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

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By Richard Fries

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This two-part series examines several options for the commercial real estate loan in distress. The first installment provided a primer on the traditional, more commonplace options available to the parties. This final installment identifies and examines a more creative approach, one which right-sizes the loan and the underlying real estate and resets value for today's market.

Right-Sizing the Real Estate Loan to Its Value and Potential Value

The options described in the first installment of this article are real, viable and varied. In many ways they are traditional. They have served the real estate and financial services industries well, in navigating through arduous, uncertain and tumultuous real estate, financial and regulatory markets in our recent history.

Parties to the workout, or their counsel, can hardly be second-guessed for pursuing any one of these paths, or multiples of them, or many subtle business and legal permutations available in each.

But let's pause and pivot from the traditional. There might be a more intriguing model for the non-recourse loan, more suitable both to today's real estate values and to the industry's realistic hopes for a brighter tomorrow.

So, let's use the same valuation scenario set forth in the first installment of this article: $100 million loan secured by property once valued at origination at $150 million, but now worth $75 million. Extend and pretend, tried and consummated in good faith before, does not work any longer; nor is there any cash infusion or additional collateral or recourse available to ameliorate the lender's risk. Remedies are still a last resort.

Here's the device: split the loan into three tranches.

Note A: $60 million, with interest at a market rate (or a slightly discounted market rate), payable monthly. The "performing" note. The property's cash flow ably services this reduced principal debt, even in a higher interest rate environment.

Note B: $20 million, with interest also payable monthly, but tied to cash flow, excess cash flow and a cash flow sweep. The "cash flow" note. Payments on this note will be made punctiliously, but only as "good news" events (described briefly below) occur or marketplace dynamics become more sanguine.

Note C: $20 million, with interest accrued and deferred. The "deferral" note. No debt service payments are due, or made, for the duration of the workout, but this debt, and the collateral for this debt, remain in place. This gives the lender leverage (and sometimes recourse) for borrower's performance of the workout.

All three notes will continue to be collateralized by a mortgage (or several split mortgages; it doesn't really matter) on the property. The lender incentivizes borrower to refinance or sell the property in a "discounted repayment" model as follows. The lender will agree to accept repayment in full, within 30 days, of $75 million ($25 million discount; today's fair market value); $80 million within six months; $85 million within nine months; and $90 million within 12 months.

In exchange for these payments "at a discount," and provided there is no intervening event of default or other full payment trigger, the lender will agree to release its lien or assign the mortgage (and the underlying debt) to a new lender.

The discounted payoff amounts above are purely illustrative and easily adjusted to the asset's and the market's current economics as well as the lender's appetite—or its institutional need—for finality. The note amounts and the discounted repayment considerations are scrupulously deal, market and collateral tied.

The debt split and monthly payments need to be correlated to revenue and prospective revenue should "good news events" occur. These events include new or extended leases, capital improvements, operating efficiencies and expense savings, tax, green real estate or other subsidies or a revitalized leasing market. Any such good news events (there may be others, asset, geography, sponsor, guarantor specific) should yield excess cash flow which can be swept and applied to service Note B.

The "discount" should be carefully synchronized to (1) fair market value (as best can be discerned), (2) property and market stabilization and appreciation, (3) the Federal Reserve's interest rate cuts and (4) a tangible return on investment for the borrower. Perhaps, lender receives a slight premium, a kicker, over fair market value for valuation imprecision and the restructure concessions it has made (maybe the initial discounted repayment amount is $77.5 million rather that $75 million).

Borrower needs an incentive to refinance and deliver the discounted pay-off. Lender needs a justification not to sell the loan now (the "first loss is the best loss," even at the market's nadir). While those objectives may fail to align, if not outright clash, the Note A/Note B/Note C discounted repayment model gives the transaction parties their best opportunity to work together to stabilize the asset, create and maximize value, the continuum of long term ownership and recovery.

This is truly an art form. It is at the cross-roads of business, real estate, finance, valuation, risk, reputation, guaranty enforcement and foreclosure remedies. It requires trust and transparency. That trust and transparency relatively easily can be collateralized by enhanced "bad acts" recourse against a creditworthy guarantor, or two.

For a structure like this—right-sizing the real estate asset; restoring value and opportunity for the borrower out of whole cloth, as well as the blessing of additional time—the guarantor should take out its pen and collateralize the lender's risk of a broken discounted repayment promise, or other surreptitious shenanigans.

This structure is not an outright gift to the borrower, nor should that ever be the case. The lender receives all of the property's net cash flow (after agreed-upon and fully examined budgeted expenses) via "hard" lock box cash management and third party property surveillance. Accrued interest on Notes B and C (and default interest), and all outstanding principal on Notes A, B and C become immediately due and payable in full, without defense, offset or counterclaim upon an event of default.

All of the traditional loan modification enhancements described in Part I are embedded here, too.

The discount materializes not on day one (all three notes remain in force), but only on day last when the negotiated discounted repayment amount is paid in full—and retained by the lender beyond bankruptcy or other crafty disgorgement.

The property's appreciation in excess of the fixed (or sliding, as applicable) discounted repayment amount belongs to the borrower. Conceivably, using the illustrated amounts, a $100 million obligation could be wiped away for $80 million in six months' time.

Which happens to be $5 million more than today's fair market value and perhaps quite a bit more than lender could achieve via a loan sale.

The lender, for its part, builds in a modern smorgasbord of air-tight foreclosure remedies. These include, without resistance, an acknowledgement of the entire debt, including the default interest accrual and protective advances (without forgiveness or compromise); blanket one-way general releases; a consensual property manager or receiver; that "hard" lock box for all revenue; a detailed, transparent, lender scrubbed and approved budget; the consent to the immediate entry of a judgment of foreclosure on consent (upon a subsequent default); a public auction where the lender could credit bid up to the judgment amount; consent to vacate the automatic stay in bankruptcy; plus, at lender's option, the delivery of a deed in lieu of foreclosure to lender's nominee, designee or a third party purchaser sourced and proffered by lender.

These remedies (there are a handful of others tied mostly to recourse and enhanced recourse for interference with remedies) would be available to lender, on consent, without contest upon the occurrence of a subsequent event of default or if the borrower is unable or unwilling to perform the discounted repayment plan.

Lender, in exchange for quantifiable business concessions and value creation for its borrower, secures finality, predictability and litigation speed and certainty. Borrower achieves exactly what it wants: continued ownership, property appreciation upside, reputational preservation.

The property is no longer "distressed."

Life, market forces, the inevitable recovery of real estate as an asset class of global captivation, mutual trust—all intervene.

Real estate right-sizing, painstakingly orchestrated to economics, the market, the asset, viability and legal predictability, may come to pass as today's most enticing, credible distressed commercial real estate fix.

Two Variations (A Brief Overview)

For the Lender: Equity Sliver

The lender's (justifiable) fear in a discounted repayment deal is that the discount is too steep; or the borrower has lined up a purchaser, lying in wait. Nothing could be more disconcerting and embarrassing than a lender that accepts $80 million only to discover the next day borrower "flipped" the property to a "stranger" for $90 million.

There's a solution, though it is difficult to achieve especially as respects new lender consent. The machinations are outside the scope of this article. In concept, the workout lender retains a remedy-less ("toothless") second lien (perhaps a mortgage, perhaps an equity pledge of the membership interests in the property owner, borrower or both) to secure a $15 million "hope certificate." This is an "equity sliver."

No payments are made on this sliver until (and unless) an asset disposition occurs. There are no defaults that can be declared during the "term."

If the property is sold during a relatively short period, say six-to-nine months after the discounted repayment has occurred, the lender receives 50% of the net proceeds of the sale in excess of the $80 million discounted repayment amount up to its $15 million hope certificate; 25% percent if the sale occurs between 9 and 12 months. This sharing arrangement can be sliced and diced.

Once that "flip period" has lapsed the equity sliver lien is released. It may also "burn away" piecemeal over time.

If the borrower intends to hold the asset generationally or durationally, the discounted repayment amount remains the "deal," unimpaired and unbothered by the short term equity sliver. If the borrower is plotting an immediate or reasonably proximate sale, the lender has a seat at the table—a sliver; via its quiet recorded mortgage or filed equity pledge—to recoup part of its loss, or part of its borrower's immediate, unfair, premeditated profit, lest that flip cannot occur.

The equity sliver is not widely or routinely available. New, institutional lenders will struggle with the cloud on their collateral, and resist. But the niceties and benign nature of the sliver can be explained. Its use should be near the top of the lender's real estate right-sizing workout wish list. It's imaginative; cutting edge; discount-worthy.

For the Borrower: Loan Reinstatement—The Relationship Continues

Feasibly: two or three interest rate reductions later in 2024 and early next year; increasing occupancy across all income producing asset classes and market sectors, not just Class A office; asset competition in key markets; market stability; investor liquidity and forecast; fear of missing out on the recovery. The market improves, good news events occur and multiply, the owner's fondness for its asset reigns supreme.

In anticipation and preparation for an inevitable recovery, the borrower can build into the workout the right to reinstate the loan. Presumably this would be for a pre-negotiated extended period. Perhaps as long as five years (let's say, three years with two performance-based annual extension options), without prepayment prohibition or premium.

This, too, is deal, parties, relationship, reputation and credit committee specific but it gives the borrower a broad brush to erase the workout and eradicate this market's distress, where no such prospect existed before. And to reinstate a friendly, mutually beneficial, relationship with its lender.

Conclusion

Commercial real estate (all asset classes, actually, including those maligned yesterday and today) is a coveted, enduring, and prideful investment, even as we pass through historically unsettling and unforeseen times and events. Both that investment, and its financing, can be safeguarded, strengthened and right-sized under the most challenging economic circumstances through a creative loan workout that is designed, thoughtfully, rigorously and collaboratively, to work.

And work it will.

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. He may be reached at rfries@sheppardmullin.com.*

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