Client Alert

Real Estate Department January 10, 2012

Profiting from Strategic Investments in a Weak Real Estate Market

We continue to see creative strategies in the workout of troubled real estate. Here are a few with our thoughts as to structure and action plans:

1. **Syndicated Loans**. No, not sub prime – that takes Wall Street type analysis and projections. But many large commercial loans on office, retail and residential properties were syndicated among a dozen or more lenders. Depending on the financial health of each of those lenders, a lender or two may want to sell their interest in the loan at a significant discount. Before purchasing, in addition to the typical property diligence, participation documents must be scoured for the rights of a participant to force action in the event of a default or on maturity.

2. **Converting Debt to Equity.** Many commercial transactions in the real estate bubble were purchased with (or later refinanced to) very high debt to equity ratios (85%, 90%, 95% and sometimes with an equity investment also). Upon maturity those loans will be impossible to replace. Not only will values have dropped but the new lenders will most likely not lend at 95% levels. The balance of the loan could be converted to preferred equity in the owner. The income tax hit for relief of indebtedness could be in certain circumstances offset by a reduction in basis. Once again the flexibility of Delaware limited liability companies permits the lender and owner to negotiate the terms of the investment. Since most of these loans are typically non-recourse, the existing mortgagee has significant motives to keep the possibility of full collection alive. Alternatively, a portion of the existing loan could be converted to a mezzanine loan, secured by a pledge of ownership interests, allowing the mortgage loan to have a lower interest rate, with the mezz portion dependent on the success of the project.

3. **New Equity Investor Permits Old Owners to Remain.** If new equity is required to salvage a foreclosure, the new investors may lessen the tax hit taken by the old investors by permitting the old investors to remain in the entity, in a deeply subordinate position. Among the tools available to create a subordinate interest are: waivers of fiduciary duty to the seller; expressly stripping any consent or voting rights from the subordinate interest; and creating a priority return to the new cash invested in the deal by the new investor.

4. **Partner Cram Downs.** Many investment agreements permit the managing member and only the managing member to call for capital infusions to rescue a project. Often the managing member may be reluctant to do so because of his or her short-term financial interest. We believe that, depending on the circumstances, those capital calls may be required by the proper exercise of fiduciary duty. With the right advice and perhaps court intervention, the managing member may be convinced to act. These calls typically dilute the non-contributing members.

Other opportunities may arise. Consult us early to review the possibility of investing in and restructuring troubled real estate assets.

Thomas D. Kearns
tkearns@olshanlaw.com
212.451.2273

Eric L. Goldberg
egoldberg@olshanlaw.com
212.451.2292