another potential impediment to the use of independent directors is the IRS’ view that a TIC must maintain and possess the “benefits of ownership,” and cannot fully delegate all management functions. See IRC Rev. Proc. 2002-22. The use of independent directors has developed mostly in the area of limited liability companies which do not have an underlying tax restraint on delegation.

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Further, the use of independent directors who do not evaluate the actual feasibility of a filing or who are remote from the operations has led to some judicial doubts as to the enforceability of a director's veto over the right to file for bankruptcy.[21] For purposes of assessing the risk from a bankruptcy filing, it should be assumed, therefore, that the special purpose entity, which holds the TIC interest, will be eligible to file for bankruptcy.

Another threshold impediment to the filing might be the use of springing guaranties. The mortgage loan will presumably have recourse carve outs, including provisions which entitle the lender to sue the individual or entity which owns the TIC interest in the event the TIC Owner files a bankruptcy petition. The use of a third party guaranty agreement which "springs" (i.e., becomes effective) upon the filing of a bankruptcy by another entity, and which involves the credit of a third party should be fully enforceable. As of this writing, there is no body of case law holding that springing guaranties are unenforceable or that they improperly chill the exercise of an ability to use the provisions of Chapter 11.

The problem with a springing guaranty, however, may not be its enforceability, but whether it will have the desired effect of persuading the TIC Owner to defer filing. If the owner of the co-tenancy interest is itself in financial trouble, and is the guarantor, then another default or judgment may simply be another claim to be adjusted in a separate bankruptcy proceeding. In short, the ability to look elsewhere may prove to be ephemeral.

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[21] See e.g., In re Kingston Square Assocs., 214 B.R. 713, (Bankr. S.D.N.Y. 1997); see also Caryl B. Welborn, The Role of the Special Purpose LLCS and Other Entities in the World of Structured Finance: Ramifications for LLC Structuring, VML0316 ALI-ABA 129 (2006) ("[I]t is difficult to believe that many bankruptcy courts will honor the veto of an independent director that is (or may be) controlled by the lender. Indeed, independent directors who are not really "independent" may create a risk of liability for lenders.")

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Accordingly, it would appear that a determined and financially distressed individual or entity owning a TIC interest could well be persuaded to put its TIC entity into Chapter 11. And thus we must inquire, what would happen next?

The TIC or TIC Owner in Bankruptcy: Who is the Debtor? What is Stayed?

The concept of a TIC in bankruptcy is somewhat enigmatic. First, the TIC Owners (the co-tenants) hold separate but undivided interests; and thus the debtor is not the sole owner of the fee interest. Thus, as has been stated, "a tenancy in common is not an entity."[22] There is nothing in the Code to suggest that a TIC is an eligible debtor.[23] Tenancy in common is a form of co-ownership, but it is not an "entity," and hence the TIC as an aggregate, single entity, is not likely to be a "debtor."

Further, it is unlikely that even if all of the co-tenants filed at the same time, that the group of tenants would be recognized as an "entity" eligible to be a debtor. The eligibility to file arises only from the status of the underlying owner, which in turn may be an individual, a form of limited liability company or other similar entity. Thus, if two or more co-tenants filed for bankruptcy at the same time, their cases would be on separate dockets, and could even be heard in separate jurisdictions.

The debtor or debtors which are likely to file for bankruptcy are one or more of the TIC Owners, and for purposes of illustration, we are assuming that one of the 35 co-owners has filed for bankruptcy. In this circumstance, and unlike the bankruptcy filing of a partnership or a limited liability company, all of those who own the fee interest (i.e. the TIC Owners) are not

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22 Robins, supra, note 11, at p. 23.

23 Pursuant to section 109 of the Bankruptcy Code, a "person" may be a debtor and a "person is defined under section 101(41) as including an individual, a partnership or a corporation. 11 U.S.C. § 101 (41). However, it should be noted that the use of the word "includes" means the definition is not exclusive, and while seemingly unlikely, could include a TIC.

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debtors and are not before the bankruptcy court. The only debtor is the single TIC Owner which has filed for bankruptcy.

What then does the debtor own, what is property of the estate, and what is the allowed amount of the mortgage lender's claim? These are all critical questions in determining relief from the stay, the need to provide adequate protection, and how a potential cram down might work under Code section 1129(b). The short answer is that even if a co-tenant owns only a 5% interest, that interest is an undivided interest in the whole. Accordingly, and conceptually, the entire fee interest is in the bankruptcy estate, and subject to the provisions of the Code, including the automatic stay of section 362.

Thus, because the entire fee interest is within the estate, a foreclosure action against the real property would appear to be prohibited. Further, the lender is presumably precluded from suing the other co-tenants on the grounds that the loan is non-recourse, unless the springing guaranty makes all tenants individually liable even if they are not the co-owners which filed for bankruptcy.

What is the mortgage lender's allowed claim, both secured and unsecured? The mortgage lender's state law claim is for the entire amount of the mortgage debt as to each co-tenant; there is no division of the debt. Thus, the dollar amount of the claim against the new debtor-co-tenant is the entire mortgage. However, the "value" of the lien interest is only 1/35th of the fair market value of the collateral, at most because the co-tenant/debtor presumably could not sell its separate interest for more than its pro rata share. Accordingly, the secured lender may find itself massively under-secured. This may support a motion for relief from the stay (see below), and may give the mortgage lender a right under Code section 1111(b) to claim that no reorganization is feasible, and hence to seek an early dismissal of the case (see below).

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Rejection of the Master Lease under Code Section 365

Ordinarily, a debtor has a right to reject various forms of executory contracts under section 365 of the Code. While the Code does not define an executory contract, an executory contract is generally recognized as an agreement in which the obligations and duties of both parties remain unperformed, so that if either failed to complete or fulfill its duties, it would constitute a material breach.[24] If a contract is an executory contract, then upon notice, motion, and a court order, a debtor may "reject" the agreement. Rejection requires a showing of some rational business judgment. The courts will generally defer to the debtor's business judgment except upon a finding of bad faith or gross abuse of their business discretion. Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043 (4th Cir. 1985).

Rejection constitutes a breach of the agreement, and gives rise to a general, unsecured prepetition claim. See 11 U.S.C. § 365(g). A persistent issue with leases of non-residential real property, however, has been the debate over whether rejection terminates the leasehold estate, and all subservient estates, or is merely a breach. This distinction between termination and breach continues to this day to be an issue of some dispute.[25]

In the present context, the TIC will be a party to at least two potential executory contracts, namely, the master lease, and the TIC Agreement. Is either an agreement which can be rejected, and if so, what are the consequences from the perspective of the mortgage lender?

The Master Lease, in which the Master Lessee is vested with the right to manage and collect the rental income, is almost certainly an executory contract under Code section 365.

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[24] Vern Countryman, Executory Contracts in Bankruptcy: Part I, 57 Minn. L. Rev. 439, 460 (1973); see also Unsecured Creditors' Comm., of Robert L. Helms Constr. & Dev. Co. v. Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.), 139 F.3d 702 (9th Cir. 1998).

[25] See e.g., Andrew, Executory Contracts in Bankruptcy: Understanding Rejection, 59 U. Colo. L. Rev. 845; Westbrook, Executory Contracts 74 Minn. L. Rev. 227.

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Could a co-tenant debtor successfully ask the bankruptcy court to reject the Master Lease under section 365 of the Code? The motivation for such a motion might be in order to permit the single co-tenant to collect the rent from the occupancy tenants, or to appoint a new Master Lessee as manager. Any such motivation sounds implausible as of now.

Assuming a motion to reject was filed, would the bankruptcy courts grant the motion? Perhaps not. First, although the decision to reject is rarely challenged by a bankruptcy court, this might be one circumstances where the rejection would appear to have no rational business justification, and hence might qualify as an "abuse of business discretion." Especially in the context of a 35 entity TIC, where all of the other TIC Owners depend upon the management of the Master Lessor, it would seem that a good argument could be made that rejection did not comport with any sound business judgment. However, in the context of a smaller, non-syndicated TIC (say with two TIC Owners), then one of the two co-tenants could readily argue that current management should be replaced, and that rejection was in the best interest of the estate.

Second, even if permitted, the rejection might achieve little. Section 365(h) of the Bankruptcy Code would appear to prevent a complete termination, since section 365(h)(1)(A)(ii) gives the lessee the option to retain its rights under such lease.[26] However, the caveat is that the retention is only of those rights that are "appurtenant to the real property." The TIC Debtor might argue that management rights are not appurtenant to the property.

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[26] Generally, courts have been liberal in relieving lessors of duties under rejected leases beyond allowing tenants to stay in possession. See In re Bedford Square Assoc., L.P., 247 B.R. 140 (E.D. Pa. 2000) (holding that, in a shopping center lease, a covenant against the debtor-lessor making alterations to a parking lot is unenforceable when the debtor-lessor rejects the lease and the tenant choose to stay in possession.); see also In re Riverside Village, 102 B.R. 858 (Bankr. M.D. Fla. 1989) (where a lessor-debtor, after rejecting the lease, did not provide clean drinking water and tenants stayed in possession , tenants rights were limited to possessing the leasehold property and setting-off the cost of bottled water against rent due pursuant to section 365(h)(1)(B) of the Bankruptcy Code).

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A TIC Debtor might seek to recharacterize the lease as not being a true lease. The purpose of such an argument would be to divest the Master Lessee of the special protections of section 365(h). This issue has come up in the context of hotel operators. Some hotel chains have management contracts in the form of "leases." Some of theses have been challenged as not being true real estate leases and hence being subject to broader rejection rights of a debtor. See e.g., Dunes Hotel Associates v. Hyatt Corporation, 212 B.R. 110 (Bankr. D.S.C. 1997)(applying state law in determining whether the disputed agreement was a "true lease.")[27]

However, it is unlikely that a TIC Debtor would succeed in recharacterizing the lease as a management agreement because of certain tax law requirements on setting up TICs. Specifically, IRC Rev. Proc. 2002-22 requires, among other things, that (1) any lease agreement entered into by the TICs must be a "bona fide" lease for tax purposes and (2) any management agreement entered into by the TICs must be renewable "no less frequently than annually." IRC Rev. Proc. 2002-22. Under such a "bona fide" lease, rent must "reflect the fair market value for the use of the Property" and not be "based on a percentage of net income from the Property, cash flow, increases in equity, or similar arrangements." IRC Rev. Proc. 2002-22.

While the definitions of a "true lease" or a "bona fide lease" under tax law and bankruptcy law may not be the same, bankruptcy courts have frequently considered the aforementioned rent payment criteria as important in determining whether a lease is a true or bona fide lease.[28] Also, the requirement under Rev. Proc. 2002-22 for rent to not be based on net

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[27] Under South Carolina law, the essential elements of a lease are:

> (a) a grant of the possession and of the exclusive use and enjoyment of the [owner's property]; (b) for a definite consideration or rental which is susceptible of being made certain, and (c) for a definitely expressed and certain term."

[28] Courts applying the "economic substance test" to determine whether a purported lease is a true lease have focused on whether the rent paid reflects fair market value of the possessory interest. See In re PCH Associates,

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income from the property allocates the risk for profit or loss from the subleasing operation to the master lessee (at least to a certain degree) rather than the TIC owners. This allocation of risks, typical of a lessor/lessee relationship, favors a bankruptcy finding of a true lease.[29] Thus, if the master lease is correctly set up to take advantage of like kind tax benefits that are often a central purpose for making a TIC arrangement, the lease is also likely to a true or bona fide lease for bankruptcy purpose. Therefore, success in recharacterizing the lease under bankruptcy law may lead to the undesired recharacterization of the lease under tax law, which presumably would harm not only the TIC Non-Debtors but also the TIC Debtor and its bankruptcy estate.

TIC Agreement as Executory Contract: Unenforceability of the Buy Out Provision

A more serious risk arising under section 365 of the Code may be with the enforceability of the buy-out provisions in the typical TIC Agreement. The TIC Agreement may provide that the filing of a bankruptcy by one or more TIC Owner triggers an absolute right in the other co-owners or the sponsor to purchase the TIC Owner's interest.[30] If the TIC Agreement is considered an executory contract under section 365 of the Code,[31] then this provision may be

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804 F.2d 193, 199 (2d Cir. 1986) (holding that the purported lease was not a true lease because, inter alia, the agreement contains "fixed rent [that] bore no relationship to the market value of the land; rather, it was strictly the result of trading tax benefits for a higher return from the joint venture."); United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609 (7th Cir. 2005) (holding that purported lease is a not a lease because "[t]he 'rent' is measured not by the market value of 20 acres within the maintenance base but by the amount United borrowed.").

[29] See e.g., United Airlines, Inc. v. HSBC Bank USA, N.A., 416 F.3d 609 (7th Cir. 2005), citing Senate Report on 11 U.S.C. §502(b)(6) ("the fact that the lessee assumes and discharges substantially all the risks and obligations ordinarily attributed to the outright ownership of the property is more indicative of a financing transaction than of a true lease.")

[30] For example, a provision might read:

> *Option*. If, during the term of this Agreement, a Tenant in Common is Bankrupt (as defined below) (a "Bankrupt Tenant in Common"), the other Tenants in Common and the Master Lessee shall have the right, to be exercised by written notice ("Bankruptcy Call Notice") to the Bankrupt Tenant in Common, to buy all of the Bankrupt Tenant in Common's Interest in the Property.

[31] At least one court has found a TIC Agreement to be an executory contract. See In re Locke, 180 B.R. 245, 251 (Bankr. C.D. Cal. 1995) (holding that a tenancy in common agreement is an executory contract because "the

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deemed to be an unenforceable "ipso facto" provision — that is, a provision which compels a loss of a contract right based on a debtor's insolvency or financial condition.[32]

Cases dealing with similar buy-out provisions in the partnership context have sometimes found them to be unenforceable under the Code. For example, in Cutler v. Cutler (In re Cutler), 165 B.R. 275, 277-280 (Bankr. D. Ariz. 1994), the court held that a buy-out provision which permitted the non-debtor partners the right to purchase the partnership interest of a debtor partner for an amount equal to the balance of the debtor partner's capital and income accounts was an ipso facto clause unenforceable under sections 541(c)(1)(B) and 363(l) of the Code. See also, Cherkis & King, Collier Real Estate Transactions and the Bankruptcy Code, ¶ 4.07[1], pp. 4-72.3-73 (Matthew Bender, 1992).[33] The courts have viewed such provisions as forfeitures of a debtor's economic interest in a partnership.[34] See also In re IT Group, Inc**.,** Co., 302 B.R. 483 (D. Del. 2003).

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[t]enancy [a]greement imposed obligations on both the [debtors] and the [n]on-[d]ebtor [c]o-[t]enant so material that the breach of those covenants by one party would excuse the other from performance under the [t]enancy [a]greement."). Of course, whether each TIC Agreement is an executory contract depends on the particular circumstances of each case.

32 Section 365(e) states that "Notwithstanding a provision in an executory contract or unexpired lease. . . an executory contract . . . may not be terminated or modified, and any right or obligation under such contract . . . may not be terminated or modified. . . solely because of a provision in such contract or lease that is condition on—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case.

33 See also Summit Inv. & Dev. Corp. v. Leroux, 69 F.3d 608, 610-14 (1st Cir. 1995) (finding that the provisions of the Revised Uniform Limited Partnership Act, § 402(4), under which a person ceases to be a general partner of a limited partnership on filing a petition for reorganization, and the provisions of the limited partnership agreement under which a general partner's interest was converted to a limited partnership interest and the debtor partner was divested of the right to participate in management in the event of bankruptcy, were ineffective ipso facto provisions under § 365(e)(1))

34 However, in other partnership cases, the courts have held that the ipso facto provisions were enforceable where it has first found that the partnership agreement was more in the nature of a "personal services" contract, and where the identity of the debtor was material to the management of the business. See e.g., Broyhill v. DeLuca (In re DeLuca), 194 B.R. 65 (Bankr. D. Va. 1996)**.**

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Generally, an ipso facto clause, such as a buy-out provision which is effective upon the debtor's filing for bankruptcy, is not valid under Code section 365(e)(1). However, there is an exception to the rule which applies where "applicable law excuses a party, other than the debtor, from accepting performance from or rendering performance to the trustee or to an assignee of such contract. . ." Code section 365(e)(2)(A). More simply stated, the ipso facto clause is effective <u>only</u> where the co-partner or co-member contractual performance is more in the nature of a "personal services contract" or is material to the management of the business.

Given the underlying nature of a TIC, with 35 members, each of whom invested for liquidity and ease of trading, it seems less likely that any one member's management was "material" to the entity. That is, there is nothing intrinsic about a tenant in commons interest in a syndicated transaction that would justify a ruling that the other co-tenants were not obligated to accept performance from a co-tenant. That being so, there is little justification to compel a forfeiture or buy out upon filing. Further, the TIC interest should be viewed as freely assignable, which also supports the notion that the buy out provision is likely to be unenforceable.

It would appear likely that a court would find that an agreement among co-tenants which permitted the other tenants to buy-out one tenant based on its financial condition (e.g., the filing of a bankruptcy) would be viewed as an unenforceable ipso facto clause. Accordingly, it is recommended that lenders and co-owners should at least evaluate the risks of a TIC Owner bankruptcy as if the buy-out provision will not provide for an early or easy exit for the mortgage lender. However, as noted below, it may be possible to achieve similar results through use of the partition and buy-out right found in the Code.

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Sale Under Section 363: buy-out right of co-tenants

One of the principal concerns in lending to a TIC is the right of a debtor to sell the fee interest in its entirety, despite the fact that the other co-tenants are not debtors in the bankruptcy proceeding. This concern arises because of Code Section 363(h), which permits a debtor in possession, or a trustee, to sell the entire property if held by co-owners as tenants in common. Section 363(h) permits a "trustee" to sell both the estate's interest in real property and the interest of any co-owner in property only if three conditions are met: (a) partition in kind is impracticable; (b) the sale of the estates' undivided interest would realize significantly less for the estate than a sale of such property free of the interest of co-owners; and (c) the benefit to the estate outweighs the detriment to the co-owners. All three of these conditions are mandatory.[35]

In determining whether the benefit to the estate outweighs the harm to the non debtors, the courts consider both economic and non-economic factors. See Community Nat'l Bank & Trust Co. v. Persky (In re Persky), 893 F.2d 15, 20 (2d Cir. 1989); Bakst v. Griffin (In re Griffin), 123 B.R. 933, 936 (Bankr.S.D.Fla.1991). Once the Trustee makes a prima facie case demonstrating that the estate would benefit from the sale, the burden shifts to the non-debtors to show facts indicating why a sale should not be approved. See Grabowski v. Sapir (In re Grabowski), 137 B.R. 1, 3 (S.D.N.Y.), aff'd, 970 F.2d 896 (2d Cir. 1992).

Bankruptcy courts have frequently permitted sales of the non-debtor's interest, although this is more commonly done in the context of a divorcing spouse who files for bankruptcy and then seeks to sell a martial home. The divorce severs the marital tenancy (such as a tenancy by the entirety) and creates a tenancy in common. The bankruptcy courts have found that the sale of single family residential property is "impracticable per se" and have permitted marital homes to

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[35] In re Batten, 141 B.R. 899 (Bankr. W. D. La. 1992).

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be sold and the proceeds to be distributed to each spouse. See e.g., In re Gabel, 353 B.R. 295 (Bankr. D. Kan. 2006). The courts have permitted such sales because they have generally found that the sale of the undivided interest would realize significantly less than a sale with the co-owner's interest. Gabel, 353 B.R. at 300.[36] But see, In re Belyea, 253 B.R. 312 (Bankr. D. N.H. 1999) where the court permitted an implied power to partition real property where such partition was found to be "practical."

Moody's has indicated that one of its "major issues" is that a bankruptcy by a TIC may lead to a "forced sale" under section 363(h) of the Code.[37] Moody's concern is that such a sale could occur such as by the IRS seeking to enforce a lien or by a co-tenant seeking to partition the property.[38] The stated concern is that the "TIC can be forced to sell its property by a bankruptcy trustee. . . by the IRS as holder of a lien against a tenant for unpaid taxes (under section 7403 of the IRC) or by a tenant seeking to partition the property." Moody's concern is that a "forced sale" in a market downturn is unlikely to maximize sale proceeds for the mortgage lender.

A forced sale may, if there is such a thing, in a market downturn should be essentially a sale to the lender, as discussed. Further, the IRS, as a secured lender, and presumably a secured lender junior to the mortgage, is precluded from forcing any sale by the automatic stay of section 362. There is no apparent way the IRS could get relief from the stay as a junior lien holder in order to sell. There is no statutory basis for having the IRS force a debtor to sell an asset under section 363 against its will. A debtor cannot ordinarily be "forced" to sell any asset. A debtor

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36 See also In re Griffin, 123 B.R. 933, 935-36 (Bankr. S.D. Fla. 1991); In re Jenkins, 347 B.R. 77, 84-85 (Bankr. N.D. Ill. 2006).

37 Nicholas J. Levidy, CMBS: Tenants-in-Common Becoming More Common, Moody's Special Report dated August 18, 2003.

38 See Gordon, supra note 13.

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may be liquidated against its will under Chapter 7, but that should only happen if there is "cause" shown to dismiss or convert the case from Chapter 11.

Although Moody's find this right to sell under section 363(h) to be problematic, it may also contain benefits to the lender and other co-tenants. For example, where a debtor seeks to exercise a right to sell under 363(h), then under section 363(i) the other co-tenants have a statutory right of first purchase. Section 363(i) states that "before the consummation of a sale of property to which subsection (g) or (h) of this section applies . . the co-owner of such property. . . may purchase such property at the price at which such sale is to be consummated." Case law supports the basic view that a trustee or debtor must provide a co-owner an opportunity to purchase co-owned property at the proposed sale price. See In re Hunter, 970 F.2d 299, 303 (7th Cir.1992); In re Oswald, 90 B.R. 218, 225 (Bankr. N.D.W.Va. 1988); In re Brollier, 165 B.R. 286 (Bankr. W.D. Okla. 1994).[39]

This right of first refusal, which arises after the debtor has tested the market and found a buyer, may give the other tenants the basis to offer the debtor a payment equal to the co-tenant's distributive share. This would functionally replace the contractual "buy out" right (which may be unenforceable) with a statutory buy out right. A bankruptcy court should permit, and perhaps compel, a debtor-TIC to accept this. This offer would seem to refute one of the statutory

[39] See also Rimmel v. Goldman (In re Goldman), 111 B.R. 230, 233 (Bankr. E. D. Mo. 1990) (debtor husband and non-debtor wife who held property as tenancy by the entireties and fraudulently transferred it prior to filing of bankruptcy. His interest went to the bankruptcy estate and her interest was either paid over to her under 11 U.S.C. § 363(h) & (j) with her retaining her right of first refusal pursuant to § 363(i)); Harkins v. Oswald (In re Oswald), 90 B.R. 218, 225 (Bankr.N.D.W.V.1988) (finding that the wife has the right of first refusal to purchase the property where both husband and wife owned one-half undivided interest in the real estate with survivorship). Other cases where co-owners of property were permitted a right of first refusal include: Gilbert v. Dixon (In re Gilbert), 18 B.R. 579, 582 (Bankr.S.D.Ohio 1982); In re Fehl, 19 B.R. 310 (Bankr.N.D.Cal.1982); Calumet Farm, Inc. v. Black Chip Stables (In re Calumet Farm, Inc.), 150 B.R. 664, 675 (Bankr.E.D.Ky.1992); Community National Bank and Trust Co. of New York v. Persky (In re Persky), 893 F.2d 15, 20 (2nd Cir.1989).

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standards for the sale, namely, that the estate would realize more from such a sale. Because it is not a compulsory buy out, nor at a discounted "book value" price, the end result may be more equitable and more appealing to bankruptcy courts.

Another protection that mitigates against this right of sale being seen as necessarily bad for lenders, is that a mortgage lender has a statutory right to credit bid under Code section 363(k). Although a court may arguably alter this "for cause," the right should generally be exercisable.

Putting this all together, it would appear that (a) bankruptcy law will permit a sale of the entire fee interest free and clear of all co-owner's interest, but that, (b) the other co-owners have a right of first refusal, which they might transform into a counteroffer to buy from the estate, and (c) if sold, the lender will have a right to credit bid, even if the co-owners do not exercise their rights. Thus, it appears likely that if a debtor triggers the sale right under 363(h) the likely purchaser will be the mortgage lender, and in effect, the sale will become tantamount to a state foreclosure, although much quicker and less expensive.

Could it not be argued that the mortgage lender would welcome a sale of the entire fee interest, with the dissident TIC Debtor's only right to receive the proceeds, if any? Given that the lender has a statutory right to credit bid if there is a sale under section 363(b) (and a sale under 363(h) is also a sale under 363(b)). Accordingly, it may well be that the so-called right to a forced sale, is actually a benefit to a mortgage lender, or at least a neutral factor. The concern over the forced sale may turn out not to be a major issue.

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Relief from the Stay; Demand for Adequate Protection; Invocation of the SARE Principles.

If and when individual tenants in a TIC begin to seek bankruptcy protection, they may encounter a series of problems which may render the TIC Owners as effectively being bankruptcy "remote." That is, the TIC Owner may find that its viability under traditional bankruptcy principles is <u>less</u> than that of a typical single asset owner. Not least of all, a bankruptcy judge may be confounded by the underlying logic or need of a single tenant attempting to restructure an "undivided" fee interest which is owned by 34 other tenants, and which is subject to a blanket mortgage. Given that the TIC Owner supposedly acquired this interest as an investor, an argument would be made that it is not seeking to "reorganize." However, given the IRS insistence that the TIC Owner retain the "benefits of ownership" there may be a conceptual clash between the realities of ownership and the bankruptcy view.

Mortgage lenders might find that their ability to obtain relief from the stay is enhanced by the special provisions dealing with a single asset real estate case. Section 101(51B) defines a single asset real estate case as involving real property which "generates substantially all of the gross income of the debtor and on which no substantial business is being conducted by the debtor other than the business of operating the real property." It is likely that the property held by most TICs will fall within this definition, assuming they are rental properties.

Section 362(d)(3) states that with respect to a single asset real estate case, a court "shall grant relief from the stay. . .

> (3) . . . unless, not later than the date that is 90 days after the entry of the order for relief
>
> (A) the debtor has filed a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time; or

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> B) the debtor has commenced monthly payments . . .in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditors' interest in the real estate.

A TIC Owner may not be able to satisfy the requirement to make monthly payments equal to the interest called for in the mortgage, although the Master Lessee may continue to do so, and hence the requirement may become moot. Further, the debtor itself may not have control over the cash, because the rental income may be both owned and controlled by the Master Lessee, and hence the debtor may effectively have no cash.[40] This issue of a lack of cash resources may prove to be the ultimate reason why no single TIC can actually utilize the bankruptcy provisions. However, given the absence of any significant experience with this form of ownership, it is still too early to predict that an entire category of ownership may be more bankruptcy remote than had been foreseen.

A lender's initial strategy to the filing of a bankruptcy case might well be to file a motion to dismiss for lack of good faith under the traditional grounds which have led some courts to doubt the viability of single asset cases. See e.g., In re Little Creek Development Co., 779 F.2d 1068 (5th Cir. 1986).[41] Section 1112(b) was amended by BAPCPA and now requires that a

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[40] Tax issues may affect all of this since the TIC Owner is required to be a true "owner." It is not the purpose of this article, however, to assess those tax issues, but merely to suggest they may become important if such entities begin to file.

[41] See also Primestone Inv. Partners L.P. v. Vornado PS, L.L.C. (In re Primestone Inv. Partners L.P.), 272 B.R. 554 (D. Del. 2002); Carolin Corp. v. Miller, 886 F.2d 693 (4th Cir. 1989). In In re 3 Ram, Inc., 343 B.R. 113 (Bankr. E.D. Pa. 2006) the court summarized the case law on dismissal as follows:

> "While no longer an enumerated ground under amended § 1112, conversion or dismissal of a Chapter 11 bankruptcy case is appropriate where the court finds that the proposed plan is not feasible and that a feasible plan is not possible. Fossum v. Federal Land Bank (In re Fossum), 764 F.2d 520, 521 (8th Cir.1985). See also Michigan National Bank v. Charfoos (In re Charfoos), 979 F.2d 390, 395 (6th Cir.1992) (quoting Toibb v. Radloff, 501 U.S. 157, 111 S.Ct. 2197, 115 L.Ed.2d 145 (1991)) ("it is recognized that generally 'bankruptcy courts [have] substantial discretion to dismiss ... [where] the debtor files an untenable plan of reorganization.' "); In re Brown, 951 F.2d 564, 572 (3d Cir.1991) (quoting United Sav. Assoc. v. Timbers of Inwood Forest, Ltd., 484 U.S. 365, 108 S.Ct. 626, 98 L.Ed.2d 740 (1988)) (discussing § 1112(b) and stating that "there must be 'a reasonable possibility of a successful reorganization within a reasonable time.' "); In re Anderson, 52 B.R. 159, 162-63 (Bankr.D.N.D.1985) (failure of the debtor to

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hearing be commenced no later than 30 days after a motion is filed. Despite the statutory change, not all courts support this notion. As one judge stated:

> Good faith, like apple pie, is difficult to oppose. The good faith of this doctrine, however, has nothing to do with honesty. When its true content is revealed, the doctrine is exposed in conflict with the Bankruptcy Code, its legislative history, Supreme Court precedent, and logic.

In re Victoria Limited Partnership, 187 B.R. 1210 (Bankr. D. Mass 1995).

Another lender strategy will be to seek relief from the automatic stay under section 362(d)(1) on the grounds of lack of adequate protection or under section 362(d)(2) on the grounds that the project lacks equity and is not necessary for an effective reorganization. Because a single TIC Owner's interest will always be worth less than the aggregate mortgage debt, section 362(d)(2) provides a highly attractive method of seeking relief from the stay.[42]

Relief from the stay could be premised on the lack of a feasible reorganization because of the inability to obtain one impaired assenting class of creditors who will approve the plan, as required by section 1129(a)(1) of the Code. Here, the TIC lender should be able to utilize the rights under section 1111(b) which converts the non-recourse loan into a recourse loan.[43] Under this provision, the mortgage lender would have an allowed secured claim equal to the value of the debtor's interest, which might be valued as 1/35th of the fair market value. If so, the lender

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meet the confirmation prerequisite of 11 U.S.C. § 1129(a)(11) is cause for dismissal under § 1112(b)). If the Chapter 11 case cannot achieve a reorganization within the statutory requirements of the Code, then there is no point in expending estate assets on administrative expenses, or delaying creditors in the exercise of their nonbankruptcy law rights. In re Brown, 951 F.2d at 572. See also In re L.B.G. Properties, 72 B.R. 65, 68 (Bankr.S.D.Fla.1987) (Chapter 11 does not provide an unlimited opportunity to seek a successful reorganization). Although this case is only pending for several months, it follows on the heels of the prior case filed almost two years ago."

[42] Once relief from the stay is granted, the lender could then seek to exercise any "buy out" rights which it might have, without concern over whether such rights are an impermissible ipso facto clause under section 365 of the Code.

[43] See In re Kvamme, 93 B.R. 698 (Bankr. N.D. 1988)(explaining how section 1111(b) operates in a typical case).

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would have an unsecured deficiency claim for the balance. Such a claim would dwarf all other unsecured creditors, and would make it nearly impossible for the debtor to construct a plan which satisfied the statutory requirement that one impaired class accept the plan. See 11 U.S.C. § 1129(a)(10). [44]

A mortgage lender might also seek to appoint a trustee, on the grounds that the trustee will stabilize the management and effectuate a more even handed outcome. Section 1104 of the Code, which governs the appointment of a trustee requires that the moving party show "cause." This standard has proven to be flexible, and there is at least some chance that a bankruptcy court will find that the management complexities alone would justify a trustee. However, since the individual TIC Debtor has no legal right to control management under the terms of the Master Lease, it might be argued that no trustee is needed.

Unlike a real estate partnership which owns the entire fee interest, the individual TIC Debtor is not entitled to all of the rental income, and thus has no feasible way of reorganizing. How would such a debtor propose to make repayments? An inventive debtor might be able to form a collation of others, but this seems speculative. Thus, it would appear that the ability to file a plan of reorganization within 120 days is remote, and that prior to such date, an aggressive lender should at least seek dismissal on the grounds of an inability to reorganize.

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[44] The courts are somewhat split over whether the mortgage lenders unsecured deficiency claim must be, or may be, in a separate class. In re Greystone III Joint Venture, 995 F.2d 1274 (5th Cir 1991)(separate classification is not permitted). but see In re Woodbrook Associates, 19 F.3d 312 (7th Cir. 1994)(separate classification mandatory); In re National/Northway Ltd. Partnership, 279 B.R. 17 (Bankr. D. Mass 2002) (collecting the various cases).

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Could the TIC Restructure and Cram Down the Mortgage Lender?

While there may be many possible ways that a bankruptcy court will view the TIC Debtor, the threshold question may be whether there is any feasible method of reorganization as contemplated under the Code, and if not, whether the bankruptcy court would grant an immediate motion for relief from the automatic stay by the lender or appoint a trustee. The debtor, an LLC in our example, owns a TIC interest. That interest, however, is presumably encumbered by a mortgage on the fee. The mortgage is for the entire amount, whereas the economic interest is for one segment (assume here, 1/35th). The tenant thus owns an equity interest which is, in the bankruptcy sense, over leveraged. The loan is presumably non-recourse to the LLC.

How would a TIC Debtor comply with any obligation to provide adequate protection under section 361 of the Code? The individual TIC Debtor would not have access to the cash flow, since the master Lessee would presumably be collecting rental income. Under the TIC Agreement, the cash flow may be allocated among the TIC Owners, such that the TIC Debtor can only receive 1/35th of the cash flow, but is liable for 100% of the debt service. The TIC Debtor might respond that there is no need for adequate protection since the property is not declining in value, and since the mortgage obligation is being maintained by the master lessee. However, if there is a situation, for example, where two key tenants have vacated, and hence the value of the property is declining and the mortgage is not current, then, to the extent that the absence of cash flow by the TIC Debtor precludes an ability to provide adequate protection, relief from the stay should be granted under section 362(d)(1), or alternatively, the case should be dismissed.

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In order to utilize the restructuring provisions, the TIC Debtor might argue that it can cram down the lender by having a lien placed on its interest for the value of the interest only, with the remainder of the debt becoming unsecured under sections 506 and 1129(b) of the Code. The debtor would now have two classes of creditors, neither of which would vote for its plan, thus making confirmation unavailable as a matter of law because at least one class of creditors must vote to accept a plan of reorganization. See 11 U.S.C. § 1129(a)(10). Since this outcome is likely to be perceptible at the time of the initial filing, it seems likely that a court would consider a motion to dismiss the case.

A tenancy in common is potentially subject to an argument that it should be viewed as a partnership, an argument that could be made by the IRS or alternatively, by one of the co-tenants.[45] The recharacterization argument is perhaps the trump card of the highly motivated TIC Debtor. This argument would, if successful, convert the TIC into a general partnership, which is an eligible debtor. The failure of the other co-general partners to agree to the filing would presumably convert the filing into an involuntary petition.

Conclusion

The credit risk involved with an individual TIC Owner filing for bankruptcy remains untested. The rating agencies have identified many of the key risks. It is frequently suggested that the buy-out provisions will provide a quick exit, but they are likely to be unenforceable under section 365 of the Code. Another structuring device is to require a waiver of the common law right of partition, but this may have little effect on the right to sell the assets under section 363(h). However, that right is subject to the lender's right to credit bid and the co-owner's right

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[45] Robins, supra note 11, at p. 24.

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to purchase. As of this writing, it would appear that lenders should be able to deal effectively with a TIC bankruptcy through the conventional arguments arising under the sections dealing with relief from the automatic stay and dismissal. In the final analysis, the ultimate bankruptcy weakness or remoteness of the TIC is its lack of control over the cash and management, and its lack of capital to contribute. In short, a party which owns $1/35^{th}$ of a fee interest may not be a good bankruptcy candidate.

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