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# What Are the Options for Real Estate Owners Facing Loan Defaults

Owners facing challenges today have several restructuring options, but it's critical to get guidance.

Harold Bordwin | Oct 31, 2023

The almost daily announcements in the press about defaults, foreclosures, deeds-in-lieu and, among other things, the forthcoming sale of Signature Bank's $33 billion commercial real estate loan portfolio are ominous signs for the real estate community. They reflect the challenges facing commercial real estate owners and lenders in this age of elevated interest rates and depressed property values.

With so many commercial real estate loans maturing, what is a property owner to do?

Property owners have several restructuring options to address real estate defaults. It's important to address a potential real estate default earlier rather than later. Whether facing a covenant default or a payment default, an owner's optionality decreases daily as the default date approaches.

Here are some of the options that are available.

**Discounted payoff (DPO)**

A discounted payoff (DPO) is an agreement between a property owner and lender where the loan is repaid for an amount less than the outstanding balance. This can be a good option for property owners who are struggling to make their loan payments and who have some equity in their property. There are investors in the market ready to support property owners by funding DPOs. Nevertheless, it is important to note that a DPO may have tax implications, so best to consult with a tax advisor before entering into a DPO agreement.

**Loan restructuring**

Loans can be restructured in several ways, among them:

- extending the term of the loan;
- splitting the loan into parts, with one piece capable of being serviced currently, and the other serviced depending upon the property's future performance; and
- adjusting interest rates, converting to interest only, payment-in-kind (PIK) interest, or otherwise negotiating an alignment of monthly payments to cash flow.

In these restructurings, the property owner typically brings additional equity to the table to pay down debt and realign the loan to value (LTV) and/or properly capitalize the commercial real estate entity to meet its ongoing business commitments. When the property owner is unable or unwilling to contribute additional equity, preferred equity can be the solution.

Preferred equity grants the new money partner "first money out" status plus a healthy return. In many instances, given how expensive preferred equity is, it is difficult to see the economic benefit to the owner of going down this route.

**Refinancing**

For those faced with maturing fixed-rate debt, sticker shock awaits you. Moreover, in the current economic climate, conventional bank lenders (driven by concerns over the state of the commercial real estate market and their existing portfolios, as well as increasing regulatory scrutiny), have scaled back their offerings. As a result, exploring alternative avenues is essential. The realm of private lending presents a diverse array of options, necessitating proactive engagement with traditional hard money lenders, bridge lenders, private equity funds, hedge funds and high-net-worth investors.

It can be difficult to refinance a loan in a distressed situation, as lenders may be reluctant to lend to borrowers who are struggling to make their payments. Here are some of the challenges that can make refinancing a distressed commercial real estate loan difficult:

- Decline in property value: If the value of your property has declined, you may not be able to refinance your loan for enough money to pay off your existing debt. In this case, you may need to write a check to cover the difference, which may not be feasible or desirable.
- Inability to find a replacement lender: In a distressed market, it can be difficult to find a lender who is willing to refinance your loan. Traditional lenders may be especially reluctant to lend to borrowers in distress.
- High costs: Even if you are able to find a replacement lender, the costs of refinancing can be high. This is especially true in the current market environment, where specialty lenders such as bridge lenders and hard money lenders are more likely to refinance distressed commercial real estate loans.

## Sale/short sale

If a property owner has equity in their property, they may be able to sell it to repay their loan. However, if the property is worth less than the outstanding balance of the loan, the lender may need to approve a short sale (absent an exception to lender consent as described in Section 363 of the Bankruptcy Code). A short sale is a sale of property for less than the amount owed on the mortgage.

## Bankruptcy

Bankruptcy, in general, is not a solution in and of itself, but it can provide property owners with tools and time to create a solution. For example, the “automatic stay” can stop a foreclosure and create space for continued negotiations. Moreover, in certain circumstances, owners can file a plan of reorganization that seeks to “cram down” the lender by extending the loan, reducing the loan amount to the value of the property, and/or paying the loan out over time at market rates of interest. Not surprisingly, such plans are highly objectionable to lenders and are typically fraught with expensive and protracted litigation.

## Deed in lieu

A deed in lieu of foreclosure is a consensual transfer of title to a property from a borrower to a lender. This can be a good option for property owners who are unable to make their loan payments and have lost their equity in their property. When a property owner has no upside in its property—and no personal guarantees—a deed in lieu is a quick and inexpensive way to resolve a default. Interesting issues can arise, however, when the mortgagee does not want to accept a deed in lieu.

As you can see, commercial real estate owners facing challenges today have several restructuring options, but it's critical to get expertise and guidance from trusted real estate restructuring advisors. Contact a trusted real estate restructuring advisor today to learn more about your options and how they can help you achieve your goals.

*Harold Bordwin serves as co-president of Keen-Summit Capital Partners. In that role, he is responsible for all aspects of business development and execution at the firm. He focuses on developing and implementing strategic real estate and corporate finance plans for his clients. Harold has more than 33 years of real estate advisory and transactional experience, with particular expertise in workouts and restructurings and other special situations.*