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Restructuring Commercial Real Estate Loans

As 2011 begins, many have seen signs of the beginning of the gradual recovery of commercial real estate markets. However, underperforming commercial real estate loans continue to present challenges for borrowers and lenders alike. As borrowers look to keep projects afloat and lenders look to continue to build loss reserves, it appears that the restructuring of commercial real estate loans will remain an important tool for borrowers and lenders in 2011. However, the opportunities for loan restructuring may decrease as lender loss reserves are increased and lender balance sheets are improved, making lenders increasingly willing to pursue loan collateral for underperforming loans.

Loan restructuring may present several opportunities for borrowers, including allowing borrowers to capitalize on historically low interest rates, decrease monthly debt service payments and extend the time for repayment. These and other benefits may allow borrowers to continue to carry projects until commercial real estate markets improve or sale or refinance opportunities are identified.

With the benefits of loan restructuring, borrowers need to be aware of potential pitfalls. Chief among these is the possibility that the borrower will realize ordinary income from cancellation of indebtedness if loan principal is reduced or forgiven, resulting in the borrower having an obligation to pay taxes on that income. Borrowers need to account for this potential tax liability in reviewing the economics of any loan restructuring. Borrowers also need to be aware that lenders may require additional collateral, guaranties or other security as part of the restructuring process or require borrowers to put additional cash equity into the project.

Loan restructuring may also benefit real estate lenders seeking to minimize or delay losses on underperforming loans and avoid taking ownership of additional assets. As described above, restructuring may provide lenders with an opportunity to obtain additional collateral or a cash infusion into the project. Restructuring may also provide lenders with an opportunity to increase control over the operation of the project. In addition, loans may be restructured so that lenders are entitled to recover additional amounts out of excess project cash flow if the lender has agreed to a reduction in the principal amount of the loan and the project performs better than expected.

As with borrowers, lenders need to be aware of potential pitfalls in loan restructuring. To the extent that there are subordinate lenders for a project, the lender will need to take adequate steps to ensure that the restructuring of the loan does not result in the lender losing its first priority security interest in the collateral for the loan. An intercreditor agreement between the various lenders may be necessary to address priority issues. Lenders also need to be aware of the immediate cash needs of the project when evaluating whether to restructure a loan, including whether funds are needed for deferred maintenance, unpaid bills or unpaid real estate taxes. Depending on the cash position of a borrower, the lender may need to allow project cash flow to be utilized for property expenses instead of debt service payments or may even need to advance additional funds to pay deferred property expenses.

At Thompson Coburn, we have represented lenders and borrowers on a range of issues relating to commercial real estate loan restructuring and have extensive experience documenting those transactions. If we can assist your business in achieving its goals with respect to the restructuring of commercial real estate loans, please contact one of the attorneys listed below.

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