

# Acquisition of Distressed Commercial Real Estate Debt

by Paul Griesmer CRE, FRICS, Harvey Berenson, and Philip L. Brady

## Background

This article addresses key considerations that apply to the acquisition and resolution of distressed commercial real estate debt. This article is based on the experience of the authors dealing with troubled real estate loan restructurings, problem loan resolutions, and distressed loan purchases and dispositions.

## Introduction

For the next several years, the commercial real estate mortgage market faces record levels of maturities. As shown in Figure 1, the annual amount of commercial mortgage loan maturities has risen steadily during the last decade from \$50 to \$100 billion in 2000 through 2003 to \$200 to \$250 billion in 2008 and 2009. Maturities are estimated to exceed \$250 billion per year from 2010 through 2015 and are not forecast to decline below \$200 billion per year until 2018. The level and extent of commercial mortgage maturities far exceed the level of maturities during the last major real estate downturn of the early 1990's.

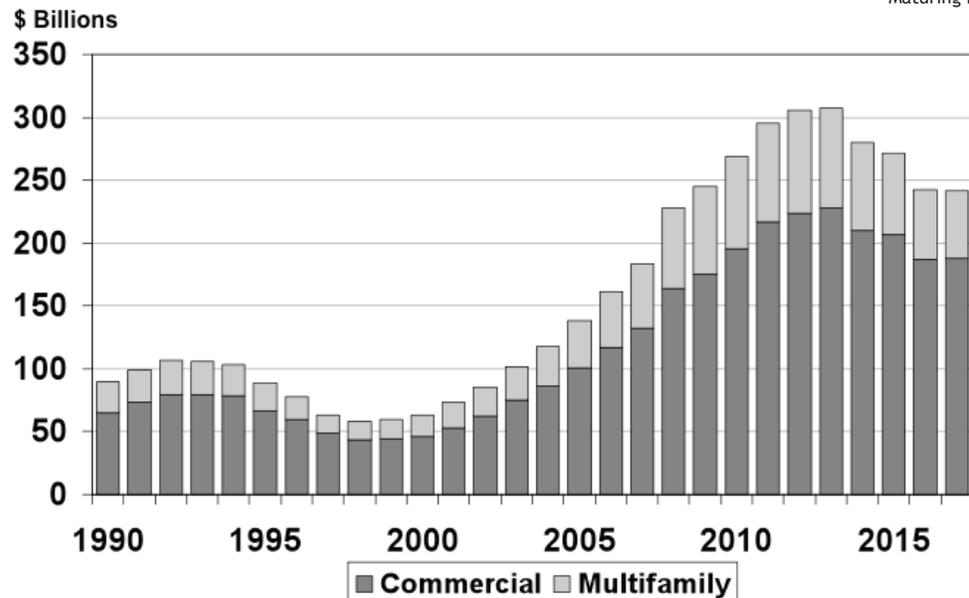
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figure 1

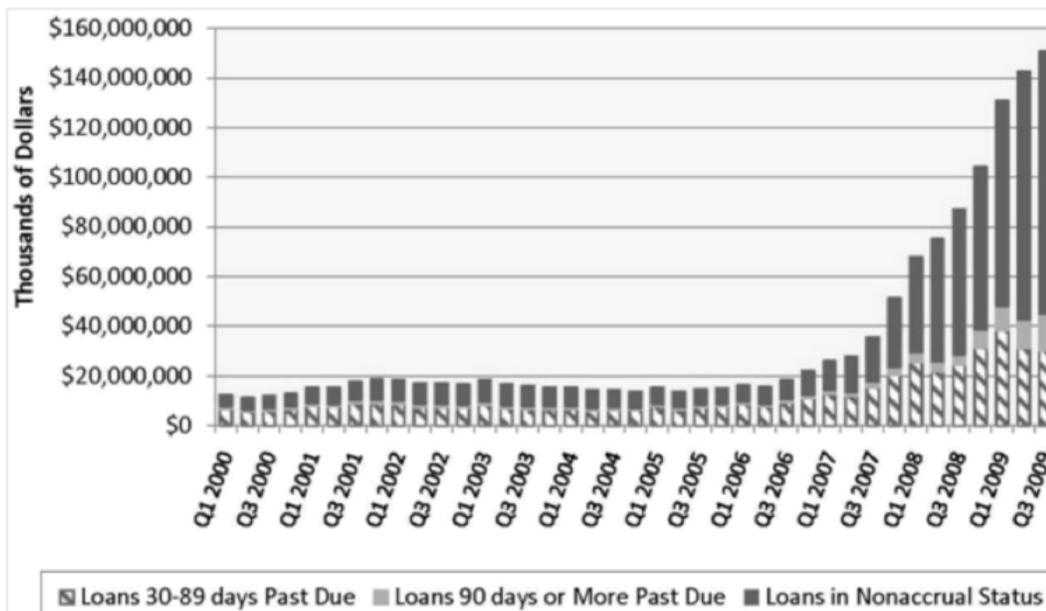
Commercial and Multifamily Mortgage Maturities Loans Maturing by Year



Sources: Federal Reserve, Foresight Analytics

Recent data indicates a significant increase in non-performing commercial real estate loans. As show in Figure 2, the amount of loans delinquent, past due, or non-performing in the U.S. banking system has risen sharply since 2008.

figure 2



Source: Congressional Oversight Panel February 2010

The continued economic recession combined with declines in rental rates, declines in occupancy levels, other deteriorating property fundamentals and increases in capitalization rates have caused declining property values. In the context of record levels of outstanding commercial mortgage debt, these factors place considerable stress on the ability of borrowers to service debt and to refinance scheduled maturities. While some loans might be refinanced or extended, many of these maturing loans will eventually result in other resolution strategies including workouts/restructurings, bankruptcies, discounted payoffs, or foreclosures. Distressed loans can be defined as loans that will follow one or more of these resolution paths. The sale and corresponding acquisition of distressed debt anticipates many of the considerations in these loan resolution strategies. Note sales do not resolve underlying distress at either the loan or property level but transfer the tasks and strategies of resolution from a selling note holder to a new, acquiring note holder. The acquiring note holder then executes on any number or combination of loan resolution strategies. Both sellers and buyers typically reflect the most likely and advantageous loan resolution strategy in their pricing. Due diligence efforts focus on developing assumptions and underwriting analyses for the properties and the loans that are appropriate for the facts and circumstances of these loans. Sellers use these techniques to determine which, if any, loans to sell and to establish an acceptable price. Buyers use these techniques to determine which loans to bid and what to offer. When pools of loans are involved, buyers and sellers use similar information to configure pools, determine specific assets on which to conduct diligence and develop pricing on either individual loans or on like kind loans using statistical sampling techniques and models.

This article focuses on the acquisition of distressed notes and mortgages on real estate at the individual loan level and discusses the manner in which various post acquisition loan resolution strategies effect the due diligence and pricing in those acquisitions. For the purposes of this article, distressed commercial real estate debt is broadly defined to include both loans secured directly by mortgages on real property and loans secured by LLC, partnership or stock interest in entities whose assets consist primarily or exclusively of real property. Interests in collateralized mortgage backed securities, collateralized debt obligations, and similar structures are not covered in this article.

This article addresses the key factors in pricing of distressed debt, including loan

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resolution strategies, types of loan buyers, effective underwriting and due diligence approaches, borrower motivations, foreclosure vs. loan modification, and tax considerations to both borrowers and note buyers. Because specific situations are complex, readers should consult with their own advisors who are experienced in distressed debt resolution when doing transactions.

## Fundamental Causes of Distressed Real Estate Loans

A key consideration in any distressed debt transaction is identifying the cause of the distress. These fundamental causes are reflected in loan resolution scenarios. On the surface, the current and looming distress in the commercial real estate mortgage market has many similarities to the distressed debt situation existing in the early 1990's especially in the increased number of distressed loans. However, while similarities exist, fundamental differences remain. In the early 1990's, many distressed loans involved acquisition and development whole loans with delayed lease-up and lower than expected rents at the property collateral level. Cash flow was often inadequate to cover debt service. Bank regulators aggressively forced write downs and took over troubled financial institutions. Fundamentally, this previous cycle involved a crisis of overdevelopment and lack of lease-up.

The current market is considerably more complex. In addition to troubled acquisition and development loans, the current cycle includes loans secured by previously stabilized and cash flowing collateral which is now worth less than the outstanding loan amount. Many loans in the current cycle are highly structured with debt stacks that are multi-layered and/or participated. The current market is further characterized by a decline in the value of in-place cash flow, declines in the cash flow itself, over leverage, and low contract interest rates on existing debt. The current cycle also includes a crisis of actual and pending loan maturity and refinancing gaps based on changes in property value, more stringent new loan underwriting criteria, and increases in interest rates and amortization requirements. More stringent loan underwriting has resulted in increased debt service coverage ratios and lower loan-to-value ratios for new loans, all negatively impacting refinancing amounts. Many lenders are extending and obtaining modest pay downs, if and while they can, to minimize or delay losses. Extensions alone do not resolve the underlying distress but defer the resolution to a later, and, ideally, better time and circumstance. Other lenders are working out troubled loans, negotiating discounted payoffs, or foreclosing. Without sufficient pay down or amortization, extensions merely defer the maturity to another day.

In the previous cycle of the late 1980's and early 1990's, the Resolution Trust Corporation (RTC) bundled and sold loan portfolios of failed savings and loans in bulk sale transactions that offered high yield returns to buyers. As subsequent regulatory pressure on other bank lending institutions forced write-downs and banks faced expensive loan resolution costs and competitive pressure, similar loan sales were used significantly to clear the balance sheets of surviving depository institutions. Whether such bulk disposition activity will be part of the current cycle remains to be seen.

As market demand fundamentals and rents decline, and funds are needed for capital and tenant improvements, the current difficulties could grow to include not only problems with overvaluation and over leverage but also decreases in collateral level cash flow for well-occupied properties. As interest rates rise or borrowers lose their ability to carry or contribute to projects, further extensions could become impractical. Rises in interest rates combined with increased regulatory or competitive pressure could make loan dispositions more attractive for existing lenders. The February 2010 Congressional Oversight Panel report on Commercial Real Estate Losses and the Risk to Financial Stability indicates a number of regional and community banks face significant commercial real estate loan exposure. The

report cautions that “over the next few years, a wave of commercial real estate loan failures could threaten America’s already-weakened financial system. The Congressional Oversight Panel is deeply concerned that commercial loan losses could jeopardize the stability of many banks, particularly the nation’s mid-size and smaller banks, and that as the damage spreads beyond individual banks that it will contribute to prolonged weakness throughout the economy.”<sup>1</sup>

Whether such trends will create distressed loan sale dynamics similar to the early 1990’s remains to be seen. Some signs about the role of distressed loan sales are already appearing with the FDIC’s sales of loans from seized banks and through online auctions of distressed debt. The FDIC’s P/PIP program represents a different approach from the RTC sales of the early 1990’s. Whether the P/PIP program will be superior to the RTC bulk sale approach also remains to be seen. Regardless of the similarities and differences between the current and previous cycles, distressed loan sales are likely to play a role. Further, the fundamentals of disposition and acquisition of distressed debt at the individual loan level are the same without regard to a particular cycle. Those fundamentals begin with consideration of pricing and loan resolution strategies.

## Pricing

Pricing of distressed debt is driven primarily by loan resolution or exit strategies, the terms of the loan, underlying collateral cash flow and value, borrower financial and operating strength, guarantees, credit support and related risk and return factors. These variables are subject to due diligence and can be considered when developing key assumptions for cash flows and values. These cash flows and values in turn are used to evaluate the potential timing and return to the loan position under different loan resolution strategies.

Target rates of return for purchasers can also be a key factor. Targeted rates of return reflect the risk in the underlying properties, markets, and loan resolution strategies. These factors are integrated in an underwriting of the cash flow to the mortgagee’s position, where the cash flow is generally the lesser of the contract payments due under the loan terms or the cash flow generated by collateral. Cash flows are further refined to include professional costs incurred after the note closing by the acquirer, potential interruptions or reductions in payments that might result from non-payment or bankruptcy by the borrower, and the potential need to advance funds to protect or preserve collateral cash flow and value. When applicable, consideration should also be given to whether trade claims in the construction (i.e. mechanics liens) have or can be filed.

## Loan Resolution Scenarios and Strategies

The underwriting of troubled debt typically involves developing cash flows for one or all of several different loan resolution scenarios. The risk and probability of each scenario should be assessed as appropriate. Troubled loan resolutions generally consist of one of the following four basic scenarios:

1. Restructured or Modified Note
2. Discounted Payoff
3. Deed In Lieu or Judicial Foreclosure
4. Debt for Equity

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<sup>1</sup> Congressional Oversight Panel, February Oversight Report, Commercial Real Estate Losses and the Risk to Financial Stability, February 10, 2010, page 2.

Although these strategies are often employed separately, certain strategies can be used in combination. Resolution of an individual loan can evolve over time. For example, a restructured note can evolve into a discounted payoff or a foreclosure. Depending on the circumstances, bankruptcy can become a factor which can affect the costs and timing of loan resolutions. However, a discussion of complex bankruptcy considerations is beyond the scope of this article. Further, bankruptcy typically results in one of the four resolutions presented above.

## Restructured Loans

Restructured or modified note resolutions can include creating A and B note structures, receiving partial pay downs from borrowers, reducing pay rates of interest, extending maturities, obtaining upside participations from properties or a combination of the above. In an A note/B note structure, outstanding debt is split into two notes with the A note (hard note) being fully secured by the property's value and cash flow and the B Note (soft note) due under certain defined circumstances. Key issues include determining 1) the amount of the A and B notes, 2) the interest rate and amortization under the A note, 3) the extent of any defer and accrue rate to be charged on the A note, 4) the interest rate and payment terms for the B Note and 5) the maturity dates for each note. The split note structure can also involve the borrower getting some credit for new money contributed. Such credit, if given, is often subordinate to the A note and either ahead of or pari pasu with the B note. In a successful restructuring, the borrower should offer a better outcome for the lender than other alternatives. Restructured notes can also involve changes to guarantees, additional collateral being offered, or additional rights being granted to the lender. In a restructuring scenario, the note buyer looks at the present value of estimated restructured principal and interest payments and the likelihood of performance by the borrower to develop a bid price for the existing loan.

To illustrate the basics of a restructured loan, assume an office building financed as indicated below.

	Amounts in \$ 000,000's		
<u>At Loan Origination:</u>		<u>Current:</u>	
Value	50.0	Value	28.00
Debt	35.0	Debt	35.00
Equity	15.0	Equity	(7.00)
Interest only debt @ 5% for 5 years			
<u>Restructured A Note:</u>		<u>Restructured B Note:</u>	
Value of Collateral	28.0	Total Debt Claim	35.00
Less: Borrower Paydown	(5.00)	Less: Borrower Paydown	(5.00)
Equals: A Note	<u>23.0</u>	A Note	<u>(23.00)</u>
		Equals: B Note	7.00
<u>Notes and Assumptions:</u>			
A Note interest @ 6.5% with 25 year amortization, maturing in 3 years			
Borrower's new capital receives 10% priority return after A Note debt service			
Borrower's new capital including any unpaid priority return paid before B Note			
B Note accrues simple interest @ 4% ; secured by Borrower's ownership interest in property			
B Note and Borrower share 50% of excess after new capital until B Note repaid			
B Note due on sale or refinance to extent payable; otherwise forgiven			
No capital expenditures are assumed to simplify the illustration			

## Discounted Payoff

Discounted payoffs (“DPO”) involve the settlement of debt for some amount of money less than the entire debt claim. This can be accomplished by either canceling the debt in return for payment of the discounted amount or selling the note back to the borrower for the discounted amount. DPO’s can be immediate or exercisable at some future point by the borrower. Key factors include the DPO amount and whether the borrower will be able to finance the DPO amount through new debt and equity. Some note buyers will seek to restructure a note to provide a current yield and give the borrower an option for a DPO at some amount in the future. DPO amounts are often determined by evaluating property and market conditions, cash flow, and value forecasts and estimating the timing, risk and amount of the DPO including any interim payments and costs. In a DPO scenario, the buyer calculates the present value of the loan cash flows including the DPO amount to develop a current loan price.

An example of a discounted payoff is illustrated below.

	Amounts in \$ 000,000's		
<u>At Loan Origination:</u>		<u>Current:</u>	
Value	50.0	Value	28.0
Debt	35.0	Debt	35.0
Equity	15.0	Equity	(7.0)
Interest only debt @ 5.1% for 5 years			
<u>Discounted Payoff</u>		<u>Takeout Financing</u>	
Contractual Debt Amount	35.0	New Third Party Debt	16.0
Less: Discharged /Forgiven Amount	(7.0)	Plus: Borrower Capital Contribution	3.0
Equals : Discounted Payoff Amount	28.0	New Investor Capital Contribution	9.0
		Equals: Capital for Discounted Payoff	28.0
<u>Notes and Assumptions:</u>			
Borrower arranges for new loan from another lender and new equity capital.			
Recapitalized entity uses new loan and new equity capital to pay existing lender.			
Existing lender accepts discounted payoff and releases balance of its claim.			
Cash flow would reflect the timing of the DPO plus any interim payments to lessen any interim costs or funding by the lender.			

## Foreclosure

In a deed in lieu of foreclosure (“DIL”), non-judicial foreclosure, or judicial foreclosure, the note buyer estimates the time and costs necessary to negotiate a DIL or to pursue foreclosure. The note buyer typically estimates the interim cash flows, costs, and amount of ultimate recovery. The type of foreclosure pursued often depends on applicable state law. Non-judicial foreclosure is generally less time-consuming and less costly than judicial foreclosure. States that require judicial foreclosure can have extended time frames depending on court dockets, the ability of borrower to contest the foreclosure, and other factors. The recovery amount often equals the value of the property in a sale less disposition costs. However, the analysis can also include a holding period cash flow and interim proceeds from a financing once the property is stabilized after foreclosure. Typically, property level judicial foreclosures take more time than foreclosures on LLC interests. Estimating

the timing for foreclosure requires consideration of the time frames in the relevant legal jurisdiction. With DIL, cash flow to the lender often continues. In judicial foreclosure, cash flow to the lender can be interrupted and value can decline. DIL often involve the lender forgiving debt and releasing guarantees in return for the borrower's cooperation.

A comparison of a deed in lieu, a non-judicial foreclosure, and a judicial foreclosure of a property is presented in the following illustration using a sale as the ultimate recovery for the lender. This example illustrates the benefits to the lender of a borrower cooperating by giving the deed in lieu of foreclosure and the benefits of a non-judicial foreclosure over a judicial foreclosure.

Amounts in \$ 000,000's							
<u>At Loan Origination:</u>		<u>Value at Foreclosure:</u>				<u>Amount of Lender Recovery on Sale in 18 Months if Foreclosure is:</u>	
Value	50.0	Today		28.0	Today		29.7
Debt	35.0	In 3 Months		27.0	In 3 Months		28.4
Equity	15.0	In 18 Months		22.0	In 18 Months		22.0

Lender Cash Flow From:	End of Quarter						
	Today	1st	2nd	3rd	4th	5th	6 <sup>th</sup>
<u>Deed in Lieu of Foreclosure:</u>							
Property Value							29.70
Costs of Foreclosure	(0.20)						
Costs of Sale							(0.60)
Quarterly Cash Flow		0.55	0.55	0.55	0.55	0.55	0.55
Net Recovery	(0.20)	0.55	0.55	0.55	0.55	0.55	29.65
<u>Non-Judicial Foreclosure:</u>							
Property Value							28.40
Costs of Foreclosure	(0.20)	(0.20)					
Costs of Sale							(0.57)
Quarterly Cash Flow	-	-	0.53	0.53	0.53	0.53	0.53
Net Recovery	(0.20)	(0.20)	0.53	0.53	0.53	0.53	28.36
<u>Judicial Foreclosure:</u>							
Property Value							22.00
Costs of Foreclosure	(0.10)	(0.20)	(0.20)	(0.20)	(0.30)	(0.30)	(0.30)
Costs of Sale							(0.45)
Quarterly Cash Flow	-	-	-	-	0.43	0.43	0.43
Net Recovery	(0.10)	(0.20)	(0.20)	(0.20)	0.13	0.13	21.68

<p><b>Notes and Assumptions</b></p> <p>The analyses are presented on a quarterly basis to facilitate presentation. Actual analysis are typically prepared on a monthly basis.</p> <p>Property value and cash flow is assumed to decline until lender takes title to the property.</p> <p>Property values increase @ 4 % per year once lender takes title and lease property.</p> <p>In DIL, lender receives 80% of positive cash flow until foreclosure.</p> <p>Otherwise, lender does not receive cash flow until foreclosure or until appointment of a receiver.</p> <p>Receiver is assumed to be appointed in the 5th quarter in a judicial foreclosure.</p> <p>Costs of foreclosure continue until lender takes title; foreclosure costs include cost of receiver.</p> <p>Costs of sale are assumed at 2%.</p>
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## Debt for Equity Conversion

Debt for equity swaps involve the conversion of all or some amount of debt for equity in a property or entity. Although somewhat common in non-real estate bankruptcy cases, these negotiated or bankruptcy court-approved exchanges most often occur in real estate with distressed mezzanine financing or in multi-property cases. Although they have a role to play, note holder concerns about lender liability, regulatory treatment, and other factors, including tax issues, make these swaps less prevalent in real estate loans.

## Types of Note Buyers

Two general types of buyers exist: (1) yield or return driven buyers and (2) ownership driven or “loan-to-own” buyers. Yield driven buyers are motivated by overall risk and return and tend to evaluate multiple loan resolution scenarios. Key factors for these buyers include time, costs, risks, ultimate recovery amount, the ability to obtain a current yield and the ability to maximize return on invested equity. Some note buyers will identify the resolution scenario that appears most likely and use that to develop a bid price for the loan. Others will make a probability determination from several possible scenarios as their basis for a bid. Many buyers will look at a number of scenarios, choosing one scenario, often the most conservative, for their bid price to earn a basic return and using other scenarios to estimate upside potential. Some buyers will look at the scenario that creates the optimal resolution in terms of present value, fastest time resolution, or the ability to earn a multiple on invested equity.

In a loan-to-own strategy, a distressed note buyer acquires debt for the purpose of ultimately owning the property using a foreclosure strategy. The loan-to-own strategy is not always successful because note holders must work within the limits of the loan documents. If defaults cannot be called or the borrower can exercise extension options, an acquiring note holder can be delayed or ultimately frustrated in owning the property. Bankruptcy courts contain famous cases where distressed borrowers were able to lease up properties and refinance at par after filing Chapter 11 leaving note buyers without the deed to the property.

## Due Diligence

Due diligence is critical to buying distressed debt. Many factors must be potentially considered to identify the key variables that can affect pricing and cash flows. These key variables can be grouped for convenience into the following five major categories:

- Property and Local Market Conditions
- Borrower Capabilities and Motivation
- Legal Structure and Documents
- Other Creditors
- Servicing History

The extent to which due diligence can or should be performed can vary under the circumstances and could include any or all of these items.

## Properties and Local Market Conditions

Property specific factors and local market conditions are fundamental to preparing

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estimates of cash flow and valuing the commercial real estate. These considerations also apply to analysis of distressed debt secured by real property. The pertinent market factors include:

1. Property type and physical condition / quality
2. Property location and competitive position
3. Property cash flows over the loan period
4. Property values (today, at maturity, at stabilization, in liquidation and recovery)
4. Rent rolls
5. Capital needs
6. Tenant defaults and payment delays
7. Tenant retention and renewals
8. Significance of personal property
9. Local market and sub market conditions

The assumptions used to develop estimates of property cash flow are often adjusted for the effects of the legal structure and the loan resolution strategy on the cash flow. For example, judicial foreclosure strategies in difficult jurisdictions often prevent tenant retention, lease up, and capital improvements during the foreclosure process. A restructured loan or a discounted payoff can result in preservation of or mitigation in the decline in value if the preservation or improvement of occupancy can be achieved as part of the workout. Values are calculated at different points in time to evaluate whether value increases, maintains, or declines, and to identify effects and incremental returns from various actions such as the effect of capital improvements. Cash flows and values are used to evaluate the ability to service and refinance debt, the ability to sell assets to satisfy debt, and the extent to which debt and equity positions are in the money at different points in time.

## **Borrower Capabilities and Motivation**

As legal owners, borrowers control the operations, leasing, and marketing activities of a property. Assessing borrower capabilities and motivations are critical to evaluating potential loan resolution outcomes. Borrower motivations are important because they influence the borrower's behavior and negotiating strategy. Borrower motivations can vary from obtaining a release from personal guarantees, maintaining control of the property to protect or to participate in its potential upside recovery, preserving management fee revenues, contributing and getting credit for "new" money, pursuing bankruptcy or lender liability actions, and/or managing tax consequences and timing. An important aspect of developing and analyzing different loan resolution scenarios involves considering which factors will motivate the borrower and whether different loan scenarios can work. Appropriate considerations of borrower motivations can allow the note buyer to select the appropriate loan resolution scenario and to assign more realistic probabilities. For example, a release from guarantees or accepting a partial payment on guaranty liability can result in a borrower cooperating with a DIL and preserving value. When appropriate, solving or accommodating borrower issues can result in greater and/or earlier recovery for the note holder. To evaluate the borrower's motivations, the following factors can be considered:

1. Borrower/sponsor financial and managerial strength
2. Extent of distress on borrower's other properties / businesses
3. Borrower's exposure on guarantees (contingent, full repayment, completion, or loss recovery)
4. Borrower's tax position
5. Borrower's reliance on management fee revenue (property, asset management, etc.)
6. The ownership entity's control, capital structure, and approval processes

Borrowers with managerial capability and/or available capital have the potential to contribute to the property's recovery. These potential contributions can be considered when estimating various distressed loan outcomes. Borrowers that lack these capabilities can inhibit or delay actions that are in the lender's interest. Guarantees can have a significant effect on borrower motivations and strategies. Borrowers with contingent recourse obligations are generally reluctant to file bankruptcy or consent to foreclosures a) if such actions could result in claims under the guarantee and b) if the guarantor has net assets to satisfy the guarantee. Lenders with borrowers who are obligated under full payment guarantees for timely payment of principal, interests, and other costs have a significant bargaining advantage to the extent the guarantor has available net assets. Borrowers can also be motivated by their tax position as discussed later.

## Legal Structure and Documents

The note holder can only resolve distressed debt by negotiating and working within the limitations, rights, and remedies of the legal documents between the borrower and the lender. Consideration of these documents is highly important. These documents define the contractual rights, obligations, and limitations of the parties. Key considerations include:

- Loan documents and key terms such as interest rates, maturities, escrows, and lock boxes
- Mortgages, assignments and other security
- Guarantees
- Additional collateral
- Other credit support
- Development and management agreements
- Lender recognition of agreements including leases
- Assignments of rents and receivables
- Lender lock box arrangements for collection of rents
- Default events, rights, and remedies
- Lender rights, obligations, and exposure under documents

Due diligence can include both an economic and legal analysis of these documents. The results of this diligence can be used to adjust cash flow underwriting, to prioritize loan resolution scenarios, and to establish pricing.

## Servicing History

A review of the loan servicing history and files is often performed as part of the effort to assess loan resolution strategies and to develop cash flow and pricing assumptions. Some of the key focus areas include:

- Servicing and payment history and sources
- Servicing and correspondence
- Existence and status of any defaults
- Correspondence to/from borrower
- Financial analysis of borrower and guarantors
- Availability of assets to satisfy guarantees

Servicing histories and borrower correspondence can be evaluated to determine which loan resolution strategies are more likely to occur and to succeed. Servicing histories can indicate whether the property or the borrower has supported the debt. Servicing files can contain information to re-underwrite the property. Correspondence with the borrower can

***“Servicing histories and borrower correspondence can be evaluated to determine which loan resolution strategies are more likely to occur and to succeed.”***

indicate whether potential leases or sales are under discussion, whether the lender has already issued default notices and demands, and whether the borrower has demonstrated a willingness to cooperate or has threatened legal action.

## Other Creditors

The existence of other creditors can complicate the resolution of distressed debt. Some of the key concerns include:

- Construction trade claims
- Mechanics liens
- Mezzanine debt
- Inter-creditor agreements
- Other secured or unsecured debt

Mechanics liens need to be satisfied ahead of debt. Construction trade claims present complications to the extent these claims can force an involuntary bankruptcy or need to be satisfied to preserve key contractors and to ensure cost effective completion of the project. Mezzanine debt presents challenges for reaching the negotiated consensus necessary for an out of court resolution. Achieving consensus between a first mortgage lender, a mezzanine lender and a borrower can be difficult especially if the debt is participated. These difficulties are compounded if more than one level of mezzanine debt exists. Mezzanine debt also presents the risk of a separate foreclosure on pledged equity interests of the borrowing entity. Such foreclosure results in new control of a borrowing entity. The ability and willingness of mezzanine lenders to be part of a solution can play a material role in a viable deal. Likewise, inter-creditor agreements creating rights and obligation between lenders can also impact the success of deal. Issues relating to mezzanine lenders are discussed in more detail below.

## Approaches to Due Diligence

Buyer approaches to due diligence can vary depending on the type and quality of information provided by the seller, the amount of time available for due diligence, whether single loans or portfolios are being sold, whether first mortgage loans or mezzanine loans are involved, and whether the loans are whole loans or participations are being acquired. If loan portfolios are being acquired, due diligence is generally focused on large balance concentrations in portfolios. Samples are sometimes used for smaller loans to provide coverage for the balance of a portfolio. Others will look at each loan but spend less time with smaller loans.

Seller approaches to due diligence vary widely. Some sellers provide reasonably complete, accurate and well-organized information to allow buyers to understand facts quickly and develop their cash flows and bid prices. Other sellers provide limited or poorly organized due diligence materials. Generally, sellers who provide better due diligence materials will receive more interest, significantly better bids, and faster execution. Although buyers will often modify cash flows from the note seller or develop their own scenarios, sellers should anticipate the information needs bidders have when developing loan cash flow scenarios. Sellers need to understand the loan resolution scenarios in order to provide this information. Sellers can also benefit from having loan scenario cash flows prepared and using this information internally in order to configure portfolio pools and establish pricing expectations.

The purpose of due diligence is to answer a series of key questions to assist in the cash flow and underwriting process. Some of these questions include:

1. What does the borrower bring to table?
2. How long will foreclosure take?
3. What rights does the borrower have under the loan documents?
4. What funding obligations exist which would bind the lender?
5. Can a discounted payoff or borrower buy back work?
6. Can the borrower finance it and when?
7. Does the property need capital or management to preserve value or to prevent greater declines?
8. Will the property decline in cash flow and value, and to what extent?
9. How and when should the debt be modified?

In performing due diligence and preparing scenario cash flows, it is important to develop scenarios that are internally consistent. Property level cash flows and loan resolution cash flows need to reflect consistent assumptions. For example, it is generally not appropriate to assume that tenants with expiring leases will be retained or replaced during the time when the property is in judicial foreclosure and new money for tenant improvements and leasing commissions is not available. In contrast, such an assumption might be appropriate in a restructuring or DPO scenario. Different loan resolution scenarios may require different property level cash flow scenarios and are best developed on a facts and circumstances basis.

## Special Considerations

Special considerations exist for cross collateralization, mezzanine debt, and participated debt. Loans with cross collateralization generally require not only the same considerations and scenarios as individual property loans but also require consideration of the cross collateralization. Depending on the nature of the cross collateralization, it may be necessary for a note holder to enforce rights in multiple jurisdictions. Deficiency amounts might also need to be calculated against ‘underwater’ properties first before these claims can be enforced against other properties.

Mezzanine loans require further consideration of senior debt obligations, senior lender rights and remedies, and other liabilities at the entity level. Mezzanine debt buyers have a crucial interest in whether the first mortgage is or will go into default, and whether the first mortgagee will consider a restructuring, require a partial pay down, or require equity infusions by the mezzanine buyer. In contrast, buyers of first mortgage loans, where mezzanine debt also exists, may need to consider whether the first loan will be resolved with the original borrower or with a mezzanine lender that has foreclosed against a stock interest. A mezzanine lender in foreclosure can significantly change the loan resolution outcome if the mezzanine lender has a position that is partly in the money or has the ability to bring new money or expertise to the situation. Where the original borrower may have signed a springing recourse guarantee that is triggered in the event of a bankruptcy filing, mezzanine lenders are often not similarly exposed unless inter creditor agreements limit their rights. Multiple layers of mezzanine debt or other debt levels complicate pricing as most buyers will consider the potential effects of these other debt claims on the debt being acquired.

The specifics of inter creditor agreements and participation agreements can influence not only cash flow to the mortgagee’s position but also the estimated timing of the cash flows and the ultimate recovery because of the time and effort needed to address inter creditor and participant issues. Inter creditor agreements that change the cash flow distributions among note holders on the occurrence of default are particularly important. For example, inter-creditor agreements can provide that all cash flow be paid, on the occurrence of a

***“Mezzanine debt buyers have a crucial interest in whether the first mortgage is or will go into default, and whether the first mortgagee will consider a restructuring, require a partial pay down, or require equity infusions by the mezzanine buyer.”***

default, to senior note holders interest and principal until the senior debt is fully repaid before any interest can be paid to subordinate holders. Inter-creditor agreements can also provide that no modification of debt terms can be made with the borrower without the consent of the senior note holder. The effect of such terms on subordinate note holders can be dramatic. Participated debt involves consideration of the ability and timing for various participants to agree on a course of action.

## Key Tax Considerations

Restructuring or foreclosing on distressed debt may have significant tax consequences to both debtor and creditor. The tax rules are complicated and the following discussion is intended simply to outline applicable law. Note purchasers and sellers should consult their tax professionals regarding potential tax consequences in any specific transaction.

Generally, cancellation of indebtedness (COD) by a creditor results in taxable ordinary income to the debtor. (The creditor may have a corresponding loss.) As the following discussion illustrates, it may be possible to defer or exclude the recognition of COD income. In the case of foreclosure, the rules may be different.

If the creditor acquires the debtor's property in foreclosure or by a deed-in-lieu (DIL), the debtor will be treated as if it sold the property to the creditor. Where the debt is nonrecourse, the sales price is the outstanding balance of the loan regardless of the fair market value of the property. If debtor's tax basis in the property is less than the outstanding balance of the loan (because the debtor has taken tax depreciation or received refinancing proceeds), the debtor will recognize a tax gain even though the debtor has lost its property. The creditor, on the other hand, will have a new fair market basis in the property. The creditor may also have a loss, if its basis in the loan exceeds the property's fair market value or a gain if it acquired the loan at a discount and the property's fair market value exceeds the creditor's acquisition costs.

If the debt is recourse to the debtor, the rules are more complex, and the debt may have both gain and cancellation of indebtedness (COD) income. Many borrowers seek to avoid foreclosure because it may involve immediate tax liability without any cash to pay the tax.

**Example:** (Amounts in \$000,000's) Debtor owns real property, subject to a \$15 nonrecourse debt, with a \$5 tax basis. The fair market value of the property is \$10. If the property is foreclosed, or Debtor delivers a DIL, Debtor will recognize \$10 of taxable gain (\$15 debt minus the \$5 tax basis) even though the property is worth only \$10 at the time of foreclosure. If the debt is recourse, Debtor will recognize only \$5 as "gain" on sale but the Debtor will also recognize the other \$5 as COD income. In either case, there is a tax impact of \$10 but the characterization can be different. The distinction may have important tax consequences to Debtor. The "gain on sale" may be treated as long-term capital gain, which is subject to a more favorable federal income tax rate. However, that gain will not be eligible for any of the potential COD exception or deferral options discussed below. The COD income will be treated as ordinary income.

Modifying existing debt also may create immediate tax liability. If the creditor takes a discounted payoff for the debt, the debtor will have COD income equal to the discount, which will be immediately taxable unless the debtor or its partners qualify for one of the exceptions discussed below. In the case of a partnership, COD is allocated to each partner, and the exceptions generally apply at the partner level.

**Example:** (Amounts in \$000,000's) Partnership AB has two equal partners

and a creditor reduces AB's debt from \$100 to \$50, AB will realize \$50 of COD income that will be allocated \$25 to A and \$25 to B.

Alternatively, the creditor may simply reduce the interest rate and extend the maturity date of the loan. If the reduction in rate and the extended due date exceed IRS safe harbors, the debtor will be deemed to have exchanged a new debt instrument for the existing loan. Though, in many cases involving non-publicly traded debt, these changes will not create COD income for the debtor. A creditor that acquired the distressed loan at a discount may have current taxable income without cash to pay the tax, despite the fact that the creditor may have actually reduced the amount of debt service. In fact, such a creditor that reduces the outstanding balance of the loan may also create a taxable gain for itself.

This does not mean that all modifications will result in deemed exchanges. The modification must be "significant" or covered by specific IRS guidelines. Also, not all deferrals are modifications. The IRS allows a creditor to grant the debtor a reprieve from debt service payments of not more than two years during which the parties are renegotiating the terms of the loan.

**Example:** (Amounts in \$000,000's) Creditor buys \$100 face value of distressed debt for \$50. Creditor agrees to modify the debt to allow Debtor to pay off \$100 at the end of 5 years without interest. For tax purposes, the \$100 face is discounted to present value using an IRS-prescribed interest rate. Here, the debt has been exchanged for a new \$80 debt instrument in a taxable transaction. Debtor has \$20 of COD, but Creditor recognizes \$30 of gain. In addition, over the next 5 years, Debtor will be entitled to deduct \$20 as interest and Creditor will be required to recognize \$20 as interest. Creditor may be required to pay tax on \$50 of income (\$30 of gain on modification and \$20 of interest) before he receives any cash.

The debtor may not avoid COD income by having a related party acquire the debt at a discount. If the acquirer is more than 50% owned by the debtor or an affiliate, the debtor will have to recognize COD based on the purchase price of the debt.

Exchanging debt for a partnership interest will no longer automatically avoid COD. For example, if the partnership interest acquired by the creditor in exchange for the debt is worth less than the outstanding balance of the debt, the existing partners will recognize COD equal to the difference.

**Example:** (Amounts in \$000,000's) AB Partnership owes C \$100. Fair market value of C's assets is \$75. C exchanges Debt for partnership interest with liquidation value of \$75. AB has \$25 of COD income. C now owns a partnership interest with a tax basis of \$100. C is unable to take a \$25 "bad debt" deduction as a result of exchanging the debt for a partnership interest. The \$25 "loss" becomes part of C's basis in the acquired AB partnership interest.

There are a number of exceptions to the immediate recognition of COD. If a debtor is bankrupt or insolvent, the COD will reduce certain of the debtor's tax attributes, such as net operating losses, instead of being currently included in taxable income. Suppose a partnership owns depreciable real property used in a trade or business which is subject to secured debt, such as a mortgage. In certain cases, a partner may elect to reduce his basis in depreciable property instead of recognizing current income under the Qualified Real Property Business Indebtedness exception. The application of this exception is often complex. It requires the partnership and the partner to satisfy certain tests involving the fair market value of the property, the amount of depreciable property, and the amount of equity, if any, resulting from the COD.

In a recent change that is effective for transactions occurring in 2009 and 2010,

corporations and, if the debt is related to a trade or business, other persons (including partnerships) may elect to defer recognition of COD income until 2014. The deferred COD will then be recognized 20% annually from 2014 through 2018. Under new IRS guidance, each partner will be entitled to either recognize the COD immediately (subject to the other exceptions) or elect deferral. The deferred COD will be accelerated in a number of events, including the sale of substantially all of the assets of the debtor or if a partner sells its partnership interest in the debtor partnership.

**Example:** (Amounts in \$000,000's) Creditor C cancels \$100 of qualifying Partnership AB debt in 2010; A owns 40% and B owns 60% of AB. AB allocates the COD income \$40 to A and \$60 to B. A has losses to offset his share of COD income, but B does not. AB may elect to defer \$60 of COD income and recognize \$40 of COD income. AB then allocates the \$40 of recognized COD to A and the \$60 of deferred COD to B. A will recognize the \$40 of COD income currently, using his losses to offset the income, but B may elect to recognize the \$60 of deferred income in five equal \$12 installments from 2014 until 2018. If B dies in 2013, he will recognize all of the deferred COD in 2013.

The rules involving REITs, tax exempt investors and entities, and foreign investors are even more complex. Advisors engaged in a distressed debt workout must consider these rules when any of these entities are participating, directly or indirectly, as creditors or debtors.

## Conclusion

The issues and challenges involved in the disposition and acquisition of distressed commercial real estate debt can range from straightforward to complicated and multi-faceted. Understanding the fundamentals of distressed debt resolution is essential to addressing the opportunities and needs of this sector of the commercial real estate market.

