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Real Estate Lending Structures and Their Bankruptcy Drivers: Understanding How We Got Here

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Introduction to Real Estate Financing Structures

- Bankruptcy has driven the evolution and form of the real estate finance structures that predominate the market.
- Various real estate finance structures and provisions affect results in a future workout or bankruptcy proceeding.
- Here we discuss taming the bankruptcy bogeyman.

The “Big-Boy Pants” Theory of Real Estate Lending

- Real estate investors leverage their returns on a project with debt:
  - Limit downside risk by recourse only to the collateral; and
  - Investors shield personal wealth and other sources of recovery.
- Real estate lenders underwrite loans on a collateral-only, recourse basis:
  - Lender underwrites loan and conducts due diligence for “non-recourse” loan; and
  - Lender takes the risk that value of real property collateral may decrease.

The “Big-Boy Pants” Theory of Real Estate Lending (cont’d)

- Lender’s willingness to lend on a non-recourse, collateral-only basis is predicated on Lender having true access and information to the collateral
  - Don’t lie;
  - Don’t cheat;
  - Don’t steal; and
  - Don’t obstruct access to recover against the collateral.
- These principles form the basis of “non-recourse carveout” or “bad boy” guaranties.

A Disturbance in the Force: Bankruptcy's Impact on Non-Recourse Real Estate Lending

- Getting into bankruptcy:
  - Despite efforts to insulate a real estate transaction from bankruptcy and attendant downsides to creditors and equity holders, these structures do not render a real estate project "bankruptcy-proof."
  - Blanket prohibitions against filing for bankruptcy protection are against public policy.
  - There are three ways an entity can be put into bankruptcy: (1) voluntarily, by the entity's management; (2) involuntarily, by the entity's unsecured creditors; or (3) involuntarily, by application of the equitable doctrine of "substantive consolidation."

A Disturbance in the Force: Bankruptcy's Impact on Non-Recourse Real Estate Lending (cont'd)

- General Principles of Bankruptcy Policy:
  - Debtor's property becomes part of an "estate" that is administered through a court-supervised process.
  - Maximize the value of the estate's assets for the benefit of *all stakeholders*, not just secured creditors.
  - Absent an agreement post-filing, similarly situated creditors are treated similarly (equality of treatment of creditors within each creditor class).
  - Watch dog appointed for unsecured creditors to ensure bankruptcy process is not run solely for the benefit of secured creditors.
  - Prohibition on enforcement actions to provide the debtor time to develop a reorganization or liquidation strategy.
  - *These bankruptcy policies are antithetical to the goals of senior secured lenders, who want quick access to the real estate if there is an event of default*.

A Disturbance in the Force: Bankruptcy's Impact on Non-Recourse Real Estate Lending (cont'd)

- Three Biggest Consequences to Secured Creditors in Bankruptcy:
  - The Automatic Stay. The automatic stay is triggered automatically upon filing, which enjoins remedial actions of all creditors.
  - Cramdown. A key bankruptcy power is to bind classes of creditors to a plan to restructure a debtor's balance sheet, even if the creditor class votes to reject the treatment proposed in the plan.
  - Priming Financing/Cash Collateral. A debtor can obtain access to liquidity post-bankruptcy to operate, either through financing on a priming basis or cash generated by the property.

A Disturbance in the Force: Bankruptcy's Impact on Non-Recourse Real Estate Lending (cont'd)

- The automatic stay enjoins:
  - enforcement of any lien against property of the estate (e.g., foreclosure actions);
  - any act to obtain possession of or exercise control over property of the estate; and
  - recovery of a claim against a debtor.
- It is possible to lift the automatic stay for "cause" (e.g., the debtor lacks any equity in the property).
- If the property is essential to an effective reorganization, courts will not lift the automatic stay to allow a secured lender to foreclose.
- If the debtor qualifies as a single asset real estate debtor, secured creditors receive enhanced rights.

Plan of Reorganization: "Cramdown" Treatment

- Cramdown. Section 1129(b) of the Bankruptcy Code allows the confirmation of a plan over the "no" vote of a class of creditors, even if the creditor class is senior and secured (known colloquially as "cramdown").
- Cramdown is a powerful tool because it binds an entire class of creditors to a plan they have voted to reject.
- Two key components to confirm a "cramdown" plan:
  - The plan must not discriminate unfairly; and
  - The plan must be "fair and equitable."

Plan of Reorganization: "Cramdown" Treatment (cont'd)

- For secured creditors, a plan is "fair and equitable" if it satisfies one of three criteria:
  - Sale. The collateral securing the debt is sold free and clear, and the liens attach to the sale proceeds.
  - Return of the Collateral. The secured creditor is provided with the "indubitable equivalent" of its claims.
  - New Loan. The secured creditor retains liens on the property and receives deferred payments: (1) totaling the amount of the allowed secured claim, and (2) equal to a value, as of the plan effective date, of the value of the creditor's interest in the estate's interest in property.

Plan of Reorganization: "Cramdown" Treatment (cont'd)

- New Loan. This cramdown treatment presents the greatest risk of full recovery to secured creditors.
- Paid over time. As the new loan will be paid over time, a rate of interest on the loan must be determined to ensure the creditor receives present value of claim.
- Two Approaches:
  - Prime Plus/Formula Approach. Interest rate on the new loan set at the prime rate (as of the plan effective date) plus a nominal increase to account for credit risk of loan to reorganized debtor.
  - Market Approach. Where a market exists for the type of loan being offered to the secured creditor, the interest rate should be set at the market rate.

Plan of Reorganization: The 1111(b) Election

- Under certain circumstances, an undersecured creditor can elect to have its claim treated as fully secured – the 1111(b) election.
- A secured creditor making an 1111(b) election is entitled to receive:
  - payments over the life of the plan aggregating the secured claim, but
  - payments over time equal the present value of the secured claim.
- Strategic considerations for making the 1111(b) election:
  - Secured creditor may benefit from a fully secured claim if the collateral appreciates in value (e.g., in the event of a sale or refinance).
  - Secured creditor may benefit from having an unsecured deficiency claim that controls the vote of the class of unsecured claims.

Other Bankruptcy Risks: Priming Loans, Adequate Protection

- The last significant bankruptcy risk that can affect secured lenders is the debtor's ability to use cash post-filing to operate its business.
- There are two ways for a debtor to obtain access to liquidity:
  - Priming Financing. The Bankruptcy Code authorizes a debtor to obtain a loan that primes senior secured lenders.
  - Cash Collateral. The Bankruptcy Code authorizes a debtor to use cash generated by the property.
- Adequate Protection. To obtain priming financing or right to use cash collateral, senior lenders must receive adequate protection.
- Adequate protection burden is usually met by the debtor in a bankruptcy case, and the form of adequate protection may not seem adequate to the senior lenders.

Minimizing the Bankruptcy Risk: Springing Recourse Liability

- Recourse liability if borrower commences a bankruptcy:
  - Borrower commences a voluntary bankruptcy; or
  - Borrower engages in collusive behavior leading to an involuntary bankruptcy.
- Recourse liability if borrower violates separateness covenants.
- Recourse liability if borrower encumbers or otherwise transfers the collateral property.
- A guarantor is on the hook for these “bad boy” behaviors, but this is only as good as the creditworthiness of the guarantor.

"Bad Boy" Guaranties – Enforceable

- Bad Boy Guaranties in Bankruptcy:
  - Can be enforced in state court (favorable forum), not necessarily in bankruptcy court.
  - Not against public policy, despite incentivizing managers to delay an appropriate or necessary bankruptcy filing.
  - That the liability of a "bad boy" guaranty may substantially exceed the damages is usually of no moment. Sophisticated financial parties can agree to full-recourse liability.

Minimizing the Bankruptcy Risk: Single Purpose Entities and Separateness Covenants

- Minimize the risk that collateral will become subject to a bankruptcy proceeding:
  - Prohibit liabilities unrelated to the collateral that may lead to insolvency;
  - Require borrower own the single asset subject to the mortgage; and
  - Require other "separateness" covenants.
- But a single purpose entity is not immune from bankruptcy….

Substantive Consolidation

- Substantive consolidation: an equitable doctrine where the assets and liabilities of two separate companies are combined.
  - Substantive consolidation is an extraordinary remedy vitally affecting substantive rights because every entity is likely to have a different debt-to-asset ratio, thus consolidation almost invariably redistributes wealth among creditors of the various entities.
  - This problem is compounded by the fact that liabilities between the consolidated entities are also extinguished.

Substantive Consolidation (cont'd)

- When does a court order substantive consolidation?
  - Creditors dealt with the to-be-consolidated entities as a single unit and did not rely on their separate identities when extending credit; or
  - The affairs of the debtor are so entangled that consolidation will benefit all creditors because disentangling is either impossible or so costly as to consume the assets of the to-be-consolidated entities.
- If corporate formalities (e.g., separateness covenants) are not observed, an entity can be pulled into a bankruptcy case if it is consolidated with one of its bankrupt affiliates.

Substantive Consolidation & Non-Con Opinions

- Non-Consolidation Opinions
    - A Non-Con Opinion is a letter from an independent attorney to a lender that its prospective borrower would not (or should not) be consolidated into a third-party's bankruptcy.
    - A Non-Con Opinion may be required by a rating agency in connection with a loan transferred to a Real Estate Mortgage Investment Conduit (REMIC). A REMIC is used to pool together similar loans and issue mortgage-backed securities, which are priced according to risk assessments performed by rating agencies.

Substantive Consolidation & Non-Con Opinions (cont'd)

- Limitations of a Non-Con Opinion:
  - It is not a guaranty.
  - Certain assumptions can neuter the opinion.
- Utility of a Non-Con Opinion:
  - Reliance on the opinion can provide protection. At least attention is paid to separateness issues that may impact consolidation and credit risks.
  - Institutional policy may require a Non-Con Opinion.
  - Maximize exit strategies—a transferee may require a Non-Con Opinion.

Non-consolidation: Lessons from the *General Growth* bankruptcy

- Given the potential for an inequitable result, the remedy of substantive consolidation is used sparingly.
- The *General Growth Properties* bankruptcy is an example where a court respected corporate separateness (notwithstanding the failure to dismiss the bankruptcy filing of GGP's SPEs).

Minimizing the Bankruptcy Risk: Additional Lender Protections

- Appointment of one or more Independent Directors:
  - From a nationally recognized company that provides professional independent directors.
  - Resignation, removal or replacement requires advance notice to Lender.
- The duties of an Independent Director:
  - Why not prohibit a bankruptcy filing and only consider the interests of the Lender?

Bankruptcy Remote, Not Bankruptcy Proof

- Notwithstanding the appointment of an independent director, the SPE can still commence a bankruptcy voluntarily:
  - Exercise of fiduciary duty of independent board member of SPE to file bankruptcy will be respected.
  - Fiduciary duty runs to SPE entity and its equity holders, not to SPE lenders.
  - Insolvency not required—an SPE can be solvent and still avail itself of bankruptcy protection.
  - Imminent risk of default is not required to commence a chapter 11 case.
  - Limiting/eliminating fiduciary duties of board members may trigger lender liability risks to other stakeholders.

Maximizing Leverage: Multiple Lender Structures

- First/Second Lien Structures, or so-called “contractual subordination.”
  - First and Second Lien Lenders share lien in common collateral, but Second Lien Lender agrees to subordination of lien, including standstill of enforcement remedies and “silent” rights regarding release of collateral, bankruptcy financings, and bankruptcy sales.
  - Generally disfavored in real estate lending, but still see this legacy structure on occasion.
  - EB-5 financing.
- Senior/Mezzanine Structures, or so-called “structural subordination.”
  - Senior-Mortgage Lender makes a loan secured by the real property of the mortgage borrower.
  - Junior-Mezzanine Lender makes a loan to mezzanine borrower secured by a pledge of the membership interests in the mortgage borrower.

Maximizing Leverage: Multiple Lender Structures (cont'd)

- "Common collateral" risks to senior lender in a first-second lien "contractual subordination" structure:
  - Modification of debt may result in loss of priority.
  - Junior lender foreclosure may result in termination of leases.
  - Bankruptcy of junior lender stays senior lender remedies.
  - Appointment of receiver by junior lender vs. senior lender.
  - Interference with deed-in-lieu transaction.
  - The rights the junior lien creditor have as an unsecured creditor are preserved.
  - Enforceable in a bankruptcy pursuant to §§ 510(a) and 1129(a)(1).

Senior/Mezzanine Intercreditor Agreements

- Bankruptcy Specific Issues in Senior/Mezz Intercreditor Agreements:
  - Common Guarantors:
    - Should a Mezz Lender be restricted from causing the bankruptcy of a common guarantor?
  - Replacement Guaranties:
    - Is the Senior Lender protected if the Mezz Lender steps into the shoes of Mortgage Borrower?

Other Bankruptcy Issues in Commercial Real Estate Lending

- Risks of Recharacterization of Loan to Equity.
- Treatment of leases in bankruptcy:
  - Assumption and rejection;
  - Section 502(b) cap on lessor claims; and
  - Protections and restrictions of Section 365(h) for lessees
- 363 Sales, Plan Sales and Credit Bidding.

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Mr. Shapiro's practice experience includes representation of real estate funds, lenders, and institutional and non-institutional investors in all areas of real estate, including: acquisitions and dispositions; construction, mortgage (fee and leasehold), mezzanine and participating financing; loan restructuring and workouts; and forming and representing limited liability companies, general and limited partnerships and joint ventures. Prior to joining the Real Estate Department, he represented debtors and creditors in high profile Chapter 11 proceedings, out-of-court restructurings, commercial bank financings and complex inter-creditor litigations.

Mr. Shapiro received his law degree from the New York University School of Law in 2000. He received his Bachelor of Arts degree in history with a minor in math, *cum laude*, from the University of Pennsylvania in 1996.

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Ms. Katzir has helped to spearhead the firm's growing EB-5 practice and has significant experience in the structuring of EB-5 financings. In this capacity, Ms. Katzir has represented developers and institutional lenders in connection with almost $1 billion of high-profile EB-5 financings secured by hotel, office, residential and retail assets, including large mixed-use developments and master-planned communities, across the western United States. Her role in these transactions includes negotiation of offering documentation, management agreements with regional centers and placement services arrangements with intermediaries and distributors. Ms. Katzir has also represented senior and junior lenders in intercreditor arrangements involving EB-5 financings, and has advised consumers of EB-5 funds regarding the integration of existing EB-5 programs into larger structured finance regimes.

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Mr. Denny, moreover, has worked from start to finish on various real estate work-outs, including the drafting of pre-negotiation agreements, forbearance agreements and loan modification agreements. Mr. Denny has represented major institutional lenders in connection with the origination and sale of construction and permanent mortgage loans and mezzanine loans, including the structuring and negotiation of intercreditor agreements and co-lender agreements.

Mr. Denny is currently a member of the Financial Lawyers Conference, the Los Angeles Bankruptcy Forum and the Los Angeles County Bar Association.

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