TRAVERS SMITH

Real Estate Recovery Team

Structuring techniques for defaulting loans

Commercial property values are still falling and many investment loans are in breach of their loan-to-value covenants, but banks do have options other than sending in the receivers.

According to recent Morgan Stanley research, nearly £100bn of commercial property loans in the UK will be in negative equity by the end of next year. Values are still falling and in the absence of debt finance purchasers are few. Because values have fallen as much as 30% or more in some sectors, many investment loans booked within the last 2 years will be in breach of LTV covenants. Forcing a sale of a property in this market is unattractive, but there are options available for banks short of sending in the receivers.

Whether to call a default?

Typically banks are entitled to call for valuation of the underlying security. But while a bank may suspect that a loan would be in breach of an LTV covenant if a valuation were called, it may be administratively convenient not to call for a valuation for the time being.

If a valuation does trigger an event of default then the bank may be in a position to do one or more of the following to improve or protect the bank's position:-

- ask for the borrower to inject additional equity;
- call on a guarantee or other security;
- impose a higher level of supervision on the borrower or the asset;
- require tenants to pay rent directly to the bank (if not already doing so);
- charge an increased margin (or default interest).

The extent to which the bank can achieve these aims will depend on the documentation and the relative negotiating position with the borrower.

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The bank's negotiating position as against the borrower's may be stronger while the borrower still has some equity left in the deal. The borrower will assume, probably correctly, that if the bank does enforce its security then a forced sale will wipe out the remaining equity that the borrower has. If on the other hand the value has already gone significantly below the bank's loan the borrower has no remaining interest and may be less inclined to co-operate.

Keeping the borrower's management

There may be cases where the borrower's equity has gone but the bank values the borrower's knowledge and expertise and would rather keep the borrower in charge of the property in the hope that this will maximise the likelihood of selling it to recoup the whole of the bank's loan if and when the market turns up.

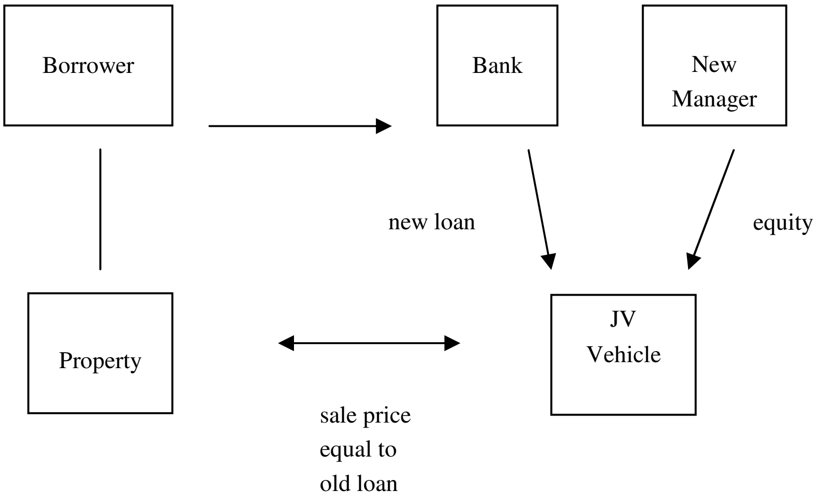
It may be appropriate for the bank to consider a debt for equity swap with the borrower, reducing the debt to a level that the property can sustain and giving the bank some upside if values rise, but at the same time increasing the borrower's chance of recovering some of its equity and therefore its incentive to manage the property.

The bank wants to change the management : development sites

The management have lost their equity in the property and see no realistic prospect of making anything further out of it. If the project is a development then the bank may have little option but to appoint a receiver to take over the development on behalf of the borrower. There are already in the UK numerous examples of receivers being appointed over part-built residential schemes. The bank will need to take control of the scheme in order to preserve any current value or to maximise the value if it is to be built out.

Banks will need to take valuation advice on whether it is actually worth building out the development – in the last property recession in the UK in the early 90's there were a number of examples of schemes where banks would have done better to abandon the development, sell the site for whatever value could be obtained and write off the rest of the loan, rather than build out the development and realise on completion less than the costs of building it out.

In these circumstances much will depend on the level of comfort that the bank has with the construction team and the project managers and the robustness of the construction documentation and the warranties the bank has.



The bank wants to change the management : investment properties

The basic scenario here is as follows (although there are numerous permutations of this):

- There is an investment loan in place where rent is still servicing interest but there is a breach of the LTV.
- The bank has lost faith in the current management – all of their equity has gone.
- Active management of the asset is required and the bank does not think the old managers have the expertise or enthusiasm for it.

The bank may set up a joint venture vehicle with a trusted third party which is prepared to put in some equity (off balance sheet for the bank).

For example, assume the original value was £10m, the bank loan is £8m and the current value is £7.5m. The bank exercises a power of sale (or appoints a receiver) and engineers for the property to be transferred to the JV for £8m – the amount of the current debt and slightly more than current market value. The purchase price repays the existing bank loan.

The bank lends the majority – perhaps 95% - of the purchase price to the JV on a limited recourse basis at an increased margin, but still covered by the rental income. The new managers put a small amount of equity into the vehicle and will manage the property. The bank and the third party managers share the upside if values rise. The bank will not have direct equity in the vehicle, but will have an equity kicker on its loan.

The bank will need clear valuation advice to ensure that there is no risk of the transaction being challenged on the basis that the bank is selling the property for less than the market value. In the scenario given the transfer price should be slightly more than the market value so this should not be an issue. Typically there will be no formal marketing of the property prior to arranging the sale to the JV. This approach is attractive where the bank has a number of properties that it wants to transfer and the whole portfolio could be transferred to a particular JV.

As described below, there are SDLT avoidance techniques which may allow the parties to avoid paying SDLT on the transfer.

From the bank's point of view, it has reduced its overall exposure to the property without any loss of income and has brought in new managers. The new managers have to put in a relatively small amount of equity which will be lost if values do not rise, but in exchange receive a management fee and a substantial share of upside.

There are accounting, tax and other issues to be addressed; and there are of course numerous ways of working out the equity injection/loan terms/distribution of management fees and profits equation.

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Tenant Default

The scenario above assumes that there is sufficient rental income to pay the interest on the loan. In the event that a tenant defaults then the position is much less attractive, but in principle the same joint venture approach could work provided that there is a mechanism to roll up the interest on a non recourse basis.

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SDLT Planning

A number of different techniques are currently available for mitigating SDLT. The most appropriate structure will depend critically on the nature of the underlying transaction and the appetite of the parties for risk. In the first instance the commercial deal should be reviewed to assess whether a relief is available as a matter of course. Where this is not the case, a more structured scheme may be appropriate.

We can advise on a number of different structured schemes which we consider to be technically robust. We recognise that a "one size fits all" approach to SDLT planning is not appropriate, and where a mitigation structure imposes commercial constraints it is key to assess at an early stage whether those constraints are acceptable in the context of the wider deal.

Portfolios

A different approach could be adopted where the bank has a large number of properties that it would like to transfer but no particular favoured third party with which to enter into a joint venture.

In such circumstances and in the absence of debt finance in the market, one approach is for the bank to market properties with a loan attached (subject to status).

On a small scale this could be done through agents; but an attractive approach for a large number of properties would be to set up a website (perhaps in conjunction with one of the main firms of surveyors) identifying the target price for each property and, importantly, the amount and terms of the loan that will come with it. This can of course be adjusted on a property by property basis, and if it is set up through a website the pricing can be adjusted to reflect interest in the properties, movements in the market etc. If in order to make a property attractive for sale the bank has to lend a higher proportion of the sale price than it would ideally wish, this could be reflected by building an equity kicker into the terms of the loan.

It would be possible to set this up as an auction website with the buyers bidding either for the price or, alternatively, the amount of loan that they will require to buy for a specified price.

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Clients

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Berlin Hypothekenbank
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How we can help

Travers Smith – Real Estate Recovery

The firm's Property Finance group is a leader in the field and has been active since the early 1980s. Work is undertaken by lawyers able to advise on both the lending and property aspects of transactions, a factor that sets us apart from our competitors and which ensures expert and efficient transaction management.

The Real Estate Recovery Team draws further upon experts from across the firm to ensure that clients are supported with legal and commercial advice of the highest quality. We are able to assemble a bespoke team with the appropriate expertise and experience to tackle the issues that arise.

We offer the full range of services needed to produce the best outcome from a distressed situation. Much of our work is undertaken outside of an insolvency process and may involve standstill and support operations, debt restructuring and debt to equity conversions. Where appropriate, however, we also advise on insolvency issues and procedures. Our clients include banks, investors, companies, their directors and turnaround and insolvency practitioners. We also regularly work with purchasers and creditors of distressed businesses as well as overseas clients and law firms.

Recently we have advised lenders and borrowers on the effects of bank insolvency (in particular Lehman Brothers and the Icelandic banks) in general and on particular transactions, and have acted in relation to several debt restructurings. We have been instructed to carry out an extensive review of debt documentation across a range of deals.

"…this consistent, high-calibre firm commands a loyal following due to its winning combination of in-depth specialist skills and overarching understanding of the market-place."

Chambers Guide to the UK Legal Profession (2006)

"A leading firm in the turnaround market, Travers Smith has an excellent spread of expertise in the insolvency field"

Chambers Guide to the UK Legal Profession (2008)

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