# What's on the Horizon for Commercial Real Estate Loans?

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Like many of you, we are seeing a significant increase in commercial real estate ("CRE") loan workouts. The magnitude of the swell in distressed CRE loans remains unclear, although one thing is certain: appreciating the options and remedies for CRE participants, particularly lenders and borrowers, has never been more critical.

**Introducing The G&S CRE Workouts team**

With CRE loan workouts on the rise, the G&S CRE Workouts team – a multi-disciplinary group of restructuring, real estate, litigation, and tax attorneys – will answer many of the questions you have (or never knew you had) through an informative content series designed to keep you up to date on these dynamics and other emerging issues related to the CRE market.

**A Changing Landscape**

Under contemporary commercial real estate finance practices, many CRE loans are typically structured as nonrecourse interest-only loans with balloon payments at maturity. In times of low interest rates and booming property values – the case over the last decade or so – borrowers were generally able to refinance their loans with relative ease.

Unfortunately for borrowers, times have changed dramatically, and the current real estate lending environment has thrown the traditional playbook out the window. In response to persistently high inflation, the Federal Reserve has raised interest rates by 500 basis points since March 2022 (with additional hikes expected this year). Rate hikes, combined with declines or threatened declines in real property values, have resulted in a challenging environment for CRE refinancings.

Borrowers eager to refinance will face higher borrowing costs, and banks, skeptical that property values will recover soon, have grown reluctant to issue new loans. Additionally, many properties (particularly in the office sector) cannot support the carrying costs associated with higher-interest alternative credit providers.

**What Lies Ahead**

A spike in real estate foreclosures, deeds-in-lieu, and CRE loan modifications is therefore looming (if not already here). Until values stabilize, CRE may become a "hot potato," with borrowers whose equity values have evaporated uninterested in expending additional resources to retain their properties and lenders reluctant to take them over.

If history is any indication of what's ahead, we expect the increased activity in loan workouts to result in a mix of mortgage and mezzanine foreclosures, bankruptcy filings, deeds-in-lieu, loan modifications, loan sales, and property short sales.

**CRE Loan Workout Outcomes**

From "amend and extend" strategies to deeds-in-lieu. there are many potential paths that a loan workout may take. There are tax implications to each outcome that will have to be considered and may drive many of the decisions in a loan workout. Those include cancellation of debt income for recourse loans, capital gains treatment for nonrecourse loans, and a material loan modification being treated for tax purposes as an exchange of debt.

**Amend and Extend:** In most cases, we expect to see agreements between borrowers and lenders to modify CRE loans permitting the borrower to continue to own and operate property under more favorable loan terms. This "amend and extend" strategy became popular after the 2008 financial crisis when experts expected property values to recover quickly, which ultimately came to pass. It remains to be seen whether lenders will show the same flexibility in the current climate.

Loan modification agreements come in many different flavors. They may simply extend maturity dates on the same terms and conditions. By extending out loan maturity dates to 2025 or later, lenders and borrowers are betting that the additional term will allow sufficient time for interest rates to fall, occupancy rates to rise, and property values to recover enough to allow for a more successful sale or refinancing. Loan modifications can also be used to adjust interest rates, loan covenants, the cash management waterfall, defer capital expenditure requirements, provide additional liquidity, allow for the entry of a new equity partner, and otherwise waive existing defaults. In many cases, to obtain these concessions form the lender, a borrower or its sponsor may be required, in addition to fees, to reduce principal or invest new equity for capital improvements or as a carried interest reserve.

**Foreclosures:** CRE loans are underwritten based on the value of the underlying collateral. A real property loan is collateralized by a mortgage on the property itself, whereas a mezzanine loan (and sometimes preferred equity) is collateralized by a pledge of the sponsor's equity in the entity that owns the property. After a loan default, the lender has several enforcement options, including foreclosure. Generally, a successful foreclosure extinguishes all junior liens and encumbrances and removes them from the property's title.

The foreclosure process differs from state to state and by the type of collateral. Foreclosures of mortgages, leasehold mortgages, or deeds of trust on real property can be judicial or non-judicial. That threshold question will typically determine the duration of the process. A judicial foreclosure takes months or years, depending on the defenses raised by the borrower. A non-judicial foreclosure can be completed in a matter of weeks. Although more common in judicial states, most mortgage loans contain provisions that entitle the lender to the appointment of a receiver early in the case to take control of the property. This remedy may also be available in non-judicial states where the lender commences an action in state court for the appointment of a receiver. A judicial foreclosure provides a borrower that wants to delay or contest the lender's enforcement of its remedies with a forum to raise defenses and create triable issues of fact. In non-judicial states, the burden is on the borrower to commence an action in court to enjoin or stop the foreclosure. That presents a higher bar to overcome.

In contrast, a foreclosure on a pledge of the membership or partnership interest in the mortgage borrower, either under a mezzanine loan or as additional collateral securing a mortgage loan, is always a non-judicial process. Equity interests in commercial entities are personal property. Thus, a pledge of an equity interest is governed by the Uniform Commercial Code, which expressly contemplates non-judicial foreclosures provided that they are conducted in a commercially reasonable manner.

Unlike the mortgage lender, which can foreclose on the borrower's fee interest, a mezzanine lender forecloses on the equity interest in the fee owning entity. This means that the mezzanine lender is taking ownership and control of an entity and all of its debts and liabilities, including the mortgage loan. This prospect of having to assume the mortgage loan and provide a replacement guaranty, if any, may deter some mezzanine lenders from foreclosing on their loans.

**Bankruptcy:** Many CRE loans have been structured as non-recourse, meaning that the lender's recourse is limited to the property itself. To discourage borrowers (who may have invested relatively limited equity in the property) from filing for bankruptcy protection in an effort to halt foreclosure proceedings and then to try to cramdown their lenders, commercial real estate loans often require a credit-worthy guarantor to provide a springing recourse guaranty (known as a non-recourse carve-out guaranty). Personal liability under the guaranty for the entire loan balance springs into existence – becoming a recourse loan – upon the happening of specified "bad" events, such as a bankruptcy filing by borrower.

The advent of the springing recourse guaranty puts the guarantor in the position of having to repay the entirety of the loan in full if the borrower files for bankruptcy (or triggers certain other defaults). As a result, borrowers generally avoid filing bankruptcy except where: (1) the property's value exceeds the amount of the guaranty and whatever other obligations may need to be paid in bankruptcy; and (2) the guarantor is insolvent or is itself prepared to file for bankruptcy protection as well, such that the liability exposure under a springing guaranty is less of a threat.

**Deeds-In-Lieu:** For a variety of reasons, borrowers may prefer to give the property to the lender via a deed-in-lieu, rather than delay the inevitable by forcing the lender to conduct a foreclosure. For borrowers and guarantors, a deed-in-lieu of foreclosure may include a release that will extinguish or reduce liability under any existing guaranties and loan documents (although such releases will typically exclude environmental indemnities). For lenders, a deed-in-lieu should expedite the transfer of the property and allow for a more seamless transition.

A similar method to consensually transfer ownership and control exists under Article 9 of the Uniform Commercial Code. This is known as a "strict foreclosure" and allows for the sponsor to transfer its equity interest in the fee owner to the mezzanine lender.

One complexity here is that the borrower cannot force its lender to take the property. While it may seem counterintuitive, once the default actually occurs the lender may be unwilling to take ownership of the property due to the expenses associated with it, required capital expenditure projects, and cost and time to manage it. The property may also have potential successor liability issues, such as environmental issues, that often deter lenders from accepting title. If the lender has control of the rents through a lockbox and cash management arrangements, a borrower will

not be able to cutoff the flow of funds without triggering recourse liability under a springing guaranty. Thus, the lender can continue to receive the cash flow without having to assume the risks of actual fee title ownership. On the other hand, if cash flow is not sufficient to cover the operating, repair and maintenance costs of the property, a lender may have to move quickly to assume ownership and control to preserve the value of its collateral. In that case, a deed-in-lieu of foreclosure may be a desired approach.

A deed-in-lieu may present other issues if a mezzanine loan or loans also exist. In certain cases, depending on the terms of the mezzanine loan documents and any intercreditor agreement between the mortgage lender and mezzanine lender, the consent of the mezzanine lender may be required before a borrower could convey the property to the mortgage lender. That requirement will give the mezzanine lender an opportunity to extract its own concessions in return for its consent.

**Other Possible Variations**

While beyond the scope of this introductory article, there are numerous other potential paths that a loan workout may travel. For example, the lender may decide to sell its loan to an opportunistic buyer that is willing to exercise remedies to acquire the property.

The borrower and lender may also agree to convert all or a portion of the lender’s loan into equity of the borrower (or a new joint venture), while bringing in another investor to inject needed funds into the project.

The possibilities are numerous, and creative thinking (and counsel) are a must.

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