



## The Real Estate Workout Equation

### *What Both Parties Should Know*

**F**ew today would argue against a significant deterioration in the residential and commercial real estate markets having occurred, both nationally and locally. As owners of troubled real estate projects weigh their options in the face of impaired cash flows, completion delays, delinquent payments and declining property values, their lenders and landlords will search for ways to recoup their investments while lessening the attraction of bankruptcy protection for their borrowers and tenants. Increasingly, both sides will turn to a real estate workout to achieve these goals.

Since many real estate projects are owned by single asset entities, any security or assurance that a lender or landlord would normally demand in the event of a default, such as additional collateral or guaranties, will not be available. The demand itself may increase the likelihood that the owner or tenant will file for bankruptcy, an unpalatable risk for most lenders and landlords.

Workouts are agreements between defaulting parties and the parties to whom they owe financial obligations that provide for payment of the obligation, while affording the defaulting party the opportunity to benefit from the value in the project. Most real estate workouts involve providing the distressed party with the time it needs to improve the asset, while maximizing the odds of

payment and minimizing the incentives for a bankruptcy filing.

Both parties can explore a number of options. The terms of the loan or lease can be renegotiated to lower the loan or rent payment, extend the loan term, allow for interest only payments for a certain time period, defer defaulted payments to the end of the term, or allow the delinquency to be repaid over time. The project may be redesigned to a more manageable size. For loans, all or a portion of the property could be sold or refinanced while the lender forebears all or part of the regular payments. The borrower or tenant could be recapitalized with a new partner contributing additional equity thereby providing the lender or landlord with a potential additional guarantor, as well as new expertise, which may decrease the likelihood of future problems. The parties could also agree on a settlement, which, for a lease, may involve early termination with payment of a termination fee. For a loan, the borrower may consider conveyance of the property to the lender with a deed in lieu of foreclosure in return for releasing the borrower and guarantors. In any event, the lender and landlord should retain the ability to pursue their original remedies if the workout is unsuccessful.

Workout agreements should be in writing. The parties should acknowledge and affirm the terms of

the original agreement. The borrower or tenant should waive any claims against the lender or landlord, and the consideration for the accommodations made to the distressed party, should be clearly explained, including payment of an extension fee or additional interest over the extended term. The distressed party should be required to fully disclose its financial condition, both at the time the agreement is executed and on a continuing basis during the term of the workout. Unlike an ordinary transaction, if negotiations concerning the workout fail, the parties cannot walk away from each other. Litigation is not just possible, but probable. Therefore, the parties should also strongly consider entering into a written pre-workout agreement before negotiations commence, providing that statements made during workout negotiations cannot be used against a party in any subsequent litigation.

If the current deterioration in the local real estate market continues, understanding the benefits and limitations of workouts will become increasingly critical for participants in every segment of the real estate industry. Be sure to consult with experienced legal counsel before entering into a workout agreement. 🌿

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