INSIDE THE MINDS™

STRUCTURING COMMERCIAL REAL ESTATE TRANSACTIONS

LEADING LAWYERS ON FACILITATING SUCCESSFUL DEALS AND CONTRACTS THAT MEET CLIENT NEEDS

ASPATORE

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Inside the Minds Project Manager, Tiffany Smith; edited by Michaela Falls; proofread by Melanie Zimmerman

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The Realities of Practicing Commercial Real Estate Transaction Law Today

Shari B. Olefson

Shareholder

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Introduction

My practice started in the late 1980s, around the same time that the Resolution Trust Corporation (RTC) was shutting down so many S&Ls and taking over a number of the properties those S&Ls had financed. An outsider might think that today's situation with the FDIC taking over banks and the need to work through so many of those now defunct commercial real estate credits is similar to the RTC days, but it is very different. That's primarily because, the last time around, commercial real estate (CRE) assets were, for the most part, liquid. Now, in the majority of cases, they are not. Instead, many commercial projects are often under water, so the approach and strategy, from both a business and a legal perspective, need to be very different too. Back then, our marching orders, as commercial real estate litigators and transactional experts, would have been to get our hands on the title to those CRE properties as quickly as possible so that the bank could sell them and satisfy the debts. Today, the banks know that selling CRE properties may be difficult, and if it can be done, in many cases the proceeds will not be sufficient to pay off the entire obligations so, contrary to the good old days, that will not be the end of it. Instead, we'll be pursuing guarantors or taking a haircut, both expensive propositions. This backdrop is important to any attorney considering a CRE practice today because it affects every deal that's happening. For that reason, understanding today's environment and dynamics is essential. Clearly, there is an infinite variety of CRE transaction types and sizes and a likewise varied range of experience and expertise among CRE practitioners. For purposes of this discussion, we will focus on practitioners familiar with real estate, but not necessarily commercial real estate, and considering starting a CRE transactional practice representing average investors in today's new environment.

The Parties Involved in Today's CRE Transactions

Much of the commercial real estate that is being purchased now is not being purchased directly from a typical seller-owner who is in good financial condition, as has traditionally been the case. In the past, it was not unusual to have multiple offers on a property, including offers above the asking price. Sellers were driving the proverbial boat. That is obviously not occurring today. Most financially healthy sellers are waiting the market out rather than listing their CRE property for sale now because the general assumption today is, if you're selling you're in trouble. This dilemma is having a significant impact on the broader CRE environment and likely exacerbating the duration of time it will likely take before the CRE market recovers.

For these and other reasons, buying distressed assets has become the predominant commercial real estate transaction. If you plan to start a CRE practice today, it is highly likely that you will end up talking to a seller who has his or her back up against the wall or to a bank that owns the property and, in either case, the parties will be operating under a different set of dynamics than in prior years when the CRE deals involved more traditional sellers. In either case, the rules have changed. The seller is no longer in the driver's seat. The buyer has a lot more leverage now. You'll quickly find that when dealing with banks, both the representatives you deal with and the banks' internal processes (including the processes that most banks utilize to approve purchase offer contracts and closing documents like the settlement statement and net proceeds that will be paid to the bank), have a noticeable impact on the CRE deals themselves. Depending upon how they are managed, special assets officers at banks can be as much a part of the problem as they are part of the solution. Because of the need at many banks to ramp up and handle large volumes of distressed CRE assets quickly, and the sudden needs that acquiring another bank can create, many special assets officers are "newbies." Even though they are positioned as the point people for these CRE transactions, there is seldom such a thing as a single person who can independently approve purchase offer contracts and the like, for example, at a bank. At a minimum, two or three signatures are required, if not full committee approval. With regard to this specific example, it's advisable to always ask anyone who says he or she will "get back to you" with a response (for example, on a short sale offer) exactly what the approval process and timeline for getting that answer is so that you can manage client (and everyone else's) expectations. And the necessity of waiting for these types of approvals from bank committees that may, for example, meet only once a month, needs to be taken into account when drafting purchase offer contract acceptance deadlines. Banks do the best they can, but dealing with a bank is never the same as dealing with someone who is an actual owner-seller and has his or her own personal pocketbook on the line.

The Real Reasons CRE Assets are Beginning to Trade Again

CRE prices are beginning to adjust to a point where buyers and sellers can make a deal as the banks write down bad CRE credits, become able to sell those assets, and prices find a bottom to climb from. For those not familiar with the anatomy of a CRE credit write down, in a nutshell, cap rates, or the values for these properties, fell so low over the past few years due to reduced tenants and rent rates that the owners either could not cover their debt service and other expenses or could not refinance when their loans matured and fell into default. Initially, banks tried to avoid reflecting these value drops and imminent defaults on their books since reflecting these issues in accounting then requires the banks to add sufficient coverage funds into their capital reserves. Likewise, selling an asset for less than what is owed, even if the lesser amount is actual current market value, requires a credit write down and is one of the reasons CRE assets have not been trading. But again, over the last year or so, banks have had no choice but to write down the value of CRE assets which then allows the credits and underlying assets to be dealt with. And, of course, those banks that have taken over others under FDIC Loss Share Agreements can reflect the lower CRE assets and credit value with less challenges since this risk is generally reflected in the bank acquisition price.

Current CRE Value and Pricing Influences

When values plummeted in commercial real estate, all project types were affected, from hotels and resorts to offices and industrial warehouses. The CRE properties that are starting to recover first are multi-family projects. These assets are recovering faster because there are users for them (i.e., residential tenants) since so many folks are hesitant to buy a home now due to uncertainly in the residential sector. Still, others are unable to buy due to poor credit, tighter lending, or a recent foreclosure. As folks are losing their homes to foreclosure, or renters are reluctant to get into the market and buy a house, renting as a housing option has become more popular. There is an increasing ability to fill these residential rental units, and the lease terms tend to be shorter on a rental unit than for a warehouse or other commercial property mean that investors can increase the rents more readily. We can expect to see increases in residential rental rates to justify these acquisition prices. Hopefully, increasing residential rents will eventually drive folks back into housing purchases and absorption of the surplus residential inventory. Fannie Mae and Freddie Mac have always been notable players in financing multi-family CRE projects. The fact that these GSEs are still lending and financing from traditional banks for other categories of CRE investments has been scarce is also helping to keep up multi-family sector values and prices for most other types of CRE projects today, lenders will consider financing only solid owner-occupied projects with a decent down payment. In some areas, the sales prices of multi-family rental properties have increased from $30 a unit to $50 a unit.

In hotel, industrial, and office, sellers are recognizing that they cannot get the high prices they'd previously grown accustomed to anymore, but even realistic prices for those assets may not be enough to bring buyers back into the market. Who wants to carry an office building if there are no tenants to put in it? Industrial and retail properties, of course, mirror what is happening in the economy. Manufacturers and exporters will do well in the coming years thanks to the devalued dollar. So we can expect warehouses, for example, that service those types of companies to increase in value. Hospitality properties, especially the higher-end properties in gateway business-oriented cities, seem to be doing well because hotel rooms can be re-priced on a daily basis.

Because these CRE assets are taking so long to price right, there is much pent up money on the sidelines. CRE purchasers are on every fund's radar screen. The annual Association of Foreign Investors in Real Estate Investors survey indicated strong global interest in US CRE: "The weak dollar represents two opportunities for foreign capital. First, the weak dollar allows more property purchased per foreign currency unit...when the dollar rebounds, the investment value increases again, making the real estate investment doubly attractive to foreigners. Current currency prices avail the foreign investor an eighteen to forty-six percent discount for US assets compared to foreign markets including Europe and Asia. Currently, foreign investors own $70 billion worth of US commercial real estate assets (approximately 3.1 percent of the total inventory by market value), according to AFIRE (Association of Foreign Investors in Real Estate)." Foreign investors have increased their intent to purchase in the United States 60 percent over last year. When working with foreign investors, other issues may be relevant to the CRE practitioner, which are beyond the scope of this discussion. This is one of the reasons we're seeing CRE prices, again on multi-family in particular, growing as investors outbid each other with money they simply have to deploy.

Because increased foreign investment in CRE is anticipated, it behooves the CRE transaction practitioner to be familiar with some of the tax, immigration, and regulatory issues that could potentially affect foreign investment in US CRE.

Decline in Foreclosure Actions on Commercial Real Estate Credits

We are seeing fewer CRE defaults because, again, banks are increasingly motivated and able to work out pending and actual defaults with commercial property owners, borrowers, and buyers. We're seeing far more short sales and, even if modifications are not consistent with the desire to get out of a credit or meet FDIC Loss Share Agreement deadlines, banks are at least more frequently willing to consider forbearances now if there is a near-future opportunity for an exit strategy. Even as the economy improves and CRE asset prices begin to do the same, we are likely going to continue to see some defaults and foreclosures. This is primarily because CRE credit is, and will likely remain, tight for some time. As the loans on value deflated CRE assets mature, it is often impossible for the owner-borrowers to refinance.

Today's Environment Dictates CRE Transaction Structure

In terms of how CRE transactions are being structured today, one strategy we're seeing more frequently is note purchases. This is a result of the current environmental dynamics we've discussed and long foreclosure backlogs. Acquiring commercial real estate assets by buying the note involves added risk to the investor-client. In some cases, the note is purchased with the intent to get paid off. In other cases, the investor-client's intent is to eventually own the underlying property. In either case, the same due diligence that would normally be done by the legal practitioner on a traditional CRE asset purchase is appropriate. Unfortunately, under these circumstances borrower-owners may be unaware of the sale by the bank or uncooperative. As an attorney for a CRE market buyer, the best case, of course, is one where the owner of that property or at least a manager familiar with it is around and will