5 Strategies For Restructuring Underperforming CRE Loans

By **Dominic De Simone, Brian Schulman and Matthew Summers** (July 7, 2023)

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The headwinds facing the commercial real estate industry by now are well documented. The office market has been hit hardest, but other sectors, including retail, are taking their lumps as well. These challenges stem from a coalescence of market factors: inflation, higher interest rates, work-from-home preferences, constrained capital, and other domestic and global economic pressures.

Among the headwinds, interest rate hikes by the Federal Reserve over the past year have boosted borrowing costs, crimping the ability of many projects to refinance maturing loans.

CRE loan delinquency rates have increased sharply. Office properties are especially vulnerable because they face additional challenges: declining occupancy rates and tenant demand, increased operating costs, and the substantial expense of reletting space or repositioning some or all of the building to an alternative use.

Distressed Loans Expected to Proliferate

Many in the industry expect conditions to deteriorate further before they get better. The present business climate — and the outlook going forward — are spurring industry members across the country to restructure CRE loans and projects through a variety of approaches.

Strategies for refinancing or restructuring are largely property-specific: Office buildings present nuanced considerations much different than malls.

Based on a property's characteristics, market participants may consider numerous options to restructure or otherwise resolve underperforming properties and related senior and subordinate loans.

Below, we outline five general strategies that may help successfully resolve challenged investments or underperforming loans. Of course, any particular strategy may not be feasible or desirable in every case, and the specific legal, business, regulatory, tax and market considerations will vary on a case-by-case basis.

1. Condominium and Land Use Strategies

Changing the use or ownership structure of a property can make it more profitable or attractive to buyers or tenants, and thereby increase the demand for, and value of, a property.

Examples of a use change include creating a health care campus at an underperforming mall property or converting all or part of an office building to residential units, retail space, coworking spaces or hospitality uses, or some combination of these or other uses.

Reimagining the use of existing structures can often be cheaper, faster, and more sustainable than new construction, and can also preserve the historic character of a neighborhood or commercial district.

For projects that have not been constructed yet, a change in entitlements can provide the path to a modified use in order to adjust to changing market and business conditions. Even for existing projects, relevant zoning may allow for a taller or expanded building, leading to further value creation.

A condominium structure can facilitate a change in use for parts of the property in order to achieve the highest and best use of the property as a whole while maximizing a property's cash flow and overall value.

Such an approach may help increase the possibility of a sale or refinancing of the property, in whole or in part, and boost the resulting proceeds from such transactions. Such changes in use and ownership may require approval from government entities, such as zoning and planning boards or state agencies.

2. Project Phasing or Repositioning

Modifying the scope, timeline, design or use of a real estate project can improve feasibility and profitability.

Project phasing — dividing a large project into smaller, more manageable stages that can be completed sequentially or concurrently — can help reduce upfront costs, risks and uncertainties, and allow for more flexibility and responsiveness to market demand and feedback.

For example, a mixed-use project could be phased to build the residential component first, followed by the retail and office components later when rental conditions are more favorable in those sectors.

Changing the original concept, design or targeted tenant base of a project can also better align it with the capital available in the market. For instance, positioning a project for a medical office or lab use might help attract capital more readily.

3. Rescue Debt and Equity Capital

Rescue capital can help resolve distressed commercial real estate investments by filling the equity gap and allowing the existing owners to retain some ownership and control of their properties while avoiding default, foreclosure or bankruptcy.

Rescue debt and equity capital can take various forms, such as preferred equity, mezzanine debt, joint venture capital, or an equity kicker, where a portion of the sale proceeds are exchanged for loan modifications.

These forms of capital are typically structured as hybrid instruments that have both debt-like and equity-like features, such as fixed or variable returns, priority over common equity, conversion or redemption rights, and participation in upside potential.

Rescue debt and equity capital transactions can be beneficial for both existing owners and new investors. Existing owners can avoid losing their properties or overly diluting their equity, while new investors can potentially earn higher returns and more exposure to

potentially valuable assets.

However, rescue capital may also come with challenges, such as higher interest rates, stricter covenants or dilution of ownership. Existing senior debt holders may also benefit from a rescue capital transaction, to the extent it helps minimize losses on an existing loan or provides for potential upside participation upon a future sale or refinancing of the property.

4. Bankruptcy or Reorganization

Depending on the specific circumstances of the property, bankruptcy is sometimes a viable option to achieve a borrower's business goals. Even lenders can sometimes benefit from a sale of real property free and clear under Section 363(f) of the Bankruptcy Code or the exemption of sales under a confirmed plan from recordation and transfer taxes under Section 1146(a) of the code.

There are significant limitations placed on single-asset real estate bankruptcy cases in which the debtor's sole asset consists of real property and rent or revenue derived from it.

These limitations include a special provision applicable only to single-asset real estate cases, providing for mandatory relief from the automatic stay unless the debtor has filed a viable plan of reorganization or commenced making interest payments at the contract rate within 90 days of the date on which the bankruptcy was commenced.

Further, secured lenders are generally permitted to credit bid up to the full amount of their debt under Section 363(k) of the Bankruptcy Code and may make an election under Section 1111(b) of the code to have their claim treated as being fully secured, thereby limiting the benefit of the cram-down provisions of the code. A bankruptcy filing can also trigger liability of guarantors.

Notwithstanding the limitations that make single-asset real estate bankruptcy cases difficult for debtors to successfully navigate, the commencement of a bankruptcy case can buy time to negotiate with creditors, provide an orderly process for selling real property free and clear, and provide an opportunity for a plan that recapitalizes the debtor or reduces the amount of debt secured by the property.

5. Enforcement Actions and Guarantor Claims

Occasionally, a borrower or sponsor is resistant to collaborative efforts to resolve a distressed situation. In those instances, the lender may benefit from a more aggressive enforcement strategy, either as a tool for removing the borrower from control over the property and related cash, or for expediting and maximizing realization on the distressed loan.

Foreclosure and receivership actions can reduce financial exposure to nonperforming assets and deter additional defaults by allowing the lender to take control over the collateral and to recover, sell, or otherwise dispose of the collateral to help satisfy the debt.

Likewise, claims can be brought against guarantors who have personally guaranteed the repayment of the borrower's debt in whole or in part. Guarantors are typically individuals or entities with a direct or indirect interest in the borrower or the property, such as owners, sponsors, managers or affiliates.

Guarantor claims — or even the threat of a guarantor claim — can encourage the borrower's cooperation in dealing with the resolution of the troubled asset. And if all else fails, guarantor claims may provide alternative sources of repayment in the event of a post-foreclosure deficiency.

Enforcement actions — and guarantor claims in particular — may provoke the borrower or guarantor to assert various defenses and challenges, including legal objections to prevent foreclosure actions or receiverships, counterclaims against the lender, and bankruptcy filings. A well-prepared lender will account for these potential reactions prior to commencing any enforcement action.

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