



## Resolving Distressed Real Estate Debt

### Overview

How to resolve the problems of a loan in distress depends on the seriousness of those problems and the goals of the parties involved, whether borrower, guarantor, lender, servicer or potential loan purchaser. Broadly speaking, these resolutions break down to four:

1. Restructuring
2. Deed in lieu of foreclosure
3. Foreclosure
4. Bankruptcy

A real estate loan may have widely varying exposure and vulnerability while a real estate project is in trouble. The lender is most vulnerable in case of partially completed construction. On the other hand, if the borrower has encountered financial difficulty, but the project is fully rented and the lender is fully secured, a wholly different scenario is presented. The signs of a loan in distress could be: late payments – non-payments; covenant defaults; change in financial circumstances; cash flow erosion; capital improvement needs; real estate tax arrears; investors unwilling to infuse capital; subordinate liens, judgments; loss of major tenant; inability to refinance; or inability to rent up or sell out the project.

### Due Diligence

Upon learning of a problem loan, or prior to acquiring a problem loan, and before being in a position to select a particular strategy, a preliminary review should be made.

- A. Review the loan documents for legal weaknesses.

This "audit" will help determine how tough the lender can or should be with the borrower in negotiating the workout, or whether there are legal issues as to the loan being acquired. If there are substantial weaknesses, they may need to be addressed in a workout with appropriate forbearance before a more aggressive posture can be taken. For example, if UCC's need to be filed, they should promptly be filed and allowed to "age" past the preference period.

- B. What are legal weaknesses that may need to be corrected?
  1. Are all documents executed?

2. Are all blanks properly filled in?
  3. Are the note and other originals available?
  4. Have all necessary corporate/partnership authorizations been given?
  5. Are all amendments and modifications identified?
  6. Are all liens properly perfected?
  7. In a construction loan, were all technical requirements complied with in originating and disbursing the loan?
  8. Review file to see if any basis for oral or course of conduct waivers exist. This review also allows for a lender liability analysis.
  9. Can lender ascertain if borrower has complied with the Special Purpose Entity (SPE) requirements of the loan documents (if any)?
- C. An analysis of the property should be conducted:
1. Are casualty, liability and title insurance in effect and sufficient?
  2. Have tax, judgment or mechanics' liens been placed on the property? A current title and UCC search should be obtained.
  3. Is there a recent appraisal and on-site inspection report? (consider updating the original appraisal and conducting an on-site inspection to obtain a feel for the project.)
  4. Are there potential environmental problems? (If a professional environmental audit was not obtained before funding, it should be obtained; and any audit that was obtained should be updated.)
  5. Is there deferred maintenance?
  6. Analysis of status of leases (when do leases roll over, and what is the likelihood of renewal or reletting?; what is the credit of tenants?)
- D. Conduct an evaluation of the borrower for: integrity, financial ability, expertise, motivation. Perhaps the lender does not want the borrower to continue in operation or development of the project. Perhaps, however, the defaulting borrower may be the best owner for the project. The borrower may have unique leasing or marketing capabilities. An essential issue is whether the borrower will be able to succeed under a new workout arrangement when it was not successful before.
- E. Analyze the cause of the problem:
1. Were economic conditions responsible?
  2. Were bad management or other problems peculiar to the borrower responsible?
  3. If the problem was not the fault of the borrower (e.g. tightening of the capital markets preventing refinance), the lender may consider extending or restructuring the loan to allow the market or other conditions to remedy themselves so that the borrower may

ultimately refinance, since obtaining title to the property might not be in the lender's best interest.

4. 4. What is the state of the relevant market? --value of collateral and borrower's business; marketability of collateral; business market trends; leasing market trends; refinance marketplace; property's sales prospects.
- F. Pre-Workout Agreement. If a workout appears to be possible resolution, often the Lender will seek to enter into an agreement with the borrower before substantive discussions progress. The lender will seek to obtain the borrower's acknowledgement as to (a) the validity of the indebtedness, (b) the existence of facts which constitute the defaults, (c) that the settlement discussions are not admissible in evidence, (d) that nothing said or written in the negotiations are to be binding until a formal written agreement is entered into, (e) the lender or borrower may terminate settlement discussions at any time, (f) lender does not waive any of its rights, and (g) if lender has enough leverage, an acknowledgment by the borrower that it has no defenses or a waiver of defenses.

### Restructuring

- A. Borrower's Objectives. A restructuring is a mutual agreement which needs to be acceptable to both sides. The lender or loan purchaser must be aware of the borrower's objectives in a restructuring. These could include:
1. Lower the amount of periodic payments. Interest or principal which is reduced can either be forgiven or "capitalized" or accrued to a later time, with future payment perhaps depending upon future project performance.
  2. Cancellation of indebtedness (note - may result in ordinary income to the borrower for income tax purposes which passes through to equity in "pass through" entity (e.g., LLC)).
  3. Extend the loan's maturity.
  4. Obtain additional financing.
  5. Avoid foreclosure, which can trigger tax liabilities to the borrower (based on sale or exchange) without receipt of cash.
  6. Lender to cooperate in a sale of the asset, or a part of the asset in an ultimate restructuring agreement.
- B. In an ultimate restructuring agreement there are numerous possible concessions that lender could seek to obtain. They include:
1. Obtain additional collateral from the borrower, guarantors and related parties (such as an equity pledge) or other lenders (including mezzanine).
  2. Cross-collateralize and cross-default all loans.
  3. Obtain a participating interest in the asset ("claw back" i.e. a portion of net cash flow or net sales proceeds to be paid to Lender) (presents risks of control, lender liability, usury or recharacterization as a partnership).

4. Conversely, limit any money which the borrower might take out of the project until the loan is repaid. This could be backed up by an exception to the non-recourse or exculpation clause should this agreement be violated.
  5. Initiate a lockbox account controlled by lender into which rents from the property are paid by the tenants, or if a lockbox is not already in place but was contemplated pursuant to the initial loan documentation, the lockbox may be implemented.
  6. Place restrictions on leasing and other project operations.
  7. Provide specific default triggers based on failure to meet specified benchmarks.
  8. Try to obtain some form of creditworthy guarantee to back up the "nonrecourse carveouts," if not already in place. And if the existing "nonrecourse carveouts" are less extensive than the current standard, seek to expand them.
  9. Obtain a waiver of all defenses or claims by the borrower existing at time of restructuring
  10. Obtain an acknowledgment that lender has not waived any rights.
  11. Obtain the borrower's consent to relief to lender of the automatic stay that would result from borrower's subsequent bankruptcy filing (risk that unenforceable).
  12. Avoid having to write down the loan, and having to charge a loss against the bank's capital or thereby impair or affect its minimum capital requirements.
- C. A restructuring may involve a "claw back" (in which a portion of the debt service payment is based on available net cash flow). This keeps a component of debt alive, with a possibility of payment out of on-going business operations, and reduces the borrower's debt service burden.
- D. Restructuring debt service with both claw back and debt forgiveness device involves: Note A as the "performing" note; Note B as the "claw back" note; Note C as the "deferral" note – parties' intention is ultimate (not immediate) debt forgiveness of the "deferral" note at maturity so long as the borrower does not default.

### **Other Parties**

- A. Guarantors' liability should be maintained in a restructuring
1. A guaranty may be waived if the loan is modified or collateral released without guarantor's consent.
  2. Even if such consent provision is in the guaranty, it is prudent to obtain confirmations by guarantors.
- B. Other liens must be considered (in situations where the debt secured by the real estate is structured into separate prioritized secured interests held by different parties or there is additional mezzanine debt secured by equity). Complications may arise because the holders of these prioritized mortgages and mezzanine debt will be at the table if the loan needs to be restructured. Problems presented include:
1. Loan advances in a workout in excess of the original commitment or advance may be subordinate to existing liens. This depends on whether the additional advances were

- contemplated by the original loan documents and on whether prioritization was established when the original debt was created.
2. Subordinate mortgagees may gain priority because of changes in the first mortgage adverse to their interest, unless the subordinate interest had agreed otherwise when the original debt was created. Generally an extension of the maturity date does not result in subordination. However, an increase in interest rates or changes in timing of debt service payments, or capitalizing accrued and unpaid interest, may be prejudicial and require a consent without there having been a subordination agreement. Each lender should review the terms of a subordination agreement - what consents are required in the restructuring?
  3. Among the restructuring issues presented by subordinate mortgages are:
    - (a) Foreclosure by second mortgagee during the workout. The lender may be relying on the borrower to operate or complete the project and a foreclosure could prevent this during the proceedings, and, of course, if judgment is obtained.
    - (b) Precludes obtaining clean title by deed-in-lieu.
    - (c) Marshalling (court may require utilization of collateral unique to senior loan before use of common collateral).
    - (d) Interference with utilization of rents, dealings with tenants and insurance awards.
  4. These issues may have been dealt with in mortgage prioritization documents (i.e., subordination agreement) entered into at origination of the mortgage, including:
    - (a) Consent to amendments and waivers of first mortgage loan, including even to additional principal advances (but up to some maximum amount, or in leasehold mortgages to pay rent, or in construction loans to complete the project).
    - (b) Standstill agreement not to foreclose, permanently or for a limited period.
    - (c) Agreement that first mortgage controls as to rents, dealings with tenants and insurance proceeds. (e.g. if first mortgage gives a non-disturbance agreement, so does second mortgage, or permit tenants to subordinate only to first mortgages).
    - (d) Parenthetically, because of these difficulties, first lien mortgage lenders often require additional financing to be in the form of an undivided interest in the first mortgage or a mezzanine loan (secured only by equity).
  5. In today's securitized mortgage marketplace, a commonly utilized loan origination structure deals with many of these issues but still may present many situations for conflict among the holders of the various positions:
    - (a) A Note – senior note intended for securitization – which is then split into tranches and sold into one or more securitization vehicles
    - (b) B Note – subordinate note but secured by the same mortgage as the senior A Note which is either retained by originator or sold to an investor, or both

- (c) A/B Intercreditor Agreement provides for consent rights of B Note as to major modifications or enforcement actions and priority of payments between A&B before and after default (after default, the A Note paid in full including prepayment penalties, late charges and default interest, prior to B Note receiving any payments).
  - (d) In a workout, concessions in principal, interest rate and scheduled payables will be absorbed by the B Note first
  - (e) B Note can cure Borrower defaults or buy out A Note after the default
  - (f) B Note holder services both the notes after default on behalf of both holders
  - (g) If significant devaluation occurs in the B Note's value (a "Control Appraisal Event" if after certain uncured material defaults the value of the B Note is less than 25% of its principal balance), B Note loses consent rights and servicing rights
6. Mezzanine Loan
- (a) Separate loan made by another lender secured by pledge of equity interests of mortgagor borrower (no lien on the real estate)
  - (b) Mezzanine Lender separately services its own loan
  - (c) Mezzanine Lender has cure and purchase rights
  - (d) Intercreditor agreement addresses similar issues as the securitization structure. A typical intercreditor agreement will require the mortgage lender to obtain the consent of the mezzanine lender (except after the occurrence of a mortgage loan event of default that the mezzanine lender has failed to cure) if the proposed modification involves, among other things: (a) an increase in the interest rate or principal amount of the mortgage loan, except for increases in principal to cover protective advances, (b) an extension or shortening of the scheduled maturity date of the mortgage loan, (c) obtaining any contingent interest or "clawback", or (e) an extension of any prepayment lockout periods. However, after the occurrence of a mortgage loan event of default that has not been cured by the mezzanine lender, the intercreditor agreement may relieve the mortgage lender from any need to obtain the mezzanine lender's consent prior to a modification (other than, perhaps, increasing the principal amount of the mortgage loan or changing the lockout provision). Thus, should the mortgage lender and the mortgage borrower agree to a workout of the defaulted mortgage loan, the mezzanine lender will have waived any ability to block or influence the agreement.
- C. Syndicated loans present additional issues (includes loan syndications among lenders with separate notes but with the lead lender holding the collateral for all, or a loan with only one lender which sells undivided interests in the debt and security to other lenders).
- 1. There is normally a mechanism in participation agreements for the lead lender to accelerate a loan and pursue foreclosure if an event of default has occurred -- other workout alternatives (such as interest rate reduction or payment forbearance) would normally require consent of participants (usually 100% if there is a forgiveness of debt or release of collateral or increased loan).

2. Some participations allow the lead lender to buy out a participant who does not consent (not a particularly attractive option in a workout). Of course, participants may be recalcitrant, so as to attempt to force a buyout.
3. Some participations require participants to fund expenditures made by lead lender to preserve and maintain the mortgage lien i.e., "protective advances" (payment of taxes, insurance and perhaps even cost to complete).
4. Relationships between the lead lender and participants may be strained in a workout. There may be disparate objectives among the group. The lead lender may be subject to claims of improper conduct, failure to obtain participant's consent, failure to keep participants informed or claims of mismanagement of the loan. A possible remedy for the participant is rescission or subordination of lead lender.

### **Ownership Issues**

- A. Why should Lender choose to restructure a loan in default rather than foreclose?
1. Foreclosures can be expensive and are protracted legal proceedings, with the attendant expense of attorneys' fees; in NY substantial transfer taxes are payable on a foreclosure.
  2. Lenders are not in the business of owning and managing real estate.
  3. Time and carry cost factors in selling the property after foreclosure.
  4. Lender is exposed to liability associated with property ownership, such as tort claims and environmental issues.
  5. Is the lender in a position to own this asset? If the lender owned this asset, what would the lender do with it? Resell it quickly? Redevelop or reposition it? Does the lender have people who can undertake such a project? Does lender have ideas for how the mortgaged property might be repositioned, redeveloped, or broken up to create value that the borrower failed to create?
  6. Does the lender have the necessary expertise, or can the lender easily buy the expertise?

### **Deed in Lieu of Foreclosure**

- A. If restructuring is unsuccessful or was not the goal of the parties, a deed in lieu of foreclosure is another mutual agreement where the borrower deeds the property to lender. Lender avoids delays of foreclosure and the statutory redemption period (if any) following foreclosure. Lender will likely have to pay for this privilege by releasing personal liabilities, paying claims incurred by the borrower and the like.
- B. From a borrower's perspective, the deed in lieu avoids the adverse effects of litigation and bad publicity of an actual foreclosure proceeding. It extinguishes the debt. The borrower avoids attorney fees and no longer has the expense of carrying the property.
- C. From a lender's perspective, a deed in lieu:
1. Gives lender (or its nominee) title, although not necessarily "clean title" as subordinate liens are not wiped out.

2. Permits faster remedial action by lender than a foreclosure- with rights as an owner - such as completion of construction or marketing.
  3. Lender will not have to foreclose, which can be time consuming and expensive. However, in a state which has a quick and effective non-judicial foreclosure procedure, a deed in lieu may not be of any benefit.
  4. With a deed in lieu, the borrower may cooperate to assist the lender in taking over the property, and, possibly, even provide transition management.
  5. A variation may be that the borrower could agree to the commencement of a "friendly foreclosure" as part of the workout, with a stipulated judgment to be entered in a foreclosure action as quickly as possible. As another variation, the borrower and lender might agree that if specified events occur the papers for a friendly foreclosure (including a stipulated judgment of foreclosure), may be filed immediately. Along similar lines, the borrower might sign a "confession of judgment" – a document in which the borrower consents to the entry of a judgment against its assets – or a stipulated judgment of foreclosure.
- D. Special risks and problems of a deed in lieu of foreclosure are:
1. Possible avoidance as preferential or fraudulent under bankruptcy laws -- this depends on whether the debtor was insolvent and whether the debtor received fair or reasonably fair equivalent value.
  2. Title insurance for such a deed will most likely be subject to various bankruptcy and preference exceptions. However, the title company might agree in advance to insure title free of such exceptions and of the deed-in-lieu problems, for a subsequent bona fide purchaser for value.
  3. Sometimes a borrower will want the lender to hold the deed in escrow, to be recorded if a workout agreement is not successful. This heightens the bankruptcy risks (by making it more possible that an intervening bankruptcy will stay recording the deed). In some jurisdictions the deed in lieu in escrow is treated as just a mortgage.
  4. A borrower may be willing to record the deed up front, but bargain for an option to purchase or right of first refusal, hoping to get the property back if there was a turn around. This gives the borrower an argument that the deed was not a deed at all, but merely a disguised mortgage or an equitable mortgage.

### **Foreclosure**

- A. If neither a workout nor a deed in lieu is feasible or desirable, the lender may have to foreclose, whether judicially (in court) or where allowed in many States by a non-judicial foreclosure (notice to parties in interest with an opportunity to redeem).
- B. Special attributes of a foreclosure are:
1. Lender will obtain clean title free of borrower's ownership.
  2. Lender will eliminate subordinate liens.
  3. A regularly conducted foreclosure sale will result in better title than a deed in lieu, as the foreclosure sale is more difficult to attack as a fraudulent conveyance.

4. Lender could cut off tenants which may have below market leases and which are subordinate to the mortgage (absent a non-disturbance agreement).
5. Lender could temporarily obtain a receiver for the property.
  - (a) A temporary receiver may be obtained by application to the court in the foreclosure action. It is not an absolute requirement that there is danger or jeopardy to the property or that the security is inadequate, if the mortgage, as most do, contains a waiver of such requirements. The receiver collects the rent and manages the property as an officer of the court. If there has been no court challenge to the validity of the debt or priority of the lien, the rents may be applied, after payment of expenses, to debt service.
  - (b) A receiver may preserve the integrity of the security by collecting all income of the property and assuring its application to necessary expenses of the property.
  - (c) Receivers are expensive - in NY a receiver may retain up to 5% of the sums received and disbursed by him.
  - (d) Receivers are court appointed - there is no assurance as to the competency of the receiver. The lender is not in control of the receiver.
- C. In a judicial foreclosure, there will be delay. Once a defendant answers the complaint and denies plaintiff's allegations, the plaintiff often moves for summary judgment. It could take a year to get summary judgment. If there are factual disputes, the case can drag on for much longer, awaiting trial. Even after judgment is obtained (whether by motion or after trial) there are various other procedural steps that must be satisfied before there is an actual sale.
- D. Many states have a statutory redemption period after foreclosure during which the borrower can redeem at the foreclosure sale price. Often subordinate lien holders can redeem as well. The redemption period varies from a few months to a year. During this period, uncertainty as to whether the property will be redeemed inhibits marketing or completion by the foreclosure transferee.
- E. A deficiency judgment can be obtained to the extent borrower or a guarantor is personally liable under the loan documents. To avoid the deficiency being measured by an artificially low foreclosure sale price, the law often determines the deficiency by reference to the fair market value of the property. The deficiency can then be enforced against other assets of the debtor, either in the state where the property is located, or by entering the judgment in other states.
- F. In many states foreclosure may be conducted without judicial proceedings through a published sale conducted by the mortgagee (Texas) or a trustee's sale (California). In New York, this procedure was created mainly for commercial property with a July 1, 2009 "sunset". This is a much faster process than judicial proceedings, but often there is no personal liability surviving the sale. In New York, lender can apply to a court for an order of deficiency judgment.

### **Bankruptcy**

- A. An unsuccessful workout may instead result in a bankruptcy or, in certain situations, bankruptcy may be the best course of action for lender, borrower or both. Bankruptcies can be brought voluntarily by the debtor, or, more infrequently in real estate, involuntarily by its unsecured creditors (a minimum of three creditors are required to bring the action unless the borrower has fewer than twelve creditors, when only one creditor is required).

- B. A common scenario is for the debtor to commence a bankruptcy just before completion of foreclosure litigation. Bankruptcy stays the foreclosure, unless the creditor can convince the court to lift the stay. Single asset real estate bankruptcies have some special rules which supposedly fast track the case by shortening the time for the debtor to file a confirmable plan, or else the mortgagee may proceed with foreclosure.
- C. Chapter 11 offers a mortgage lender certain advantages as to third parties:
1. The debtor's assets may be sold free of liens and interests.
  2. Burdensome contracts and leases may be rejected.
  3. Current pre-petition taxes may be paid out over six years, making more cash available up front.
  4. Bankruptcy will stay enforcement by other creditors, and property already seized by creditors might be recovered.
  5. The debtor can be permitted to borrow with clear priority over existing liens.
  6. Defaulted contracts may be cured and assumed despite contractual prohibitions.
  7. Non-consenting creditors can be bound by majority vote and dissenting classes can be crammed down.
- D. There are advantages in dealing with Debtor:
1. Debtor must protect value of collateral or risk foreclosure.
  2. Requirements of confirmable plan within reasonable period may shorten overall delay before foreclosure.
  3. Creditor plan may be forced on debtor.
  4. If debtor defaults under plan, foreclosure is assured.
  5. Transfer taxes (if sale is part of a plan of reorganization) can be avoided.
  6. Insider preferences can be recovered from the insiders and their claims potentially subordinated.
  7. Bankruptcy may be "pre-packaged", i.e. filed to implement the previously agreed "work-out" with the lender.
- E. What are disadvantages of Chapter 11?
1. Lack of certainty or finality in a Chapter 11 proceeding.
  2. Lender can no longer improve its position with respect to the borrower; it cannot obtain additional collateral (outside of a confirmed plan) or perfect liens.
  3. Transfers of any additional collateral received during past three months may be subject to avoidance as preferences; transfers during past year from a non-guarantying parent or

from another affiliate may be avoided if affiliate files also. If original loan was an LBO, the lien and claim could be avoided as fraudulent.

4. Lender's claims may be subject to subordination if it has controlled debtor and acted unfairly toward other creditors.
5. Lender's loan documentation and perfection will be subject to scrutiny and possible attack.
6. Other creditors will have increased say in the outcome and, therefore, more leverage.
7. The Court may resolve disputes in an unexpected, unfavorable manner, thereby weakening lender's position.
8. Possible appointment of a trustee creates enormous uncertainty and risk of loss of value.
9. The Chapter 11 proceeding may cause harm to the project or the debtor's business by adversely affecting tenants, suppliers, key employees and investors.
10. The filing may trigger the loss of valuable legal rights such as loan commitments, personal service contracts.
11. The lender is subject to the risk of "cram down" and unfavorable outcome. A reorganization plan may be approved, and therefore made binding on all creditors, even if a majority of one or more classes of creditors (including a secured creditor (mortgagee) in its own class) votes to reject the plan. This may be accomplished if the "cram down" requirements of the Bankruptcy Code are met. A secured creditor, such as a mortgagee, can be forced to accept the plan, so long as the plan provides for the secured creditor to retain its lien and receive payments over the life of the plan, the present value of which is at least equal to the value of its lien.
12. The proceedings may be protracted and expensive, thereby impairing the lender and reducing what is available to creditors.

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For more information about solutions to distressed real estate debt or any real estate concerns, please contact **Richard Strauss**, co-chair of Moses & Singer's Real Estate practice, at **212.554.7812** or **rstrauss@mosessinger.com**.

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