Special Issues in a Workout of Real Estate Owned in a Code Sec. 1031 Investment Program

By Arnold S. Harrison

Arnold Harrison addresses some of the unique issues that arise in a workout situation when real estate has been acquired by investors in a Section 1031 Program when the program sponsor or one of its affiliates is the Master Tenant of the underlying real estate.

Real estate investors interested in deferring their gains under Code Sec. 1031 have, especially since 2002, been investing proceeds from their relinquished properties in passive multi-owner investment vehicles (“Section 1031 Programs”) that are specially designed to qualify as replacement property for purposes of Code Sec. 1031. Many of these Section 1031 Programs eliminate the need for investor involvement in day-to-day management of the underlying property by using a “Master Lease” structure. Under such a master lease structure, the investors collectively lease the property to an affiliate of the program sponsor (a “Master Tenant”), who would then sublease the property to space tenants.

Of course, like much of the rest of the real estate marketplace, real estate held in Section 1031 Programs has been confronted with falling rents, increasing vacancies and other challenges. However, dealing with these challenges within the context of a Section 1031 Program where property is held subject to a Master Lease raises unique issues that have only recently begun to be fully explored. This article will address some of the unique issues that arise in a workout situation when real estate has been acquired by investors in a Section 1031 Program when the program sponsor (the “Sponsor”) or one of its affiliates is the Master Tenant of the underlying real estate.

Background

Beginning in 2002, a specialized real estate securities market developed to provide a passive real estate investment product for taxpayers wishing to complete a Code Sec. 1031 exchange. The target investors were often older or retired individuals seeking to defer gain from the sale of real estate that they had held for a long period of time, but no longer wished to have “hands on” property management responsibilities. In addition, their main goal in acquiring real estate at this stage was to provide a steady cash flow. In response to this demand, multi-owner investment programs were designed to provide these investors with a passive real estate investment that offered a predictable stream of cash distributions, while still qualifying as replacement property for purposes of Code Sec. 1031. Interests in these Section 1031 Programs were offered pursuant to private offering memoranda that were intended to permit the investment program to be exempt from federal registration under Regulation D of the Securities Act of 1933.

Qualification of interests in Section 1031 Programs as replacement property (and not as partnership interests) was critical to their success. Because a partnership interest does not qualify as replacement property under Code Sec. 1031, the programs were generally structured so that the investors would acquire and own the real estate either as tenants in common (or “TICs”) under state law, or through a

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Delaware statutory trust (or “DST”) in which investors would acquire a beneficial interest in the DST.

Although TIC structures were often used before 2002, no organized market for Section 1031 Programs structured as TICs existed before then. It was only when the IRS issued Rev. Proc. 2002-22 that a framework approved by the IRS was provided for having TIC interests be treated as real property and not as partnership interests. Rev. Proc. 2002-22 set forth numerous requirements that a Section 1031 Program needed to satisfy to avoid being treated as a tax partnership, the most significant of which being

1. that major decisions such as sales, refinancings and entry into new leases or lease renewals required unanimous consent of all the investors;
2. no more than 35 investors could participate in a single Section 1031 Program; and
3. the activities conducted by the investors with respect to the real estate were limited to the maintenance, repair and rental of the real estate.

In 2004, the IRS issued Rev. Rul. 2004-86, which provided the DST as an alternative structure for Section 1031 Programs. Like investors in a TIC program that satisfied the requirements of Rev. Proc. 2002-22, investors in beneficial interests in a DST that complied with Rev. Rul. 2004-86 could be treated as having acquired a direct ownership interest in the real estate held by the DST for Code Sec. 1031 purposes. To qualify under Code Sec. 1031, the DST had to be structured as a “fixed investment trust” under Reg. §3011.7701-4(c). Although the DST structure had certain advantages over a TIC structure, such as not having a 35-investor limit or unanimous investor voting requirements, it did have its own limitations because of the fixed investment trust requirements. Chief among these limitations, a DST could not raise new capital, enter into new mortgage financing or refinance the existing debt, and most significantly, could not enter into new leases.

From 2001 through 2006, the growth in equity raised in Section 1031 Programs was staggering—beginning at approximately $300 million during 2001 and reaching almost $3.7 billion in 2006. Since then, the amount of equity sold has significantly declined, with approximately $2.8 billion in equity sold in 2007, $1.3 billion sold in 2008 and only about $120 million in the first two quarters of 2009. One of the main reasons for the massive increase in equity in the early years was the availability of financing through the commercial mortgage-backed securities (CMBS) market. The cause of the significant decline since the second half of 2007 relates to the general real estate market and financing collapse, and in particular the near-evaporation of the CMBS market.

The absence of available financing has shrunk the market of people needing Code Sec. 1031 replacement property because prospective sellers were (and continue to be) unable to find buyers for their properties. The Sponsors of Section 1031 Programs have had difficulties locating properties to purchase due to the lack of available financing. The situation has been exacerbated by the general severe downturn in the economy, which has caused many tenants to go bankrupt (in the commercial and retail context) or lose their jobs or income (in the residential real estate context), produced a downward pressure on rents and increased vacancies in both the commercial and residential real estate markets. Furthermore, many of the CMBS loans were of a short-term nature (commonly three to seven years), and, even with performing properties, loans are beginning to come due with substantially reduced property values, no available replacement financing, and lenders generally reluctant to extend the terms of their loans.

### Workouts of Section 1031 Programs with Master Leases

With this as background, this article turns to focus on special issues that arise when the real estate investment underlying a Section 1031 Program is no longer operating profitably and the property is subject to a Master Lease.

#### The Role of a Master Lease in a Section 1031 Program

As noted above, a Master Lease is generally a lease of an entire property by the TICs or DST to a Master Tenant, which in turn subleases the property to the space tenants. In the context of a Section 1031 Program, the Master Lease rent often has three components:

[L]ike much of the rest of the real estate marketplace, real estate held in Section 1031 Programs has been confronted with falling rents, increasing vacancies and other challenges.
1. “base rent,” which is an amount which is necessary to pay the underlying debt service;
2. “stated rent,” which usually provides a given percentage return on the investor’s capital in the form of current cash flow; and
3. “bonus rent,” which is payable upon the property achieving various levels of gross receipts from the space tenants.

The Master Tenant is generally owned and controlled by the Sponsor or one of its affiliates. The Master Tenant will customarily be a newly formed limited liability company (LLC) and be capitalized with demand notes from its members which notes will be guaranteed by the Sponsor. The Master Lease will be subordinated to the mortgage loan secured by the underlying property (the “Loan”), and a default on the Master Lease may be a default on the Loan. In addition, a change in the ownership of the Master Tenant without Lender approval will often result in a Loan default.

DST and TIC programs are structured with a Master Lease to comply with certain tax requirements in Code Sec. 1031. For example, if some or all of the space tenants have short-term leases, a long-term Master Lease is necessary because DSTs cannot enter into new leases and all leasing decisions in a TIC program require unanimous consent of the TICs. While these tax-driven restrictions make direct leasing to the space tenants either very cumbersome or impossible, there are no prohibitions on a Master Tenant entering into new leases and all leasing decisions in a TIC program require unanimous consent of the TICs. While these tax-driven restrictions make direct leasing to the space tenants either very cumbersome or impossible, there are no prohibitions on a Master Tenant entering into new leases. Another tax-driven limitation is that the TICs’ or DSTs’ activities with respect to its underlying property (the “Loan”), and a default on the Master Lease may be a default on the Loan. In addition, a change in the ownership of the Master Tenant without Lender approval will often result in a Loan default.

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What Goes Wrong
Trouble generally starts when net operating income (NOI) from the property will no longer be sufficient to fund the Master Tenant’s rental obligations to the DSTs or TICs under the Master Lease. Decreased NOI can result from
- reduced rental income due to a loss or the bankruptcy of Space Tenants or new reduced Space Tenant lease rates; or
- increased operating costs, leasing commissions, tenant improvements or tenant replacements.

The problems become exacerbated when the Sponsor has already funded its legal obligations under the Master Tenant demand notes and the Sponsor cannot and or will not fund additional amounts to the Master Tenant, to enable the Master Tenant to pay its Master Lease rents. To complicate matters, a default by the Master Tenant on the Master Lease may result in a Loan default.

Attempting a Workout in a TIC Program
The workout process in a TIC program often begins with the Sponsor or the Master Tenant proposing an amendment of the Master Lease to the TICs. The amendment may provide for:
1. a permanent or temporary reduction in rents; or
2. conversion to a cash-flow lease with unpaid rent accruing, with or without interest.

As partial consideration, the Sponsor may agree to waive any fees during the period of reduced rents. Generally, any required Lender approval should be attainable if the base rent (to pay the debt service) will be paid first out of available cash flow and the Master Tenant agrees to remain liable in all cases to fund any base rent that may not be covered by cash flow. In a workout, it may be difficult to tie the Master Lease...
amendment to a loan modification, especially if the mortgage is a CMBS or conduit loan. Assuming the loan servicer will even negotiate a loan modification, in addition to requiring a fee, the lender might require
1. additional funds to be contributed to the property reserves;
2. a partial guarantee on the Master Lease obligations from the Sponsor; and/or
3. pre-approval of all modifications by the TICs.

Rev. Proc. 2002-22 requires that all decisions regarding lease and loan modifications must be approved by 100 percent of the TICs. This unanimity requirement can cause long time delays and can be expensive (in terms of legal fees) and be very time consuming for the Sponsor.

The TIC voting process will require conference calls with all of the investors and their representatives, and those calls may become very contentious. If there is a 100-percent investor approval of the modification proposal, then the process can move forward. However, without unanimous approval, the proposal cannot be implemented. Luckily, most co-ownership agreements governing TIC programs (“TIC Agreements”) have procedures in place to protect the majority of investors from a lone or small group of dissenters. One example is a “Texas Shootout,” which provides that if there is a substantial majority approving an action, the majority can offer to buy out the dissenting TICs at a price of the majority’s choosing. This will generally require that the dissenting TICs must either
1. agree to sell their units to the majority at such price,
2. buy all of the majority’s investments at that unit price or
3. change their vote.

However, this process does not always work quickly or smoothly. It can take a long time for the approving TICs to all agree upon a buyout price, and to decide who will be the buyers. Also, the buy/sell provisions under a Texas Shootout can have lengthy notice and response time periods.

It is critical that the Sponsor maintain constant communication with the investors and their investor representatives. It may also be beneficial to have the investors form a small committee to represent the group, especially where the modification of the Master Lease is going to be tied to an attempted modification of the Loan agreement. With respect to a Loan modification, it is best if the TICs give their prior approval to the Sponsor to enter into a binding agreement with a Lender, because some Lenders may not wish to deal with a Sponsor that does not have the authority to bind the TICs. Also, any proposal regarding a Master Lease modification must be fair and not overreaching to the TICs; although the TICs should be aware of the unfavorable alternatives which will flow if an agreement cannot be reached.

In handling contacts with investors, the Sponsor must be very careful to avoid a number of foot faults:

- All TICs must get all information and be treated the same.
- The Sponsor should carefully review the private offering memorandum, Master Lease, TIC Agreement and Loan forms, particularly as to any acts that could trigger recourse liability to itself, or the investors.
- The Sponsor should not say or do anything that is inconsistent with the provisions of the documents stated above, nor should they paint an overly rosy picture of the future or guarantee any results.
- The Sponsor should consult with its counsel, particularly as to potential securities laws issues involving communications (written and oral) with investors.

**Attempting a Workout in a DST Structure**

A DST operating structure is very different from a TIC structure because of the different income tax rules with respect to protecting Code Sec. 1031 treatment. DST investors are required to be very passive and generally have no right to vote on leases, loans, or other transactions. Instead, all decision-making power generally resides with the “Signatory Trustee” of the DST, which is almost always an affiliate of the Sponsor. There will be a conflict of interest because the Master Tenant and the Signatory Trustee are both owned by the Sponsor or its affiliates. Therefore, because the Sponsor has the power to unilaterally amend the Master Lease, it is important that such amendment shall be fair and even handed.
Rev. Rul. 2004-86 prohibits lease modifications except where the Master Tenant is in bankruptcy or insolvent and such situation presents an imminent risk of default on the loan. It would seem that if the Master Tenant cannot make its payments under Master Lease, by definition it is insolvent. Fortunately the same insolvency exception permits the Signatory Trustee to negotiate a loan modification with the lender at the same time.

Of course, a unilateral modification of the Master Lease can lead to adverse investor reactions and potentially a lawsuit. However, if the Master Tenant does not modify the Master Lease so it can pay the rent, there could be a Loan default leading to a foreclosure of the real estate. It would seem that the only reasonable course of action is to modify the Master Lease, but the modification needs to be fair to the investors and the minimum modification needed to solve the problem. The Sponsor needs to listen to investor feedback, but in the end it must act. In this regard, it is important for the Sponsor and its advisors to carefully review the DST agreement to see what standards and duties are imposed upon the Signatory Trustee making this type of decision. Under Delaware law, the trust agreement can negate all fiduciary and other duties by specifically providing for that duty negation in the trust agreement. However, the Trust Agreement cannot negate the Signatory Trustee’s obligations of fair dealings and good faith.

The Future of Section 1031 Programs with Master Leases
Looking forward at future offerings, there can be certain planning steps taken to prevent some of these problems. For instance, the loan documents should be negotiated so that nonmonetary defaults in the Master Lease are not always loan defaults. Alternatively if this cannot be negotiated in the Loan, then there should be limited nonmonetary defaults in the Master Lease. In addition, there should be flexibility in the Master Tenant’s obligations to pay stated rent (the percentage return) to the DST. If NOI is insufficient to pay the stated rent, then the Master Lease could provide for an accrual of the shortfall, with or without interest. Also the Master Tenant can be granted the right to withhold stated rent for some limited period time if there is an anticipated NOI shortfall that might not cover the base rent that is used for the debt service payments. Finally, the lease could provide that increases in noncontrollable costs such as taxes and utilities are landlord costs.

In summary, the issues that are raised when a property is in a distressed situation and subject to a Master Lease are very serious. Capable and experienced counsel should be consulted to help solve these problems.

ENDNOTES

1 All “Code Sec.” and “Reg. §” references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.
4 Omni Real Estate Services.
5 The LLC will be newly formed and have no other assets or liabilities to meet lender requirements that it be a “bankruptcy remote” special purpose entity.
6 The procedures for voting on a loan or lease modification require the program sponsor to give adequate notice to the TICs and provide the TICs with a reasonable response period.