PRIMER ON COMMERCIAL REAL ESTATE LOAN WORKOUTS AND RIGHT-SIZING

Richard S. Fries is a partner at Sheppard, Mullin, Richter & Hampton in the firm's Real Estate, Energy, Land Use & Environmental Practice Group, a fellow of the American College of Real Estate Lawyers, and a member of the Executive Committee of the Real Property Law Section of the New York State Bar Association and co-chair of its Real Estate Finance Committee. He may be reached at rfries@sheppardmullin.com.

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 lesser known. This article will discuss traditional options, as well as a more creative solution to right-size assets in distress, regardless of real estate asset class, geography, or emotion.[1]

THE COMMERCIAL REAL ESTATE LOAN IN DISTRESS

In more robust times (and a near-zero-interest-rate environment), the owner of a 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 beeline to its collateral or its revenue stream. Perhaps the lender obtained a guaranty of debt service, real estate taxes, and insurance. A deficiency (e.g., 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, inconceivable.

Well, the inconceivable 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 regulators alike.

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

"Take the keys," the 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 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 the 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:

- 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.
- 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.
- 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.
- Principal amortization (if applicable) is suspended to maturity.
- There are countless nuances suitable to the asset, its economics, and the market: 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.

In short, this is 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).[2] 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, 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.[3]

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 30 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, typically, appointed. By court order, the receiver is obligated to preserve the asset and separate the defaulting borrower from the revenue. Receivership is expensive, whimsical, difficult to underwrite, and, 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, and tenant confrontations are not its forte.

There are alternatives within this realm. The lender can (in the borrower's name) engage a broker of renown to market the asset for sale. The borrower can promise, in writing, to deliver the deed to lender's designee, nominee or prospective purchaser, at the lender's election in its sole and unfettered discretion. In certain states, the 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" the borrower's promise to deliver the deed with full recourse to that guarantor in the event the 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 the 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.[4]

So, there's an inflection point; deeds in lieu of foreclosure are delivered; borrowers, lenders, syndicate members, investors, and 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 the borrower that go nowhere, or backtrack, 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.

Voilà, 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), and 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, no 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 risktakers. 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, 10 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—overpays.

After all, the mortgaged property is deeply in distress, foreclosure and receivership is 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.

RIGHT-SIZING THE REAL ESTATE LOAN TO ITS VALUE AND ITS POTENTIAL VALUE

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 right-sizes the loan and the underlying real estate and resets value for today's market.

The options described in the first part 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 part 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) on the property. The lender incentivizes the 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 that are asset, geography, sponsor, or guarantor specific) should yield excess cash flow which can be swept and applied to service Note B.

The "discount" should be carefully synchronized to: (i) fair market value (as best can be discerned); (ii) property and market stabilization and appreciation; (iii) the Federal Reserve's interest rate cuts; and (iv) a tangible return on investment for the borrower. Perhaps, the 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 than $75 million.)

The borrower needs an incentive to refinance and deliver the discounted pay-off. The 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, and create and maximize value, the continuum of long term ownership and recovery.

This is truly an art form. It is at the crossroads 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 and 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 above are embedded here, too.

The discount materializes not on day one (all three notes remain in force), but only on the last day 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, which happens to be $5 million dollars 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.

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

The property is no longer "distressed."

Life, market forces, the inevitable recovery of real estate as an asset class of global captivation, and 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

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 with respect to new lender consent. The machinations are outside the scope of this article. In concept, the workout lender retains a remedyless ("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 percent of the net proceeds of the sale in excess of the $80 million discounted repayment amount up to its $15 million hope certificate; or 25 percent if the sale occurs between nine and twelve 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, and discount-worthy.

For the Borrower—Loan Reinstatement

The next year could feasibly see several interest rate reductions, 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, and 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. 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.

Notes

1 Reprinted and edited with permission from the May 2, 2024, and May 9, 2024, editions of the New York Law Journal© 2024 ALM Media Properties, LLC. All rights reserved. Further duplication without permission is prohibited; contact 877-257-3382 or reprints@alm.com. Also reprinted and edited with permission from the Fall 2024 edition of the New York Real Property Law Journal.

2 For amplification, see Richard S. Fries, Exchange of Enhancements for Concessions – Insights into the Modern Loan Workout, N.Y. L. Journal (June 19, 2020).

3 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.

4 This is subject to certain "tender" conditions and criteria, often negotiated, that are also outside the scope of this article.