Primer on Commercial Real Estate Loan Workouts and Right-Sizing, Part I

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By Richard Fries

Today's commercial real estate market is in distress and has been, across a variety of asset classes, for several years. The reasons are well-known. Less well known is possibly the surest solution in this down cycle. This is a method to right-size commercial real estate loans where the value of the underlying real estate is so much lower than it was only a few years ago.

Today's commercial real estate market is in distress and has been, across a variety of asset classes, for several years. The reasons are well-known. The options for the loan in distress are somewhat well known. They are becoming less mysterious day by day. These, more traditional, options will be described in the first installment of this article below.

Less well known is possibly the surest solution in this down cycle. This is a creative, opportunistic method to right-size commercial real estate loans where the value of the underlying real estate is, sadly (and in some cases, shockingly), so much lower than it was only a few years ago. It saves real estate assets in distress and maximizes the potential (long term recovery) upside for all parties to the transaction. The second installment of this article will identify and explore that solution, available regardless of real estate asset class, geography or emotion.

The Commercial Real Estate Loan in Distress

In more robust times, and a near-zero interest rate environment, the owner of well-constructed, managed and tenanted income producing property borrowed $100 million from a "balance sheet" institutional lender. The mortgaged property had a fair market value of $150 million, a value expected to appreciate over the life of the loan, as historically was the case.

Lenders competed with each other for the loan and relationship, comforted by the sponsor's pristine reputation, cash flow from leases and the sponsor's equity ($50 million) in the asset. The lender did not need, or require, guarantor recourse for the principal indebtedness with a sizable equity cushion. Guaranties were limited to well-defined, ample, "bad acts"—those that could interrupt or interfere with the lender's "bee-line" to its collateral or its revenue stream. Perhaps the lender obtained a guaranty of debt service, real estate taxes and insurance.

A "deficiency"—a reduction in the value of the property from $150 million to below $100 million—was, to the

lender's credit committee and to the world at large, in a word, "inconceivable."

Borrower Has No Equity, Now or Foreseeably

Well, the inconceivable has occurred, as we read and bear witness every day. For reasons we know too well, and lament, that $150 million real estate asset is now worth $75 million, or maybe less. Its value is declining. Valuation horror stories abound. Appraisers proclaim loudly that this is the most difficult and uncertain commercial real estate valuation period in their careers. Appraisals are commissioned and delivered. They haunt lenders, borrowers, investors and the regulators alike.

Borrower has no equity in its asset, now or foreseeably. But borrower's reputation remains pristine. Its relationship with the lender, and with other lenders, is honorable and beyond reproach.

"Take the keys," borrower offers openly and apologetically. "I am a victim of a post-COVID world filled with 11 interest rate increases, inflation, supply chain disruption, tenant space needs consolidation, regional bank failures, regulatory oversight and general market uncertainty. Take the keys, I will walk away and live for another day."

The last thing the lender wants is the keys.

The Traditional Options for the Non-Recourse Loan in Distress

The lender has options, under the loan documents and applicable law. These have proved to be viable, fruitful "paint by numbers" choices, and solutions, in down-cycles past, and even over the last year or two.

Extend and Pretend (Loan Modification)

A typical loan modification for a defaulted loan or distressed asset looks like this:

1. The lender forbears the enforcement of remedies (or waives defaults) and extends the maturity date. Either for years, or for a series of years via built-in extensions, if business, revenue, leasing and other property-related milestones have been achieved.
2. The interest rate (especially a floating rate in a higher rate environment) is split into a note rate and a pay rate. Interest is paid monthly at the pay rate.
3. The shortfall between the higher note (or contract) rate and the lower pay rate (which is established based on net cash flow) is accrued and either due at maturity or forgiven if the principal balance is timely and uneventfully repaid.
4. Principal amortization (if applicable) is suspended to maturity.
5. There are countless nuances: partial guarantor recourse; expanded non-recourse carve-outs; enhanced covenants and financial reporting; up-front or staged partial debt reduction; an equity pledge; soft—or not so soft—additional collateral; waiver by borrower of defenses and counterclaims; acknowledgement of the indebtedness; ratification of the loan documents and perfection of the security agreement; leasing and capital improvements obligations, milestones and hurdles; among others suitable to the asset, its economics and the market.

In short: the traditional commercial real estate loan workout. Battle tested; fair. An exchange of concessions (time, debt relief, forbearance, additional funds, waiver of defaults) for enhancements (acknowledgement of debt, general release, enhanced guaranties, additional—perhaps dual—collateral, remedies). (For amplification, see "Exchange of Enhancements for Concessions – Insights into the Modern Loan Workout," Richard S. Fries, New York Law Journal, June 19, 2020). This was a staple of the great financial crisis and early-Covid (and earlier real estate "recessions"). Real estate, cyclical as it is, will appreciate. Property values increase. Interest rates will peak (have peaked) and will decline.

There are many candidates for the traditional workout and, if carefully devised, those may work out fine. That's the plan. It has historical precedent and appeal.

Foreclosure

But, alas, the lender is tired of extending and pretending again and again. Frustrated, chastised by its senior credit committee or its regulators, or both; facing a borrower's empty pockets, scarce tenant attendance and market naysayers. The lender cannot endure another indecisive loan extension. It cannot return to "square one" at the new loan maturity. Not once more.

So the lender accelerates the indebtedness and forecloses, either judicially or non-judicially via power of sale, depending on the jurisdiction.

Once, borrowers (and guarantors) opposed. They asserted a litany of affirmative defenses and lender-liability-type counterclaims. All—or most all—the product of threadbare "creative word processing," routinely rejected by the courts. All were designed to delay, not so much the inevitable judgment day, but to capture sunnier days in terms of valuation. Or, they were utilized as strategies to exact forbearance or concessions from the lender's litigation averse senior management (The contested judicial foreclosure; standing to sue; the impact of a backlogged, congested judiciary; election of remedies; receivership; lender liability—new and classic theories; deficiency rules; the bankruptcy petition filed five minutes before the foreclosure auction; are all outside the scope of this article).

Instead, today's property owner, perhaps because of judicially sanctioned full recourse under the non-recourse carve-out guaranty for interference with remedies or bankruptcy, or its honor and reputation, does not oppose. The foreclosure is uncontested or on consent (a subtle but artful distinction). It proceeds more swiftly (though in many states still unacceptably glacially) to public auction.

Whereupon, the lender, lonely at the courthouse steps, will "credit bid" for an asset it does not want. Occasionally, a third party (distressed asset focused, opportunistic) bidder will acquire the property at auction for an amount—payable in all cash in thirty days; no financing contingency; no due diligence; no representations or warranties—measurably below its then already deflated market value.

The foreclosure remedy is sacrosanct, inviolate and utilized (lest the lender has effectively made an unsecured loan). However, it is hardly preferred by lenders, regulators or most anyone for that matter.

Foreclosure is time-consuming, expensive, hyper-technical and unpredictable. All this while the distressed collateral deteriorates, tenants default or leave, capital improvements are deferred and repairs are ignored. The judiciary is overwhelmed, understaffed and not stirred to set aside its caseload's urgencies for an institutional

lender's foreclosure travails, sympathetic and compelling though they seem.

For income producing property, a receiver is obligatory to separate the defaulting borrower from the revenue. Receivership is expensive, whimsical and difficult to underwrite; at times, treacherous.

Deed in Lieu of Foreclosure

"Take the keys," is the refrain. It fills the real estate reports nationwide, perhaps more so in the last two years than in decades before.

But, for a hodge-podge of reasons, risks and burdens, the lender does not want the property. That's not its business model. Ownership, management, leasing, asset revitalization, repairs, tenant confrontations — not its forte.

So, there are alternatives within this realm. The lender can (in borrower's name) engage a broker of renown to market the asset for sale. Borrower can promise, in writing, to deliver the deed to lender's designee, nominee or prospective purchaser, at lender's election in its sole and unfettered discretion. In certain states, borrower can deliver the deed in escrow, to be released therefrom as and when required to the purchaser. In other states, a creditworthy guarantor can "collateralize" borrower's promise to deliver the deed with full recourse to that guarantor in the event borrower, for whatever reason, defies that promise.

When the borrower has decided to deliver the deed, it is done; it wants out. It no longer intends to deal with tenants for the lender's or purchaser's benefit. It will not invest a dime (beyond cash flow) in capital improvements, real estate taxes, insurance, property maintenance, tenant improvements, leasing commissions, or marketing. It wants permanently "off" of title as a matter of record and law.

If there is a debt service and carry guaranty, the guarantor may be relieved from future debt service (perhaps after a negotiated duration, called a "tail") upon tendering the deed (this is subject to certain "tender" conditions and criteria, often negotiated, that are also outside the scope of this article).

So there's an inflexion point; deeds in lieu of foreclosure are delivered; borrowers, lenders, syndicate members, investors, the courts all move on.

No one is joyous.

A benign, amicable understanding that the parties will engage in a "deed in lieu" structure begins to fill with angst, anxiety and animosity.

The Loan Sale

The lender is exhausted by weekly workout meetings with borrower that go nowhere, or back track. Or the anticipation of such, from similar defaulted loan excursions. Senior management is frustrated. Seemingly, after a few for this asset or with this sponsor have been put in place and failed, there's no longer a viable restructure at hand.

Reputable, seasoned loan sale brokers hover. They report there's liquidity in the market. There's gossip that

opportunity fund buyers are more interested in and business-model capable of acquiring the debt than the underlying collateral, wholly counter-intuitive though that would seem. They will pay more, the brokers postulate.

Voila, the loan sale. With no borrower engagement or consent needed (provided the loan documents say that, as they should) the lender hires a broker, creates a loan documents and collateral electronic repository, provides access thereto (upon execution of a standard non-disclosure agreement), markets and sells the loan.

Swiftly, with minimal representations or warranties (other than ownership of the loan and authority to sell, typically) and even less fanfare. The timeline is rigorous and the contingencies to the sale, other than a modicum of due diligence (sometimes) are virtually non-existent. The pace is blistering. There's no belligerence.

There's execution certainty, no risk and loan workout exhaustion and/or protracted regulatory oversight is spared.

The downside: Price.

Distressed loan purchasers, opportunity funds flush with cash and decision precision do not overpay for the asset. They are, as they should be, bred to prey; they are nimble, opportunistic, strategic. They are aggressive risk takers. They know inherently the lender's impatience, exhaustion, frustration—and regulatory restraint.

We have seen bidding spreadsheet summaries that state from a gamut of hungry, notable bidders: "all cash, no contingencies, no due diligence, ten percent deposit, contract execution one week, closing 10 days thereafter."

How musical that summary—those spirited offers—must sound to the lender's senior-most management.

That music, that execution certainty, that finality bears a burden: Price.

The loan purchaser never—well, there are exceptions: exceptional, trophy assets, unicorns, bidding wars, good deeds (e.g., affordable housing, clean air), governmental subsidies, conversion values, long term relationship or transactional kindness, so not never, but rarely—over pays.

After all: the mortgaged property is deeply in distress, foreclosure and receivership costly and the process, even in the hands of an aggressive, unregulated "loan-to-own" buyer – is potentially endless. Court dockets are still ponderous. There's little or no guarantor recourse and the loan purchaser uses expensive funds to pay all cash, now. In the negotiation stare-down with the lender-seller the loan purchaser is armed with unassailable knowledge that the lender wants out, for whatever reason, and wants out now.

In this friendly but not so "arms-length" sales process, something has to give, and usually does: Price.

That's a business decision lenders are prepared to make.

And, of course, there are "win-win" stories from time to time. The loan was written down to X; the loan purchaser paid X plus $10 million; the underlying property was (or will be, in more capable hands) worth X plus $20 million. (We may see more as the market recovers and the cost of capital diminishes.)

Everyone was calm. The process was swift and elegant.

So loan sales already abound and they are expected to proliferate. As are loan portfolio sales, many of which bundle inviting, performing loans with others irreparably in default.

Up Next: Use of the Workout to Right-Size the Distressed Commercial Real Estate Loan

Today's market cries out for a more creative workout device. One that splits the debt and ties debt service payments to cash flow. One that has, for borrowers and lenders alike, built-in mutual incentives, economic return, long term ownership and reputational allure. This construct will be covered in the next installment in this series.

Richard S. Fries *is a partner at Sheppard, Mullin, Richter & Hampton in the firm's real estate, energy, land use and environmental practice group, the co-chair of the real estate finance committee of the Real Property Law Section of the New York State Bar Association and a fellow of the American College of Real Estate Lawyers.*
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