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SPECIAL REPORT
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Structured Debt Complicates Dealing with Troubled Loans

Attorneys finding each layer of the capital stack and every lender has different priorities

BY MANDY JACKSON/ *CREJ STAFF WRITER*

As if the process of working out troubled loans wasn't complicated enough, attorneys are finding that structured financing makes the exercise more complex and less predictable than in past real estate cycles.

It's not that each type of lender in the capital stack has a different agenda, but every bank, institution and equity partner has a different set of priorities. Some are more willing than others to let another player take over and others are more able than some to sink additional capital into a project.

Mikel Bistrow, partner in the San Diego office of **Duane Morris LLP**, said she has stopped predicting which route borrowers with troubled loans should take based on the type of lenders they are dealing with.

"People are so intermixed in what their loans and investments and strategies are, it becomes hard to predict what the lender's strategy is on a project," Bistrow said.

The motivations of each lender and their tolerance for adding time to the repayment period varies. Since regulated banks have to report defaults, they have added pressure to deal with borrowers that anticipate problems repaying their debt. A non-regulated institution doesn't have that concern.

"When you have multiple-tier lending, one of the things that is a problem is the borrower needs permission from all of the lenders to do anything," Bistrow said. "The junior position may be willing to give more time than the first lender who expected to be paid back quickly."

Structured financing boomed as banks competed to fund acquisitions and new development and private equity players sought vehicles to invest in real estate.

In structured transactions, debt from a first or senior lender, such as a bank or an institutional source of capital, is supplemented by secondary financing from a mezzanine or junior lender who funds a smaller portion of the project or provides equity to reduce or eliminate the buyer's or developer's required contribution to the deal.

"These deals have been unraveling for some time," Bistrow said. "Really, in the last year or so, there's been quite a pickup in foreclosures in which these have been unraveling."

Greg Pyke, partner in the San Diego office of Best Best & Krieger LLP, said every troubled loan with structured financing and the response of the lenders is unique in the current market.

"There is always a fundamental analysis of what is the collateral or what secures the fundamental rights of the creditor and then who's in a position to move forward with their remedies," Pyke said.

Usually, the primary lender in a structured transaction, whose loan is secured by the land or building, is in a better position than the mezzanine lender, which may be required to hold off on its remedies for a period of time under an inter-creditor agreement. There are some cases where the mezzanine lender is in a better position and they're able to move forward with trying to restructure the asset's debt.


CREJ PHOTO BY MANDY JACKSON

Julie Mebane, left, and Mikel Bistrow of Duane Morris LLP in San Diego said lenders involved in structured financing for condominium projects are considering their options from working out loans to foreclosures when developers default on loans.

"It's quite an interesting phenomenon, because it just really depends on how badly these land-secured lenders are getting gored," Pyke said. "In the last go-around, they were essentially unwilling to let the mezzanine lenders work their way out of it."

Now that many banks and institutions have growing inventories of defaults and foreclosures, if there is another party that might be able to turn around a troubled loan, they're willing to give them some rope, he said.

Pyke has been working on troubled loans involving office developments and acquisitions in San Diego County. Some investors have run into problems where the buildings they purchased have lost tenants and the vacancy rate is high enough that they don't have enough income to pay down their debt.

"I also have some developments where they got money and began developing the property and they ran into problems where they couldn't get the property leased," Pyke said. "Where the developer hasn't gotten pre-lease commitments and he's not coming out of the ground, those are easier to deal with. Others are coming out of the ground and now they're trying to figure out what to do."

Condominium Woes

During the last six months, Bistrow has been working with developers to prevent foreclosure or negotiate workouts for structured financing on condominium projects that she helped put in place a few years ago.

She said inter-creditor agreements sometimes have an option for the secondary lender to buy the first loan, possibly at a discount, so that construction can be completed or vacancies can be filled and the property can be sold.

When borrowers default, lenders make project-by-project determinations. In the case of condominium developments or conversion projects, the first and second lenders may allow a completed project to become a rental complex until the for-sale market improves enough to sell condominiums again.

Angela Yates, partner in the San Diego office of Pillsbury Winthrop Shaw Pittman LLP, said there have been some foreclosures on condominium conversions in San Diego and some projects are reverting back to rentals.

"I believe that in many cases because the values just aren't there, the mezzanine lenders are taking some losses," Yates said. "It depends on how much equity is in the project and it depends on the values."

If there's a substantial decrease in value, where it looks like a conversion to condominiums will not sell the units in a reasonable timeframe or an apartment investor won't pay enough for the asset to cover the debt, Yates said lenders have taken losses and foreclosed on some properties.

If there is some ability to recover the loan value and some equity, the first and second lenders will usually support the condominium conversion until it is complete.

Some lenders are facing problems with projects that haven't even started construction, but there is debt on the land acquired for condominiums.

San Diego-based Simplon Ballpark LLC has filed for Chapter 11 bankruptcy protection to avoid foreclosure on a one-block site between J Street, Seventh, Eighth and Island avenues in downtown San Diego. The developer planned to build more than 300 condominiums over ground-floor retail space and a new fire station, but is now seeking loan commitments for a tower with a mix of hotel rooms and condominiums.

"Most of the lenders who make loans to residential developers expect to be paid off when the condos are sold," Bistrow said. "They have to look at [troubled loans] on a case-by-case basis. They may be willing to extend the maturity date of the loan. They may take [the property] back. They may restructure the loan and allow a standstill while the project is a rental. It depends on who the lender is and the borrower."

It's easier for a lender to adjust the maturity date on a loan if the borrower is current on loan payments. Some lenders are willing to take a hit by foreclosing on a project to get a nonperforming loan off their books.

Julie Mebane, partner in the San Diego office of Duane Morris, said there have been a lot of problems with commercial real estate loans made for multifamily housing development, and it may be better for the secondary lenders if they can take over the loans and guide the projects to completion rather than lose out on their initial investments.

"The problem is junior lenders may not be in that position," Mebane said. "Some of them became really sloppy without the kinds of protections they had in other times."

Varied Levels of Commitment

With new development, it will also depend on where the borrower's project is in the construction process, Bistrow said. Lenders will consider whether or not more money needs to be spent to finish construction and pay contractors for completed work.

"A lot of times the lender is willing to stay committed but not put more money in," Bistrow said. "That's one way to test the mettle of the developers and junior lenders, if they're willing and able [to invest more equity], rather than willing and unable. I have had times when the junior lender is unwilling and unable and at that point the project fails."

When the mezzanine lending started coming from private equity funds instead of institutions, the private investors were generally versed in operating property, so they were not afraid to foreclose. Bistrow said such strategies used to be called loan-to-own and there are still private equity partners with real estate backgrounds who are interested in taking over projects when their developer partners default on their loans.

That doesn't mean institutional investors are looking to foreclose at the first sign of trouble, however. Mebane noted that many large institutional lenders have several outstanding loans with the same borrowers for multiple projects.

"I have one client with a lot of lending from two or three institutions and [those lenders] are really trying to work with this borrower," she said.

Jon Janecek, partner in the Newport Beach office of Newmeyer Dillion LLP, said he has seen a few troubled commercial real estate loans this year, but it doesn't seem like lenders are prepared yet to deal with workouts and foreclosures.

"Part of the issue, at least the way I'm seeing it right now, is that in 2007, even though the real estate market wasn't doing well, the lenders didn't want to deal with it so they were putting it off to 2008," Janecek said. "The lenders are now putting together teams that know how to foreclose loans."

Complicating matters further is the fact that most borrowers had only one loan in the early 1990s. When they defaulted, banks looked at the guarantees they had in the terms of the loans and what they could do with the assets if they took control of the properties. Today, Janecek is working with a developer who has structured financing on a condominium conversion in Long Beach. The debt involves an institutional lender, a mezzanine lender with an ownership interest and an inter-creditor agreement.

"The owner really is out of it; they don't have any skin in the game," Janecek said. "The lender and mezzanine lender just focus on their inter-creditor agreement."

Randy Orlik, partner at Cox Castle & Nicholson LLP in Los Angeles, noted that the creditors involved in structured financing with commercial mortgage-backed securities might not have a resolution other than foreclosure when borrowers default on loans.

Securitized debt is put into real estate mortgage investment conduits, or REMICs, which are pools of loans from which investors buy pieces of loans in the secondary market. Orlik said the tax-exempt status of REMICs puts limitations on how the debt financed by conduit lenders can be restructured.

The entities are formed as tax-free structures to avoid double taxation since the investors who buy pieces of securitized debt are taxed on their income from those investments.

However, the Mortgage Bankers Association reported last month that delinquency rates were at or near record lows for most major investor groups in 2007, including CMBS conduits.

The analysis looked at delinquency rates since 1996 for commercial banks and thrifts, CMBS, life insurance companies and the government-sponsored entities, Fannie Mae and Freddie Mac. Those lenders hold more than 80 percent of the commercial and multifamily debt outstanding in the United States.

The CMBS market has a 0.4 percent delinquency rate while life companies have a rate of 0.01 percent. Fannie Mae's delinquency rate is 0.08 percent and Freddie Mac's rate is 0.02 percent. Banks and thrifts reported a delinquency rate of 0.8 percent. Each group's classification of delinquencies varies. While banks count loans 90 days or more past due, the CMBS market includes loans that are at least 30 days delinquent.

CMBS delinquency rates at the end of 2007 were lower than those for nine of the previous 10 years. Life companies finished 2007 with a delinquency rate lower than the year-end figures for all of the preceding 11 years. Fannie Mae and Freddie Mac finished 2007 with delinquency rates equal to or lower than 10 of the previous 11 years. The delinquency rate for banks in 2007 was only lower than five of the prior 11 years.

But with foreclosures on the rise in 2008, Yates said there is resistance from lenders now to fund transactions in which borrowers are looking for structured financing.

"I'm not seeing [transactions with] more than one lender, but that doesn't mean it's not happening," she said. "Borrowers understand that the banks are less interested in the stacked capital structure. They want some equity in the project to keep them in the deal."