New York Law Journal
Real Estate Trends
WWW.NYLJ.COM

An ALM Publication
VOLUME 243—NO. 114 WEDNESDAY, JUNE 16, 2010

LEARNING FROM HISTORY

1990s Market Collapse Puts Current Downturn in Context


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It seems as though one can scarcely open a newspaper these days without encountering an article about the state of the United States commercial real estate market, analyzing whether the worst has passed or whether it is yet to come. Anyone who could predict the future of the commercial real estate market with any certainty would not be spending his or her time publishing articles.

"Whoever wishes to foresee the future must consult the past."

— *Machiavelli*

To properly analyze the current downturn, it is useful to put it into historical context and to look at the types of transactions that are taking place today.

Many observers have been eager to draw comparisons between the current condition of the commercial real estate market and the real estate market collapse that occurred in the early 1990s. While in some respects, the present situation appears to resemble that earlier downturn—both followed periods of lax underwriting standards spurred by competition by lenders for market share and significant increases in property values—in many ways the two are easily distinguishable.

To begin, the downturn in the early 1990s was not as globally pervasive as that which began in 2007. Given the increased financial globalization that occurred over the last decade, developed and developing nations alike were impacted by the more recent economic crisis, and capital markets throughout the world were frozen while the effects of what had transpired in the United States rippled through the global economy. (One wonders whether the current difficulties in Europe will have a similar effect in the United States and cause a "double dip.") This contrasts with the earlier real estate market downturn, in which the decline of the U.S. real estate market was, in part, mitigated by the eventual influx of capital from foreign investors and lenders who were relatively unscathed by events in this country.

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In addition, capital structures today are significantly more complicated than they were in the early 1990s, making workouts and other solutions to problem loans far more difficult. Whereas real estate financings preceding the earlier downturn were relatively straightforward—generally involving only a single lender and a single borrower—today's real estate transactions frequently involve numerous classes of participants, including mortgage lenders (with A and B notes) and mezzanine lenders (each level of which may itself be further divided into various tranches), not to mention preferred equity holders. Determining the respective interests of each of these classes and the relative rights of holders within each class can be both time-consuming and expensive, and in our experience, many of these transactions were documented with flaws that make reconciliation of these rights and interests formidable.

Making matters worse, many real estate loans have been pooled into commercial mortgage-backed securities vehicles and sold to investors pursuant to intercreditor and securitization agreements that provide for special servicing and other procedures when issues arise. Although these provisions were, in theory, crafted to protect cash flow to certificate holders, in practice, the prescribed processes limit the servicer's flexibility to modify the loans prior to default and therefore impede workout efforts. Regardless of whether a loan has been securitized, however, it is clear that the complexity of commercial real estate capital structures has dramatically increased since the downturn of the early 1990s and that, as a result, lenders and borrowers are faced with a far greater challenge in reacting to and addressing troubled loans. Overleveraged assets in need of restructuring clog the pipeline of transactional activity.

Likewise, just as lenders and borrowers have been required to take a different approach with respect to the recent economic downturn from the approach they took in the early 1990s, the regulatory response to the current economic downturn as compared to the response to that of the earlier downturn has been markedly different. Following the collapse of the savings and loan associations in the late 1980s, the U.S. government took swift action, including the creation of the Resolution Trust Corp. ("RTC") to liquidate distressed real estate-related assets and mortgage loans held by failed lenders. In carrying out its mandate, the RTC prompted aggressive write-downs on these assets in connection with its disposition program, thereby establishing market value and promoting participation by the private sector.

By comparison, in the current downturn the U.S. government has exerted only minimal pressure on financial institutions to mark-to-market their real estate assets. Lenders have been free to engage in "pretend and extend" practices to extend or modify troubled loans, even if it is unlikely that borrowers ultimately will be able to repay them, so that lenders may avoid further impairing their balance sheets by immediately recognizing write-downs or foreclosing on the underlying properties. As a result, prices in the market have remained artificially inflated, disappointing buyers who anticipated bargains and infusing the market with additional uncertainty.

Moreover, the TALF and PPIP programs that were intended to jump-start the markets have not had their desired effect. Even though the FDIC has played an RTC-like role with respect to certain failed financial institutions, a significant portion of the distressed debt is held in securitization vehicles and outside the FDIC's reach.

"Things are more like they are now than they ever were before."

—*Dwight D. Eisenhower*

As alluded to above, at the outset of this downturn, the commercial real estate market, like the financial markets more broadly, was seized by paralysis, with real estate lenders and investors reacting to the uncertainty pervading the economy by taking no action at all. As has been well-documented, the 2008 financial collapse was characterized by, and in part resulted from, the unavailability of commercial paper and other forms of credit arising as a result of the inability of lenders to ascertain borrowers' creditworthiness. Similarly, real estate lenders lacked reliable metrics for measuring cap rates or evaluating tenant credit, and, consequently, no new debt was issued and no liquidity was infused into the marketplace.

It appears now that the terror that gripped commercial real estate market participants over the past several years is beginning to diminish and the market is slowly reopening. Lenders and equity investors have declared their willingness to engage in new transactions, such as the Canadian Pension Plan Investment Board's recently announced acquisition of a 45 percent interest in 1221 Avenue of the Americas. Likewise, non-distressed sellers have begun marketing properties. And, most significantly, transactions are closing, providing the market with data regarding value and precedents establishing the new norms in commercial real estate transactions.

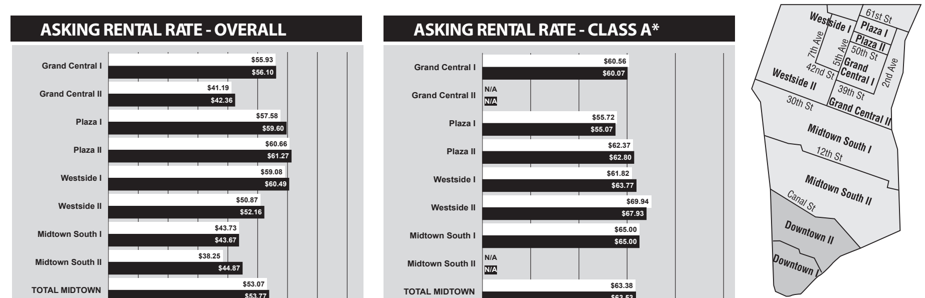
These new standards, not surprisingly, focus almost entirely on traditional underwriting and financing considerations. Purchasers and sellers alike are relying less on projected income, favoring instead actual income with conservative default and delinquency assumptions in modeling these transactions and determining value. Purchasers and lenders are also showing an increased interest in tenant estoppels, requiring estoppels from a greater proportion of tenants and heightening the standards attested to in those documents.

From the seller's perspective, certainty of a closing is critical. To this end, sellers are concentrating on the identities and financial wherewithal of a buyer's sponsors and lenders to gain comfort that closing will occur. Understandably, this analysis takes on additional importance if the buyer will be assuming debt in connection with the transaction, and notable transactions have been scuttled by servicers due to concerns about the quality of the buyer.

The desire for an expeditious and assured closing takes on even greater urgency when the seller is a lender that took title by foreclosure or deed-in-lieu of foreclosure. Because the lender-seller in this situation has likely substantially written down its investment in the asset and also most likely does not want to be in the business of owning and operating real estate, its priority will be a fast and certain closing, even if the highest possible price is not obtained. In some circumstances, the lender-seller may even offer seller financing on attractive terms to eliminate conditionality and to help ensure that a sale closes. Despite this desire to transfer the property quickly, however, the lender-seller will typically hold fairly firm on providing limited representations to the buyer (in part due to the lender's limited knowledge of the property) and limiting the buyer's recourse in the event of default.

When the market was at its nadir, the few sale transactions that were being consummated sometimes included highly unusual features. Some buyers were insisting on, and successfully obtaining, financing contingencies as well as the right to terminate (and get its deposit back) if a key tenant or a specified percentage of tenants filed for bankruptcy during the contract period. Indeed, in at least one instance we encountered, the allocation of risk of tenant

Rental Rates Per Square Foot for Manhattan Commercial Space



*Class A Buildings - Contemporary buildings with above-average rental rates and ability to compete for premier office tenants. These facilities contain state-of-the-art systems, provide exceptional accessibility and project an overall perception of high quality.

Source: Studley

bankruptcy continued post-closing with the parties agreeing to maintain a portion of the purchase price in escrow on the condition that such amount would be returned to the buyer in the event of a tenant bankruptcy within a specified period following closing. It seems highly unlikely that these provisions will continue to be seen as the market improves.

Transaction parties are also having to find creative solutions to the anomalous transfer tax situation that arises in connection with the purchase of property subject to high loan-to-value mortgage debt; because transfer taxes are calculated based on the entire consideration for a property (which takes into account the outstanding debt), in theory the transfer tax could approach or even exceed the cash portion of the purchase price to be paid by the purchaser. For example, the sale of a property once valued at $400 million but now valued at $300 million, subject to a $275 million mortgage that the purchaser will assume, will result in a cash purchase price of $25 million to the seller but require payment of almost $10 million in transfer taxes. A seller looking to raise cash will be significantly disincentivized to consummate this transaction. To address this scenario, parties will consider transaction structures in which less than 50 percent of the interest in a property is sold (in the stated example, this partial sale would yield nearly the same net consideration to the seller). Moreover, some creative structures have been implemented to substantially consummate the intended transaction in a transfer tax-efficient manner.

In light of the current state of the economy generally, one might have expected to see a plethora of distressed sales; however, while there have certainly been some measure of distressed sales, the volume has been much less than most experts expected. Instead, "pretend and extend" policies have permitted borrowers to retain troubled assets in the hopes that market conditions will improve enough for them (or, more likely, their lenders) to mitigate their losses by delaying disposition of the assets until some time in the future.

"Those that fail to learn from history, are doomed to repeat it."

—*Winston Churchill*

Although buyers, sellers and lenders have been resourceful in their efforts to minimize the effects of the recent economic collapse and structure transactions that make sense in light of the market conditions, it is likely that none of this innovation would have been necessary if these participants had heeded the lessons offered by the events of the early 1990s. As the commercial real estate market begins to emerge from this downturn, it is likewise worthwhile to reflect on the measures that can be taken to prevent similar systemic failures in the future.

Lenders have already tightened underwriting standards that deteriorated as property values rose and additional entrants into the real estate finance markets heightened competition for market share. As should be obvious, reducing leverage and requiring borrowers to have more "skin in the game," while decreasing a lender's yield, will curtail lenders' risk and ultimately bring stability to the market. Remaining vigilant, even as the economy improves and opportunities like those seen in the early part of this decade return, and not slipping back into bad habits will be integral to a sustained recovery.

Similarly, borrowers will have to adjust their expectations and strategies. Buyers need to recognize that they will not enjoy the quick returns on their investments to which they had become accustomed and that a long-term holding approach may be more appropriate. Moreover, as has already been seen, purchasers and lenders should rely less on projections of cash flow in modeling transactions and focus instead on current cash flow. In addition, buyers should also strive to identify lenders and capital partners with strong reputations and solid balance sheets.

Though nobody can predict the future, the cyclical nature of the commercial real estate market and the short memories of its participants means that another downturn will likely be inevitable. To delay this eventuality, however, sellers, buyers and lenders would do well to remember the lessons of the past.