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COMMERCIAL REAL ESTATE SEEMS DOOMED — CORPORATE RESTRUCTURING MAY BE A VIABLE STRATEGY

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According to the Mortgage Bankers Association, approximately \$1.4 trillion of commercial real estate loans will mature this year and the next, which raises important questions about how the sector will fare with remote work continuing to remain dominant and with an uncertain economic environment in the post-pandemic world. Described as a “debt time bomb” in recent news reports from *Bloomberg Businessweek*, office buildings have not returned to pre-pandemic occupancy levels due to the shift to work-from-home office policies and the latest rounds of layoffs. With interest rates at their highest point since 2001, there seems to be no end in sight to the financial distress facing the commercial real estate market, leaving many to speculate what will come next and how these challenges can be surmounted.

Distressed building owners, lessors, and lenders are in the difficult position of determining the best strategy to weather the coming storm and address the challenges they are facing. Interestingly, they are all generally in the same proverbial boat: softening occupancy rates. While far from ideal, some owners might consider handing over the keys and walking away from the debt (and the building). Others may consider repositioning property for a mixed-use strategy combining residential, commercial, and retail tenants. Sound familiar? Shopping malls have looked to this solution in recent years with only mixed results for most.

However, the conditions seem ripe for an uptick in chapter 11 filings within this distressed sector. Why? There is currently no reason to believe there will be a significant improvement expected on the horizon. In the long-term, the challenges facing the commercial real estate sector will work themselves out — one way or the other; however, many of these companies are not going to be able to survive in their current, over-leveraged state. It would take significant economic growth and expansion for commercial real estate companies to rebound to occupancy levels seen prior to the pandemic. Going a step further, it may take a full-blown paradigm shift back to office occupancy seen during pre-pandemic days for the sector to return to “healthy” levels of substantially full tenancy in the near future.

Why have we not seen more commercial real estate chapter 11 filings? You hear that nearly daily — and have for the past two or even three years. Some speculate that one of the reasons we haven’t seen more chapter 11 filings in this sector is the systemic nature of the problem: all parties are in a similar predicament. After all, let’s be honest here: most lenders do not want to own (or operate) commercial properties — even if such commercial properties were profitable. That is not their bailiwick. And if no one can make commercial real estate profitable right now in light of the prevailing economic environment, then all involved parties may hunker down to minimize the losses as much as possible until the market recovers. Additionally, rising interest rates make the prospect of refinancing and renegotiating debt a more

challenging process whether in or outside of a bankruptcy environment.

Regardless, corporate restructuring remains one of the few avenues for distressed commercial real estate companies to weather the storm. As commercial real estate entities teeter on the brink of insolvency, their advisors and turnaround professionals must evaluate the circumstances of each case to determine whether corporate restructuring might play a beneficial role in stabilizing them and returning them to a more profitable state. In doing so, it’s crucial that turnaround professionals ask the right questions and keep in mind important considerations so they can determine the best course of action.

What Is the Goal of the Restructuring?

Each commercial real estate company will have unique needs and circumstances, and therefore it’s critical to fully understand the desired outcome and purpose of the restructuring. For example, for some commercial real estate companies, chapter 11 may offer an advantage and alternative to just handing the keys to the lender. Perhaps they can maintain control of their assets. Instead, they may be able to renegotiate with the lender from a slightly stronger position using bankruptcy as a strategy. Many reject corporate bankruptcies as a solution, arguing they are too expensive. While that remains debatable, the carrying costs to hold on to unprofitable assets with no end in sight is itself very expensive. In fact, corporate bankruptcy could be used to provide commercial real estate companies with more time to hold out until market conditions begin to improve — or provide the necessary leverage to reorganize their portfolios into a form better able to weather the current economic conditions.

Understanding the Company Structure

The first step in evaluating whether corporate restructuring is the proper path for a commercial real estate company is understanding the company structure. Does the entity have one property or multiple properties? How is it incorporated? Where is it incorporated? How is financed and what are the terms? These and other factors will often determine what can be accomplished in chapter 11... and what cannot.

For example, if each building is a separately incorporated entity, and some are underwater and some are not, equity could theoretically cast off the underperforming ones and reorganize around the healthy ones. In doing so, equity could still maintain its prevailing interests because of the way the structure is laid out and where the banks have liens and where they don’t.

However, if the company holdings are held as separately incorporated businesses but are each simply a piece of real estate, such properties might disadvantageously be considered a single-asset real estate (SARE) case which would face its own unique set of challenges in chapter 11. If an entity qualifies as a SARE, that limits its ability to use the Bankruptcy Code as a



means to reorganize and get out from under the impending debt load. Congress put restrictions in place for what can be done in SARE cases because of its potential for abuse as they represent mostly two-party disputes involving owners and the lenders without any other operations.

Evaluating the Capital Structure

Another important step to gaining insight into whether chapter 11 is an advantageous strategy for a commercial real estate company is to evaluate the capital structure of the company. Commercial real estate entities vary significantly in how they are financed, their capital structures and layers of debt. An analysis of these complexities can shed light on whether filing for chapter 11 would be an appropriate course of action.

An important element of the capital structure is whether the debt is cross-collateralized. Is there one lender or many lenders? Are there separate lenders for each building? While cross-collateralization of loans helps a borrower to secure a larger loan with better interest rates, it also protects the lenders by giving them more collateral and hamstringing the borrower/building owner's ability to reorganize around better properties. For example, in the hypothetical scenario above discussing options where a multi-building real estate company has separately incorporated a company holding each building, it would be theoretically possible for the company to only file underperforming holding companies for bankruptcy. In a cross-collateralization situation, all of the holding companies would necessarily need to file as they are all co-borrowers for the entire debt.

Embrace a Proactive Strategy

Whatever the scenario may be for a commercial real estate case, it's always better to be proactive than reactive. In fact, this is a rule-of-thumb for all companies facing financial troubles. Bankruptcy is a complex process, and it takes a great deal of planning and time to do it right. And time is money, as they say. It's always best to file for bankruptcy before the last dollar goes out the door. That gives the debtor the flexibility that's needed, allows them to hire the best counsel possible and with any luck, encourage lenders and other players to dance to their tune and cut a better deal at the end of the day. Put another way, act early and their arsenal has many more options.

If a commercial real estate entity is already under water, it may be advantageous to file chapter 11 so that creditors do not have any causes of action against the debtor, wiping the proverbial slate clean. However, these protections are only in place if and when the plan is confirmed. Conversely, filing for chapter 7 can

paint a target on your back for trustees who may be seeking to sue for breaches or violations – clawing back more funding for the estate. This underscores the importance of taking action sooner than later.

As part of a proactive strategy, the prospective debtor and its advisors should also carefully consider the venue for a chapter 11 filing. In most cases, the available venue(s) for each debtor will depend on the size and headquarters of the company but there may be other circumstances to consider in each unique case. One important consideration concerns the complexity of the company and its finances — certain jurisdictions are more experienced with large and complex reorganizations and better able to facilitate quicker resolutions than others.

Conclusion

For companies in the commercial real estate sector, the advantage of filing chapter 11 is mostly cut-and-dry: they can drive the process rather be driven — rather than handing the keys over to the landlord/owner (who likely wants nothing to do with actually running the property itself). Ultimately, the goal is to line up the lenders, reorganize the loan structure, and emerge leaner and more profitable than before. With the right analysis, asking the right questions, and acting *early*, turnaround professionals can assist in guiding the process, and in making the appropriate determination, corporate restructuring can serve the needs of this distressed sector until it recovers.

ABOUT THE AUTHORS



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Daniel is Senior Counsel with the Bankruptcy and Restructuring Group at Morris Nichols. He has been involved in bankruptcy proceedings and litigation on behalf of a variety of national and regional clients, including debtors, creditors, official committees of unsecured creditors, an official committee of equity security holders and various ad hoc committees. He currently represents publicly held-

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