# Navigating Distressed Real Estate

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# How is This "Crisis" Different From That Faced in 2008?

- Economy – strong economic growth due to recovery from pandemic; federal reserve raised rates twice as fast in 2022-2023 as it did in the run up to 2008
- Household – people de-leveraged in the wake of the great recession, and income to debt ratios much higher in 2023 than in 2008; strong labor market
- Banks – better capital position and higher credit quality, but the fast pace of rate increases challenged liquidity
- Housing – under supply keeping prices stable/higher; high interest rates means lower rate of refinancing; lessons learned from 2008 in in terms of low supply of developed ground, high costs of lumber during onset of pandemic also affected supply
- CRE Debt – better underwriting and stronger fundamentals should mean lower losses; but still challenges with respect to refinancing risk in vulnerable sectors (older office, high end hotels, malls, assisted living/memory care)
- CRE Market – there are winners and losers depending upon location and type


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# What Are the Key Risk Drivers?

- **Property Type**
  - Apartment, office, retail, industrial, hotel
- **Location**
  - St. Louis, Chicago, Nashville, San Francisco
- **Property condition**
  - Class A/B, amenities, age
- **Tenants**
- **Chain/Flag**


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# What Are the Headwinds Creating Challenges in the Various Sectors of CRE?

- **Office sector**
  - Hybrid and remote work reducing demand; high interest rate environment, reduced availability of capital and increase operating costs
- **Hotel**
  - COVID-19, decline in business travel, interest rate environment, labor costs
- **Retail**
  - E-commerce, COVID-19, labor
- **Assisted living/memory care and senior living sectors**
  - COVID-19, interest rates, labor, inflation (food, supplies)


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# What is the Outlook for the CMBS Market in the Short Term (12 Months) and 3-5 Years?

- Short term likely more sponsors to be returning the keys to lenders in markets like Manhattan and San Francisco
- Strategic defaults necessary to renegotiate terms on bonds
- Office usage 50% of pre-pandemic levels
- CMBS will be the heart of distress for the next 3-5 years


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# What Can Banks Do Now to Get Ahead of the Curve?

- Loan and property updates
- Comp and valuation analysis
- Refinance analysis
- Concentration risk
- Market risk
- Tenant risk
- Borrower risk


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# What About Borrowers/Sponsors?
## *Is There Anything That They Can/Should be Doing Now?*

- **Refinance**
- **Sell**
- **Restructure**
- **Chapter 11 – Automatic Stay**
  - Use of Cash Collateral
  - DIP Financing
  - Executory Contracts/Franchise Agreements
  - Plan options for the Debtor- cram down to present valuations, re-amortize debt, extend maturity date, fix the interest rate


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# 1111(b) Election

- **1111(b) election by the Lender**
  - The right of a secured creditor that believes its collateral has been under-valued in the bankruptcy process to elect to be treated in a Chapter 11 plan as “fully secured” rather than partially secured and partially unsecured.


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# Example of 1111(b) election

- **The 1111(b) election affords real but limited protection against under-valuation. If the creditor makes the election, the plan must provide for payments to the creditor equal to at least the total amount of its claim. But the payments need only have a present value of at least the court-determined value of the creditor's collateral. Thus, although the electing creditor's claim is initially fully secured by the collateral, it is not entitled to interest on the entire amount of its claim—only on the portion of its claim that would be its secured claim absent the election.**

  - Secured creditor is owed a total of $12 million but the court values the creditor's collateral at only $8 million.
  - No election - The property is sold the day after the plan becomes effective, the creditor is entitled to receive only $8 million—payment of the court-determined value of the collateral. The creditor will receive payment on its $4 million unsecured claim only to the extent provided in the plan.
  - Election made- Creditor would be entitled to payment of the entire amount of its $12 million claim.


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# 1111(b) Election

- **Creditor makes the 1111(b) election and the property is sold one year after the effective date of the plan.**
  - Assume that the creditor is paid under the plan monthly interest only payments at the rate of 10 percent per annum. The creditor will receive $800,000 in interest payments over the one-year period.
  - The interest payments are, in effect, credited against what might be called the “excess principal” amount of the claim (i.e., the $4 million above the court’s $8 million valuation of the creditor’s collateral).
  - At the end of the one-year period, the “payoff” amount to the creditor in a sale (including a foreclosure sale) if the creditor made the 1111(b) election would be $11,200,000 ($12 million in principal minus $800,000 in payments). Absent the election, the payoff would be only $8 million, so the creditor would be better off for having made the election.


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# CMBS Loan Delinquencies

- **With CMBS Loans delinquency and special servicing rates spiking? ..and an increase in jingle mail" (i.e. Westfield handing the keys to Brookfield Center) what can be done to stop the tide, if anything?**
- **CMBS Servicers and CMBS Special Servicers approach to delinquencies vs. traditional banks?**


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# Policy Updates

- **The new policy statement updates, expands on and supersedes existing guidance from 2009, and reaffirms the message that prudent commercial real estate loan accommodations and workouts are often in the best interest of both financial institutions and borrowers.**
  - Adds a new discussion of short-term loan accommodations;
  - expands guidance regarding the evaluation and assessment of guarantors, to also encompass loan sponsors;
  - incorporates information about changes to accounting principles since 2009; and
  - updates and expands the illustrative examples of commercial real estate loan workouts.


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# Policy Updates

- The new policy statement provides important guidance to banks and other financial institutions, on matters of risk management, classification of loans, regulatory reporting and accounting considerations in the context of workouts and restructurings.


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# MAC Clauses

- Is it appropriate/advisable to utilize a “material adverse change” or “insecurity” clause in the loan documents to trigger the default and acceleration of a loan?
- Are there reasons that a lender might do that despite the risks involved?
- What about a non-monetary default (DCSR, FCC, repair and maintenance, etc)?


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# Avoiding Lender Liability

- **Draft protective loan documents**
  - Jury waivers
  - Objective financial and reporting covenants
  - Secure releases with each modification
  - Obtain consents to appointment of receiver
  - Secure consent to relief from stay in connection with forbearance agreements


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# Avoiding Lender Liability

- **Don't make promises without consulting the loan documents and your legal counsel.**
  - Distressed borrowers are looking for assurances from the bank. However, the bank should not make any commitments, oral or in writing, without first completing its due diligence and analyzing its options. Once the bank determines a course of action, any commitments to a loan modification, forbearance agreement, or anything else should come from the lender's counsel, or a document from the lender drafted by the bank's counsel.
  - Communicate clearly with the borrower.
  - Do not make a sudden move.


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# Avoiding Lender Liability

- **Maintain open lines of communication with the borrower and always act professional.**
  - The tone and vocabulary choice should reflect well on you and the bank. Do not send an email to the borrower or internally which you would regret being read by a judge or jury.
- **Document all discussions.**
  - Any time you talk with a borrower, make sure to document what was communicated in the conversation. This can be done by a simple email to the borrower summarizing what was discussed, and a reminder to the borrower that the bank reserves its rights and remedies, that oral agreements are not enforceable, etc.


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# Avoiding Lender Liability

- **Do not act to control the borrower's business or provide business advice**
  - You are not a consultant or financial advisor to the borrower
  - Do not give advice to your borrower as to how he/she could better run their business.
- **Keep a detailed loan file and carefully review your loan documents**

**These documents govern the relationship with the borrower.**

**Lenders must review them and make sure the bank complies with all of the obligations in the documents.**



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# Default vs Event of Default

- **What is a Default vs. an Event of Default?**
  - An “Event of Default” is an occurrence which constitutes a violation of one or more provisions set forth in the loan agreement that gives rise to certain rights or remedies of the Lender, including: (1) the right to terminate any obligation to make further advances under the loan agreement, (2) the right to charge interest at the (higher) default rate, and (3) the right to accelerate the loan and begin collection activities.
  - A “Default” is an event, which with the giving of notice or the passage of time, or both, would become an Event of Default under the loan agreements.


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# Event of Default

- When does an Event of Default arise?
- Most Event of Default provisions are self effecting (i.e. the Event of Default occurs when the underlying default occurs). For example, the nonpayment of any principal, interest or other indebtedness under the Note when due.
- Adding grace or cure periods, extends the date that a default (the failure to pay) becomes an Event of Default. For example the nonpayment of any principal, interest or other indebtedness under the Note within five (5) days after such payment is due.
- Some grace or cure periods require a written notice and cure period, further delaying the change of a default into an Event of Default.


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# Default Has Occurred

- **File review (loan documents, title policy, appraisals, UCC filings, correspondence)**
- **Lien searches**
- **Update Title Work**
- **Identify potential claims and documentation issues**
- **Confer with workout counsel**
  - A workout team is made up of not only competent, objective workout officers, but also counsel experienced in handling workouts.
  - A lender should always work with counsel who fully understands the issues and risks of litigation with a borrower, and has carefully reviewed the loan documents, before a default is declared.


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# Lender vs. Borrower Goals

- **What are the Lender's goals following default?**
  - Exit/Retain – current problem and cause; short term problem, collateral position and leverage
    - Reservation of Rights Letter
      - Notice to Borrower outlining defaults
      - Clear written notices and reservation of rights during work out process can minimize a borrower's ability to protract future litigation by preventing the assertion of equitable defenses.
      - May include information as to the effect of discussions.
      - Gives Lender an opportunity to further negotiate the terms of the loan and obtain additional protections or benefits should it choose not to accelerate.


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# Lender vs. Borrower Goals

- Default Letter
  - Gives or reinforces "exit" message and may exercise some rights and remedies (i.e. default interest, acceleration, set off). No matter what action is taken, all communications must be in writing, sent by a verifiable delivery method and (in most every circumstance) after review by counsel. Use the address dictated by the loan documentation and be sensitive to who will be receiving the letter (i.e. an assistant) and the impact it may have on the borrower's operations.
- Minimize/Defer – financial loss, adverse publicity, lender liability, impact on balance sheet

- **What are the Borrower's goals?**
  - Minimize financial loss, continue operation, preserve project, avoid reputational risk


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# Transfer Troubled Loans to Workout Officer

- **When should a distressed loan be transferred to a workout officer?**
  - Once a loan is distressed, a loan officer who at one time enjoyed a harmonious working relationship with the borrower may have mixed emotions that can cloud the officer's judgment in continuing to handle the matter.
  - Distressed loans should be handled by persons who specialize in handling troubled loans, and who can bring fresh perspective to the situation.


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# Pre- Negotiation Agreements

- **What is a Pre-Negotiation Agreement and why would you use one? Why not?**
  - Frames effect of discussions
  - May include full waiver and release to eliminate lender liability claims, procedural defects, compulsory counterclaims and other interference with remedies.
  - Upside – Limits claims from borrower in the future regarding oral statements
  - Downside – Can be heavily negotiated and a distraction from the discussion needed to address the underlying credit
  - Solution:
    - Unilateral letter to borrower setting forth the pre-negotiation terms.
    - May also provide information on new “special asset” contact at bank.
    - While not executed by the borrower, it does serve as notice.


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# Conditions for Negotiation whether Through Executed PNA or Unilateral PNA

- Without prejudice to rights
- No waiver of rights
- Not to be used as evidence
- Not admissible as evidence
- Not subject to discovery
- No agreement to forbear
- No individual points resolved until all points resolved
- Discussions may terminate at any time
- Acknowledgment of default, amount of debt, validity of loan documents and absence of any defenses.


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# Modification vs. Forbearance

- **Forbearance Agreement**
  - Agreement by Lender to refrain from enforcing certain of its rights for a limited period after a default or an Event of Default has occurred under the existing loan documents.
  - Goals of Forbearance vs. Modification
    - Obtain information or ascertain strategy going forward or both;
    - Preserve the Event of Default as a leverage point;
    - Confirm indebtedness and existence of liens;
    - Acknowledge existence of the Events of Default; and
    - Secure a release of any and claims.


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# Modification vs. Forbearance

- **Modification Agreement**
  - Can implement the exact terms of a forbearance agreement without preserving the existing Events of Default;
  - Most often used when the Event of Default is the passage of the maturity date;
  - May also be used to waive an Event of Default, and modify documents to avoid future Events of Default;
  - A properly drafted Modification Agreement which set a maturity date in the future while implementing the same required action steps by the borrower still allows the Lender to pursue all remedies at the end of the new extension period absent a new Event of Default.


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# Modification Options

- Extend maturity
- Change the interest rate
- Defer payments of principal
- Modify covenants related to DSCR or Loan to Value
- Enhance reporting requirements
- Resize the loan

- **How does an "A Note" / "B Note" restructure work for both the Borrower and the Bank?**
- **If a restructuring is not possible, what are options for Lender in terms of exit strategy?**


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# Advantages to Modification

- **Effective Modifications/Forbearance**
  - What do you want from the Borrower?
    - Payment stream
    - Additional collateral, lockbox, and/or guarantors
    - Borrower and guarantor waiver of claims
    - Consent to appoint receiver
    - Consent to relief from stay.


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# Restructuring Alternatives

- How does an "A Note" / "B Note" restructure work for both the Borrower and the Bank?
- If a restructuring is not possible, what are options for Lender in terms of exit strategy?


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# If a Restructuring is Not Possible, What Are the Exit Strategy Options for the Lender?

- Short refinance/discounted payoff
- Short Sale
- Note Sale
- Foreclosure/deed in lieu
- Receivership
- Conversion to other use
- Sale of property


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# C-PACE

- Commercial Property-Assessed Clean Energy (C-PACE) is a form of financing that allows property owners to borrow money for energy efficient, renewable energy and resiliency property improvements and make payments via a voluntary special assessment added to their property tax bill.


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# C-PACE

- C-PACE is long-term, fixed-rate, non-recourse, non-accelerating, can be prepaid at any time, and the loan can be transferred upon resale.
- C-PACE financing is supplemental to traditional senior financing, but depending on the asset and financing strategy, it can offer lower interest rates than mezzanine financing or preferred equity. The funds available can cover up to 100% of the cost of any improvements determined to be covered by the program (i.e. lighting upgrades, HVAC systems, building insulation, water conservation, roof replacement, solar, fire resiliency and EV charging stations).


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# Senior lenders and C-PACE loans

- The C-PACE  lender is in a first lien position created due to the C-PACE loan being securitized by a special assessment applied to the property tax bill, effectively taking first priority over the senior mortgage.
- In the event of a foreclosure sale, the only payment due to the C-PACE lender is any outstanding real estate taxes, not an acceleration of the full outstanding C-PACE balance. However, if the buyer of the REO is not willing to assume the C-PACE loan the accelerated C-PACE loan balance will have to be paid at closing of the REO Sale.
- If there is a receiver sale either the purchaser must assume the C-PACE loan or the C-PACE loan must be paid off at closing.
- There is little incentive for a discount from the C-PACE lender.
- In a distress situation the lender must analyze the C-PACE loan’s affect on the cash flow of the property.



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# Questions


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