A Prepackaged Bankruptcy Could Be the Answer to a Mortgage Default

It may offer an attractive option compared to those typically available.

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Chapter 11 bankruptcy has long been thought of as anathema to commercial real estate (CRE) lenders. This is due to the debtor-friendly bankruptcy forum, particularly with respect to (i) the up to 18 month exclusivity period during which only the debtor could propose a plan of reorganization and (ii) threats of a “cram-down” plan used to lever concessions from lenders. These provisions can be, and often were, abused by debtors with no real rehabilitative intent using bankruptcy only as a leverage tool. These abuses led to changes in the bankruptcy code (for example, reducing modifying deadlines in single-asset real estate bankruptcies) and also to widespread use of non-recourse carve-out guaranties that would make the sponsor guarantor fully liable for the loan if any party acting on behalf of the special purpose borrower entity files or acquiesces to a bankruptcy proceeding. These events also established a principle in CRE lending that is seldom questioned almost 30 years later: bankruptcy is to be avoided.

But for single-asset commercial properties in jurisdictions with high real estate transfer taxes, prepackaged Chapter 11 bankruptcy may offer an attractive option compared to those typically available to lenders, such as foreclosure, a deed-in-lieu of foreclosure, or a short sale.

The foremost advantage of a Chapter 11 bankruptcy lies in its exemption from transfer taxes for properties conveyed under a confirmed Chapter 11 plan of reorganization. In jurisdictions such as New York City, where state and local transfer taxes combine to reach 3.025%, and Los Angeles, which has recently adopted a “mansion” tax applicable even to commercial property sales over $5 million, these taxes can amount to millions of dollars upon property relinquishment or disposition. Furthermore, “pre-packs” can move relatively swiftly through courts.

In short, if the cost of a prepackaged bankruptcy is lower than the transfer tax burden, this path can expedite a lender’s recovery of its collateral and reduce expenses through the relief of tax obligations.

With many commercial real estate loans already in default and an estimated $2.8 trillion in commercial property loans set to mature between 2024 and 2028, lenders that have been in a holding pattern when it comes to commercial mortgage defaults should expect that, at some point, there will be increased regulatory pressure to deal with their distressed real estate debt portfolios. The reality is that a variety of factors—ranging from elevated interest rates and diminished tenant demand to rising operating costs and pandemic-driven/accelerated disruptions—have converged to leave many CRE properties worth significantly less than the debt encumbering them.

In what follows, we’ll delve further into this strategy and discuss the value of prepackaged bankruptcy as an alternative route for addressing commercial mortgage defaults in high tax jurisdictions.

Typical commercial mortgage debt restructuring options

When a property is worth significantly less than the debt that encumbers it, loan restructurings present challenges and complexity. Borrowers are reluctant to inject equity to pay down existing debt or to fund ongoing leasing costs or capital expenditures—it may be seen as throwing "good money after bad"—while rescue capital is likely unavailable without debt relief and lenders want some consideration for any write-down. When the cause of the decline in value is tied to external factors rather than property management or the need for upgrades or renovations (i.e., "fixable" issues), consensual restructurings can seem close to impossible.

In these scenarios, lenders typically take one of two paths, both of which involve paying real estate transfer tax: they can either foreclose on the property or take it back through a deed-in-lieu of foreclosure. In the rare case where there exists a potential buyer for the property, a lender can also cooperate in a short sale of the property.

Foreclosure is a legal process through which the lender acquires the property in a public or private sales process and, depending on the jurisdiction, as part of a court proceeding. Once acquired, lenders look to sell the property in order to apply the proceeds from the sale to pay off the debt. Most lenders do not intend to own and operate commercial real estate. In fact, regulated bank lenders are legally required to dispose of foreclosed real estate, typically within two years of ownership (although extensions can be obtained). In many of the distress scenarios prevalent in the current CRE market, properties confront operating deficits, leaving the borrower lacking the funds to cover real estate transfer tax. Consequently, absent a guaranty of the payment of transfer taxes from a credit-worthy sponsor guarantor, the lender can end up liable for paying transfer taxes twice—initially upon foreclosure or repossession of the property, and again upon its resale to a third party.

In other instances, the property owner may opt for voluntary surrender by offering the property back to the lender through a deed-in-lieu of foreclosure. These are heavily negotiated transactions. For the lender, a deed-in-lieu accelerates its recovery of the property, a crucial advantage when time is of the essence, particularly if there are pending lease transactions, renewals, ongoing repairs, or construction projects that that could incur significant costs if interrupted and recommenced. Time is often critical to preserve a property's value in the marketplace since a property that languishes due to reluctance to ingest capital often becomes "tainted" in the leasing market for prospective tenants. For borrowers, while there is no per se benefit over simply allowing a foreclosure to happen, a deed-in-lieu presents opportunities for the borrower to mitigate or resolve guarantees or other liabilities, or to extricate itself from a negative cash flow situation. We see deeds in lieu are more often utilized in scenarios where the gap between the debt and the property value is most substantial.

While a deed-in-lieu may be more expeditious than a foreclosure in certain jurisdictions, it does not alleviate the burden of transfer tax. Typically, transfer tax remains applicable in most jurisdictions upon the transfer of the property to the lender, and again upon the lender's subsequent sale to a third party.

Saving time and money with prepackaged Chapter 11 bankruptcy

In contrast, prepackaged Chapter 11 bankruptcy can offer a solution for single-asset commercial properties that rivals the speed of a deed-in-lieu while delivering substantial savings on transfer tax.

In a "pre-pack", the lender cuts its deal with the borrower prior to any bankruptcy filing, a process akin to a deed-in-lieu negotiation, while simultaneously reaching agreement with any other creditors of the borrower. Given that single asset real estate borrowers typically have few creditors (such as tenants, vendors, property managers and suppliers), this process often is streamlined. Moreover, lenders often prefer maintaining existing arrangements and leaving other creditors unimpaired by the bankruptcy filing, unless there are specific issues, such as a landlord default under a lease, that necessitate a re-negotiation. Therefore, reaching agreement with the other creditors of a borrower usually does not present a very substantial obstacle in most cases.

Negotiating these agreements and incorporating them into a Chapter 11 plan, of course, involves time and money, particularly in the form of legal fees. As a result, a "pre-pack" may only make sense for properties located in jurisdictions with high transfer taxes. A pre-packaged Chapter 11 also requires the borrower's cooperation which naturally entails some negotiation and, potentially, costs or concessions. At the end of the day, the benefits of potential transfer tax savings and expedited resolution must be weighed against the cost of putting a pre-packaged bankruptcy in place.

Pre-packaged Chapter 11s can offer additional benefits in that they present the opportunity to address other challenges impacting a property. Claims against the borrower can be resolved through the process, with negotiated resolutions implemented by the bankruptcy court order confirming the Chapter 11 plan, ensuring that lenders don't get stuck with uncertain liabilities attached to the property.

It's important to note that while properties transferred pursuant to a confirmed Chapter 11 plan are not subject to real estate transfer taxes, a Chapter 11 plan cannot be confirmed if the bankruptcy court concludes the principal purpose of the plan is the avoidance of tax. That said, resolution of the defaulted mortgage loan generally is the principal purpose of the bankruptcy case, as is addressing issues relating to the debtor's financial situation. In a way, the bankruptcy exemption from transfer tax is the consequence of the consensual prepack, not the primary purpose of it.

By way of example, a hotel in Manhattan was recently foreclosed upon by its lender. If we assume the mortgage debt was $500 million, with the property worth less than that amount, the transfer tax on the foreclosure alone would be $16,375,000 (2.625% for New York City and 0.65% for New York State, on the greater of the foreclosure bid price and the amount of the debt). By contrast, the legal, other advisory costs, and bankruptcy-related costs would most likely come in well below $16 million. It is not hard to see how pursuing a pre-packaged bankruptcy could have saved the lender millions of dollars—even if it had to pay the borrower something for its cooperation.

To be sure, prepackaged bankruptcy isn't an unusual workout strategy at the corporate level—recent notable examples include crafts retailer Joann Inc. and radio broadcaster Audacy. But it remains vary rare in the commercial real estate context at present.

Why now is the time to explore prepackaged bankruptcy

Right now, there are a vast number of properties in the U.S. commercial real estate market that are not worth the debt they are encumbered by. But lenders are not acting aggressively to address the issue. Instead, some banks are not extending loans that are now in default, while also not taking those properties back, either, because they don't want to book the loss.

As commercial-property distress keeps rising—it totaled $85.8 billion at the end of 2023, the highest level in the past decade—banks should expect to come under heightened scrutiny from regulators. While action is unlikely to take place in an election year, it is inevitable that banks will at some point be forced to take more significant steps to address that glut of troubled debt.

That means now is the time to explore the prepackaged bankruptcy option—before the clock starts ticking in earnest.

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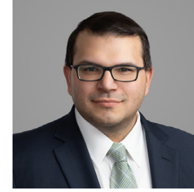

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