The Game Plan for Avoiding Foreclosure and Restructuring Loans for Troubled Shopping Centers

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It is no secret that the Great Recession and the exasperatingly slow pace of the economic recovery have left scores of financially distressed shopping centers in their wake throughout the country. Commercial property values have dwindled, and high vacancy rates due to struggling tenants are continuing to make for a difficult recovery for the foreseeable future. The more than 100,000 neighborhood shopping centers typically anchored by a grocery store across the country have been particularly hard hit, and the National Association of Realtors forecasts an 11.5 percent vacancy rate for retail properties for 2012. The rates will be considerably higher in some of the hardest hit markets.

Many centers have been able to stave off foreclosure by what has become known as "extend and pretend," with lenders extending the terms of the loans and pretending that the properties will regain their financial viability as the economy improves. However, it has become obvious that while the recovery seems to be commencing, significant improvement could still take a few years, and many of these loans that had been extended during the past several years will soon be reaching maturity while the underlying properties continue to struggle.

For these troubled retail properties and their owners, the best advice is to work closely and openly with their lenders to determine feasible and fair resolutions for both parties that enable the property owner to retain ownership or, at the minimum, avoid foreclosure and any personal financial liability. Bear in mind that the lenders are keenly aware that 60 percent of the $1.8 trillion in commercial real estate debt that is scheduled to mature between 2012 and 2016 is currently "impaired," according to Trepp. They understand that the majority of these loans may exceed the real market value of the underlying properties, so the lenders with the financial and regulatory flexibility to restructure the terms rather than exit the loan are likely to be willing to consider some sort of restructuring at maturity. The lenders have also come to realize that there are significant financial and administrative impairments to owning, managing and selling these retail properties in the current market, so it behooves them to continue to be receptive to working with their borrowers to create mutually beneficial solutions.

Another factor that plays into the decision to renegotiate a troubled shopping center loan includes the relationship between the lender and borrower, which may go beyond the present loan and could lead to additional loans in the future in an improved economic climate. Both parties are also able to avoid the cost of litigation, which can easily mount

with possible bad-faith, breach-of-contract, breach-of-fiduciary-duty and other claims, and they can also eliminate the possibility for negative public exposure and business disruptions. In addition, there is the prospect of uncertainty and delays that could be on the horizon should the owner elect to file bankruptcy.

Working With the Lender

For shopping center owners, one of the main keys to achieving a satisfactory restructuring is to act in good faith and be as open as possible with their lenders. By maintaining a good working relationship with the lender, the owners are more likely to be able to re-negotiate their loan covenants.

The process for both parties begins with a detailed and accurate assessment of the true current market value of the property. If the owners can commission an appraisal of the property, they should do so. It is incumbent on the property owners to do their due diligence by collecting all the relevant financial and market data to provide a complete picture of the value of the asset to the lender. In addition to a current appraisal, this should include the current-year property income and expense budget from a cash perspective (not depreciation) and the three-year and year-to-date occupancy report. It should also include actual property income and expenses, a pro-forma operating statement budget, borrower/guarantor(s) latest balance sheets and financial statements, and historical sales volumes and financial information for all the current tenants. It is also helpful to include expense reimbursement schedules by tenant, the capital expenditures schedule for the last 12 months, and the schedule of tenant improvement allowance, brokerage commissions and free rent for all leases for the prior 12 months. Also important are the current rent roll for the property and any pending changes to the rent roll or pertinent information regarding the current and future status of the tenants, the marketing and leasing activity for any vacant space, a deferred maintenance schedule and budget, a detailed market study with three-year projections, updated engineering and environmental assessments, the latest property tax bill, and an abstract of all current lease agreements.

Also relevant is an overview of everything that is being done to improve the property's outlook going forward. Rather than focusing on the past and how things got to where they are today, it is best to concentrate on the changes that are being made or can be implemented in the future to maximize the property's potential.

The lender will likely wish to conduct its own appraisal, and in many cases the property owner should encourage the lender to inspect the property and meet with the current tenants, as the lender will certainly wish to determine if there is any collateral at risk.

Possible Solutions

Restructuring into an A&B loan structure has become an increasingly popular option. In this scenario, the lender creates an A note for the existing loan at a lower principal amount and a B note for a new loan that covers part or all of the principal reduction. For lenders, this helps to ensure that they will be able to recover some of the principal that was eliminated in the event that the property value and economic fundamentals improve over the long-term. The B note, however, is typically subordinate to any additional equity investment.

The "Hope Note," or equity participation, is also a realistic option in many cases. Here,

the lender eliminates some of the principal or changes the terms of the loan in exchange for some upside value, if any, upon the eventual sale of the property. The lender hopes to recoup the difference between the original loan balance and the new loan if the property value improves over time.

Alternative collateral pledges, in which the borrower pledges to reduce or eliminate the equity deficiencies in the property in exchange for a reduction in principal, also can be favorable for both parties.

If the borrower achieves a reduction in the principal from a lender or modifies the terms of the debt to the point where it triggers a "significant modification," the borrower may recognize taxable cancellation of debt (COD) income. In addition, if the lender receives equity participation rights, it may be viewed as acquiring a partnership interest for tax purposes, and this too could result in the borrower recognizing COD income. Tax considerations must be factored into the equation for all loan modifications and restructurings, otherwise the workout may lead to greater problems for the borrower.

A discounted payoff offer (DPO) is also becoming a viable strategy for troubled shopping center loans. This entails a proposal from the borrower or a third party to acquire the existing debt from the lender at a discounted value. These arrangements provide the lender with an exit strategy while also allowing the borrower to reconfigure the loan to a level that it can afford to maintain.

Final Options to Avoid Foreclosure

If these loan modification and debt restructuring options are explored and ultimately rejected, short sales remain one of the most effective courses for both the borrower and lender to avoid the costs and uncertainties of foreclosure. These sales attract new money from a third-party buyer at a purchase price that is usually less than the debt, so they enable the lender to reduce bad debt while also allowing the borrower to be freed from its loan obligations. For these deals, the owner should ensure that the lender does not create any additional fiduciary duties that could result in claims from creditors.

A deed-in-lieu of foreclosure agreement can also be a favorable solution. Since these are amicable transfers of the property to facilitate a smooth and knowledgeable transition, borrowers, lenders and guarantors are able to trade information and certifications as well as cash or rights. The parties often agree to keep details of the transfer and property confidential. In addition, the entire transaction can be set aside if bankruptcy, guaranties and other liabilities spring back, so the structuring of the giveback has to be negotiated carefully, and the final agreement must be well drafted. Typically, all current litigation over the outstanding debt is resolved and settled, the borrower admits default and waives all defenses under the loan as well as all future rights in the property and any rights of redemption, and the lender waives any right to seek a deficiency against the borrower and any guarantors. The borrower also conveys rights in leases, plans, entitlements, personal property, contracts and accounts, and turns over any reserves as well as personal property to the lender. The borrower will most likely remain liable for third-party claims that accrued prior to transfer, but this is generally of little concern given that most properties are held in special purpose entities that will have little to no assets after the conveyance. Tax considerations play a major role in these

types of transactions as well, and proper tax planning is essential to avoid negative tax consequences.

Conclusion

Of course, every loan and retail center has its own unique characteristics, and there is no one-size-fits-all cookie-cutter approach to achieving a favorable loan modification or restructuring for all shopping centers. However, the universal factors in these cases are that borrowers will typically wish to retain ownership of the property, and lenders will work to convert non-performing loans into performing loans. Given this and the state of the current market for retail properties and commercial real estate debt, there is more than sufficient incentive for lenders and borrowers to turn to the negotiating table in order to find creative and feasible resolutions to even the most complex financial situations.

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