

Real Estate Law & Practice

When Converting (Debt to Equity) Enables Conversion (of Office to Residential): Suggestions and Practice Notes

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The state of the office sector is grim. The end of the era of cheap money, coupled with a shift to remote work, has resulted in widespread value destruction and mounting distress. The tide of bad news is unlikely to recede any time soon. As has been widely reported, U.S. property owners must refinance \$137 billion of office mortgages this year and nearly half a trillion dollars in the next four years, at a time of widespread lender retrenchment. Compounding the distress, spiking interest rates, coupled with the staggering cost of interest rate hedges for floating-rate loans, have dramatically raised the cost of the few loans on offer.

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The Playbook, and the Case For Ripping It Up

When a borrower cannot repay a loan at maturity, lenders have customarily chosen between two options: modification and extension of the loan; or the exercise of the lender's remedies under the loan documents. Modification and extension agreements typically afford the borrower additional time to repay the loan, in the hope that market conditions will improve before the new maturity date. They also frequently afford the borrower additional relief, such as the right to accrue interest during the extension period, and even a promise

of additional loan advances to fund tenant improvement and other costs required to reposition the asset. The exercise of remedies under the loan documents entails either judicial foreclosure or the delivery of a deed in lieu of foreclosure.

It may be time to rip up the playbook and turn to a third option. Historically, lenders have been unwilling to go into business with their borrowers, preferring to observe a rigid separation between debtor and creditor. This approach made sense in past downturns, when lenders could be confident that the market would rebound and their collateral would recover its value.

What happens, though, when the rules of the game have changed, and no one can offer any assurance of a recovery in demand for office

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buildings, especially Class B or C properties outside prime locations? What is the point of extending the term of a loan if there is no path to repayment? What is the appeal of taking ownership of the collateral (or selling it at auction) if the prize is a white elephant, competing for scarce tenants and likely in need of costly capital improvements?

If an office property can be repositioned for another use, there is a path between extending the term of a loan and hoping for the best, and taking the property back and realizing a cata-

strophic loss. This third way of dealing with distressed debt consists of converting a portion of the debt (including unpaid interest, protective advances, and a portion of the principal amount of the debt) to equity.

Office to Residential Conversion: Today's Real Estate 'Alpha Topic'

While the demand for office space is anemic, the demand for housing, especially in New York City, remains robust. Inevitably, office conversion has become the "alpha topic" in commercial real estate, holding out the promise of absorbing excess office space and abating the housing crisis. Conversion, however, is fraught with difficulties, presenting an array of engineering and regulatory challenges, such as ensuring that each apartment has sufficient light and air. Owners must also figure out how to empty their buildings of remaining office tenants. If an owner can solve these puzzles, however, conversion may be the only way out of the present morass.

No owner would undertake such an effort with the Sword of Damocles of a loan maturity and a mountain of debt contracted during boom times in the office sector hanging over its head. Given the skittishness of the lending market, even an owner with a compelling business plan is likely to face long odds in any effort to refinance debt and finance conversion costs. So owners and existing lenders of properties ripe for conversion are essentially stuck with each other, with no good options, other than recasting their relationship from one strictly of debtor and creditor into a hybrid relationship involving both debt and equity. The authors of this article recently

negotiated one such debt-to-equity transaction on behalf of a borrower, and based this article on that experience.

Structuring a Conversion JV

To start, the lender and the borrower must modify the loan terms to convert a portion of the debt to equity and extend the maturity to a date after the anticipated completion of the project. The lender would then form a new limited liability company (Newco JV), to which an affiliate of the lender (investor member) would contribute the converted debt, and an affiliate of the borrower (sponsor member) would contribute the property.

For those lenders with the latitude to consider it, a carefully crafted joint venture with the borrower can afford sponsorship the breathing room to convert an obsolete asset into a profitable one.

The parties must then assign capital contributions, and percentage interests, to the members. The capital contribution of investor member would equal the converted debt, while the capital contribution of sponsor member would equal the fair market value of the property.

Determining fair market value, however, is more of an art than a science. No one really knows what value, if any, to ascribe to an obsolete office building. Accordingly, the parties might simply agree upon an equity split that seems equitable, given the anticipated returns of the project, and then “reverse engineer” the capital contribution of sponsor member to comport with this equity split. Using this

method, if the parties ascribed a percentage interest of 40% to investor member and 60% to sponsor member, and the investor member capital contribution (consisting of the converted debt) equals \$20 million, the capital contribution of sponsor member would equal \$30 million, for total capital contributions of \$50 million (\$20 million being 40% of \$50 million, leaving a capital contribution of \$30 million to sponsor member).

In a typical operating agreement, the members are obligated to contribute additional capital contributions to the company in accordance with their respective percentage interests as the need arises for capital. That concept is unlikely to meet with favor from the lender in a conversion transaction, whose contribution to the transaction derives from the conversion of debt, rather than the contribution of fresh capital. Accordingly, the Newco JV operating agreement should provide that sponsor member is entirely responsible for all capital contributions required to effectuate the conversion, at least until the (reduced) mortgage debt is paid in full. Additional capital contributions by sponsor member should not impair the interest of investor member, whose percentage interest in Newco JV should remain the same, notwithstanding investor member’s additional capital contributions. The obverse should also be true: if capital contributions are required to fund the business plan and sponsor member fails to fund them, investor member should have the right to contribute this capital, and dilute the interest of sponsor member, at a one-to-one rate or a punitive rate.

Mitigating the Risk Of Lender Liability

The governance rights in a conversion operating agreement would also depart from the norm. In a typical operating agreement, a member with a large equity stake has broad approval rights over decisions undertaken by the sponsor. In a conversion operating agreement, a lender should avoid arrogating too much management control to itself. Sponsor member should have wide latitude to execute the business plan, including engaging contractors and professionals, seeking permits, and filing plans. While there are certain decisions that must remain within the purview of investor member, such as approval of contracts with affiliates of sponsor member or any financing of the property (other than a financing that would pay off the mortgage debt in full, which should not require investor member's consent), they should be narrowly tailored to reduce the risk of lender liability. By limiting the scope of its approval rights, investor member would reduce the risk that sponsor member later successfully claims that the lender may not exercise its rights under the mortgage loan documents because its affiliate Investor Member unduly interfered in the operation of the property, precipitating a loan default.

There are other ways to limit the risk of lender liability. The lender could require the borrower to sign an agreement confirming the inviolability of the debtor-creditor relationship created by the loan documents, which would remain unimpaired notwithstanding investor member's

acceptance of an equity interest in Newco JV. The lender could also require that the existing guarantor supplement the nonrecourse carve-out guaranty by converting the loan to full recourse if sponsor member claims that investor member's acceptance of an equity stake precluded the lender from enforcing its rights under the loan documents.

With Risk and Rarity Comes Reward

As the allusion to lender liability indicates, converting debt to equity is not without risk. (It may also have significant tax ramifications, requiring early engagement of knowledgeable tax counsel.) Opportunities for conversion may also prove to be exceedingly rare. Securitized debt, characterized by rigid loan covenants and inflexible servicers, is not a candidate for conversion. (Indeed, a lending model that treats real estate as a commodity seems particularly ill-suited to address a secular shift in the uses of real estate.) Balance sheet lenders and insurance companies also face regulatory constraints that may preclude conversion. For the moment, conversion may only be an option for non-bank lenders and other players in the private credit space. But with risk and rarity comes reward. For those lenders with the latitude to consider it, a carefully crafted joint venture with the borrower can afford sponsorship the breathing room to convert an obsolete asset into a profitable one, and the lender an opportunity to recover its investment and even realize equity-level returns.