REAL ESTATE LOAN WORKOUTS: Coping With Future Shock

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Dallas, Texas
# REAL ESTATE LOAN WORKOUTS: Coping With Future Shock

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REAL ESTATE LOAN WORKOUTS: COPING WITH FUTURE SHOCK

Robert E. Wilson *

I. INTRODUCTION.

A. CHANGES AND INNOVATIONS.

It is universally acknowledged among real estate lawyers that real estate financing has undergone profound changes and innovations over the past generation.¹

A. REASONS FOR CHANGES AND INNOVATIONS.

Some of the reasons for these changes and innovations include:

1. The need to combat inflation;

1. An increase in the number of lending institutions, with a concomitant increase in competition for business and customers;

1. The evaporation of traditional boundaries among lenders where commercial banks made "prime" loans, insurance companies made real estate loans, finance companies made consumer loans, etc.;

1. The vacillation of Congress between regulation and deregulation of financial institutions; and

1. The globalization of financial markets.

A. SOME POSITIVE EFFECTS OF CHANGE AND INNOVATION.

Many of the changes and innovations in real estate financing enabled developers and lenders to weather the storms of double-digit inflation in the late 1970s and a 20%-plus prime rate in the early 1980s. Phenomenal profits in real estate also allowed investors to diversify, especially as more and more industries were deregulated throughout the 1980s.

A. SOME NEGATIVE EFFECTS OF CHANGES AND INNOVATIONS.

Not all of the changes in real estate financing have proven favorable, let alone predictable:

1. To produce higher returns on investments, greater risks were assumed by developers and lenders.²
1. Traditional relationships among borrowers and lenders were strained to the breaking point.\textsuperscript{3}

1. Relationships among lenders suffered.\textsuperscript{4}

1. Deregulation was an invitation to venture into areas with little or no expertise, with a partial direct result that 1,059 banks and savings and loans failed from January 1, 1980, through December 31, 1989.

I. THE REAL ESTATE LOAN WORKOUT IN THE 1990s.

It is against this background of change and uncertainty that a real estate loan workout must be negotiated in the 1990s. Some might contend that real estate financing, and the unraveling of a real estate financing, has entered the age of FUTURE SHOCK: Changes happen so rapidly that one cannot be assimilated before the next is upon us. For those real estate attorneys that have been absent from the workout arena for a few years, an inventory of legislative enactments and court decisions that directly impact real estate loan workouts may prove overwhelming. Indeed, even for the workout specialist, current trends and patterns are impossible to predict, and some of the changes are no less surprising. A sampling of significant developments in the real estate loan workout area in just the past six months best illustrates the point.

A. \textit{In re Sandy Ridge Development Corp.} \textsuperscript{5}

Can a bankruptcy court's determination of the value of the debtor's collateral be \textit{res judicata} or collateral estoppel as to a creditor in a subsequent state court action against a guarantor?

Example:

Debtor owes Creditor $2 million, which is guaranteed by Guarantor and secured by a first lien on real estate. Debtor files a plan of reorganization in the bankruptcy court pursuant to which, among other things, the real estate is surrendered to Creditor; the real estate is valued by the court at $1.5 million, leaving Creditor with a $500,000 unsecured claim against Debtor's bankrupt estate. Creditor forecloses on the real estate under state law and is the successful bidder at $1.3 million, which is based upon a current appraisal. Creditor sues Guarantor in state court for the deficiency of $700,000 (that is, $2 million debt minus the $1.3 million foreclosure price). Can Guarantor successfully argue as an affirmative defense either \textit{res judicata} or collateral estoppel to limit the deficiency to $500,000 (that is, $2 million debt minus the $1.5 million bankruptcy court valuation of the real estate)? The Fifth Circuit left open this very argument.

If the answer is yes, are creditors effectively put to an election of remedies, and have all states become single action states if a bankruptcy is involved? For an in-depth discussion of
the possible ramifications of this case, see Stewart, Tucker & Landis, Sandy Ridge: Real Estate Practitioner Beware, 28 State Bar Newsletter 3, Real Estate, Probate and Trust Law Section, State Bar of Texas, (April 1990).

A. LOANS-TO-ONE-BORROWER LIMITS UNDER FIRREA.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) requires that the loans-to-one-borrower limits for national banks now apply to savings and loans in the same manner and to the same extent as applied to national banks, with limited exceptions. Generally, the limitation is 15% of unimpaired capital and unimpaired surplus. Violations of these prohibitions carry hefty civil penalties.

In January 1990, the Office of Thrift Supervision ruled that the accounting concessions known as "forbearances" (which permitted buyers of insolvent thrifts to operate at less than the minimum capital requirements) would no longer be recognized. The significant ramifications of this ruling are twofold. First, many of the savings and loans sold in 1988 to purchasers who relied upon "forbearances" may become insolvent if the purchasers refuse to pump additional capital into the savings and loan to meet the rigorous new capital requirements of FIRREA. Second, new investor enthusiasm may have been chilled upon learning that $1.50 of tangible capital must be invested for every $100 in loans or other investments made by the thrift; this may be viewed as a high price to pay for a sick savings and loan.

Example of the Effect on Workouts:

Borrower owes Savings and Loan $5 million secured by real estate valued at $3 million. Savings and Loan has $10 billion in assets but a loans-to-one-borrower limit of only $500,000. Borrower proposes a workout to Savings and Loan whereby the property would be sold to General Motors for $3 million, all of which would be applied to reduce Borrower's loan. Savings and Loan is to provide $1 million of financing secured by a first lien on the property and a full recourse promissory note signed by General Motors. Borrower proposes that its $2 million deficiency be settled by the payment of $1.5 million in cash from other sources and the execution of a 5-year unsecured deficiency note in the amount of $300,000 and forgiveness of the $200,000 balance.

While it clearly may constitute an unsafe and unsound practice for Savings and Loan to reject this workout, it must be rejected as it violates FIRREA in the following respects:

1. The loan to General Motors of $1 million exceeds the loans-to-one-borrower provisions; and

1. The partial release of Borrower from liability is not a permitted "renewal."
A. In re The LTV Corporation, et al.

In 1982, LTV issued a face amount of $150 million of 13-7/8% debentures ("Old Debentures"). In 1986, shortly before filing its Chapter 11 case, LTV made an exchange offer of $1,000 face amount of 15% senior notes ("New Notes") and 15 shares of common stock for each $1,000 principal of Old Debentures; $116,035,000 of Old Debentures were exchanged for $116,035,000 of New Notes.

The court held that the difference between (i) the fair market value of an Old Debenture as of the date of exchange and (ii) $1,000 (the face amount of each new note) constituted "original issue discount." Under Section 502(b)(2) of the Bankruptcy Code, the unamortized discount is disallowed as unmatured interest. The court ordered further proceedings to determine the value of an Old Debenture given in exchange for the New Notes. If the court found that the Old Debentures traded on a market on the exchange date at, say, $700 per debenture, the difference of $300 would be disallowed as unamortized original issue discount. The net gain to LTV under this example would be the disallowance of $34,810,500 of the $116,035,000 indebtedness.

The respondents argued in their brief in opposition to the motion for summary judgment that this ruling could be applied "to any and all other debts which have been restructured so that any claim which has passed through a workout should, in the event of a subsequent bankruptcy, be discounted as containing [original issue discount]. This would apply not only to bond claims, but to secured claims, bank claims, and trade creditors as well."

Example of Effect on Workouts:

Borrower owes Creditor $1 million pursuant to a first lien real estate note dated July 1, 1989, secured by real property currently valued at $800,000. The note bears interest at 10% per annum and matures on March 30, 1990. The note is secured only by the real estate, but Borrower is personally liable on the note. After missing two months in interest payments, Borrower and Creditor enter into a workout whereby Borrower brings the note current, the note is extended for 90 days, to June 30, 1990, and the interest rate is dropped to 8%. Immediately after the restructure, Borrower files bankruptcy.

Under the LTV ruling, it could be argued that Creditor exchanged its old real estate lien note with a face amount of $1 million but a value on the date of exchange of only $800,000 (the value of the real estate since the Borrower was insolvent), for a new note with a face amount of $1 million. The difference between the value of the old note and new note would be $200,000 of unmatured original issue discount which would be disallowed under Section 502(b)(2).
Giving up a $200,000 claim in bankruptcy would not be the end of the world; however, by holding that the difference is "unmatured interest" (that is, $200,000 of the $1 million new note is original issue discount), the Creditor would be faced with an allegation of contracting for $200,000 of interest on a 90-day, $800,000 "true principal" amount note. With the face rate of 8% per annum and the $200,000 of "unmatured interest," the annual percentage rate would be roughly 108%.

There are numerous reasons why the LTV ruling should and must be limited to the facts before that court:

1. The decision ignores that the "value" of the debt to the creditor is irrelevant to the debtor -- LTV owed exactly the same amount of debt before and after the exchange;

2. The decision ignores the distinction between a novation and a renewal of debt; and

3. The decision ignored the clear intent of the parties in effectuating the exchange.

While there are numerous other arguments that the LTV ruling should not be expanded to other workout situations, surely debtors' counsel will make the attempt.

I. THE LAWYER’S CHANGING RISKS IN WORKOUTS.

Unquestionably, the legal profession has itself undergone dramatic changes during the past decade: with a tremendous increase in the number of practicing lawyers; a severe increase in competition for clients; a decline in attorney-client loyalty and attorney-firm loyalty; and a growing controversy over lawyers investing with and in clients, serving on boards of directors, and offering non-legal services. To be sure, one unpleasant consequence of these changes, and the changes which have occurred in the area of real estate workouts, has been lawyers joining the pool of eligible defendants when things go wrong.

I. BRINGING THE OTHER SIDE TO THE TABLE: HOW DO I GET STARTED?

A workout cannot begin until each party realizes that it is not going to get exactly what it bargained for. Everybody is going to have to give a little: the building will not be completed on time or within budget, the tax benefits will not be as projected, the return on the investment will not be exactly as expected. In the end, everybody is going to lose something, even if it is only the legal fees expended in staying out of a mess.

Frustrated expectations are not easily accepted. After the investment of thousands of dollars and hundreds of hours in dreaming, planning, and documenting, to receive less than expected, or to lose the investment, is not easy. Consequently, as a prelude
to any real estate loan workout, the parties must go through a predictable witch hunt to determine who is to blame, to rally the troops to wage offensive and defensive battles and, in general, to engage in a lot of chest beating.

A. **LENDER OFFENSIVE ALTERNATIVES: Things That Will Get a Borrower’s Attention.**

1. Acceleration of the debt (and any ancillary cross-defaulted debt);
2. Offset of accounts;
3. Assignment of rents (revoking the license to collect rents or triggering the assignment of rents);
4. Mortgagee in possession;
5. Writ of sequestration;
6. Injunction against use of rents and other actions;
7. Receivership;
8. Suit on the debt and/or guaranty;
9. Involuntary petition in bankruptcy;
10. Suit on mortgage or posting for foreclosure;
11. UCC remedies; and
12. Contractual remedies (assignment of architects contract, construction contract, etc.).

A. **BORROWER OFFENSIVE ALTERNATIVES: Things That Will Get a Lender’s Attention.**

1. Withholding of rents;
2. Allowing insurance policies to lapse;
3. Failing to pay ad valorem taxes;
4. Delaying payments to contractors and suppliers;
5. Claims or counterclaims for lender liability:
   a. Breach of contract;
   a. Tortious interference;
   a. Fraud;
a. Breach of fiduciary duty; and
a. Breach of duty of good faith and fair dealing.

1. Injunction to prevent foreclosure or other exercise of remedies by lender.

1. Bankruptcy:
   a. Automatic stay;
   a. Preferences;
   a. Fraudulent transfers;
   a. Equitable subordination; and
   a. Cram down.

A. DEALING WITH THIRD PERSONS: Things That Will Get a Third Person’s Attention:

1. Income tax consequences to limited partners;
1. Consequences of breaking interest rate swaps, caps, and collars;
1. Cutting off a subordinated lender or mechanics’ and materialmen’s liens;
1. Claims under payment and performance bonds;
1. Relocation expenses of tenants (no place to move);
1. Claims against a title company;
1. Claims against a surveyor;
1. Claims against an architect;
1. Claims against an engineer; and
1. Claims against a vendor.
Robert E. Wilson received a Juris Doctorate degree from Southern Methodist University, 1969, and is a partner of the firm of Haynes and Boone, Dallas, Texas; Member of American College of Real Estate Lawyers


In re Sandy Ridge Development Corp., 881 F.2d 1346 (5th Cir. 1989).


Case Nos. 86B11270 through 86B11334, inclusive, 86B11462 and 86B11464 U.S. Bankruptcy Court S.D.N.Y., Memorandum Decision on Motion for Partial Summary Judgment on Objection to Claims, January 11, 1990

Response of IBJ Schroder Bank & Trust Company, as Indenture Trustee, in Opposition to the Debtor's Motion for Partial Summary Judgment with Respect to the Debtor's Objection to the Claims of Valley Fidelity Bank & Trust Company, at 41.


Ballard, Record Verdict May Lead to Huge Losses, 5 Texas Lawyer, No. 41, January 15, 1990, at 1, col. 3, discussing a $20 million malpractice verdict for "botching the prospectuses on a series of real estate transactions."

See generally Kane and Barrett, Real Estate Workouts – Dealing with Third Parties, in Real Estate Bankruptcies and Workouts: A Practical Perspective (Section of Real Property, Probate and Trust Law of the American Bar Association, 1983).