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Finding Leverage To Overcome Real Estate Frustration:

Using "Borrower Recapitalization" to Acquire Distressed Properties Held by Intransigent Owners

by Edward J. Hannon, Partner, Corporate and Real Estate Practice Groups

A FREEBORN & PETERS WHITE PAPER

ABOUT THIS WHITE PAPER

Buying out a distressed commercial property from its owner can face many obstacles, not the least of which is the owner itself. This white paper explains how and paves the way for getting the owner, the existing lender and new third-party financing all on board quickly.

Why Does Borrower Recapitalization Work?

With an innovative approach, note purchasers can use leverage with distressed real estate owners and acquire control over the property and obtain take-out financing.

Andrew and his business partners earn a nice return by buying out loans on distressed properties. Their strategy has been quite simple and very lucrative: purchase notes on defaulted properties from lenders, and then pursue foreclosure in state court.

Recently, this traditional note purchaser approach has become riddled with delays and extra costs caused by borrowers filing for bankruptcy protection and using the court system to frustrate the process. Andrew and his partners also discovered that having the property controlled by a receiver while this extended process played out prevented them from infusing the funds needed to put new tenants in the building.

Andrew has also tried other approaches like taking a deed-in-lieu of foreclosure. But even here things can be difficult, because third-party financing won't happen until title issues are settled.

But things have changed now that Andrew has realized where and how he can apply negotiating leverage to make the building owner cooperate in the adoption of an alternative structure. He sees that many borrowers are terrified of the risks involved if personal loan guarantees are invoked; and they are even more frightened by the risk of substantial tax liabilities that can arise if Andrew – in his role as note purchaser – writes down the loans as the foreclosure process plays out. Now he has the ability to give them an offer they can't refuse – and one that benefits him greatly.

This process – known as a "borrower recapitalization" – is usually a better bet for the building owner. More importantly, it delivers new properties to Andrew's portfolio quickly and with the possibility of higher rates of return.

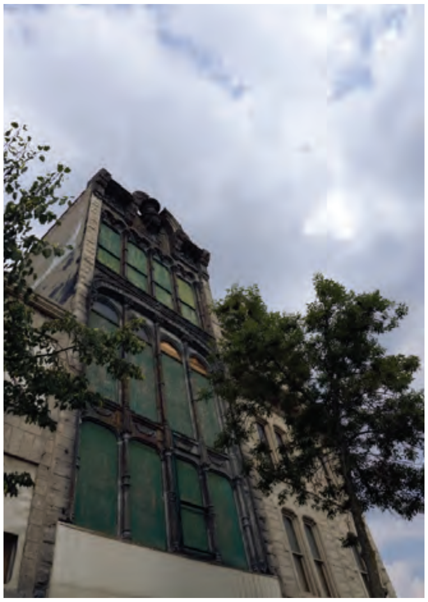
Simply put, in a "borrower recapitalization", a note purchaser offers a building owner an alternative to the foreclosure process, its associated tax costs and the threat of a vigorous pursuit of the personal guarantees. For the note purchaser, this alternative structure presents all the characteristics of a great deal – faster, less expensive, more certain and facilitating a rapid injection of third-party debt. For the building owner, it is simply the "least worst" option available.

For the Note Purchaser

- By avoiding receivership or foreclosure, a "borrower recapitalization" significantly reduces the general expenses involved and substantially drives down the time between the note purchase and receipt of property ownership.
- Since the note purchaser can obtain third-party financing on the day he receives ownership of the property, he can recover his investment through take-out financing much faster than under either a foreclosure or a deed-in-lieu of foreclosure.
- Gaining certainty on when ownership is obtained and reducing the time until a large proportion of the initial investment is recovered through take-out financing significantly increases the note purchaser's internal rate of return and allows him to price his bids more competitively.

For the Building Owner/Borrower

- As in the deed-in-lieu process, the building owner cooperates in return for the release of claims under his loan guarantees.
- Unlike in a deed-in-lieu of foreclosure, the building owner can avoid any immediate tax costs if the "borrower recapitalization" is properly implemented.
- The building owner continues to hold "indirect" ownership of the property, preventing the stigma of having given a property back to a lender.
- In some circumstances, the borrower may be permitted to co-invest with the note purchaser as part of the current or future recapitalizations of the property.



How Does Borrower Recapitalization Work?

Andrew has found a large downtown office building – owned by Brad, a former colleague – which was in financial distress. It fits the mold for a "borrower recapitalization" perfectly.

Brad's partners want him to walk away and to let the building go into foreclosure. However, Brad can see the consequences: foreclosure will lead to a big tax liability, and he knows his personal guarantee on the debt means the bank can attempt to come after his house and other personal assets.

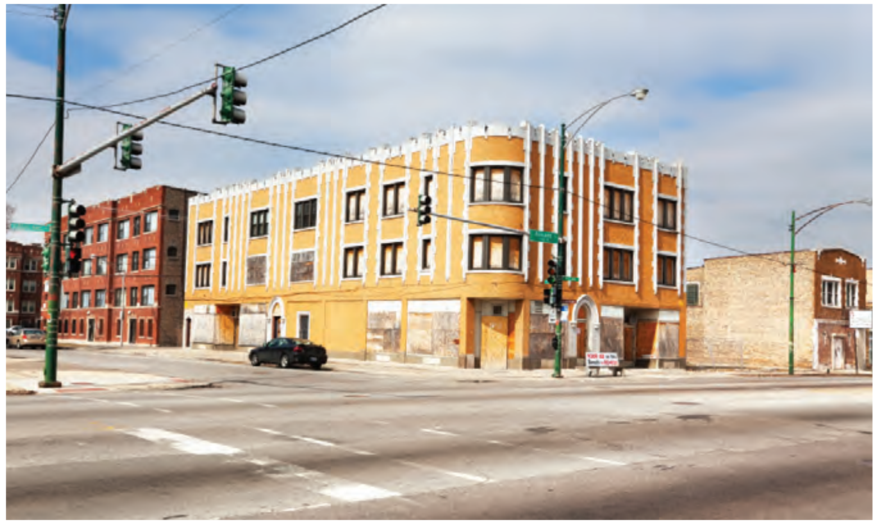
While a "borrower recapitalization" involves several key steps, Brad sees that Andrew's offer allows him to save face – but, more critically, it can allow him to avoid the costs of trying to protect his personal assets from claims under the personal guarantee. It also allows Brad to avoid the tax costs that would arise in a foreclosure.

How does a typical deal work? What are the steps involved in recapitalizing a building owner, while allowing the note purchaser to preserve overall control of the deal and of the property?

Consider the situation of the downtown office building owned by Brad, which is now Andrew's target for a "borrower recapitalization":

Amount of principal outstanding under the loan:	$16,000,000
Accrued and unpaid interest (including default interest):	$450,000
Andrew's offered purchase price for the loan:	$15,800,000
Andrew's loan commitment from third-party lender (conditioned on completing the "borrower recapitalization"):	$11,000,000

Andrew agrees to release Brad from existing personal guarantees and forgive the default interest if Brad agrees to participate in the structure.



Once Brad, the building owner, agrees to a "borrower recapitalization," he and Andrew, the note purchaser, must take several steps to complete the deal:

- **Step 1:** Brad creates a Limited Liability Company (LLC) called PropertyCo. Brad contributes the property to PropertyCo.

- **Step 2:** Brad contributes all of the membership interest in PropertyCo to an LLC called NewCo. Andrew wholly owns NewCo immediately prior to this contribution by Brad. As part of this capital contribution, Andrew holds Class A membership interest and Brad holds Class B membership interest in NewCo.

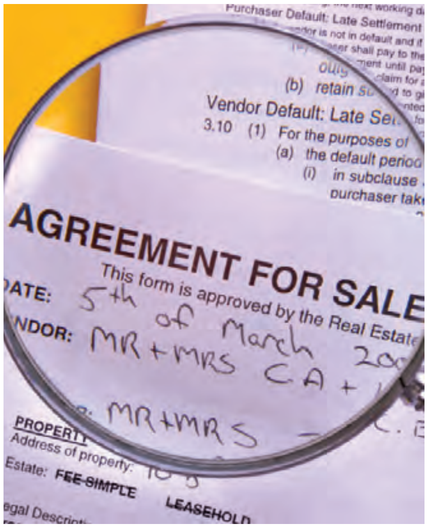
- **Step 3:** Immediately upon the contribution of the interests in PropertyCo to NewCo, PropertyCo borrows the $11 million from the third-party lender and uses the funds to pay down the existing loan (i.e., to Andrew). As part of this refinancing, the original loan (which has been paid down from $16 million to $5 million) is converted into a mezzanine loan, secured only by the membership interests that NewCo holds in PropertyCo.

Once these steps have been taken, Andrew holds Class A membership interest in NewCo and is also the managing member. NewCo owns all of the membership interest in PropertyCo, which in turn owns the property. The $11 million loan made by the third-party lender is secured by a mortgage on the property.

Because completion of the "borrower recapitalization" significantly shortens the time period in which Andrew can obtain take-out financing, Andrew is able to recover a significant portion of his $15.8 million purchase price more quickly than under either a foreclosure or deed-in-lieu of foreclosure.

In addition, Andrew has avoided the risk that the property's value would decrease while it was operated by a receiver as the foreclosure process moved along.

Brad holds a Class B membership interest in NewCo, which gives him very limited voting rights, but which also provides him with a continuing economic interest in the property. Because there has been no foreclosure or forgiveness of principal, Brad should not recognize any tax costs in connection with the transaction (which would not be the case in either a foreclosure or deed-in-lieu of foreclosure). In addition, because Brad's exposure under the personal guarantees was eliminated, he no longer faces the risk that he will need to expend significant costs to attempt to protect his personal assets.



Can A Borrower Recapitalization Work For You?

Third-party note purchases can be attractive to all parties to a deal but they are far from a real estate "no brainer". In fact, each transaction must be structured based on the specific facts and circumstances.

Here are five quick considerations for both note purchasers and building owners/borrowers alike:

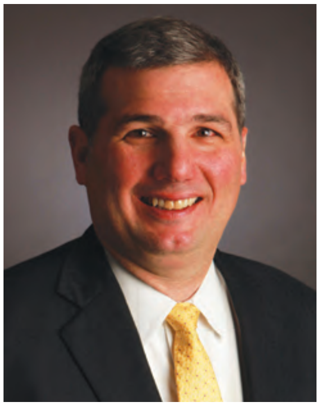
1. **Don't Underestimate the Direct and Indirect Costs of a Foreclosure Fight:** Depending upon the type of property, the longer that this fight drags out the greater the adverse effect. Even if the property is in receivership, the note purchaser foregoes the right of outright ownership and the corresponding rights to make improvements and fund retenanting costs. So, the longer the fight, the greater the risk to the long-term financial viability of the property itself.

2. **Make Sure the Carrot is Just Big Enough:** Note purchasers must realize that if the terms of a deal are too onerous, the only reasonable choice for a building owner is to fight. Forcing a confrontation is not the right path for a note purchaser in all cases. Instead, the better option may be to "induce" cooperation. Sometimes, that inducement can be as simple as creating a structure to defer the borrower's tax hit; other times it will require something more. But, overall, the wise choice is to remember the building owner needs something to make the deal worthwhile.

3. **Prepare for Speed:** Once terms have been reached, document the transaction as quickly as possible. These transactions should go from note purchase to control over the property and third-party financing in 45 to 60 days. Given this, it's important to have a team in place to implement the transaction – and all of its component parts – on an extremely fast timetable.

4. **Save Face, Preserve Reputation:** The building owners in these deals stay in the real estate game and stay off the radar. Their cooperation means they won't be tagged as people who give their properties back and can't save a deal.

5. **It's All About Funding:** For the note purchaser, remember that once you get third-party financing, you can redeploy your capital to another note purchase. Before you know it, your capital can turn it into five more deals in a short amount of time.



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A seasoned tax advisor, Ed Hannon is a Partner in both the Firm's Corporate and Real Estate Practice Groups. He works with property owners, real estate investors, note purchasers and developers on issues including tax, governance, entity formation and related areas affecting real estate partnerships and joint ventures. Ed's experience includes note purchaser roll-up transactions, the restructuring of existing limited liability companies in real estate recapitalizations and the formation of joint ventures between landowners and developers for the development or repositioning of real estate projects.

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