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It's All About the Guaranty

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Insolvency professionals, both lawyers and financial advisers, are often facing an all-too-common issue when advising on real-estate-related situations in today's market. The issue they face is that the property has more debt than it can support and/or more than it is worth and the entity they represent, the debtor, may be only one of the guarantors in the failed real estate venture. Every legal and financial adviser dealing with distressed real estate needs to put up a sign reminding themselves (and their clients) that "It's all about the guaranty." In almost all distressed real estate situations today, the banks are looking to the guaranty as a source of funds for repayment.

Since real estate asset values can be established, this means the guaranty is the main factor that will impact the ultimate economic resolution and therefore the one the banks will focus on the most. This situation often creates numerous issues for the legal and financial advisers — first and foremost that "the client," the debtor is often only one of the decision makers in resolving the issues. In fact, the other guarantors may have different guaranty obligations than the debtor and therefore have retained their own legal advisers to protect their interests. Depending on the relative strength of the guarantors, the debtor you represent may or may not be the "real power." This entire situation (very commonly) is further complicated when the debtor, often a LLC or other single purpose entity, has both corporate and personal guaranties — often with many of the same key principals with a financial interest in both.

Whether your real estate client is a large single-asset entity or a holding company with multiple real estate types, you are likely to find that there is no restructuring plan, no matter how creative, that will change the asset value materially in the short-term (two-three years). If the fair market value of the property is less than the debt, then the lender is effectively the equity holder. But if there is no equity value then there are two vastly different scenarios to deal with, properties with recourse debt and those with non-recourse debt.

The focus of this article is on those situations that are cash-flow-negative — where any additional cash infusion by the existing owners is effectively a "call option."

Non-Recourse Debt

In the case of non-recourse debt, the solution is often pretty cut and dried — hand the keys over. Unless there is an expectation of significant equity value in the near to intermediate term, it is better to give the keys to the banks and focus on properties with equity value. Notwithstanding the lender's many persuasive arguments why the principals should invest more equity, the lender had the opportunity to require security above the asset level and chose to underwrite the credit non-recourse. Since lenders are rarely willing to write-down debt to market value while leaving the principals in the deal, there are few alternatives for an underwater non-recourse deal. The principals need to focus their capital and attention on properties that are not underwater or on new investment opportunities.

Projects with recourse debt are often much more complicated than they might seem on the surface. Recourse can come in many forms; holding company guaranties ("Holdco"), personal guaranties and pledged assets among the most common. Lenders who happily put those impressive looking financial statements in their files in 2006 or 2007 and paid little attention when the 2008 year-end statement came in may be in for a rude awakening when the loan matures in 2010 or 2011. A Holdco with substantial net worth in 2006 or 2007 most likely provides little or no additional security to the loan, today or in the future.

Holding Companies

Let us look at what frequently happened. Loan X was made in 2005 for Holdco (and its principals), whose balance sheet showed little in the way of liquid assets but a number of projects in various stages, all which with comfortable LTV's and significant "equity" value. Several stabilized cash flowing deals showed carrying values well above their debt. The development, pre-development and existing stabilized projects all had impressive projections.

Fast forward to the situation today. Loan X will mature in the near-term, and has not been performing for six months and lender T, realizing project X has big problems, tells the principals to find a new lender or face

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Algon Group is a specialized financial advisory and investment banking firm that is currently engaged in several high profile real estate restructurings involving in excess of $4 billion of indebtedness. Each of these assignments has required a unique solution due to the complexity of the guaranty issues.

foreclosure. There is no new equity available for the project at the current capitalization and the lender refuses to take a write-down to market value or a level that leaves a realistic chance for the equity holders to have any value. Lender T takes a hard line because it initially believes that any shortfall at the project/assets level will be made up by the guarantors. Lender T is "shocked" (or some people at the bank are, but they shouldn't be) to learn the following about the value of the guaranty they hold:

1. The stabilized properties, which appeared to have substantial value above their respective debt, have been the victim of falling NOI's (vacancies, delinquencies and bankruptcies) and expanding cap rates (lack of buyers, lack of financing, falling expectations). Their values have plummeted and have little to no equity value today, especially if liquidated, and may be underwater themselves.

2. Holdco is not a 100% owner in the stabilized properties and the other equity holders of the projects may be the only (or best) buyers in a liquidation situation. The fact that there is a limited market for these fractional equity positions in the stabilized deals further diminishes their value.

3. The development and pre-development deals are virtually all dead (bad economics, no equity or debt available to continue development) and the A&D lenders all have the same guaranty and are making noises about foreclosing and chasing the guaranty value which would result in more competing claims.

4. The guarantors' personal collective net worth consists mostly of equity in Holdco and the same deals. Other assets are often protected (trusts, pensions, personal residences, joint assets) or illiquid. Costs to pursue them likely exceed any possible recovery value.

The news gets worse for Lender T. It syndicated out Loan X to two other lenders, Y and Z, and is the agent bank with the most knowledge of the borrower and the guarantor. Lender Y has reserved a significant portion of the loan when they were acquired last year and they want to take whatever value they can get and "be done." Lender Y definitely does not want to pursue expensive litigation. Lender Z is carrying the credit with the minimum reserve and does not understand why the guaranty will not cover any deficiency and wants to fight to the last penny. Also, the project needs working capital to support monthly burn and none of the lenders is interested in carrying it. In fact, Lender Z may not have the financial capacity to fund its pro-rata portion of the shortfall.

Lender T is also a participant in one of the stabilized deals now likely under water and holds 100% of one of the A&D loans. If lender T forecloses on the A&D loan and chases the guaranty, they could trigger a stampede against the guaranty and fear a lawsuit from lenders Y and Z for conflict of interest. If Holdco files bankruptcy virtually all of the limited remaining value will be spent on administrative costs.

It becomes increasingly apparent that the guaranty structure is complicated and inter-connected and none of the guaranty holders can expect to realize any substantial recovery without spending significant time and money in litigation suing the guarantor and potentially one another. After that they may end up with little or nothing for their efforts.

What the financial and legal advisers need to do:

- Do a thorough analysis of the current market value of the properties owned by the guarantors;
- Review each of the guaranties to understand any nuances or differences;
- Educate the lenders on the limited value of the guaranty;
- Consider the structure and composition of the lending syndicates;
- Get all parties to understand that a consensual plan will likely maximize their value;
- Advise all parties that any single guaranty holder can start a rush to litigation;
- Foster negotiations that will result in a global settlement of all guaranty issues; and
- Educate the guarantors to the difficulty of these negotiations and be realistic on how long a global consensual will take.

Advising Clients

Advising clients on real estate restructurings often requires a steady approach and calming influence. Many times the owner(s) has not come to grips with the declines in value or do not have the patience for a long or contentious global consensual workout — however, it is likely the only one that makes sense.

Continue to educate the lenders in the same way, as they also have trouble coming to grips with the declines in values and the resulting losses they will experience. A key for any adviser is to understand the guaranties and how they are interconnected. You must understand the effect of any action by any lender or claim holder.

Four Important Factors

1) Do a realistic analysis of the values of underlying assets. Old rules no longer apply and do not project returning to "old values" quickly; 2) Use realistic discounts for illiquidity due to lack of financing, limited buyers, legal entanglements and fire sale pricing. Buyers have a number of hurdles in today's market and will price their offer accordingly; 3) Determine the number of parties with guaranties. If there are many slices of the pie, each slice may be too small to chase; and 4) Calculate the costs of litigation and/or bankruptcy. These costs often eat a significant portion of the potential value.

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