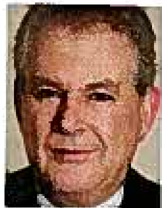
JOSHUA STEIN

After the Thaw

Eventually, commercial real estate lenders will start lending again. When they do, how will it look? Will the commercial real estate financing boom that starts in 2012—or whenever—differ from the one that ended in 2007?



JOSHUA STEIN is a real estate and finance partner with Latham & Watkins LLP.

SOME LESSONS FROM TODAY'S collapse seem fairly straightforward, and may produce minor changes in how the industry works. Other lessons, however, could produce larger changes, moving real estate finance out of its historical box—although that seems much less likely. Borrowers may initiate some of these changes and find other possibilities less attractive.

As one major starting point for this time around, expect simplicity and transparency. This means "plain-vanilla" first mortgages, with lower loan-to-value ratios and minimal, if any, mezzanine financing or other layers of multiple lenders. As the late lending boom crested, the industry saw ever-increasing levels of complexity, with multiple lenders —some new to the business— providing different flavors of debt at multiple layers of the "debt stack." Almost all of that will probably go away—at least for a while.

Deal structures also relied heavily on single-purpose entities, whose requirements grew ever more complex and triggered ever more documentation and requirements—all premised on the idea that if a lender did enough to create a "separate" borrower, then bankruptcy might no longer play a great role in real estate.

The General Growth Properties (GGP) bankruptcy has somewhat undercut that notion, although the GGP borrowing entities have so far not been consolidated with their bankrupt parent. Lenders have experienced other unpleasant surprises from bankruptcy judges, though typically only in extreme cases thus far. In short, bankruptcy remains more relevant than real estate lenders had expected, though not necessarily in plain-vanilla, single-asset loans.

If some of the themes in the GGP bankruptcy start to play out more widely in commercial real estate financing, lenders and the rating agencies may do what they can to beef up bankruptcy remoteness. They could, for example, require more layers of entities to insulate a borrower from its parent company.

The role of independent directors —or other third parties inserted into the borrower's ownership structure —may change, along with the borrower's ability to replace them. To the extent that these changes raise issues under corporate or limited liability company law, they may lead to requirements for waivers of fiduciary obligations, or other measures to prevent issues. Lenders may seek other ways to beef up separateness covenants.

Beyond that, lenders may look for practical, real-world comfort that each entity truly operates independently.

The separateness covenants may expand to require each particular borrower to have an independent financial identity, to not rely on its affiliates for any refinancing or financial support, and to be in no way part of a larger investment group. Perhaps, if the documents say it enough times and in enough ways, it will be true. More lenders may perform periodic due diligence to confirm that their borrowers actually comply with the separateness covenants.

Lenders might favor multiple investment groups joining together to acquire a single property, because this reduces the likelihood that either owner will so closely control the asset that a bankruptcy judge might bring it into that owner's bankruptcy proceedings. Instead of allowing either group to buy the other out, the loan documents may require that both groups maintain their investment, simply to reduce possible exposure from a parent's bankruptcy. When GGP brought its subsidiaries into the parent company's bankruptcy, for example, it did not do the same for joint ventures in which it participated. Maybe lenders will learn to love joint ventures.

It is possible that there will be an even greater distinction between the ownership of real estate and its management, so that operations are even further from title to the real estate than in the past. The entity that owns the real estate might play no role in management at all, with trade creditors and tenants dealing only with the management company, as in a third-party-managed hotel. The actual property owner could approve or require certain major actions, but the manager would handle day-to-day operations, including particularly all trade contracts.

Trade creditors might be asked to agree to look only to the property manager. As a backup measure, creditors might be required to give the mortgage lender an option to purchase their claims, thus maybe allowing the lender to neutralize an entire class of claims in a borrower bankruptcy.

Measures like these would further simplify the actual property owner's—the borrower's—activities and financial structure, hence any possible bankruptcy. To insulate the manager from credit risk, the manager would need to maintain appropriate reserves. An intercredi-

tor agreement would seek to protect the lender from manager-driven problems in a borrower bankruptcy.

On the other side of the property management coin, lenders may want stronger controls over a property's net cash flow—or all cash flow—to prevent that cash from feeding the borrower's affiliates or principals in times of stress. This could mean a hard lockbox from the day of the closing, allowing a lender to block all disbursements to equity—trap all net cash flow—if any financial issues arose. If the lender fully implements a lockbox at closing, a bankruptcy court might have more respect for the arrangement than if it arises only when the borrower starts to encounter rough sailing.

As a major change in lockbox expectations, a lender may want the right to trigger the trap if the borrower's parent company or affiliate—not just the borrower itself or the property—starts to suffer problems. This way, the lender can perhaps get ahead of the situation, acting before a bankruptcy strikes elsewhere in the corporate structure.

Borrowers and lenders may also explore other steps to enhance a lender's security structure. As one simple example, lenders may find that funding and holding two loans—secured by two mortgages—instead of one gives the lender greater leverage and control if a loan gets into trouble, whether or not the borrower finds its way into bankruptcy. In other words, lenders may find they still like layers of debt, but only if the same lender holds all the layers.

Pledges of the borrower's equity, often seen as window dressing, may reappear as a way to give the lender better access to its collateral and more leverage.

Lenders will return to traditional, old-fashioned conservative underwriting, at least in the early stages of the next commercial real estate financing boom. They will lend against income in place, not models for future increases in income or a borrower's strategy to sign new leases, redevelop the asset, or otherwise create value. Even for income in place, they will ask more questions about stability and whether the borrower could replace income if a tenant vanished.

Lenders will lend against income in place, not models for future increases in income or a borrower's strategy to sign new leases, redevelop the asset, or otherwise create value. Even for income in place, they will ask more questions about stability and whether the borrower could replace income if a tenant vanished.

To the extent that lenders rely on guaranties for anything, they will look further behind those guaranties. Expect more questions about exactly what the guarantor owns, with regular updates after the closing. Lenders may restrict the guarantor's other transactions or financial ratios, with consequences for the loan (e.g., a cash sweep) if a guarantor has problems.

Even then, lenders will not always regard guaranties as reliable solutions to problems. Recent history shows that when real estate values go down, so does the net worth of most real estate guarantors, thus eroding any guaranty when the lender needs it most.

Lenders will note, however, that nonrecourse carve-out guaranties—regardless of what credit backs them—seem to have had their desired effect. Thus, expect to see these guaranties remain prevalent and perhaps universal in real estate financing. To the extent that today's wave of real estate distress reveals new ways that borrowers can hurt lenders, expect the carve-outs to expand accordingly in response.

Today's marketplace disruptions may conceivably lead participants in real estate financing to think outside the box, perhaps even revisiting and rethinking basic assumptions about the ownership and financing of real estate.

For example, why must real estate draw a bright line between "debt" and "equity," treating a potential loss of "equity" as some special cataclysmic event that attracts judicial protection, leading to unpredictable results?

If, as suggested earlier, "single-purpose entity" considerations might drive lenders to further separate the property owner from property management, tenant relations, and property revenue, why not go a step further, by separating the property owner even from actual legal ownership of the property? Instead, actual title to the property might go into a relatively neutered entity owned, for example, by a corporate service company or a charity. The bundle of rights now called borrower's equity could instead take the form of contractual rights to direct the property manager; make certain decisions; and receive certain cash from the property if conditions were met.

Those contractual rights would go away, after a generous cure period, if the property failed to throw off enough to pay more senior interests everything to which they were entitled. The holder of these contractual rights would have the option to contribute cash to preserve its position. Any decision not to do so would simply result in a package of contractual consequences. In effect, equity ownership would be replaced by a bundle of rights similar to—but beyond—those of a B-note under an intercreditor agreement.

Whoever bore equity-type risks would want to make sure they did not lose the tax benefits of owning real estate, which could require tax law adjustments. Changes in commercial real estate structures might also require other legislative changes, particularly in the bankruptcy code. The federal government, as bag-holder of last resort for all risks of the banking system, including declining real estate values, may find that such measures make sense if they help restart the commercial real estate marketplace.

Any fundamental restructuring of real estate ownership sounds bizarre and unheard of. Real estate is emphatically not an area that welcomes wholesale—or any—changes in ways of doing business. On the other hand, if changes like these can be implemented in a way that produces greater certainty and lower borrowing costs, other transaction costs, and uncertainty, everyone may find them appealing.

As another "outside-the-box" response, mortgage lenders may note that the layers of mezzanine debt created through 2007 did at least discourage borrowers from fighting with mortgage lenders and filing bankruptcy. Subordinate debt created a buffer between the first mortgage and the borrower, lessening the temptation for the borrower to go to war with the first mortgage lender, simply because the borrower would need to fight any such war on many fronts, with great complexity, and at great expense.

Thus, mortgage lenders might see if they can figure out how to allow more layers of debt, perhaps on a "springing" basis, but in a way that gives the mortgage lender complete control. That extra "controlled" debt could help the lender better navigate any borrower bankruptcy that might occur.

Today's commercial real estate disaster will teach lenders and borrowers many things. Loan structures and documentation may change accordingly, and they more likely will not, at least not in any major ways. UL