

# Rescuing Underwater Real Property

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## Market Trends

As a result of deteriorating market conditions over the last 3 or 4 years, both owners and lenders address problem loans and the related real property collateral more proactively in anticipation of imminent cash flow distress and loan payment issues. In many cases, short-term extensions or debt service relief for a short period of time until the market recovers will not suffice. As we have all seen, the market has been an unpredictable roller coaster ride, and market conditions are likely to impede recovery of real estate for some time.

In this volatile environment, what can the owner do to protect against further deterioration of its real property, and what can the lender do to improve its real property collateral?

## Determine Appropriate Steps for Recovery

*Understand why the real property is in trouble*—If the real property and its operations are suffering due to troubled market conditions, the property may be seeing reduced traffic, which translates into reduced income. If the ownership structure of the owner is in financial distress, there may be no cash to fund expense deficiencies, debt service or tenant improvements and leasing commissions. In a shopping center context, the current composition of tenants may deteriorate in a troubled market, ultimately affecting the success of the shopping center. However, other factors may delay recovery. Is the location of the property compromised? Is new development in neighboring areas threatening the viability and future of the property? Is the property located next to an environmental hazard? Is the property itself experiencing environmental issues? Who is the current manager? Does the current manager have the experience or sophistication to identify and resolve property issues? Identifying the source of the problems will direct focus to potential solutions and recovery.

*How good are the property financials?*—If the owner is not sophisticated, an accountant experienced in the same property type and business can generate proper financial information to help either the owner or lender evaluate the operations of the business at the property and any deficiencies.

*Market Conditions*—Is the property of a nature and type particularly affected by current market conditions? If yes, studying current market information, including industry trends, local competition and the local real estate market areas, will assist in evaluating the recovery potential of the property.

*Broker Relationships*—Brokers can gain advantage as trusted advisors to lenders and property owners due to the resources they have available in the market. They are typically involved in similar transactions and have a wide network of contacts for accountants, distressed asset consultants, environmental companies, investors and take out lenders. Brokers can also identify and help resolve problem leases, and resource potential replacement tenants and alternative business operations.

*Distressed Asset Consultants*—Consultants with experience in distressed assets of the same type and business as the real property are valuable in navigating the road of recovery. A consultant can evaluate financial information, business operations, current vendors, suppliers and tenants, and the property's financial health and future in light of current and projected market conditions. For example, for a shopping center, evaluating a change of the composition of the tenants, negotiating new terms for troubled tenants, and resourcing new and popular tenants for empty or troubled space, may give the shopping center a new and fresh face. A troubled hotel property in an area with recent growth and fierce hotel competition may need to restructure its current debt and change its flag to generate a competitive advantage. Good consultants provide critical expertise that can save time and money. Hundreds of consulting groups claim to be market leaders with

the required experience. Check around to confirm their experience, reputation and success rates.

*New Management*—In many situations, hiring a new third-party management company provides a fresh expert look at the property and its operations. Too often, management is not sophisticated or is a related entity with emotional ties to the property and its operations, which risks neutral and unbiased management. Look for a management company or an operator that has experience with the same property type and operations and will achieve savings as a result of the number of properties they manage, including shared staffing, umbrella insurance coverage and their past experience with the same property type and operations. Experienced managers and operators can bring immediate improvement in the operations and performance of the property.

*Available Cash and Escrows*—If conditions at the property are deteriorating, the owner should talk to its lender. Escrows held by the lender to secure the loan encumbering its property might be redirected for much needed repairs and deferred maintenance, to upgrade and make improvements, to provide funds for new tenant build out or to otherwise update the property to ease its road to recovery.

*Restructured Ownership; Fresh Capital*—If the members of the ownership structure are suffering financially, is new money available to buy into and restructure the ownership to fund the property going forward? New money can pay down and restructure existing debt service, fund new reserves, pay for much needed repairs and deferred maintenance, fund a new marketing plan for the business operations and otherwise bring immediate stability to the property through increased working capital.

*Restructure Existing Debt*—The consultant can assess what relief the owner may need with respect to existing debt service. At what discount in principal or at what reduced rate of interest, whether temporary or long-term, will the real property continue to service debt

through turbulent market conditions? The lender will likely require infusion of cash with respect to any reduction in principal, including new escrows for deferred maintenance and other improvements to the real property, and new guarantees. For some time period, the lender may also require that all cash flow be paid into a lock box with controlled release for payment of operating expenses pursuant to a budget approved by the lender. An owner or investor will have to have “skin in the game” for the property and its operations to succeed and any workout of the loan encumbering the real property to be successful.

*Third-Party Consents*—Depending upon the nature of the property operations, the owner may be required to seek the approval of third parties before the owner or lender can engage in certain recovery activities. For example, in a fast food restaurant or convenience store operation, the owner may be subject to agreements with vendors or franchisors such as Chevron, Shell, McDonald’s, who have rights of first refusal and consent rights before the owner can sell any part of the ownership or the property. If the real property is subject to a ground lease, the landlord may have these same rights. Lenders exercising remedies may be equally restricted. View these third parties as a resource. Typically, they want to preserve market share built over time and may have valuable resources available to assist. For example, in a recent transaction, a large franchisor purchased troubled convenience stores from a franchisee and then leased them back, generating cash to allow the franchisee to improve its properties and bring them back to current market standards.

## Alternative Remedial Action

In many cases, the lender may lack the resources or patience to help the owner work through troubled market conditions. Instead, at the first sign of distress, the lender will take action to protect its collateral and initiate remedies as soon as permitted under its loan documents. In

many states, foreclosure is a time-consuming and expensive process. For example, if the lender takes title at the foreclosure sale, the lender's expenses may include hiring a manager to operate the property and paying for operating expense shortfalls and deferred maintenance. The lender will want to weigh its alternatives and the potential expense. For example, the lender may consider the following alternatives, which may provide the owner with a new opportunity to work through property issues and offer third parties an opportunity to invest:

*Loan Sale*—The current market appears to be flooded with new investor groups interested in purchasing troubled loans. The broker or consultant can help the owner and lender identify interested prospects who may want to purchase the loan encumbering the real property or make an investment through a restructure of the loan with the owner or after foreclosure.

*Assumption of Loan*—Instead of a loan sale, the potential investor may consider purchasing the real property and assuming the loan through a discounted restructure of the loan with the lender. If the real property and its operations suffer from current market conditions and the property can recover with the infusion of new cash, the owner may stay in management and retain some minority ownership in the real property.

*Receivership*—When lenders believe the property and its operations are in jeopardy, the real property suffers from an environmental issue, there is no current or acceptable management, a workout is perceived to be unlikely or difficult, or the property would be subject to a judicial foreclosure, filing for a receivership is a popular option. With a receivership, the lender does not take possession or title to the real property, and all matters relating to the real property and its operations are supervised by a court. The property can be sold to a third party, the loan encumbering the property can be restructured and/or assumed by a third party or the property can be foreclosed under court supervision. Although receivership offers an expedient transfer of the

real property away from the owner, once possession is transferred to the receiver, the owner has lost control over its management and operations. Allowing the lender to control cash through a lock box, establishing a waterfall for payment of debt service and expenses pursuant to an approved budget and putting up new escrows with lender, may postpone the lender's appetite for receivership. Receivers are appointed by the court and do not always have the appropriate experience or ability to add value to the operations of the property, and typically have less flexibility with respect to ownership and operational issues. Most receivers manage the property and its operations with minimal effort and have no interest in turning the property around. If possible, recommend a receiver who is experienced in the applicable property type and who has a high success rate for resolving property and operational issues in a positive manner. Your counsel will likely have worked with the most capable receivers and can give recommendations. Worst case, the receivership may give the owner an opportunity to seek a discounted payoff of the loan or a restructure of its debt encumbering the property at a discount.

*Deed in Lieu*—A deed in lieu offers a much cheaper alternative to a receivership. The owner executes a deed of the real property to the lender in payment of the owner's obligations on the debt encumbering the property. The lender can then either extinguish the debt and sell the real property to a third party or keep the debt alive for a potential assumption by a third party. This alternative reduces costs and allows the owner to avoid potential litigation. There are, however, risks to the lender. The lender will conduct due diligence with respect to environmental matters and prior liens before taking a deed in lieu.

*Bankruptcy*—If all else fails, there is always the bankruptcy option. The bankruptcy process can be protracted and very expensive for both sides. However, if there is significant equity value in the project and the owner cannot negotiate a positive restructure of the loan encumbering its real property, the owner may wish to pursue this option to protect its equity.

The bankruptcy process may buy the owner some time to propose and work through a plan of reorganization or sell the real property in a bankruptcy auction or sale. This option will not, however, prevent the lender from seeking its rights to have the automatic stay lifted with respect to its real property collateral and to pursue foreclosure.

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## A Modern Real Estate Practice

It is no secret the commercial real estate market has seen some tumultuous times, both recently and in decades past. Location isn't everything anymore. Commercial real estate deals come with significant price tags, high stakes and are among the most complex transactions any business can undertake. But where others see risk, we see opportunity.

With more than 60 real estate lawyers, Andrews Kurth has the strength and experience to provide legal assistance for closing the full gamut of commercial real estate transactions. We represent clients in financing, buying, selling and developing real estate projects and have unbridled access to the firm's resources and attorneys in banking, construction, environmental, securitization and tax law to ensure a smooth process from start to finish. We know that significant transactions require sophisticated counsel. When opportunity knocks, we help our clients open the door.

## The Andrews Kurth Real Estate Practice:

- Represented the Houston Sports Authority in the development of Reliant Stadium, Minute Maid Park and the Toyota Center.
- Understands many essential transactional languages, including REIT and REMIC, UBIT and CMBS, and understands real estate development from the ground up and structured finance from the AAA tranche down.
- Regularly helps clients address related issues, such as land use, joint ventures, restructuring, foreclosures and bankruptcy.
- Provides integral legal assistance to clients who are acquiring, financing or developing oil and gas, pipeline or electric generating facilities throughout the United States.
- Is consistently recognized as one of the leading real estate practices in Texas by *Chambers USA: America's Leading Lawyers for Business*.

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Brigitte has experience in all areas and with all types of commercial real estate (including shopping centers, hotels, office buildings, office parks, industrial parks, restaurants and franchise properties, including fast-food establishments, gas stations and convenience stores). She advises clients on transactions involving real estate portfolios and multiple properties in multiple states, emphasizing lending, leasing, sales and acquisitions, sale-leaseback transactions, note sale transactions, and restructuring and workouts of defaulted loan transactions. She received her J.D. in 1986 from Southern Methodist University Dedman School of Law and her B.B.A., with honors, from The University of Texas in 1983 where she was a member of the Dean's List and Golden Key Honor Society. She earned her Abitur in 1980 from Gymnasium Osdorf, Hamburg, Germany (Scientific Mathematical High School–13 Years).

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