Real Estate Workouts (Part1 With Checklist)

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Before you decide how to handle a workout, make sure you understand what led to the need for it.

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ALTHOUGH THE precise nature of the actions to be taken in response to a real estate default vary widely with the nature of the project, the clients' involvement in the project, the type of default, whether the financing is conventional or securitized, and the financial resources of the client, the approaches taken by seasoned attorneys have many common elements. Defaults of various kinds are common in all real estate projects, but the "serious" default arises when current or anticipated financial shortfalls result in a present or forecast nonpayment of secured debt relating to the project. Most real estate defaults do not immediately result in foreclosure of the liens securing payment of the debt or precipitate a filing for voluntary or involuntary relief under the Bankruptcy Code. While those results might be the ultimate legal devices selected by one or more of the parties in response to the default, the commencement of the foreclosure or bankruptcy proceeding only changes the arena in which the workout occurs. The purpose of this discussion is to examine the actions preceding litigation which might or should be taken under default circumstances.

1. Initial Actions

Assuming that the attorney and the client have a fundamental understanding of debtors' relief proceedings and creditors' rights and that the psychological impact of the default is rapidly overcome, it becomes readily apparent that the major problem encountered in any default is the ability to rapidly compile and assimilate the facts relating to the project. Decisions must be made and approaches adopted under circumstances that do not usually leave much time for reflection. If it is initially determined that the client executed documents containing carve-out provisions that will give rise to springing liabilities, those facts must be resolved in the initial review of the transaction. If they are present, the initial actions will be abbreviated and the cost-to-benefit ratio will not justify a workout of any type. If the loan documents are conventional and contain no springing liabilities, the initial actions as hereafter described are usually undertaken. Many times, the facts seem to be acquired by osmosis as the attorney attempts to respond to the progression of crises emanating from the default. The initial philosophy is almost always dedicated to containment of the rupture so that the structure of entwined contractual rights and remedies that the project represents will not collapse under the weight of nonperformance.

1.1 Determining the Cause of the Default. Given the cyclical nature of the economy in general and the real estate industry in particular, prior judgments are regularly demonstrated to have been too optimistic. Some inquiry into the proximate cause of the default is helpful in attempting to understand and devise solutions to the problem.

1.1.1 Unrealized Receipts: National, regional, or local market collapse resulting in lower than anticipated sales or rental income; business failure of prospective tenants or purchasers; delays in delivery of sale or rental units; inability to obtain financing; inability to locate replacement financing; inability to fund financing commitments.

1.1.2 Unanticipated Disbursements: Delays in completion (labor disputes, labor or material shortage, regulatory intervention, non-delivery of off-site facilities, design difficulties, defaults by contractors, subcontractors or suppliers, casualty loss, mismanagement, unrealistic projections, weather, death, disability); cost overruns (excess interest expense arising from increase in variable rate or time to completion), "cost plus" contracts, incomplete or inadequate plans and specifications, inadequate allowances, "front loaded" construction contracts followed by contractor default, price inflation (utilities, fuel, specialty items), increase in the scope of the work, construction, architectural and engineering extras, extraordinary site conditions (rock, de-watering, hazardous substances), excess tenant improvements and inducements, unanticipated brokerage and other marketing expenses, tax escalation, attorneys and other professional fees).

1.13 Inadequate Management: Misconception (bad idea, bad location, change of surrounding area, loss of access); poorly underwritten (cost, income, market); poorly administered (construction bottlenecks, delays in disbursement of funds, inadequate marketing efforts, neglect); inability to satisfy contingencies (term lending commitments, occupancy leases, sales contracts).

1.14 Technical Inadequacies: Use limitations (zoning, restrictive covenants, licensing, title defects, easement requirements, access, building code violations, environmental restrictions); available utilities; special user requirements (HVAC loads, floor loading, trackage, visibility, signage, waste disposal); design defects; construction defects.

1.15 Uncontrollable Events: Eminent domain; casualty loss; death; disability; weather; change in law; national emergency.

1.16 Intentional Acts: Diversion of funds; theft; dissipation of assets.

1.2. The Problem of Perception. One of the unspoken reasons for attempting to determine the cause of the default is to provide a forum to enable each party to the workout to form a perception of the other parties. At some point the lender invariably asks, "Where did the money go?" In many, if not most, cases the borrower doesn't know. Accordingly, some time and money is inevitably spent in attempting to answer the question and, in some cases, the workout becomes an inquisition with all parties seeking to document their respective files to avoid, justify, rationalize, or obliterate the mistakes that party has made with respect to the project. In civil matters, the process of fixing blame for a default is a disorganized procedure with little concern for due process. Speculation and innuendo constitute the primary evidence available to the parties. The successful prosecution of any workout requires a certain level of cooperation among the parties holding various interests in the project. If a cooperative effort cannot be mounted, one or more of the parties will be forced to resort to the state or federal courts to impose the moving party's remedies on the other participants. Whether that result follows is in great part a function of the perception that each party develops with regard to the other parties. The term "perception" is used advisedly because the opinion that is developed might or might not have any factual basis. The essence of the workout is the parties' willingness to compromise in the mutual protection of their enlightened self-interests. Like politics, workouts are a study in the art of the possible and the abilities of the participants to produce a product of compromise. If there is in fact no willingness to compromise or if there is no perceived willingness to compromise, litigation is generally the only available approach and the workout efforts will fail. In any default situation, the borrower begins with a credibility handicap that must be controlled or overcome if the borrower is to ultimately benefit from continued ownership of the project or mitigate the losses arising from the default.

1.2.1 Default Recognition: Party discovering; party reporting; manner of reporting; time of reporting; extent of reporting; nature of acknowledgment; use of preparatory warnings; meetings or letters.

1.2.2 Financial Reporting: Withholding required or requested information; volunteered information; liability for representations; control of information; confidentiality; forecasts versus guarantees; selection of accountants; change in accountants; use of internal accounting personnel; use of special auditors; consultants employed by creditors; credibility and reputation of individuals employed; engagement limitations; criminal and civil liability; discharge in bankruptcy.

1.2.3 Selection of Legal Counsel: Continuation of previous counsel; employment of special bankruptcy counsel; importance of pecking orders; retaining the hired gun.

1.2.4 Workout Negotiations: Control of meeting dates; meeting agendas; invitees; attendees; meeting place; control of expectations; excluding counsel; gauging the horsepower of the participants; minutes of meetings; excluding individuals or creditors; collusion; postponement; adjournment.

2. Determining The Facts

The assembly and condensation of the facts relating to the defaulted project is an arduous task which is complicated by the assumptions on which the respective clients are operating. In most instances, the documents creating the contractual relationships will not have been reviewed by the participants since the original closing date. It is not unusual for the client's files to be disorganized, incomplete, or for the files to contain a draft rather than a conformed copy of the executed document. Commonly, in the course of dealings among the parties to the various transactions, the parties have departed from the terms of the original documents and letter or oral modifications have been made as circumstances required. An attorney involved in a workout cannot assume anything. Each fact must be independently verified by the attorney. The use of an associate or experienced legal assistant becomes a virtual necessity in the organization of the investigation unless the lead attorney has the luxury of handling one transaction at a time.

2.1 Determine the Extent of Default: Multiple defaults with respect to individual claimants; simultaneous defaults with multiple claimants; waivers of previous defaults; material or technical default; amounts owing; cure periods provided by contract, statute or practice; remedies available to claimants; penalty clauses; liquidated damages; late charges; default interest rates; pyramiding defaults; domino effect on other projects undertaken by the principals; global or single project solutions.

2.2 Determine the Deficiencies in Documentation: Unperfected liens; notice and opportunity to cure; unrecorded modifications; waivers; estoppels; nonrecourse obligations; missed collateral; missing collateral; seasoning periods; duress; fair dealing; usury; transfers of ownership; intervening claims.

2.3 Determine the Physical Status of the Project: Under construction; in lease-up; occupied; existing management; available security; insurance coverage; presales; essential contracts (maintenance, management, franchise, service, utility); executory contractual obligations; quality of work in place; deferred maintenance; security deposits; earnest money deposits; escrowed funds; capital replacements.

2.4 Determine the Amount and Nature of the Claims Against the Project: Secured creditors; unsecured creditors; essential trade creditors; other trade creditors; priority claimants (mechanics' liens, taxes, utilities); tenants; landlords; owners' associations; sureties; partners, shareholders and other equity owners; professional services.

2.5 Determine the Identity of the Parties and Their Relationship(s) to the Project: Project owner (proprietor, members, members' officers, directors, shareholders, general partners, limited partners, trustees, beneficiaries, spouses, attorneys); secured creditors (account officer, chief executive officer, workout division, regulatory status, reputation, likely decision process, attorneys); unsecured creditors (trade accounts, account dependency, project dependency, lien rights, reputation, affiliation with principals, attorneys); priority claimants (type of entity, person responsible, filed liens, unperfected lien rights, withholding taxes, ad valorem taxes, assessments, insurance premiums, utility charges, attorneys); tenants (in possession, in negotiation, security deposits, brokerage claims, inducements, attorneys); title insurer (reinsurer, coinsurer, title officer, attorneys); surety (types of bonds, contract modifications, obligees, attorneys); landlords (ground lessors, occupancy lessors, lenders to landlords, attorneys); troublesome claimants (tenants' associations, owners' associations, holders of investment securities).

2.6 Determine the Status of Performance Under Contract Rights that Benefit the Project: Lending commitments; occupancy leases; ground leases; master leases; construction contracts; architectural and engineering contracts; subscription agreements; management contracts; brokerage agreements; contracts for sale; franchise agreements; other projects in which the principals are involved.

2.7 Survey Assets Potentially Available for Use in the Workout: Undisbursed loan proceeds; loans subject to re-advances; unencumbered assets; underleveraged assets; cash deposits; owner's unrelated assets; owner's line of credit lenders; gap loan possibilities; bridge loan possibilities; assessments against investors; shareholder or member contributions; financing by the surety; title insurer financing; guarantor funding; contractor funding/subordination; tenant or purchaser funding; rich relatives.

2.8 Survey Management and Control Devices Available During the Workout: owner involvement (personal relationships, term lender requirement, tenant requirement, technical skills, marketing ability); financial reporting (draw requests, operating reports, appraisals); cash controls (sequestration of rent, security deposits, operating receipts, authority for disbursement, payroll taxes); creditor representation (nominees, directors, consultants, clerk of the works, inspectors, auditors, management designees, management decisions); required approvals (liens, indebtedness, sales, management changes, project changes, major decisions); insider risks (seasoning period, liability to owner, liability to other creditors, liability to users and other third parties, participating lenders).

2.9 Obtain Estimates of Workout Cost and Benefit: Cost to complete construction (original estimates, percentage of completion versus percentage of disbursement, front loading, retainage, change orders, extras, allowances); appraisals (original value, current value, anticipated value when complete, bankruptcy evidence, regulatory requirements); administrative costs (architects, engineers, accountants, estimators, attorneys); marketing cost (advertising, seller's representations and warranties, brokers); carrying cost (interest nonaccrual, operating expenses, taxes, insurance).

2.10 Assess Risk of Lender Liability: Aiding and abetting violation of securities laws; violation of laws governing financial institutions; control of the borrower; interference with contractual rights and obligations; equitable subordination; duress; implied covenant of good faith and fair dealing; usury; tying arrangements; deceptive trade practices; recharacterization of transactions; class action suits; derivative actions; environmental laws; bankruptcy fraud; preferential transfers; fraudulent transfers.

2.11 Determine the Ramifications of a Voluntary or Involuntary Filing Under the Bankruptcy Code During the Course of the Workout: Automatic stay; executory contracts; seasoning timetables; preferential transfers; triangular preferences; fraudulent transfers; insider determination; use of debtor in possession or trustee financing; proof of adequate protection; control of venue; selection of trustee; selection of trustee counsel; chapter conversions.

2.12 Determine the Results of a Successful Workout: Payment of costs; incentive bonuses (to borrower, to creditors, to attorneys); clogging the equity of redemption; risk/reward relationships.

3. Formulation of a Plan

From the end of World War II to the mid-1980s, the solution to real estate defaults was constant: inflation was the universal panacea. The appreciation in value of the project (whether complete or not) enabled the party with the staying power to ultimately recover most if not all of the investment in the project. Inflation has traditionally been the economic cornerstone of all real estate development activities. The failure of Penn Square Bank in 1982, the adoption of the Tax Reform Act of 1986, the collapse of the energy boom, the thrift debacle, the passage of FIRREA and the regulatory witch hunts which characterized the late 1980s and early 1990s, all signaled major changes in the manner in which defaults were resolved. The cyclical recovery of the economy in general and burgeoning real estate markets in many parts of the country always seem to herald a return to good times for real estate developers and investors. The collapse of the general economy and the real estate sector in particular during 2009 was an overnight calamity. The continuing consolidation of financial institutions coupled with actual and hypothetical regulatory modifications and penalties for federal governmental grants and loans has produced an unreliable and unpredictable financing posture. Resulting overdevelopment and evaporation of financing sources has caused defaults to be forecast with regularity and realized in amounts exceeding the forecasts. One confronted by a default should consider the following alternatives:

3.1 Do Nothing: Conscious decision; buy time; waiting for other parties to move; ultimate result of inadequate commitment; time required for regulatory approvals.

3.2 Sale of the Project: Valuation issues; necessity for purchase money financing; inadequate consideration; non-availability of replacement financing; transfer of management; claims by other creditors; owner cooperation; project subdivision; earnout arrangements.

3.3 Creditor Takeover: Mortgagee in possession; management capability; liability to owner; liability to other creditors; liability to users; cost of carry; financial institution accounting treatment; regula-

tory limitations; discharge of guarantors and sureties; waiver of deficiency capability; application of proceeds on ultimate disposition.

3.4 Reinstatement: Number of creditors; necessity for supplemental financing; management capabilities; financial reporting; financial impact to creditor; level of cooperation; risk-sharing devices; reward sharing devices; operating capital requirements; use of nominees.

3.5 Define the Limits of the Creditor's Ability to Manage the Workout: Use of subordinate loans; lending limits; concentrations of credit; liquidity; regulatory supervision; management capability; conflicting business relationships.

3.6 Gaining Control of the Workout: Determine the parties with the greatest risk of loss; determine the parties with the greatest dollars at risk; identify commonality of interest and conflicts of interest; establish communication procedures; retention or creation of personal liability for performance; meshing personalities.

3.7 Timetables for Performance: Identify critical dates; schedule of reports; required times for performance; creation of performance hurdles; notices of default; opportunity and time to cure.

4. Implementation of the Plan

The primary distinction between the negotiation, documentation, and administration of a workout arrangement and any other commercial transaction is the pervasive concern that litigation, foreclosure, or bankruptcy could occur at any moment. From the perspective of the lender or any other party having a sizeable cash investment in the project, the renegotiated contractual rights represent a lesser standard of performance to which the borrower and other obligors will be held and might merely be the beginning point for the next round of negotiation if the workout is not successful.

4.1 Documentation: Default notices (forms, notice addresses, manner of service, times for response, addressees); confessions or admissions of default (lender necessity, borrower advisability); certified financial statements; memoranda of meetings; memoranda of understandings; settlement agreements; releases from liability.

4.2 Collateralization of Existing Debt: Document review; ratification; waiver of defenses; confirmation of perfection; perfection of rent assignments; confirmation of amounts; ratification by guarantors and sureties; preferential transfers; fraudulent conveyances.

4.3 Collateralization of New Debt: Valuation of collateral; requisites for perfection; subordinate mortgages and security interests; wraparound devices; controls on disbursement; necessity for recourse; treatment and collaterization as mezzanine debt.

4.4 Concepts in Documentation: Demand obligations; escrow accounts; cross-collateralization; cross-default; moratoriums; standby commitments; conditional letters of credit; floating maturity

dates; variable amortization schedules; variable interest rates; false caps; forgiveness of debt; performance hurdles; obligatory or non-obligatory future advances; exempt assets; statutes of limitation; due on sale; due on encumbrance; guaranties of performance; guaranties of payment; guaranties of collection; springing guaranties; depository accounts.

4.5 Creation of Priorities Among Creditors: Inter creditor agreements; participation agreements; subordination agreements; stand still agreements; drop dead dates.

4.6 Management and Controls: Creditors' committees; nominee arrangements; workout entities; collateral agents; cost sharing; levels of authority; voting approvals; major decisions; regulatory supervision; lender liability.

5. Conclusion Of Workout Arrangements

Given the pervasive nature of the bankruptcy considerations which are present in many workout arrangements, the workout period should be used to scout the opposition in anticipation of the bankruptcy proceeding so that the filing of a petition does not mean that the transaction begins anew. Accordingly, most of the considerations which will be discussed with respect to a plan of reorganization should be incorporated in the workout arrangement and the institution of a bankruptcy proceeding might merely be the means of finalizing and ultimately enforcing a pre-petition workout structure. In the alternative, a successful workout arrangement will generally mean that the project is returned to its original owner and, given appropriate foresight, the creditors might receive some extra compensation for the forbearance which made that result possible.