LOAN WORKOUT CONSIDERATIONS IN THE REAL ESTATE CAPITAL STACK

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While it is expected that vaccination rollouts and fiscal stimulus will provide relief across markets, the commercial real estate industry continues to feel the effects of COVID-19. This has played out through tenant vacancies, debt service delinquencies, debt maturity issues, and operational changes across asset classes.

As a lender, your place within the capital stack guides any analysis of a distressed real estate situation. Aligning your goals with your rights and obligations and then developing a strategy to reach those goals requires informed consideration of your borrower's and fellow lenders' interests. To think through the various issues posed by the following scenario, consider yourself in the second mezzanine position, within three layers of mezzanine debt, on an office property that used to have a safe risk profile but now is in trouble after key tenants were hit hard by the pandemic. Now, the borrower is heading for a default.

The first step to addressing a loan in distress is to determine the status of the loan, the other relevant loans in the capital stack, the borrower, the guarantors, and the collateral. Take these critical key steps to quickly gather as much information as possible:

File review

Dust off the deal files and find out early if the loan administration practice has deviated from the requirements of the loan documents. For example, has the cash management structure been respected? Have waivers consistently been granted (explicitly or not) regarding certain requirements? Have the lenders abided by the terms of the intercreditor agreement?

Collateral review

Order and review new searches of title, UCC and lien filings, bankruptcy filings, and litigations involving the borrower parties. Confirm the location and status of any possessory collateral (especially any notes and pledged equity certificates and powers). Also consider whether jurisdictional procedures or requirements exist based on the situs of the collateral and/or the governing law of your documents—such as one form of action rules.

Capital structure

Consider the rights and obligations of other members of the capital structure. Make sure you know of any horizontal parties (co-lenders) and any vertical parties (senior lenders, mezzanine lenders, and preferred equity holders) and the rights and obligations of each in relation to you and the borrower. Follow every word of the intercreditor agreement to avoid potential forfeiture of your rights. Take this opportunity to confirm you and your counsel have the correct entity and contact information (including counsel) for other lenders and the borrower parties and that all parties have yours as well.

Changing regulatory backdrop

As the world grapples with COVID-19, multiple new regulatory schemes at the federal, state, and local levels address the economic fallout, and protective measures now exist, including moratoria on foreclosures, evictions, and other legal actions in various jurisdictions. Review and consider the obligations and options those provide to you, the other lenders, your borrower, and any tenants of the collateral property.

Begin formulating a strategy that accounts for the above information and any insight about the borrower's and other lenders' goals. In some situations, a lender may need to take control of the collateral. Before pursuing that route, consider whether you should (or even can) own and operate a property. Instead, pursuing prompt disposition of your interest in the loan may be the best course. Alternatively, pursuing a workout with the borrower that involves disposition of the mortgaged property or some other interim operating solution may be preferable. Coordination among lenders and with the borrower to stabilize the value of the collateral is in everyone's best interest.

In terms of shaping your strategy, think about the following:

Source

What is causing the problem? Has the loan historically been underperforming or is a change in market forces causing this issue? Is there a one-time problem at the heart of the pending default or has a new issue (perhaps COVID-19) exposed and accelerated an underlying weakness? Has the management team failed or would any group face the same challenges?

Future prospects

Understanding your position in the capital structure is critical when determining how to proceed during a distressed situation. Collateral needs to be preserved. If you are in the money, preserving your rights and interests typically requires less cash than if you are not in the money. In our example, you are faced with multiple creditors coming before you in line. Before determining whether to throw additional money at the problem (via curing senior loan defaults, purchasing more senior interests or otherwise investing or advancing additional funds), it is important to understand the property's realistic potential. Is bankruptcy a possibility? What does the "bad boy" guaranty cover and is there a credit-worthy entity or warm body behind it?

Other lenders' plans

The lenders will eventually need to make their intentions clear to each other, but this may not occur until any relevant deadline under the applicable intercreditor agreement. Often, much pontification occurs before you eventually understand each lender's underlying motives and position. Given the myriad opportunities for your plans (or the other lenders' plans) to go awry, you should plan and prepare to execute your preferred strategy as if you were the first person in line interested in doing so, while simultaneously making plans based on what the others may elect to do. Often lenders dual track their takeover plans, which, while potentially costly, is generally considered prudent in most cases to ensure your position is protected.

While working to gather information, balancing the desire to be constructive and negotiate effectively with the need to avoid fodder for litigation can be difficult. To reconcile these conflicting demands, most parties rely upon a prenegotiation agreement, which essentially provides that nothing either party says or discloses during workout negotiations may be used against that party in court. Be especially careful with email.

After a prenegotiation agreement is in place, the parties are generally free to craft a custom solution for their situation. Some common deal elements that are often considered include the following:

Additional equity

An equity infusion from the borrower's parent may be enough to remedy the situation, although this is usually part of a larger cure package with additional structuring often required.

Additional loan disbursements

Putting additional money into a failing loan seems counterintuitive, however it may be worth funding through a default if additional capital would increase the value of the collateral significantly (e.g., by finishing construction to allow for a new tenant to take possession) or prevent further decreases in value (e.g., by completing necessary capital improvements). As part of any funding or senior loan cure decision, you must consider whether you are in the money or out of the money and how desirous you are of protecting your current investment.

Additional security

A guarantor or borrower parent may be able to supplement the collateral package in order to buy more time to rectify a problem asset.

Leadership change

If the management team seems problematic, you and the other lenders might consider negotiating a change without requiring a sale of the property. For example, the developer or property manager may be replaced or the managing member of a joint venture borrower could be removed.

Reductions or discounts

Something is better than nothing, especially when you are not in a position to own a property or otherwise dispose of collateral for a profit. In such circumstances, you might consider offering a discount or reduction in principal and/or interest payments or implementing PIK interest. At times this is paired with an equity kicker or a larger fee at the end of the relationship as lenders try to maximize the value they can recoup.

Deed in lieu, settlement, and release of personal liability

A negotiated transfer of the property from borrower to lender/lender group, which sometimes includes upside protection for a borrower in the event of a later sale of the property, is always an option and can be structured in a multitude of ways. If property ownership does change, often borrowers (or guarantors) request a release from liability, if it was not already part of the documentation. Be prepared for this issue to be raised. Due diligence as to current property status will help you ascertain what is appropriate.

Although a good workout plan sets up the borrower to avoid future problems, that is not always the final result. You should keep in mind the increased likelihood of more issues while crafting the revisions. Typically, lenders tie a second chance to a tighter covenant package, with more requirements and lower thresholds for lender action. For example, a higher debt service coverage ratio or a cash trap and/or cash sweep can mitigate the damage by alerting the team earlier in the event of future problems.

Consulting with counsel at the first signs of loan distress is critical to working through a strategic plan and to protecting yourself through each step of the process. In these situations, preparation is key. So, act quickly to gather information internally and obtain sound legal advice before taking action to ensure you advance toward your long-term goal.