

# Distressed Commercial Real Estate: To Know Where You're Going, You Have to Know Where You Are

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# Observations on the Current Situation

# Current Market Conditions

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- Without accounting for particular assets, the consensus is that asset values across the board have fallen roughly 30% since the beginning of the year. We remain in a period of price discovery as sellers have not yet capitulated.
- Owners continue to be resistant to distressed selling or rescue capital recaps until their hands become forced by their lenders. Some of the core funds and NTRs have begun marketing assets in order to fund redemptions but it is unlikely they will transact at prices below their marks.
- Lenders are segregating their books into loans made to important relationship borrowers and others. To the extent these loans are impaired or represent a significant refinancing risk the non-relationship borrower loans will trade. Even with respect to the relationship borrower loans “extend and pretend” will not be the story and equity pay-downs will be a condition to any modifications.
- Office assets are not in a recession but may be in a depression as a number of B and C assets are zombies. Even the Class A assets are suffering from weak rental growth and leasing velocity as well as cap rate expansion. Eighty percent of the leasing velocity is taking place in 20% of the office buildings. Conversions to residential are a possibility but remain challenged by sub-optimal floor plates, windows that don’t open, elevator banks that need to be re-designed and undesirable neighborhoods.
- The secondary market buyers remain relatively bullish as they view trading in LP interests in funds that are fully invested as less risky and they are not that concerned about buying at an absolute bottom as long as they like the real estate.
- PE generally remains on the sidelines not only because of the challenging debt capital markets but because of the schmuck factor.
- Real estate is always a slow train wreck in every down cycle.

# Owner / Borrower Perspective

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## A. Understand the Situation; Not All Distress is the Same

- Is it a distressed asset, or a distressed capital stack (or both)
- Distressed Assets
  - The property is uneconomic as currently operated
    - Is there opportunity to unlock value through change in use, new construction, etc.
    - Are there fundamental problems (title, environmental, physical, etc.) that cannot be economically cured
- Distressed Capital Stacks
  - Current and/or prospective cash flow cannot meet projected obligations (operating expenses, debt, equity, etc.)

## B. The Hard Look/Hard Decisions – Big Picture

- Provide "best outcome" for investors; make hard choices of what to save and what not to save
- Good money after bad; likelihood of return
- Reputation
- Different motivations of "Sponsor" and "Money Partner"
- Avoid personal liability
- Comply with fiduciary duties
- Avoid adverse tax consequences

## C. Thoroughly Understand Rights and Obligations Under Debt Documents

- Recourse Liabilities
  - Above the line/Below the line – springing liability vs. actual loss
  - Environmental
- Cash Sweeps/Lockboxes
- Fundamentally is there a deal that makes sense? Is there enough value to induce all the parties to reach a deal (lender to forebear, borrower to put cash in, etc.)?
- Is there equity? A reasonable chance of turnaround?
- What Can the Borrower/Owner Offer (without bringing something to the table, not likely to succeed).
  - Escrows – TIs, leasing commissions, capital repairs, interest, etc.
  - Partial paydown
  - Guarantees

# Owner / Borrower Perspective

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## D. Thoroughly Understand Rights and Obligations under Equity Documents

- Defaults
- Who is Obligated to Fund What?
- Can the Sponsor be Forced Out (as Managing Member, Property Manager, Etc.)?
- What Other Remedies Are Available (Dilution, High Interest Loan, Etc.)?
- What Decisions are “Major Decisions” Requiring all Partners’ Agreement and What Can Be Implemented Unilaterally
- What Happens if an Agreement Cannot Be Reached Among the Partners
  - Does the Timing of the Dispute Resolution Process “Work” in the Present Situation?
- If There is a Buy/Sell or a Forced Sale Right, Does One Party Have an Advantage Based on Access to Capital, etc.?
  - Is Only One Partner (or its Affiliate) on a Guaranty; Can Lead to Significantly Different Interests and Objectives

## E. Common Restructuring Alternatives

- Forbearance
- Extend Maturity Date (“Delay and Pray”/“Extend and Pretend”)
- New Equity Injection (A/B Loan Split)
- Partial principal paydown
- Interest Only or Adjust amortization schedule
- Interest rate adjustment (up or down) – including different accrual and payment rates
- New Reserves
- New guarantors (or expanded guarantees)
- Added collateral
- DPOs or Coordinated Sale by Owner (FBO Lender)
- Structured deeds-in-lieu of foreclosure
- Equity dilution (while avoiding recapture)



# Owner / Borrower Perspective

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## A. Tranching structures

- A/B notes and A/B participations
- “Rake” bonds
- Securitized whole loans

## B. CMBS securitizations structures - parties

- Trustee
- Servicer/Primary Servicer
- Master Servicer
- Special Servicer

## C. Controlling Holder

- Who is the controlling holder?
- What rights does the controlling holder have?

## D. How CMBS structures handle distressed loans

- Transfer of Loan to special servicing
- REMIC restrictions on modifications
- Contractual restrictions on modifications
- Asset Status Report, Appraisal Reduction

## E. Payment priorities for B notes, B participations and rake bonds

## F. Other Rights of B note / B participation holders

## G. Mezzanine Loans

- Cross default
- Structural subordination
- Servicing / administration of mezzanine loans
- Mezzanine ICAs
  - Transfer restrictions
  - Rights relating to the property
  - Limitations on mortgage loan and mezzanine loan modifications
  - Cure rights
  - Purchase rights
  - Foreclosure of mezzanine loan collateral

## H. CLOs

- Key differences with securitized debt

# FDIC Takeover – Impact on (Commercial Real Estate) Borrowers

# “Defaulting Lender” *Provisions*

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- D. Typically included in syndicated loan documents, and provides borrower and other lenders with a course of action against one or more lenders unwilling or unable to meet funding obligations, i.e. lender placed into FDIC receivership
  - Borrower and non-defaulting lenders granted additional rights – removal / replacement of defaulting lender (as lender or agent)
  - Defaulting Lender provisions limit rights of defaulting lender, i.e. “Required Lender” votes, fees, other payments
- E. “Defaulting Lender” rights are not automatic upon lender placement into FDIC receivership
  - New bank created via FDIC receivership that may or may not be in default of old bank obligations unless new bank defaults, i.e. failure to disburse a loan, etc., Defaulting Lender rights may not be implicated



## **“Defaulting Lender”** *Counterparties Limitation of Rights and Powers*

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- A. Borrower / other lenders right or power to terminate, accelerate or declare default under any contract to which old bank (in receivership) is a party (absent FDIC consent) are limited
- B. 90-day moratorium on judicial actions or proceedings upon request of receiver
  - Not automatic or self-effectuating like bankruptcy automatic stay
  - Mandatory upon request by receiver (12 U.S.C. 1821(12)(A) and (B))
- C. Section 1821 stay provides that “...no person may exercise any right or power to terminate, accelerate, or declare a default under any contract to which the depository institution is a party, or to obtain possession of or exercise control over any property of the institution or affect any contractual rights of the institution...” (§1821(e)(13)(c))



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