

Recapitalize or Restructure Real Estate Assets? Advice for Borrowers

By Mark S. Bressler

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Billions of dollars of commercial real estate (CRE) loans will be maturing over the next few years. The substantial decline in CRE asset value has eroded borrowers' equity in these assets. As a result, lenders are pushing Borrowers to recapitalize their CRE properties to bring new equity to the property. Many initial investors will see their equity stake substantially diluted as a result of this recapitalization.

Restructure of debt is a sensible objective for borrowers who have limited access to capital debt and equity markets. But lenders have not been willing to discount mortgage debt, even when such debt far exceeds asset value.

Banks have not been entering into the type of loan workouts commonly seen during the banking crisis of the 1990's. Instead, banks have been pushing out maturity dates (commonly known as the "extend and pretend" strategy) or waiving financial covenants in the hope that an economic recovery will restore lost asset value, and facilitate refinancing of CRE loans. There are several reasons why banks are reluctant to restructure debt:

1. New FASB accounting rules no longer require a bank to assign a value to an asset based on the *current* market value for the asset. As a result, loans that may have been non-performing in the 1990's are being carried on the banks' books as assets, rather than posted as losses.
2. Following the closure of insolvent banks, FDIC typically enter into "loss-share" agreements with assuming banks who agree to liquidate failed bank assets on a risk sharing basis with FDIC. But these loss-share agreements have led to conservative collection practices, rather than efforts to restructure debt.
3. Many special servicers of distressed securitized mortgage (CMBS) loans have fiduciary responsibilities to multiple classes or "tranches" of bondholders. Frequently, the owner of the junior "B" tranche is designated as the special servicer for distressed assets, to assure optimal recovery for Tranche B bondholders. But rather than pursue a restructure that could create a performing asset, the special servicer may prefer to hold the CRE asset, with the hope that the economy will recover, to placate bondholders who do not want to see any write-down of asset value.

4. Special servicers receive monthly fees for servicing distressed assets and may not have appropriate incentives to restructure CRE debt. If recovery of Tranche B debt is remote, the special servicers may rule out a debt restructure.
5. Low interest rates have minimized the “carrying cost” for keeping these “bad loans” on the Bank’s ledger, reducing the urgency for Banks to restructure the bad debt.

Federal banking policies and FASB accounting rules will continue to hinder loan workouts and diminish borrower access to CRE debt and equity markets. The banking market will become more receptive to loan restructuring if interest rates rise. Higher interest rates will increase the banks’ cost of carrying non-performing loans, and will create urgency for banks to restructure their CRE assets and write off uncollectable debt. At the same time, however, if higher interest rates are not accompanied by economic and employment growth, banks will fail and developers will go bankrupt. If the U.S. economy remains weak, the government will likely keep interest rates low as long as possible.

Borrowers seeking to restructure debt may find solace in the pending loan portfolio sale sought by Anglo Irish Bank. The beleaguered nationalized Irish bank has put its entire \$10 billion U.S.-based CRE loan portfolio for sale. The sale has attracted much interest from U.S. investment banks and hedge funds who expect to acquire the portfolio at a significant discount off book value. The sale of this massive portfolio of U.S. CRE assets will likely encourage other foreign banks to unload their U.S. holdings, and will hopefully re-set CRE market values at more realistic levels. Ultimately, this sell-off of U.S. CRE debt will induce the broader U.S. banking market to restructure or liquidate its non-performing assets, as well.

Given the uncertainties facing the U.S. economy, borrowers seeking to restructure distressed CRE mortgage debt must consult knowledgeable legal, financial and wealth management advisors who understand the motivations, objectives and limitations of banks and loan servicers, and can advise borrowers how to best position their assets for recovery, and how to best protect their remaining assets from the long reach of creditors.

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