Real Estate-Secured Loan Workouts: The Borrower's View

DOUGLAS VAN GESSEL AND KATHARINE E. ALLEN

The author discusses potential loan workout objectives, strategies and structures from a borrower's perspective.

The continued deterioration of the credit markets and the declining value of commercial real estate have created unprecedented challenges for commercial real estate borrowers. Given the large number of loans that are scheduled to mature in the next few years, and the general unavailability of capital, many otherwise financially solid borrowers may find themselves falling into default under their loans. This article discusses potential loan workout objectives, strategies and structures from a borrower's perspective.

BORROWER'S OBJECTIVES

Obviously, the most important objective to any borrower is to retain the real property collateral securing the loan and its related equity. In order to do this, the borrower most typically tries to buy time from the lender in an effort to design and implement plans to attract more equity, find a new loan, sell the property and/or stabilize the property with new tenants.

Other related objectives are to:

Douglas Van Gessel is a partner in the Real Estate Practice Group in the San Francisco office of Sheppard Mullin Richter & Hampton LLP. He can be reached at dvangessel@sheppardmullin.com Katharine E. Allen, an associate with the firm, can be reached at kallen@sheppardmullin.com.

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

(a) maintain control of the cash flow from the property;

(b) reduce loan payment obligations;

(c) extend the loan maturity date;

(d) minimize the personal liability of the principals;

(e) avoid or minimize additional equity contributions required by the lender;

(f) avoid or defer the tax consequences of a foreclosure or deed-in-lieu thereof;

(g) avoid collateral damage to other assets owned by the borrower or its affiliates, such as the implication of cross-default provisions or net worth or liquidity covenants in other loans; and

(h) keep the current management in place for the property.

Meeting these objectives requires the borrower to act quickly, be frank with its lender and convince the lender that a workout offers the lender more value than the lender's enforcement of its remedies.

BORROWER STRATEGIES

In approaching a loan workout, the borrower should pursue the following strategies:

Initiate Action, Act Quickly

It is important for borrowers to realize that they need to initiate the workout process. There is no guaranty that a lender will approach its borrower with any alternative other than foreclosure of the loan. Further, the earlier that the borrower acts, the more likely it is to retain credibility as a competent borrower who has simply been overwhelmed by market forces outside of its control, as opposed to being deemed a poor manager. If it is anticipated that the value of the collateral may decline further in this difficult market, it is better to negotiate now, before that deterioration occurs. Disclosure of problems associated with the asset and anticipation of the lender's concerns will increase the chance of a successful workout.

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

Anticipate Your Lender's Concerns

Borrowers need to be realistic in their objectives and prepared to make reasonable concessions as part of a loan workout. The velocity with which the real estate market has deteriorated is truly remarkable, and all parties to the workout will have to face some harsh realities.

Typically, the two main things the lender wants in a workout are repayment of the monies due under the loan and the cooperation of the borrower. That cooperation may take the form of a smooth transition to the lender of the ownership and management of the property, an avoidance of the time and expense of foreclosure and/or the waiving of lender liability claims or other defenses by the borrower and related guarantors.

It is often said (but is not verifiable) that real property loses twenty percent of its value as soon as it is foreclosed upon by a lender. Lenders do not typically want to foreclose on property. Further, to the extent that the loan is classified as distressed, the lender must set aside reserves against the loan, removing monies that it otherwise could lend at lucrative interest rates. In any event, it is important for the borrower to understand the range of alternatives open to its particular lender. A local bank may have the freedom to discuss creative alternatives to foreclosure, but a special servicer who has inherited a CMBS loan may not. Lenders of every variety are generally understaffed and soon-to-be overwhelmed with problems, one more reason borrowers need to be ready to initiate action in a prepared, organized fashion with their lender.

If the underlying real property acts as security for more than one loan, the borrower will need to consider which lender in the "capital stack" to approach first. In those situations, most workout solutions will require the consent of each lender. Each lender's motives will differ, depending on whether there is sufficient equity in the property to ensure repayment of its loan. The borrower should consider which lender may be most sympathetic to its cause, and which lender is empowered under relevant intercreditor agreements to make decisions for others. For many loans, that lender is the junior or mezzanine lender. Since the mezzanine lender is most likely to be wiped out by a reduction in equity in the property, and since most intercreditor agreements initially establish the junior lender as the party who gives direction to the servicer of the loan, that mezzanine

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

lender may be ready to negotiate with a borrower, especially since those same intercreditor agreements often provide that as the amount of equity in the real property decreases (as measured by an appraisal), control over loan enforcement decisions reverts to the senior lender. This race to retain control may inspire the junior lender to extend the loan term in hope of a later increase in value of the collateral. It might also make the junior lender more inclined to accept a quick partial payoff of the loan before it is totally wiped out. That reduction in the leverage on the property may allow the borrower to subsequently negotiate additional concessions from the senior lender.

Get Organized

It is essential to get organized before beginning the workout process. First of all, this means getting the borrower's own house in order. Are there other members or partners of the borrowing entity who should be consulted? If the borrower is a limited liability company, most operating agreements provide that restructuring debt or transferring the related real property require the consent of all members. Also, are there other lenders with liens on the property or borrower? If so, they will have to be consulted. If other collateral is being offered as part of the workout, has the borrower received the consent of the relevant third parties to the granting of that collateral? Sometimes, albeit less often, there is a relevant redevelopment agency, other governmental agency or assessment district with approval rights over transfers or loan restructurings.

A borrower should also anticipate the documentation a lender will require in connection with a loan workout. The lender will be greatly concerned about the value of the collateral, so it will typically ask for a new appraisal. It will also ask for a new preliminary title report (and perhaps a trustee's sale guaranty), a UCC search, updated financial statements on the borrower and guarantors, and possibly a new environmental report and survey. It may also ask for estoppel certificates and a subordination, non-disturbance and attornment agreement from certain tenants. If there is subordinate debt, the lender will probably want a reaffirmation of that subordination. Be ready for these requests. Since the borrower will be

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

paying for them, see if there is any way to control the process and negotiate some savings from the relevant vendors. If there are mechanics' liens or stop notices affecting the property or lender, they will need to be paid, bonded over or indemnified against.

The borrower should also begin assembling an appropriate team. In addition to the vendors described above, the borrower should consult legal counsel, possibly including a bankruptcy effort. It is important for the borrower to realize the conflicts of interest that may arise for some team members in a workout context. The interests of the developer and the interests of the institutional equity in a borrowing entity may begin to diverge by the workout stage, and it may be necessary to hire different counsel for each entity, along with the borrowing entity itself.

Know Your Strengths and Weaknesses

Borrowers should stop to consider the strengths and weaknesses of their position before entering the workout process. Here in California, borrowers have many inherent strengths provided to them by law. If a lender pursues a nonjudicial foreclosure, it forfeits the right to pursue the borrower (but, in most cases, not the guarantors) for a deficiency judgment. If the lender pursues a judicial foreclosure, it can obtain a deficiency judgment, but the process is much longer and expensive, and the borrower retains a right of redemption to buy back the property for a year after the foreclosure, hampering the marketability of the property. On the other hand, the relatively brief (roughly four months) and inexpensive California nonjudicial foreclosure scheme defeats many of the borrower's arguments that a loan workout prevents a protracted, painful and expensive process.

In addition, a borrower should ask itself the following questions to determine the strength of its position:

1) *Nature of Default*: If the borrower is already in default, how bad is the default? If the loan has matured without payment, obviously the default is significant. But if the default involves a non-monetary or other technical default, there is more room to negotiate. Lenders are generally adverse to foreclosing as a result of a non-monetary default, such as a material

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

adverse change or other financial test provision, for fear of lender liability claims. California law requires that non-monetary borrower defaults be of a material, adverse nature affecting the lender's security interest before a lender is entitled to foreclose. A monetary default based only on the failure to make a monthly payment also may allow more room to negotiate.

2) *Complexity*: How complex is the project? Do the principals have a management expertise unique to the project? Clearly, the more complicated the asset, the less likely it is that the lender will want to inherit it without capable management.

3) *Status of Project*: Has the project been completed? Is the general contractor affiliated with the borrower? How difficult would it be for the lender to complete the project?

4) *Entitlements*: Do the entitlements for the project expire soon? Does the borrower have a strong political connection with the source of such entitlements that cannot be duplicated by the lender?

5) *Equity*: Are there principals of the borrower who are willing and able to invest additional equity?

6) *Guaranties*: Have the principals signed guaranties of the loan? If so, are they full repayment guaranties, or merely non-recourse carve out guaranties?

7) *Tenants*: Has the landlord received attornment agreements from all of the tenants, or might some tenants who are junior to the lien of the debt be free to leave the property upon a foreclosure?

8) *Claims*: Will the lender inherit significant claims, such as construction defect claims, from third parties once it has foreclosed on the property?

9) *Lender Liability*: Does the borrower have legitimate liability claims against the lender? Unfortunately, courts are not as willing to accept lender

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

liability claims as borrowers might hope. A lender might have liability for exercising excessive control over the borrower, such as requiring review and veto power over the borrower's payment of all applicable expenses, controlling the way the borrower conducts its business, making decisions regarding hiring and firing of employees or deciding which assets are to be sold. It might also have liability for not following the terms of the loan documents or acting dishonestly in a way that violates the covenant of good faith and fair dealing, but, otherwise, lender liability claims are not generally available.

10) *Defenses*: Does the borrower have any legitimate defenses to the lender's enforcement of the loan documents? While these defenses are rare, they include: (a) the absence of a default or use of incorrect figures by the lender; (b) the failure of the lender to give proper notices of default; (c) waiver of rights by lender; (d) fraud or negligent misrepresentation by loan officers; and (e) oral modifications of the loan documents by the lender. The borrower might also attack any modifications of the loan as a fraudulent conveyance in bankruptcy to the extent it did not receive "reasonably equivalent value" for its agreements in the loan modification documents. A mere forbearance in return for additional collateral is not always considered "reasonably equivalent value."

11) *Bankruptcy*: Can the borrower credibly threaten bankruptcy? Note that the advent of "springing" guarantees from principals of the borrower stating that the loan will become payable by the guarantor upon the borrower's filing of a bankruptcy will typically prevent (or at least make the borrower think twice about) such a bankruptcy filing. Also, note that the 2005 amendments to the Bankruptcy Code have further limit the usefulness of bankruptcy protections for single purpose entity real estate companies by providing that such companies must either begin paying the monthly interest payments due under their loan or submit a reasonable bankruptcy plan to the court within 90 days of filing a bankruptcy petition, thus hampering a traditional stalling tactic by real estate company borrowers. Also, to the extent that the lender can show that the borrower no longer has any equity in the real property and, therefore, the asset is not relevant to the

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

reorganization, the lender can move to lift the stay of a bankruptcy action from precluding enforcement of its lien on the real property.

Be Aware of Changes in the Tax Laws

While any portion of indebtedness forgiven by a lender traditionally becomes taxable income for the borrower, the recently enacted "American Recovery and Reinvestment Act of 2009" contained a provision allowing a taxpayer to elect to report certain income realized in 2009 and 2010 from the cancellation of indebtedness for tax purposes ratably over the five year period beginning in 2014 and 2018, rather than in the year in which the cancellation occurs. This deferral election applies fairly broadly to debt instruments issued by the borrower that are modified, settled for a cash payment, exchanged for another debt instrument, exchanged for an equity interest in the issuer, contributed to the capital of the issuer, or completely forgiven by the lender. However, please note that the new law does not apply to deeds-in-lieu of foreclosure or other arrangements by which the real property security is conveyed to the lender in exchange for forgiveness of debt. Therefore, in order to take advantage of the new law, the real property must be retained as part of the loan workout.

PRE-NEGOTIATION LETTERS AND FORBEARANCE AGREEMENTS: BEGINNING THE WORKOUT PROCESS

A lender will probably begin the workout process by asking the borrower to sign a pre-negotiation agreement setting forth the ground rules for negotiation of the workout terms. If the borrower is already in default, this agreement may instead take the form of a forbearance agreement by which the lender agrees to refrain from exercising its remedies for a designated period of time. In each case, the lender will want the borrower to acknowledge the current status of the loan, establish the parameters for discussions, reserve the rights of the lender to pursue its remedies under the documents and at law and, most likely, establish the documentation needed by the lender in order to pursue discussions (i.e., title reports, appraisals) and confirm the obligation of the borrower to pay the cost of

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

those items. In addition, the lender will probably use these agreements as an opportunity to try to require the borrower to acknowledge that it is in default under the loan, and to agree to waive any current or future lender liability claims, rights to trial by jury or rights to the automatic stay set forth under bankruptcy law. Borrowers should resist such provisions in a pre-negotiation agreement, since merely confirming the ability to speak with a lender should not be grounds to waive these important rights. Although a forbearance agreement gives the borrower a stay from lien enforcement by the lender, such provisions should be heavily negotiated in that context, too. In addition, these agreements commonly require the borrower to reaffirm all of the representations originally made by the borrower in the loan documents, but such representations may no longer be factually accurate, and such reaffirmations should be examined carefully.

VARIOUS WORKOUT STRATEGIES

There are a remarkable number of ways to structure a loan workout, depending on the goals of the parties and the particular challenges faced by the real property security. This section discusses some of the most common issues found in those model structures.

First of all, the borrower must determine its exit strategy for paying off the loan (partially or in whole) and how to sell that strategy to its lender. Does the borrower think that it can imminently sell the real property to pay off all or some portion of the loan? If a sale is unlikely, how does the cash flow for the property compare to the debt service? Presuming that cash flow cannot meet debt service, how can the borrower demonstrate to the lender that there is a credible plan to increase that cash flow in the not-so-distant future?

If a sale of the property is imminent, the borrower will most likely ask for a short term forbearance or extension of the maturity date. If the lender agrees, it may seek a fee for such an extension. If a sale is not imminent, so the borrower is asking for a longer term extension of the maturity date, the lender will likely require the borrower to pay down a portion of the loan and possibly offer additional collateral or guaranties for the loan.

In addition, if the cash flow for the project cannot meet the debt ser-

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

vice, the borrower will most likely ask for a reduction in the interest rate. It can propose that the debt service be reduced to equal the cash flow from the project (i.e., a "cash flow" mortgage), with the remaining debt service accruing until the property is stabilized or the loan matures. Obviously, the borrower will have to convince the lender that such property stabilization is likely. As part of that restructuring, the existing promissory note might be divided into a "performing" note, a "claw back" note based on cash flow from the property and a "deferral" note based on the portion of the loan that is forgiven but reinstated upon a default.

In the event of either a loan term extension or modification of the interest rate, there are numerous items that may be offered by the borrower in order to "sweeten" the arrangement for the lender. Those items are:

(a) a partial paydown of the principal portion of the loan;

(b) the implementation of a cash management system for revenues from the property;

(c) the addition of further collateral in the form of deeds of trust on other real property or pledges of the revenue therefrom;

(d) pledges of membership interests in the borrower or other related entities owning other collateral;

(e) the subordination, termination or tolling and accrual of property management fees;

(f) the addition of further guarantors of the loan or the modification of existing non-recourse carve out guaranties into full repayment guaranties or other forms of "springing" guaranties;

(g) adding additional non-recourse carve-outs to the loan;

(h) the creation or modification of existing loan-to-value, loan-to-costs, debt service coverage ratios or other financial or liquidity tests for the borrower or guarantors;

(i) changes in management of the borrower or property;

(j) the termination of any further funding obligations or creation of new conditions precedent or other phasing to such future funding;

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

(k) the creation of "equity kickers" by which the lender participates in any upside in the economic performance of the secured real property; and

(l) a consent judgment to the hiring of a receiver or a foreclosure, a conditional deed to the real property collateral or some other sort of confession of judgment.

BORROWER'S REMAINING OPTIONS

So what happens if the borrower cannot negotiate an extension or other workout of the loan? Here are some remaining options:

Deed-in-Lieu of Foreclosure

The borrower may offer to give the secured real property back to the lender in exchange for a complete or partial release of the debt. This approach is advantageous to the borrower in that it:

(a) extinguishes some or all of the debt;

(b) avoids the expense of the foreclosure process, including the payment of lender's legal and other costs;

(c) avoids having a mortgage foreclosure or a judgment on a credit report;

(d) avoids potential cross-defaults with other obligations;

(e) cuts off the borrower's obligations to pay land carry costs sooner; and

(f) allows for an arrangement by which the borrower may retain the right to manage the property and possibly a future right of repurchase.

A disadvantage to the borrower is that the forgiveness of debt will result in taxable income to the borrower in the absence of any applicable exception (such as where the borrower is bankrupt or insolvent, or in the case of a discharge of "qualified real property business indebtedness"). And, as discussed above, while the new economic stimulus law provides for the deferral of certain cancellation of federal indebtedness income over a five year period, that deferral does not apply to deeds-in-lieu of foreclosure.

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

The lender will be attracted to a deed-in-lieu of foreclosure since it allows the lender to avoid the time delay of a foreclosure and avoids the statutory redemption right of the borrower to buy back the property. It also makes it easier for the lender to retain the borrower's cooperation on obtaining property management issues and avoids the taint of foreclosure on the property. However, since, unlike foreclosure, a deed-in-lieu of foreclosure will not terminate subordinate mortgages and mechanics' liens claims, the lender will be loathe to enter into a deed-in-lieu if such interests exist. The lender must also contend with various other legal hurdles regarding "clogging the equity of redemption," the "merger" doctrine and fraudulent conveyance theories under bankruptcy laws that may scare the lender away from a deed-in-lieu of foreclosure, especially since the California non-judicial foreclosure laws are not that expensive or time-consuming an alternative.

File Bankruptcy

As described above, the borrower might instead file for bankruptcy, which will result in a temporary stay of any foreclosure proceedings against the property and may ultimately result in a bankruptcy court judgment for an amount far in excess of the original amount of the debt. Of course, that bankruptcy filing will affect the borrower's credit rating and ability to obtain financing or enter into other business transactions in the future.

"Short Sales" and Buying the Loan on a Discounted Basis

The borrower might negotiate to sell the real property and use the proceeds to pay off as much of the loan as possible and be released of the remaining loan balance upon the close of escrow. If the borrower cannot (or does not want to) sell the property, but can raise the requisite capital, it might instead buy its loan from the lender on a discounted basis. It is important for borrowers to know that before a lender tries to sell a loan to third parties, it will almost always approach the borrower first, under the theory that the borrower will always pay a higher price for the loan than

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.

the traditional institutional parties. As lenders feel increasing regulatory and investor pressure to rid themselves of subperforming and nonperforming assets, the pace of this process will probably increase significantly in 2009.

Squeeze Down

Although unusual for a variety of reasons (including lender liability concerns), the lender and borrower might agree to a deed-in-lieu of foreclosure to a new entity which is a joint venture of the lender and borrower. Pursuant to that joint venture, the old borrower is then required to meet certain performance obligations relating to the property (i.e., entitlements or leasing). Its initial economic interest in the property is diluted to the extent it fails to meet those obligations.

CONCLUSION

The next few years are likely to be a difficult time for borrowers of real estate-secured debt, but by being proactive, organized and focused on their objectives, borrowers should be able to successfully work out issues associated with that debt.

Published in the April 2009 issue of Pratt's Journal of Bankruptcy Law.
Copyright ALEXeSOLUTIONS, INC.