Distressed Commercial Real Estate Debt: New Opportunities and Legal Risks
Strategies for Buying and Selling Loans Facing Default

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
George E. Covucci, Partner, Arnold & Porter, Washington, D.C.
Amy B. Rifkind, Counsel, Arnold & Porter, Washington, D.C.
Ren R. Hayhurst, Partner, Bryan Cave, Irvine, Calif.
Thomas O'Connor, Partner, Cooley Godward Kronish, New York

Thursday, March 11, 2010

The conference begins at:
1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

You can access the audio portion of the conference on the telephone or by using your computer's speakers. Please refer to the dial in/ log in instructions emailed to registrations.

CLICK ON EACH FILE IN THE LEFT HAND COLUMN TO SEE INDIVIDUAL PRESENTATIONS.

If no column is present: click Bookmarks or Pages on the left side of the window.
If no icons are present: Click View, select Navigational Panels, and chose either Bookmarks or Pages.

If you need assistance or to register for the audio portion, please call Strafford customer service at 800-926-7926 ext. 10
For CLE purposes, please let us know how many people are listening at your location by

• closing the notification box
• and typing in the chat box your company name and the number of attendees.
• Then click the blue icon beside the box to send.
DISTRESSED COMMERCIAL REAL ESTATE: New Opportunities

George E. Covucci
George.Covucci@aporter.com
202.942.5026

Amy B. Rifkind
Amy.Rifkind@aporter.com
202.942.6137

555 Twelfth Street, NW
Washington, DC 20004-1206
Introduction

- The Real Estate Market Today

- Case Study #1: Potential Solutions for the Inherently Unworkable

- Case Study #2: Problems with Solutions
THE FOLLOWING PROGRAM CONTAINS THE LATEST DISTRESSED REAL ESTATE NEWS.

VIEWER DISCRETION ADVISED.
Headlines from  

Troubled Banking Industry Sharply Reduced Lending in 2009  
(Feb. 24, 2010)

Realtors Give Commercial Real Estate Outlook  
(Feb. 23, 2010)  
“… The commercial real estate market is not expected to recover...rates will trend higher and...”

Commercial Real Estate “Underwater”  
(Feb 19, 2010)  
“...'Underwater' means the mortgage exceeds the current property value....”
Headlines from THE WALL STREET JOURNAL.

Commercial Mortgages Ailing in February (Feb. 23, 2010)
“...The performance of loans bundled in commercial mortgage-backed securities deteriorated sharply in February, raising fears...”

Tarp Panel: Small Banks Are Facing Loan Woes (Feb 11, 2010)
“Nearly 3,000 small U.S. banks could be forced to dramatically curtail their lending because of losses on commercial real estate...”
Distressed Real Estate: January 2010

Billions

$38.0

$31.8

$30.8

Retail  Office  Apartment

Delta Associates: Distressed Commercial Real Estate Journal, January 2010
“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.”
February 22, 2010

Ben S. Bernanke
Chairman
Board of the Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW Washington, DC 20551

Dear Chairman Bernanke:

I write to express my concern about the state of the commercial real estate (CRE) market and the potential impact on the financial system and the greater economy.

Recent reports and testimony indicate that while the economy is showing signs of stabilizing, the CRE market continues to face significant challenges. The Congressional Research Service, for example, reported last month that commercial mortgage defaults and losses are at unusually high and increasing levels. According to the report, delinquency rates for commercial mortgages climbed from 4% at the end of the third quarter of 2009 to more than 6% in January 2010.

I understand that you have been raising concerns about the CRE market as well. Indeed, in a speech before the Economic Club of New York in November 2009, you stated that “poor fundamentals have caused a sharp deterioration in the credit quality of CRE loans” and that these “pressures may be particularly acute at smaller regional and community banks.”

Others also have expressed concerns. At a hearing last month before the Congressional Oversight Panel (COP), a Federal Reserve official testified that “Federal Reserve examiners are reporting a sharp deterioration in the credit performance of [CRE] loans in banks’ portfolios and loans in commercial mortgage-backed securities,” and warned that more than $500 billion of CRE loans will mature each year over the next few years. This point was reinforced in an oversight report published by the COP this month, which stated that nearly half of CRE loans at present are “underwater” and that the largest “loan losses are projected for 2011 and beyond.”

In response to the growing concerns, I understand that last October the Federal Reserve and other agencies on the Federal Financial Institutions Examination Council released a policy statement on prudent commercial real estate loan workouts to “assist examiners in evaluating institutions’ efforts to renew or restructure loans to creditworthy CRE borrowers.” I appreciate your efforts to coordinate action in addressing this critical issue and ask that you keep me informed as to your progress. While it may still be relatively early in the process, I would like you to provide an update on how this guidance is helping to stabilize the CRE market. In addition, I would like an explanation of how the Federal Reserve has addressed the CRE issue so far, and what additional steps you plan to take.

I believe that the weakness in the CRE market requires prompt and robust responses from the regulators to guard against harmful effects on financial institutions and the economy. I urge you to redouble your efforts to provide appropriate oversight of this vital component of our economy, and look forward to working with you to bring much needed stability to the CRE market.

Sincerely,

CHRIS DODD
Chairman

Recent Letter from Senator Dodd to Ben Bernanke
1330 Avenue of Americas – New York Sells 3 times in 10 years

1101 Brickell Ave - Miami Sells 3 times in 8 years

The Watergate Hotel – Washington, D.C. Sells 3 times in 11 years

- **Purchase Price:** $42,930,000
  - **Loan:** $69,815,000
  - **August 2004**

- **Purchase Price:** $39,000,000
  - **August 1998**

- **Lender Forecloses:**
  - **$25M**
  - **No bidders other than Lender**
  - **July 2009**
Commercial Real Estate World Turned Upside Down

2007 Acquisition

Assume:
- $5M NOI
- 5% cap rate
- 80% loan

Equity: $20M
Commercial Real Estate World Turned Upside Down

Assume:
- NOI declines by 10% to $4.5M
- Cap rates increase by 200 basis points to 7%

Deficiency: $15.7M
Real Estate Loans in Trouble: Buying and Selling Distressed Debt

Ren Hayhurst (Irvine, CA)
949-223-7125; rrhayhurst@bryancave.com
Overview of Note and REO Sales

• **Note Sales**
  – Acquire Debt, Not the Underlying Asset
  – Seller is the Lender, Not the Borrower/Debtor
  – Subject to Defects in Documentation, Title, etc.
  – Must Complete Foreclosure Process Before Assuming Control of the Property
  – Know Your Enforcement Options

• **REO Sales**
  – Take Title to the Asset; Deal Directly with Owner
  – Must Wait for Remedies to be Completed
  – Uncertainty Pending Foreclosure
Overview of Pricing & Due Diligence Issues

• Overcoming the Bid and Ask Gap
  – Reasons for the Gap
  – Possible Solutions that Will Bridge the Gap – TARP? PPIP? FDIC Loss Sharing? What will work?

• Due Diligence Challenges
  – Note Sales Require Due Diligence on the Loan, Title and the Property
  – REO Sales Requires Standard Property Purchase Due Diligence
Overview of Alternative Strategies

• Use of Deeds in Lieu of Foreclosure
  – Allows Immediate Possession of Asset
    – Subject to Liens/Claims/Development Issues
  – Works Best When Combined with Note Sale and Subsequent Foreclosure

• Option Transactions
  – Provides Immediate Pricing and Allows Immediate Due Diligence
    – Contingent on Foreclosure Sale Results

• Other Alternatives
Note Sale Issues

• Abundant Product Available
  – Wave of Commercial Loans Maturity or In Default
    • Banks More Likely to Sell than Special Servicers
  – Numerous Potential Purchasers

• Reasons for Lenders to Sell
  – Avoids time and expense of foreclosure
  – Avoids risk of being stuck with REO for lengthy period
  – Preferred Disposition Method for the FDIC
Note Sale Issues (Part 2)

• Reasons for Investors to Purchase
  – Can Often Get Better Pricing on Note Sales
  – Can Provide Greater Options By Transferring Ownership of Entire Debt Package

• Obstacles
  – Pricing Very Uncertain – Lenders reluctant or unable to sell at too steep of a discount
  – Purchaser must have the ability to deal with the foreclosure process
  – Purchaser Assumes Bankruptcy/Foreclosure Risk
    • Risk Sharing is Difficult to Negotiate
Due Diligence – Note Sales

• Loan Issues
  – Must Understand Risk of:
    • Borrower Bankruptcy,
    • Lender Liability Claims,
    • Defects in Loan Enforcement

• Title Issues
  – Must Understand Effect of Foreclosure On Title
    • Eliminate Junior Liens
    • Effect on Development Rights?

• Property Due Diligence
REO Sale Issues

• **Advantages Over Note Sales**
  – Title is Cleaned Up for Purchaser
  – Bankruptcy Risk Eliminated
  – Can Be Structured in a Manner More Familiar to Purchasers
    • Requires No Special Expertise or Experience as Required for Note Sales

• **Obstacles**
  – Lenders Increasingly Reluctant to Take REO on Books
    • Glut of Residential REO on Lenders' Books
  – Long Delays for Buyers and Sellers
Due Diligence – REO Sales

- **Focus On Property**
  - Title Report
    - Which rights eliminated by foreclosure and which rights survive the sale
  - Market Research
    - Effect of Foreclosure on Market
    - Tenant Issues – Co-Tenancy Clauses, Rent Reductions, Etc.
  - Environmental Report
  - Effect of Judicial Foreclosure vs Non-Judicial Foreclosure on Redemption Rights
Pricing Issues

- **Where is the Bottom?**
  - Pricing of deals difficult/impossible due to appraisal uncertainty and unpredictability of future market

- **Capital and Reserve Requirements**
  - Effects on Regulated Lenders

- **The “Liquidity Problem”**
  - Market Value(?) vs. Appraised and/or Book Value

- **What Happens to the “Toxic Assets”?**
  - Lessons From the RTC Experience
  - Lessons From the Current FDIC Experience
  - Use of “Bad Bank” Model
    - Who Will Invest and Own the Assets?
Pricing Issues (Part 2)

- **TARP?**
  - Focus on Management and Compensation Issues Have Shifted This to a Small Bank Program
  - No Longer Viewed as a Solution to the Sale of Distressed or Toxic Assets
    - Provides Additional Capital For Lenders in Trouble
- **ARRA?**
  - Not Designed to Address Distressed Loan Issues
- **TALF?**
  - Addresses Only CMBS Loans
  - Designed for AAA Product, Not Whole Loans or Distressed Assets
- **PPIP?**
  - Might Work Only If Price Point Can Be Found
- **Others?**
  - FDIC Loss Sharing – Not A Big Enough Program
Alternative Transaction Options

• Alternatives to Foreclosure
  – Deed in Lieu of Foreclosure
  – Title Subject to Competing Liens and Other Defects

• Consensual Foreclosure
  – Permits a Lender to “Clean Up” Title, And Can Speed Up the Process

• Consensual Bankruptcy
  – Risk Of Trustee Or Judicial Interference
Conclusion

• Understand the Advantages of Approaches and Use Them As Required to Negotiate the Best Price and to Address Timing Issues
• A Little Advance Warning to Third Parties Is Invaluable to Identify Problems Or Possible Claims
• Explore The Extent of Your Potential Remedies, and take Action To Factually and Legally Preserve All Rights and Remedies
Case Study # 1

Possible Restructuring of Office Building Investment
In Las Vegas
Background Facts

- In 2005, Owner sells long-held apartment property for large gain
- Owner engages in 1031 transaction, investing proceeds of apartment sale in office building located in Las Vegas

Basic Economics
- Total purchase price: $30 million
- Equity, including reserves: $8 million
- CMBS Debt: $22 million

Office Building Profile:
- 138,000 square feet
- Key tenant leases 96,000 square feet (70% of available space) with 2009 expiration date
- Projection: 5% vacancy in 2009
Background Facts (cont’d)

- **Loan terms:**
  - Interest rate: 5.75%
  - 10-year maturity
  - Interest-only for 5 years; 30-year amortization
  - Annual debt service: $1.2 million/$1.5 million starting in 2010
  - LTV: 80%
  - Required Reserves for TIs, Taxes, Insurance: $2 million

- **Investment Profile:**
  - Price per square foot: $215
  - Debt per square foot: $155
  - Projected hold period: 7-10 years
  - Projected IRR: 9%
The Picture at the End of 2009

- **What happened?**
  - Key tenant loses lucrative contract and leaves; so does second largest tenant
  - Crisis and collapse: failure/insolvency of Fannie Mae, Freddie Mac, Bear Stearns, Lehman, AIG et al
  - Big boom begets big bust in western states
  - By the end of 2009, building occupancy rate is **10%**

- **Building economics at end of 2009:**
  - Monthly income: $30,000
  - Monthly operating expenses: $130,000
  - Monthly debt service: $100,000
  - Monthly deficit: ($200,000)
  - Remaining TI reserves: $1,700,000
Questions to Consider in Reviewing Options

- To what extent does lender have recourse to individual members?
  - Review carefully Note, Deed of Trust, and Guaranty
  - Example: Is Guarantor liable for failure to pay operating expenses and real estate taxes?

- Can reserves be applied to debt service?

- Is investment salvageable?
  - How long will the building need capital infusions to meet debt service and operating shortfalls?
  - If need to invest new capital, is the return competitive with other similar opportunities?
  - How does the tax recapture affect this analysis?
  - Would investing additional capital improve the building’s short-term sale prospects? Who would benefit from such a sale?
  - Is there a source of new equity?
  - Can the debt be renegotiated? And, if so, what are likely terms?
Options to Consider

- Extend and pretend; delay and pray; kick the can
- Foreclosure
- Deed in lieu of foreclosure
- Section 1031: Credit tenant lease coupled with deed-in-lieu
- Bankruptcy
- Negotiate a possible restructuring with CMBS lender
What Does It Mean to Negotiate With the Lender?

- Who is the lender?
- Who is the special servicer?
- What is his phone number?
- Is he a nice guy?
- Will he listen to me?
- Should I trigger a default?
- Can I argue there is an “imminent default”? 
Who is the Borrower?

- Strength of sponsor
  - Financial
  - Management
- Tenant-in-common structures
- Financial strength of existing investors
Options to Discuss With Lender

- Foreclosure or deed in lieu (for tax purposes, this is a sale)
  - Capital gain: $13 million
  - Tax: estimated at $3.5 million
  - Results differ depending on whether debt is recourse (debt minus fmv) or nonrecourse (debt minus basis)

- The impracticable restructuring: A-Note/B-Note Structure
  - Proposed Restructuring
    - A Note: $5.7 million at 6.3% interest only
    - New equity: $5 million at 12% compounded return before any B-Note payment
    - B Note: $16.3 million; no interest and subordinate to new equity
    - Lender reserves of $1.7 million available to Borrower
    - After A Note and new equity repaid: 50% to B Note/50% to old equity
  - Potential COD Income (taxed as ordinary income)
    - Note: 2009 stimulus bill creates new options to defer COD income and other options are potentially unreliable
Options to Discuss With Lender (cont’d.)

- Why impracticable?
  - Borrower’s investors have no confidence in Las Vegas office market
  - $5 million new equity is viewed as very risky
    - Substantially overbuilt commercial market
    - Tenants are difficult to find
    - Brokerage commissions, TI, and concessions are staggering
    - For a 100,000 sf lease with a 5-year term
    - Total - $5.1 million upfront costs to owner if locate tenant
    - Total rental stream - $9 million
  - Prefer to walk away and pay taxes or engage in Section 1031 transaction

  - Purchase Note from Lender
    - Purchase price: $6 million, plus Lender retains $1.7 million TI reserves
    - New equity: $5 million plus purchase price
      - Can any of this new equity be borrowed?
    - If purchased by borrower or principals of borrower, results in COD Income but there may be ways to avoid this result
Options to Discuss With Lender (cont’d.)

- **Bankruptcy**
  - Triggers liability of guarantor under nonrecourse carveout guaranty

- **Section 1031 Approach:** results in credit tenant lease acquisition by Borrower and deed in lieu to Lender
  - **Summary:** existing property with $22M debt traded on a tax-deferred basis for property with $2M equity +$20M debt
  - **Step 1:** Owner invests approximately $2M through Qualified Intermediary (QI) to acquire credit tenant lease property
    - Tenants like CVS, Walgreen’s, Walmart are good
    - Self-amortizing mortgage for 25 years
    - Cost – approximately 11% of debt
    - Significant deferral of tax for 25 years
    - Residual value of ground
  - **Step 2:** QI transfers deed to Las Vegas office building to Lender
  - Lender must be cooperative and willing to take back property
    - Why would Lender cooperate?
Step 2 Pursuant to Exchange Agreement:
Deed in Lieu Relinquished Property (Las Vegas Office Building)

Step 1: Exchange Agreement

Step 3 Pursuant to Exchange Agreement:
Deed to Replacement Property (CTL Property)

$2M equity
$20M debt

Third Party

Qualified Intermediary

Release of Debt

BORROWER

LENDER
Case Study #2

Multi-Family Apartment Investment
In Las Vegas
Background Facts

- In 2005 Owner sells long-held commercial real estate for large gain
- Owner then engages in 1031 transaction, investing proceeds in a 300 unit apartment complex located in Las Vegas

Basic Economics
- Total Purchase Price: $30 million
- Equity: $6 million
- CMBS Debt: $24 million

Apartment Complex Profile at Time of Purchase:
- 300 units, mix of 1 bedrooms and 2 bedrooms
- Occupancy Rate: 97%
- Current (i.e., 2005) NOI: $1.5 million
- Projected 2006 NOI: $1.8 million
- Assumed 5% increases in NOI thereafter
Background Facts (cont’d)

- **Loan terms:**
  - Interest rate: 5.5%
  - 10-year maturity
  - Interest-only for 5 years; then 30-year amortization
  - Annual debt service: $1.44 million/$1.64 million starting in 2010
  - LTV: 80%
  - Reserves: Nominal

- **Investment Profile:**
  - Price per unit: $100,000
  - Debt per unit: $80,000
  - Projected hold period: 7-10 years
  - Projected IRR: 12%
The Picture at the End of 2009

What happened?
- Vegas apartment market loses tenants, increases concessions, and values plummet

Project economics at end of 2009:
- Occupancy 82%
- NOI (before debt service) $1 million [33% decline]
- Yearly debt service: $1.44 million, scheduled to bump to $1.64 million
- Annual deficit: $440,000/$640,000
- 2009 Appraisal: $14.3 million (at 7% cap rate) [52% decline]

Impact of foreclosure/deed in lieu
- Borrower tax recapture Estimated at $4.8 million (unquantified by Lender)
Question To Consider in Reviewing Options

- To what extent does lender have recourse to individual members?
  - Review carefully Note, Deed of Trust, and Guaranty
  - Is Guarantor liable for failure to pay operating expenses and real estate taxes?
  - Is the springing guaranty triggered if the Owner files for bankruptcy?

- Is investment salvageable?
  - If need to invest new capital, is the return competitive with other similar opportunities?
  - Can the debt be renegotiated? Will the debt need to be refinanced and, if so, what are likely terms?
  - Is there a source of new equity?
Options to Discuss with Lender: Lender Perspective

- Sale of Note (assume 25% discount on appraised value)
  - $10.9 million less recovery and transaction costs
- Foreclosure/Deed in Lieu and Operate
  - $1 million annual cash flow less recovery costs and internal costs to manage
- Foreclosure/Deed in Lieu and Sale (assume 10% costs)
  - Cash: $11.6 million (10% discount off appraised value)
  - Lender financing (no discount)
    - Cash  $3.87 million
    - Note  $9 million @ 6% interest only for 5 years

In summary, absent a restructuring (see below, p. 34, for restructuring option), present value recovery to Lender is in range of $10-14M
Liquidation Expenses as a Percentage of Proceeds by Property Type

Options to Discuss with Borrower: Borrower Perspective

- Foreclosure/deed in lieu (OUCH!!!)
  - Loss of investment and $4.8 million tax recapture
- Continue to fund deficits
  - $640,000/year and investment still underwater by approximately $10 million
- New investors (NO WAY!!!)
  - Cannot pay a market return absent loan restructuring
- Section 1031 exchange into credit tenant lease with deed in lieu to Lender
  - Requires Borrower to fund $2.88 million acquisition cost
  - Requires Lender to cooperate and take deed in lieu
  - Better for Borrower than foreclosure or deed in lieu only
  - 25 year tax deferral
  - Land will have residual value
Restructuring Between Borrower and Lender

- **STEP 1**: New equity from Borrower of $3 million, reducing note to $21 million
  - Better than foreclosure/deed in lieu for Borrower
  - Requires slightly greater investment by Borrower than Section 1031 exchange

- **STEP 2**: Lender writes off $3 million, reducing note from $21 million to $18 million
  - $3 million haircut to Lender but $3 million in cash from Borrower
  - More potential value to Lender than other options (present value in range of $16M)
  - Tax consequences of COD must be considered by Borrower

- **STEP 3**: Bifurcate note into 2 pieces
  - A - Note $13 million at 5.5% interest only for 5 years
    - Preserves current interest rate
    - Approximately $ 750K debt service annually to Lender, in addition to $3 million cash upfront
  - B – Note $5 million at 4% accrual
    - Payment contingent on capital event
  - New Equity ($3 million): in middle between A Note and B Note
Restructuring Between Borrower and Lender (cont’d)

- New equity return
  - Subordinate to A Note
  - Entitled to additional cash flow up to 8% return
  - Cash flow likely available from day one
  - Balance of cash flow
    - To be negotiated
  - Split of capital proceeds
    - To be negotiated

- What happens with restructuring in a refinancing?
Special Services Issues

- Overwhelmed by volume of defaulted loans
- Performing triage
- Borrower should develop credibility
- Borrower and special servicer should try to have common understanding of legal and business issues
- Borrower should do the analysis for servicer to move things along
- Does the special services have a hidden agenda?
  - Capmark purchase by Berkadia
  - LNR possible bankrupting filing
- Not all special servicers and asset managers are alike
  - Different attitudes among special servicers
  - Different strategies even among asset managers representing a specific special servicer
Conclusion

- One size does not fit all situations
- Borrower and lender must realistically assess legal and business issues
- Potential workout or restructuring will be measured against worst case scenario – bankruptcy/lender liability or suit and recovery under guaranty
- Outside factors (regulatory, accounting, or tax consequences) can result in irrational conduct by borrower and/or lender
- The key may be some new equity but whether new equity makes sense may be a real question
- Creativity on the part of Borrower and Lender may make for a win-win for many
Conclusion (cont’d)

- This is a new world which calls for new solutions
- Examine carefully borrower
  - Management Strength
  - Financial Strength
- Special servicers may have conflicts to the extent they are acting as servicers for transactions in which they own a piece of the deal
- May we survive this global recession and not as quickly forget, as we have in the past, lessons learned regarding:
  - Careful underwriting and due diligence
  - Benefits of the transparency of financial products
  - Better oversight by ratings agencies
  - Limits on leverage
Negotiating and Structuring the Deal

A. Representations and Warranties

- Closing Conditions
- Intercreditor Rights
- Third-party Rights

Thomas D. O’Connor
Cooley Godward Kronish
New York, NY
212-479-6265
Toconnor@cooley.com