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Breaking the Gridlock: Strategies for Managing Distressed Real Estate Issues

Despite indications that commercial real estate (CRE) prices may have hit bottom and that some market stability has returned, the relationship between borrowers and lenders remains tenuous at best and fractious at worst.

With more than $1.4 trillion in CRE loans set to mature over the next several years, many borrowers have little hope of refinancing due to the collapse of CRE prices following the worldwide economic crisis. This is expected to increase the volume of distressed CRE properties within financial institutions, since many borrowers are underwater and lenders are unable to exit their position.

Although the values of many commercial properties purchased in the past seven years have fallen below their purchase price and cash flows have dwindled, borrowers are still expected to uphold the original terms and conditions to which they agreed years earlier. Facing high vacancy rates due to struggling tenants and weak economic fundamentals, many borrowers are trying to renegotiate the terms on their distressed or maturing loans to explore their options and avoid losing control of their properties.

At the same time, many banks and other lending institutions are faced with a glut of nonperforming assets that comprise a much larger portion of their lending base than they had anticipated and that weigh heavily on balance sheets. Even as loans continue to mature or default, many lenders are reluctant to take definitive action against borrowers due to financial, operational, and administrative hurdles associated with owning and managing the property until it is sold.

Further contributing to the lenders' hesitancy was the hope that property valuations and operations would bounce back if they waited a little longer. However, with the realization that sufficient improvements could be years off and that litigation and foreclosure are expensive, borrowers and lenders are beginning to take a proactive approach to restructure or exit deals on mutually acceptable terms.

How far are lenders willing to go to avoid taking properties back? It appears to depend on the fundamentals of the asset and the relationship with its borrower. If the borrower has acted in good faith and the asset has the potential to maintain its value in the short to medium term, it bodes well for a renegotiation. As a result, some lenders may be willing to overlook covenant defaults as long as the loan can either pay some of the current interest due or does not require additional capital from the lender during the remaining term of the loan.

However, if the asset is not performing and the borrower is not being reasonable about recapitalizing or restructuring the loan terms, then the lender may look to assume ownership of the asset or sell the note.

The bottom line for lenders is that ownership of nonperforming real estate has a negative impact on their balance sheets and few institutions have the adequate infrastructure in place for owning and managing properties. Further, if the lender believes the borrower is less likely to repay the loan as a result of a default, the lender must increase its loan loss reserves. This action has a negative impact on its available capital and, therefore, its ability to make new loans.

As a result, it may ultimately be in the best interest of both the borrowers and lenders to recognize the "current" market value of the asset and to look for acceptable solutions to avoid further potential losses on the assets.

Strategies for Finding a Middle Ground

Finding a middle ground between borrowers and lenders on distressed assets can be a difficult task, even if both parties recognize there is a problem. Typically, stalemates occur from conflicting interests over the go-forward plans and how losses might be allocated.

In many cases, both sides can get bogged down in why things went awry with the loan rather than focusing on what needs to be done to maximize recovery. What oftentimes contributes to the finger pointing is including the original borrower and bank underwriting team in the negotiations, rather than independent third parties. This can lead to a situation where emotions are driving the resolution process rather than sound business judgment. Once both sides recognize the current reality and leave the history behind, they can begin a constructive dialogue.

In framing the discussion for both sides, borrowers and lenders need to have a good understanding of the motivations and goals of their counterparty in order to reach a middle ground. For instance, what flexibility, from a financial and regulatory standpoint, does the lender have to restructure the terms, or does the lender need to exit the credit? Is the borrower a valued client, and what is the relationship with the lender? Is this a core asset of the borrower, and is there liquidity available to recapitalize or reduce the lender's exposure? Questions like these will, in most cases, highlight the available courses of action and ultimately facilitate the negotiations between the parties.

In addition, finding the middle ground between borrowers and lenders should involve careful consideration of the tax implications to both parties.

A loan workout that appears to be ideal may wind up being less so when the tax implications are factored into the equation. For example, a loan modification, restructuring, or foreclosure may carry with it a significant tax liability for a borrower that is already struggling financially. As a result, the failure to carry out proper tax planning may end up defeating the purposes of the workout and may lead to greater problems for the borrower.

There are various ways to reduce, defer, or exclude the impact of income related to the forgiveness of indebtedness. Achieving the most advantageous result from a tax perspective, while accomplishing other business goals, is an objective that underscores the need for knowledgeable third-party advice.

The following are some of the amicable strategies lenders and borrowers have implemented on defaulted real estate loans.

Restructuring the Loan

Restructuring the original loan terms in a manner that eliminates the existing default and provides the borrower the flexibility needed to fulfill most, if not all, of its loan obligations can be a win for both sides. While this would appear to be the logical outcome for most distressed loans, several factors, such as the operating performance of the asset and the borrower's or the lender's stability, influence the outcome. If the loan can be restructured in a feasible manner for both sides, this is typically the first approach in the workout process.

There is no one-size-fits-all approach to restructuring a loan, and resolutions tend to be driven by asset and loan-specific issues, with outcomes ranging from a simple principal write-down to complex recapitalization strategies. For borrowers, the implications of a loan restructuring are critical as it provides them with the ability to maintain control of the asset and the time needed to potentially turn it around. For lenders, the implications include the opportunity to transform a potential nonperforming loan into a performing loan and to maintain the relationship with the borrower. For both sides, a restructured loan eliminates the potential of a foreclosure and may help ease tensions between both parties.

The following represent some of the creative restructuring strategies that borrowers and lenders are currently employing:

• **A&B Note Structure.** The lender creates two tiers of debt—an A note (the existing loan that has been reworked with a lower principal amount) and a B note (a new loan for part or all of the principal reduction agreed to on the A note). The B note will usually be subordinate to any additional equity investment, but it ensures the lender can recover some of the forgiven principal in the event the property value improves over time.

• **"Hope" Note or Equity Participation.** The lender reduces principal or changes the terms of the existing note in exchange for a piece of upside value, if any, at sale. The potential for the lender to recover some or all of the difference between the original note balance and the new note balance is dependent on the "hope" the property value will improve with time. Both the hope note and equity participation reduce the secured debt and required payments on the properties.

• **Alternative Collateral Pledges.** These are pledges by the borrower to shore up equity deficiencies in a property. These pledges are usually negotiated by borrowers that are short of cash in exchange for a reduction in principal.

When a borrower negotiates a reduction in the principal amount of the debt from a lender, the borrower may recognize taxable cancellation of debt (COD) income. Also, if the lender and borrower otherwise modify the terms of the debt, the borrower may trigger a "significant modification," [1] which could also result in taxable COD income. Further, if the modified loan is subordinated to equity or the lender receives equity participation rights, the lender may be viewed as acquiring a partnership interest for tax purposes. Such an acquisition could also result in the borrower recognizing COD income.

Triggering COD income, however, will not necessarily mean that tax must be paid immediately. There are certain exceptions to the recognition of COD income available to taxpayers aimed at providing them with relief after experiencing financial difficulties. COD income exclusions may apply in cases of bankruptcy, insolvency, certain farm loans, and qualified real property business indebtedness. Note that the amount excluded from COD income under any one of these exceptions is applied to reduce certain tax attributes of the taxpayer.

In addition, certain modifications of debt between the original buyer and seller of the property are treated as purchase price adjustments and do not give rise to COD income.

In addition to the ability to exclude COD income, a deferral option is available for "reacquisitions" of applicable debt instruments occurring in 2009 or 2010. This deferral option applies to most debt forgiveness transactions that result in COD income, but has limitations on its use. If this deferral option is applicable and is elected, recognition of COD income generally is deferred until 2014 and is then recognized over the succeeding five-year period.

Joint Venture/New Equity

Another strategy for borrowers facing difficulties is to bring new equity into the deal from the existing partners or by introducing new partners to the deal. These deals are typically orchestrated to enable the borrower to maintain control of operations and demonstrate the property's long-term viability.

The new partner's additional equity will likely be negotiated with the lender and may include some forgiveness of principal in exchange for recapitalizing the loan and reducing the amount outstanding. The new equity will often have priority over the existing equity and may provide accelerated repayment at specific operating milestones for the asset. The benefit to the lender is a reduction in the capital at risk and a potentially stronger borrower on a performing loan.

As is the case for the "restructuring the loan" strategy, if, in connection with the admission of a new partner, a borrower negotiates for a reduction in the principal amount of the debt or otherwise significantly modifies the terms of the debt, the borrower could recognize COD income. As also previously discussed, in certain cases, COD income can be excluded or deferred.

Additionally, the admission of a new partner could raise several other tax considerations. Notably, the admission of a new partner will likely cause the partners to alter their economic arrangement on a going-forward basis. This new economic arrangement will need to be reflected in the partnership agreement. Hence, the partners should be careful not to make changes to the partnership agreement that could trigger unanticipated, adverse tax consequences.

For example, if, as part of the negotiations for the new contribution to the partnership, the lender has agreed to reduce the amount of the debt following the contribution to the partnership, certain distortions could occur with respect to the manner in which the new partners have agreed to share in partnership operations on a going-forward basis. Such potential distortions should be addressed as part of the workout.

The admission of a new partner could also cause shifts in the allocation of the partnership's liabilities for tax purposes, which could result in gain to the existing partners. That is, a reduction in a partner's share of a partnership's liabilities is treated as a deemed distribution of money to that partner. If the deemed distribution exceeds the partner's basis in its partnership interest, the partner will recognize gain.

A reduction in an existing partner's share of the partnership's liabilities could result from the initial admission of the new partner for an interest in the partnership, from the reduction of the liability by the lender, or from the paydown of the liability with the proceeds received from the new partner.

Discounted Payoff Offer

A discounted payoff offer, or DPO, is another common loan resolution strategy currently being implemented. A DPO is a proposal from the borrower or another friendly party to acquire the existing debt from the lender at a discount to face value. This arrangement allows the borrower to reconfigure the debt on the property to a manageable level, while providing the lender an exit strategy at a price they can live with. The source of funds may come from the borrower or a new outside investor.

For existing lenders, given the decline in real estate values and volume of defaults, the prospect of an immediate cash payment and an exit from the credit after a period of nonpayment may be the inducement to accept the arrangement.

As is the case for the “restructuring the loan” and “joint venture” strategies, if, in connection with a DPO, a borrower negotiates for a reduction in the principal amount of the debt or otherwise significantly modifies the terms of the debt, the borrower could recognize COD income. This consideration is equally relevant to a DPO in which an outside investor steps in and acquires all or a portion of the debt from the lender and modifies the terms of the debt.

Moreover, in certain cases, if the outside investor acquiring the debt is considered a related party to the borrower, or subsequent to the acquisition becomes a related party, the borrower could also recognize COD income even if the terms of the debt are not changed. In certain cases, interest deductions on the continuing debt between related parties could be disallowed, while interest income must still be recognized.

Additionally, if the borrower is a partnership, the admission of a new partner to provide needed capital in connection with a DPO may imply other tax considerations, as described under the “joint venture” strategy. Finally, if the outside investor acquires the debt and subsequently contributes the debt to the partnership in exchange for a partnership interest, the partnership could recognize COD income if the value of the partnership interest issued is less than the adjusted issue price of the debt.

When All Else Fails

When all else fails, and the lender/borrower relationship becomes irreconcilable, the lender may exercise its right to take control or ownership of the property. Options that lenders can take include the following.

Foreclosure Action

Foreclosure is the lender's initial step toward taking control and potentially owning property related to a defaulted loan. Once a borrower falls behind on payments and is unable to cure a default on the loan, the lender (in most jurisdictions) will file a notice of default, or NOD. The NOD protects the lender's interest in the property by setting the procedural framework for the lender to ultimately force a sale of the property via a foreclosure auction if all other restructuring and sale attempts fail. Once the NOD goes unresolved, the lender has the right to request the court to allow the foreclosure to proceed and to schedule a sale date.

While protecting their interests and moving forward with foreclosure proceedings would appear to be a logical outcome for most unresolved loans, it is usually the last resort of lenders as it leaves them at odds with the borrower and may result in the lender owning and managing the asset.

Receivership

In the event of an uncured default and the potential for further diminution of collateral value, the lender can petition the court to install a receiver. This "court-appointed" action is usually taken in conjunction with the lender's initiation of foreclosure proceedings, and by making the case the borrower is not meeting its obligations to preserve the asset value, the lender can get an interested party to control operations.

Receivership typically occurs once the parties have reached an impasse and the lender wants to assume control of the property without taking ownership. Additionally, although the receiver does not work for the lender, the receiver is incented to maximize asset value for a fee. Therefore, the hope is that this stage in the foreclosure process will provide for a stabilization and sale of the asset rather than the lender taking back the property.

Foreclosure and receivership laws vary by state; as a result, having an adviser who understands the rules in each jurisdiction is helpful.

From a tax perspective, lenders should carefully determine if the terms of the receivership amount to the transfer of tax ownership. Generally, tax ownership of property is determined based on who has the benefits and burdens of ownership with respect to the property. Alternatively, the terms of the receivership could unintentionally amount to a partnership between the lender and the borrower. In determining the existence of a partnership, courts have used a list of factors focusing on the intent of the parties to form a partnership and to share in the resulting profits.

Deed-in-Lieu

A deed-in-lieu is a cooperative way for both parties to transfer ownership of the property back to the lender "in lieu" of a final foreclosure auction.

For borrowers who have no hope of recovering their equity due to low values, a deed-in-lieu avoids having a record of a foreclosure sale and may help to preserve the relationship with the lender; however, the default will still show up on credit reports. An additional incentive for both borrower and lender is that this is a cooperative solution when all restructuring attempts have failed.

This arrangement is also often more cost-effective and faster than foreclosure proceedings. For instance, there are several states where foreclosure proceedings can take more than 12 months due to the procedural steps and court backlogs; a deed-in-lieu, however, can typically be executed in a matter of weeks.

For a borrower, agreeing to relinquish its ownership may help maintain a relationship with the lender if there are other outstanding loans or business. Simply put, this is a civil way to resolve an intractable decision that is becoming increasingly common due to the volume of underwater loans and the limited prospect for meaningful appreciation in the near future.

For tax purposes, a deed in lieu of foreclosure generally is treated as a taxable sale of the property and may result in COD income and/or gain or loss being recognized by the borrower. The measurement of the gain or loss and the prospect that COD income could also be incurred will depend on whether the debt being forgiven is recourse or nonrecourse debt for this purpose.

If the debt is nonrecourse, the debtor generally will recognize gain or loss equal to the difference between the amount of the canceled debt and the adjusted tax basis of the property. If the debt is recourse, the gain or loss is calculated on the difference between the fair market value of the property and its adjusted tax basis. However, in this case, COD income may arise in an amount equal to the difference between the amount of the canceled debt and the fair market value of the property.

The primary difference between recourse and nonrecourse debt involves what a lender can seize if a borrower fails to repay a loan. In both cases, the lender can take the collateral used to secure the loan, which often will be the property purchased with the loan proceeds.

Generally, in the case of a nonrecourse loan, the lender may upon default take the property that secures the loan, but the lender cannot recover additional amounts from the borrower, even if the collateral does not cover the full default amount. With a recourse loan, the lender can pursue the borrower's other assets after seizing the property to satisfy the debt.

From the borrower's perspective, a nonrecourse loan is obviously preferable; however, depending on the project and borrower, such loans may not be available.

In any event, nonrecourse loans often come with higher interest rates and have certain credit requirements and restrictions. Therefore, in many cases, a loan is structured as a recourse debt, which can mean COD income when the lender takes the underlying property.

Conclusion

The current economic crisis and downturn in real estate values have resulted in many borrowers and lenders facing the prospect of renegotiating the terms of deals set to mature in the next three to five years. Since the main goals for borrowers are to maintain control of assets and to protect their investments, and the main goals for lenders are to ensure a portfolio of performing loans and to protect their principal, there are often ways to find a reasonable middle ground in even the most complex situations.

Still, there is no “cookie-cutter” approach to resolve defaulted loans since each asset/loan has a variety of unique characteristics to address.

As a first step, borrowers and lenders should regularly and proactively communicate to identify potential issues well before they become potential impasses. Once identified, engaging an impartial financial and tax adviser with experience evaluating and negotiating all available options can be invaluable to protecting each party's interests. When impasses exist between borrowers and lenders, amicable solutions usually involve compromise and objective consideration of all available options. A qualified and impartial third-party financial and tax adviser can be invaluable in breaking logjams and in enhancing the prospect of both sides realizing their mutual goal—maximizing asset value.

Note Sale

If the lender cannot reach a deal with the borrower, but does not want to foreclose or have the situation devolve into litigation, the lender may decide to opt out of the deal entirely via a note sale.

In a note sale, the original lender puts the current note up for sale directly to another institution or hires a broker to find a buyer prior to foreclosing on the asset. Note sales are typically on nonperforming or defaulted loans where the parties are at an impasse. Similar to a discounted payoff offer, a note sale

allows the lender to exit the credit/position at a discount and transfer the rights and risks of the loan to a new owner who may want to work with the borrower or foreclose.

Note sales raise tax issues similar to those involved in DPOs when an outside investor acquires all or a portion of the debt from the original lender.

REO (Real Estate Owned)

Once a lender assumes ownership of an asset, it faces the financial and operational risk of holding a noncore asset for an indeterminate period; since most lenders are not in the business of direct ownership of real estate, the value of these properties must be reserved against the assets held in a transitory position on the balance sheet.

Given the glut of underwater loans set to mature over the next few years, lenders should develop proactive processes—and involve the proper resources—to maximize the assets' values. In addition to estimating the right timing for disposition, the lender must also determine how it will manage the property on a day-to-day basis, which may include capital expenditures, leasing, vendor selection, and a variety of tactical decisions that will impact the property's ultimate value.

Some of the key issues lenders should consider with REO assets are:

- capital locked up in assets with uncertain exit timing,
- shortage of resources and infrastructure to manage the asset on a daily basis,
- how to manage the disposition process, and
- lack of long-term real estate expertise needed to maximize total value.

[1] For tax purposes, a sale or exchange takes place if a debt is subject to a “significant modification” under Section 1001 of the Internal Revenue Code Section 1001 of the Internal Revenue Code. If the modification is significant, the debt is treated as retired, and the resulting obligation is treated as a new debt. The sale or exchange may trigger a taxable gain or loss for the lender and cancellation of indebtedness income for the borrower.