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Unprecedented Challenges in Commercial Real Estate Restructuring

By Paul Melville
and Melissa Dimitri

It is not often that restructuring professionals agree on anything, but if you ask which sector of the economy is providing them with the most opportunities, they will pretty much agree on the answer as commercial real estate (“CRE”). Many scholarly articles point to frightening statistics such as the \$1.4 trillion in CRE loans that are scheduled to come due in the next three years. Or perhaps they mention the fact that office-sector vacancy rates were forecast to rise from 16.3% in the fourth quarter of 2009 to nearly 18% in 2010, only to remain high in 2011. Then, of course, there’s the well-publicized liquidity crisis.

The unprecedented challenges currently facing the CRE industry make many of the traditional restructuring strategies, including cash preservation, traditional debt restructuring and delevering, and divestitures, too generic to be actionable, or, simply impractical.

In this article, we identify some practical “watch out for’s” when attempting to restructure a CRE entity against the backdrop of today’s unprecedented market conditions.

NEGATIVE EQUITY AND ITS IMPACT ON MULTI-LENDER DEBT RESTRUCTURINGS

In March 2010, Elizabeth Warren, chairperson of the Troubled
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League Impact on the Sports Team Bankruptcy Process

*The Good, the Bad and the (Coyote) Ugly**Part Two of a Two-Part Article*

By Thomas J. Salerno and Jordan A. Kroop

Professional sports team bankruptcies are, happily, more rare than a pitcher’s perfect game. Only six teams from the “big four” American sports leagues — Major League Baseball (MLB), the National Football League (NFL), the National Basketball Association (NBA), and the National Hockey League (NHL) — have filed bankruptcy cases since Congress adopted the U.S. Bankruptcy Code in 1978.

In Part One of this article, we explored two recent Chapter 11 bankruptcy cases for two MLB franchises — the Chicago Cubs and the Texas Rangers. The Cubs’ Chapter 11 bankruptcy case — The “Good” in our Clint Eastwood-inspired formula — was intended to effect the sale of the team before the start of the 2010 baseball season. That bankruptcy sale process went smoother and fared far better than most of what the Cubs managed on the field in 2010. The sale of the Cubs was completed in a manner that avoided much of the drama that would befall the Texas Rangers’ bankruptcy case only months later. The Rangers’ case — The “Bad” — demonstrated what can happen when two would-be ownership groups (only one with the MLB imprimatur) compete. That case is perhaps a distant memory for fans as the Rangers head into this year’s playoffs. (The Rangers were, until press time, the only MLB franchise never to have won a post-season series.) But the team’s new ownership group, headed by baseball legend Nolan Ryan, will be sitting nearest the field-side bunting this fall owing, in part, to MLB’s participation in the bidding.

THE ‘UGLY’ — THE COYOTES’ CHAPTER 11

The Chapter 11 experience of the NHL’s Phoenix Coyotes was far more prolonged, far more contentious, and far less satisfying than the Rangers’ case, which at least featured a competitive bidding process that ultimately resulted in a sale that paid creditors in full. The Coyotes did not fare nearly so well. Nor did their

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creditors. And depending on what happens to the Coyotes during and immediately after this coming NHL season, the Coyotes' bankruptcy case may have been the beginning of the Coyotes' farewell to Phoenix.

Background

The Phoenix Coyotes moved to Arizona in 1996 from Winnipeg, Canada, where they played as the Winnipeg Jets. Since making the move to the desert, the team never made a profit, losing more than \$300 million between 1996 and 2009. See *In re Dewey Ranch Hockey, LLC*, 414 B.R. 577 (Bankr. D. Az. 2009). After acquiring the team in 2006, Jerry Moyes sunk over \$100 million of his own money into keeping the team afloat — with no luck. By November 2008, the NHL was effectively financing the team's operating losses through secured loans while Moyes searched for a buyer.

Moyes informed the NHL that no offers had been received from any buyer wishing to keep the team in Arizona, but that Jim Balsillie (CEO of Research In Motion, maker of the ubiquitous Blackberry) had expressed an interest in acquiring the team and moving it to Hamilton, Ontario. The NHL told Moyes that he was expressly prohibited from negotiating with anyone who would want to relocate the team. Moyes nonetheless continued to negotiate with Balsillie, and filed a Chapter 11 case in May 2009 to implement a sale of the Coyotes to Balsillie, who

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offered over \$212 million for the team, conditioned on his ability to move the team in time for the start of the NHL season in October. To accommodate Balsillie's timelines, the team requested that a sale hearing be held by the end of June. See *In re Dewey Ranch Hockey, LLC*, 406 B.R. 30 (Bankr. D. Az. 2009).

Incensed with the Chapter 11 filing and the Balsillie offer, the NHL did everything it could to stop the court from even considering Balsillie's offer. The NHL asserted that there was insufficient time to find other buyers for the team, assuring the court there were at least four other parties interested in buying the team and leaving it in Arizona. Further, the NHL agreed to continue financing the team's operations during the bankruptcy process to avoid giving Balsillie, who had offered DIP financing, any creditor standing in the case. Ultimately, the bankruptcy court was persuaded that the timelines requested by the team and Balsillie were too ambitious, setting bid deadlines further into the summer. Balsillie waived his original deadlines and remained a viable bidder.

The Coyotes play at Jobing.com Arena in Glendale, AZ, west of Phoenix. The City of Glendale built the arena through bond financing, and the Coyotes signed a 30-year lease. Because Glendale faced the possibility of being left with an arena but no tenant, the city came out strongly against Balsillie's offer and the debtors' proposed sale process. Aligning itself with the NHL, Glendale argued that the lease could not be rejected because it would cause irreparable harm to the city, creating alleged damages that could exceed \$500 million not subject, the city argued, to the Bankruptcy Code cap on lease rejection damages. The city also applied for a TRO in the case (similar to the TRO obtained in the Pittsburgh Penguins' Chapter 11 in the 1990s), that would have prevented the debtors from negotiating with any potential buyer that would move the team. Unlike in the Penguins case, Glendale's TRO application went nowhere, largely because

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Developments in Distressed Lending

Postpetition Principal Payments As Adequate Protection

By Fredric Sosnick, Jill Frizzley and Robert Britton

Most participants in the distressed debt market for secured loans are familiar with the concept of adequate protection in bankruptcy. Typically, as part of a cash collateral order or an order approving a priming DIP loan, adequate protection is provided to secured lenders to protect against diminution in value of their security during a bankruptcy case. Although adequate protection often takes the form of replacement liens, superpriority claims, and payment of interest, fees, and expenses, the bankruptcy code allows it to take any form that results in the realization by secured lenders of the “indubitable equivalent” of their interest in collateral. 11 U.S.C. § 361(3). Recently, in *In re TOUSA Inc.* (“TOUSA”) and *In re Capmark Fin. Group Inc.* (“Capmark”), secured lenders have received, as part of their adequate protection package, the right to obtain principal paydowns during a bankruptcy case.

Principal paydowns during a Chapter 11 case not only provide lenders with obvious benefit, but also could benefit debtors’ estates by reducing interest expense in cases where secured creditors are oversecured. In such cases, pursuant to § 506(b) of the bankruptcy code, the oversecured creditor would be entitled to receive post-petition interest at the applicable rate provided in the loan document through the effective date of the plan of reorganization, while debtors typically are

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required to hold their cash in bank accounts at approved financial institutions that have minimal risk and corresponding loan interest rates. 11 U.S.C. § 345. The resulting negative interest spread, therefore, could be significant.

As illustrated by *TOUSA* and *Capmark*, when principal payments are made during a Chapter 11 case, the payments can be tailored to account for single or multiple payments of fixed or floating amounts under circumstances involving single or multiple liens. They can even be used when there is a threat of an avoidance action which could ultimately result in disgorgement of the payments.

THE CASES

TOUSA and *Capmark* both involved borrowers whose operations suffered during the recent recession. In each case, a borrower with well over \$1 billion of outstanding obligations possessed non-performing illiquid real estate assets. Unable to meet their debt obligations, both companies filed for bankruptcy.

TOUSA

TOUSA Inc., a home-building company, entered bankruptcy together with certain affiliates obligated under a first-lien loan in the approximate principal amount of \$832.5 million, secured by substantially all of TOUSA’s assets. The company conceded that the collateral’s value exceeded the amount of first-lien debt. Stipulated Final Order (I) Authorizing Limited Use of Cash Collateral Pursuant to Sections 105, 361 and 363 of the Bankruptcy Code and (II) Granting Replacement Liens, Adequate Protection and Super Priority Administrative Expense Priority to Secured Lenders at 7, No. 08-10928 (Bankr. S.D. Fla. June 20, 2008) (“*TOUSA CCO*”). In exchange for the debtors’ use of cash collateral, the TOUSA lenders received adequate protection in the form of replacement liens, superpriority claims, payment of interest, fees and expenses, and a principal paydown of \$175 million, with an optional additional paydown at the debtors’ discretion. *TOUSA CCO* at 20-25.

TOUSA’s unsecured creditors’ committee and certain minority noteholders, who ultimately successfully pursued an avoidance action against

secured creditors, filed objections to the proposed cash collateral order arguing that paydown of principal was more than adequate protection. The committee’s objection was resolved and the cash collateral order was approved. That decision was appealed by parties, including the minority noteholders, who sought to remove paydowns from the adequate protection package. In affirming entry of the cash collateral order, the Southern District of Florida found that: 1) the noteholders lacked standing to appeal because they had no direct economic interest in the lenders’ cash collateral; 2) the appeal was equitably moot because the order had been substantially consummated and excising a provision of the order could cause the product of intense negotiations to unravel; and 3) it lacked jurisdiction because potential disgorgement of principal payments prevented the order from being final and appealable. *Aurelius Capital Master, Ltd. v. Touse Inc.*, 2009 WL 6453077, at *7, *10, *16 (S.D. Fla. 2009).

CAPMARK

Capmark Financial Group Inc., a commercial real estate finance company, entered bankruptcy together with certain affiliates while obligated under a \$1.5 billion term loan secured by mortgage loan assets. In exchange for their consent to the debtors’ use of the cash generated by collateral, Capmark lenders received as adequate protection replacement liens, superpriority claims, fee and expense reimbursement, interest payments and quarterly principal payments from funds generated by the collateral on specified dates, less a cash cushion. Final Order (I) Authorizing Use of Certain Cash Collateral Postpetition and (II) Providing Adequate Protection to Prepetition Secured Parties in Connection Therewith at 11-14, No. 09-13684 (D. Del. Dec. 22, 2009) (“*Capmark CCO*”).

Due to the nature of Capmark’s collateral, which were real estate loans made by Capmark to third parties that were being serviced and/or sold, it was anticipated that a significant amount of principal could be repaid during the four quarterly payments.

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To provide the unsecured creditors' committee some ability to limit the amount of principal payments made, the Capmark cash collateral order provided that the committee could move to terminate the payments after \$400 million in principal was paid (though approval of such an order would terminate the debtors' ability to use cash collateral). *Id.* at 11-12, 28. There were no objections to the entry of the Capmark CCO.

CERTIFICATION OF ABILITY TO REPAY PRINCIPAL PAYMENTS

Although the trend of paying principal as adequate protection is relatively new, the payment of interest is widely accepted as a form of adequate protection. In cases where cash interest is paid, unsecured creditors typically preserve their rights in the event that the secured creditor is later found to be undersecured (and, therefore, not entitled to post-petition interest under § 506(b) of the bankruptcy code) or even unsecured (for example, as a result of an avoidance action), by negotiating for a provision in a cash collateral that provides for recharacterization of interest to principal in such an event. It rarely is a concern, given the relative size of interest payments, that the amount of interest paid under a cash collateral order would either exceed the amount of the secured creditor's interest in the collateral, or, even if the secured creditor were ultimately found to be unsecured, the size of ultimate distribution to unsecured creditors. As a result, although such orders typically have provisions regarding disgorgement, they tend to be very general in nature as the likelihood that recharacterization alone would not be a sufficient remedy is remote.

The payment of large amounts of principal dramatically increases the prospect that recharacterization alone would be insufficient if a secured creditor were later found to be undersecured or unsecured. In those circumstances, effective clawback procedures, which not only require disgorgement, but also account for the credit risk of lenders who receive cash payments, take on heightened importance. As a result, the cash collateral orders in both

TOUSA and *Capmark* contained complex certification procedures that debt holders were required to comply with in order to receive principal payments.

As the representatives of the parties that would most directly be impacted in the event that disgorgement were required, the unsecured creditors' committee, not the debtors, was responsible for determining whether to accept lenders' certifications. *Capmark* CCO at 17; *TOUSA* CCO at 30-31. If the committee objected to a certification and that objection was not resolved consensually, the Capmark cash collateral order provided that the affected lender could appeal to the court. *Capmark* CCO at 17-18.

To address the general risk of disgorgement, certifications in *TOUSA* and *Capmark* contained an acknowledgement of the certifying lender's obligation to return paydowns it received if so ordered, as well as consent to personal jurisdiction over the lender by the bankruptcy court with respect to principal paydown disputes and consent to accept service of process. *Capmark* CCO at 14-16; *TOUSA* CCO at 26-29. To address the ability of a lender to repay should disgorgement be required, the certification also contained a representation that the lender maintained certain asset and liquidity levels keyed to its payment share.

As evidence of their ability to repay, lenders also were required to provide financial information to the creditors' committee to confirm their representations. To help lenders meet the financial requirements of the certifications, the *TOUSA* and *Capmark* orders permitted lenders to certify together with an "affiliate guarantor" if the affiliate was willing to be liable for potential disgorgement. This proved useful for special purpose lenders that did not maintain high liquid asset levels and families of funds that did not have the required financial information readily available on a fund-by-fund basis. *Capmark* CCO at 14-15; *TOUSA* CCO at 26. A simple provision in the *Capmark* cash collateral order also allowed the creditors' committee to agree, on a case-by-case basis, to alternate certification

requirements, which served lenders that could not gather required information or signatures by applicable deadlines by allowing them to agree with the creditors' committee to extensions of time or alternate indicators of financial health. *Capmark* CCO at 18; *TOUSA* CCO at 30.

To facilitate the certification and paydown process, trading in the facility was frozen several weeks prior to each principal paydown so that the universe of potentially certifying lenders remained constant. Once submitted, the creditors' committee had several days to review and object to certifications, after which it provided the administrative agent with a final list of certified lenders. On the payment date, the debtors transferred the principal payment to the administrative agent, which distributed the money to certified lenders.

The aggregate amount of principal attributable to non-certifying lenders was placed into an escrow account maintained by the administrative agent and, from the estate's perspective, treated as repaid for all purposes including interest accrual. *Capmark* CCO at 20; *TOUSA* CCO at 31. The escrowed funds were held in ordinary deposit accounts, and, therefore, earned interest at rates well below the contract rate. However, because the principal had been repaid from the debtors' perspective, non-certifying lenders would be unable to recover the differential while their paydown share was held by the administrative agent.

Capmark lenders were required to reaffirm their certifications prior to each paydown for the sum of all prior principal payments received. This was true even if a certifying lender had sold its position, because the cash collateral order provided that lenders actually receiving a paydown would be liable for future disgorgement. *Capmark* CCO at 19. To track potential disgorgements, the administrative agent kept a register of payments received by certifying lenders and amounts in the paydown account. To facilitate that task, lenders choosing to certify were required to certify their entire

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position in the loan on each certification date.

TRADING IN LOANS SUBJECT TO PRINCIPAL PAYDOWNS

Having both certifying and non-certifying lenders holding debt in the same facility raises issues for lenders and counterparties trading in the loan. In both *TOUSA* and *Capmark*, the majority of those issues were resolved through amendments to the applicable form of assignment and acceptance agreement. Foremost among the amendments was an acknowledgment by certified assignors, regardless of whether they continued to be lenders, that they remained bound by the cash collateral order and its attendant risk of disgorgement of amounts received prior to assignment.

The *Capmark* assignment documents also were amended to allow

trading parties to record whether the interest being assigned had been the subject of a principal paydown or whether any related amount was held in the paydown escrow account. Non-certifying lenders assigning an interest in the loan were required by the *Capmark* cash collateral order to assign their ratable interest in the paydown escrow account, and the form of assignment and acceptance was modified to reflect this requirement.

Principal paydowns and associated disgorgement risk presumably affect pricing. For purchases from certified lenders, pricing issues should be relatively obvious, as any paydowns received would have reduced the outstanding principal balance of any loan purchased. For purchases from non-certified lenders, pricing issues are more subtle. In pricing non-certified debt, purchasers should consider that, as described above, prior principal payments would have

been made into an escrow account that may earn minimal interest for a significant amount of time before the purchaser is able to certify and receive them.

CONCLUSION

Adequate protection principal payments are a flexible tool that debtors, secured lenders, and unsecured creditors can use to their advantage, and as a result, distressed lenders should look for this adequate protection trend to continue to develop in the future. Although principal paydowns present significant opportunity to lenders trading in the distressed debt market, the risks and burdens that accompany any paydown certification process should be considered. A well-drafted set of principal paydown procedures can benefit all parties-in-interest and be easy for sophisticated lenders to trade and experienced agents to administer.



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of Glendale's full-throated support of the NHL's offer to buy the Coyotes, which explicitly gave the NHL the right to move the team after the 2009-2010 season.

A 'Bifurcated' Sale Process

The NHL, attempting to control and slow the sale process, ensuring an auction could not be held before the start of the season, urged a "bifurcated" sale process. Specifically, the NHL preferred an auction first just for buyers who wished to keep the team in Arizona. Only if that auction did not produce a court-approved buyer could a second auction be held, open to bidders who would move the team. In all events, however, no team relocation could occur without express NHL consent, something the NHL assured the court would not be possible in time for the upcoming season. The debtors, Balsillie, and even the unsecured creditors committee opposed the NHL's approach, but the NHL reassured the court, in declarations by Commissioner Gary Bettman and others, that there were at least four potential buyers who were serious about buying the

team and leaving it in Arizona. The NHL, of course, wanted the bifurcation because it knew the team was not worth nearly as much in Arizona as it would be elsewhere — the NHL didn't want lower, non-relocation bids compared on an equal footing with the Balsillie bid. The NHL further assured the court that these mystery bidders would bid enough to take care of all "legitimate" creditors — which, in NHL lingo, meant all creditors other than Moyes.

The court rejected a bifurcated auction, a choice made easier when the initial bid deadline passed without any qualified bids (on any basis); only Balsillie's original bid remained. Balsillie even sweetened his bid during the process, offering Glendale \$25 million in cash simply to support his bid, and another \$25 million to offset the city's rejection damages if his bid prevailed. Balsillie also offered to pay, in addition to the purchase price, a court-determined "relocation fee" to the NHL. In all, the Balsillie bid exceeded \$250 million by the auction date in late August.

The NHL Makes Its Own Bid

Faced with no bidders to compete with Balsillie's enhanced bid, the NHL

made its own bid to buy the Coyotes (for about \$140 million), keep the team in Arizona for the upcoming season, pay operational losses for that season, and seek a buyer who would keep the team in Arizona. The NHL reserved the right to move the team if no such buyer emerged by the end of the 2009-10 season. (In fact, no buyer was found by June 2010, but Glendale convinced the NHL to keep the team in Arizona through the 2010-11 season by making up to \$25 million of Glendale's own funds available to pay the team's operating losses for that season.)

The NHL bid allocated sales proceeds to pay off secured creditors (including the NHL itself), but also allocated sales proceeds to pay off, in full, certain unsecured creditors while excluding other, disfavored creditors — Moyes and NHL legend and former Coyotes head coach Wayne Gretzky. The debtors objected, arguing that the NHL's offer as structured was an unconfirmable

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sub rosa plan. Glendale rejected Balsillie's \$50 million and supported the NHL bid despite that, by its express terms, the NHL's bid could have resulted in the team leaving Glendale after the 2009-10 season.

To decisively end Balsillie's pursuit of the Coyotes, the NHL held a meeting of its board of governors in July 2009, at which the other 29 team owners voted on Balsillie's ownership application. Unsurprisingly, the NHL informed the bankruptcy court that Balsillie was unanimously rejected by the other owners on "character" grounds — apparently a first in NHL history.

The Court Decides

The court ultimately rejected both Balsillie's bid and the NHL bid. *See In re Dewey Ranch Hockey*, 414 B.R. at 593. The court found the attempted allocation of sales proceeds to some unsecured creditors and not others to be impermissible. Furthermore, the court found that it did not have the ability to approve an offer that would move the team over the NHL's opposition, and that there had been insufficient showing of a mature-enough dispute to allow the court to override the NHL's veto. In essence, the NHL's private club veto power trumped the Bankruptcy Code.

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Asset Relief Program Congressional Oversight Panel, famously commented that about half of all commercial real estate mortgages will be "underwater" by the end of 2010. Given the recent volume of restructuring engagements in the CRE sector, this statement certainly appears to be holding true.

The phenomenon of negative equity alone makes restructuring difficult; strategic sales and divestitures are more or less off the table unless a lender is willing to take a significant "haircut." Vulture investors are abundant — unfortunately, strategic buyers with access to capital and a willingness to pay a premium for synergies are not. Today's multi-lender

The court's ruling left the Coyotes and its Chapter 11 case in limbo. Balsillie immediately ended his pursuit of the Coyotes. The team was hemorrhaging cash — operational losses, on average, were about \$1 million per week. Faced with no buyer, the debtors, the NHL, Glendale, and the creditors committee negotiated a revised NHL offer that effectively addressed the court's concerns about allocating proceeds to some but not all creditors. Rather than pay the claims of creditors directly, the NHL agreed to purchase the claims it desired to have paid, assert those claims against the bankruptcy estate, but voluntarily subordinate them to all unpurchased unsecured claims (like Glendale's claims) other than Moyes' and Gretzky's claims. This understandably won the creditors committee's support and, given the mounting economic losses, the debtors and Glendale agreed to the sale of the Coyotes to the NHL, which closed on Nov. 2, 2009. That night, the Coyotes lost to the Los Angeles Kings 5-3.

BLOODY AND CONTENTIOUS

The Coyotes bankruptcy process was bloody and contentious. The NHL won after a bruising fight that ultimately left about \$100 million of value on the table for a team that may very well end up relocating from Arizona anyway. The bankruptcy imperative of maximizing value for creditors seemed to yield to the

environment only complicates this issue further as a lender's willingness and ability to engage in a restructuring can be tied to internal policies and whether the lending institution has already written down the loan in question.

With several lenders often present at the bargaining table, competing viewpoints can make reaching a consensus difficult. One lender who has already taken a significant write-down on the loan may be willing to explore a debt restructuring. Another lender who has reserved nothing may be loathe to reserve any portion of the loan whatsoever, particularly if its portfolio is full of troubled credits and bank regulators are closely monitoring their capitalization. A third lender may be faced with an internal mandate that compels it to

NHL's demands, while many creditors, including Glendale, are likely to receive only cents on the dollar irrespective of whether the Coyotes stay in Arizona. The Coyotes' remarkable on-ice success in 2009-10 — they made the playoffs for the first time in seven years — was not enough to attract a buyer and, as of this writing, no buyer has yet been found to keep the team in Arizona. If such a buyer is to emerge, it had better be soon — the NHL's agreement with Glendale allows the NHL to complete a sale and relocation of the team at any time after Dec. 31, 2010.

POST-GAME COMMENTS

Professional sports in the United States is always viewed as operating under a different set of rules. The same seems to hold true in professional sports team bankruptcies. Imagine, in any other industry, participants finding fault with a process that generates more value for legitimate creditors owed real money! Only in the surreal world of professional sports can legal and economic doctrine be made to yield to the parochial needs of an entertainment performed with balls and pucks. In the end, we must rely on courts to discern what's good, what's bad, and what's ugly — what's good for all of us and what's good for the game.

—♦—

aggressively pursue any and all guarantors.

A restructuring professional's role in the above scenario is key to a successful outcome. Brokering a consensual agreement with so many competing interests can be a tall order, and a creative and imaginative solution needs to be crafted on a case-by-case basis.

Some deals have been brokered by restructuring notes in such a way as to divide them into performing and non-performing tranches. Shortfalls can be converted into equity positions, allowing a financial institution access to any upside resulting from a general recovery in the CRE industry. This strategy is useful in that it allows those lenders who want to exit the relationship the ability to sell their

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performing note, while those lenders with more of an appetite for a hold strategy can restructure their note, take a leadership role in the overall restructuring effort, and wait for the longer term benefit to accrue.

SUB-OPTIMAL DEBT STRUCTURES AND OTHER LIQUIDITY PITFALLS

The growth of the CRE industry brought on the genesis of many unconventional and creative financing arrangements that are resulting in unintended consequences. It is more important now that the restructuring professional involved in a CRE restructuring must therefore have an understanding of the kinds and types of debt instruments that finance the underlying assets.

Many CRE loans, particularly those used to finance Real Estate Investment Trusts (REIT) acquisitions, were not designed for the long term. Many of these loans included tantalizingly low interest rates, interest-only provisions with balloon payments on the back end, and few cash controls ... so long as the CRE asset was sold by a certain date. At origination, these terms didn't give anyone concern — at the time, financing was abundant and loans that became cost prohibitive could more often than not be replaced.

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Unfortunately, many REIT managers never contemplated the current scenario where the criteria for obtaining financing have become more rigorous and the underlying assets have reduced in value. Loans that were designed to be short-term instruments are now maturing and encountering unforeseen and unintended consequences. Springing lockbox provisions may be enacted, giving the lender the ability to sweep all operating cash. For the borrower, this can make an illiquid situation even worse, and for the lender, this is a way that the repayment obligations are repaid. Some loans contain letters of credit provisions that require an owner to secure a new lease commitment within a certain number of years of an existing lease's expiration. If they fail to re-lease the space by a certain date, a sizable letter of credit is often required to protect the lender against default.

An adviser must identify these issues as soon as possible so that they are adequately equipped to provide advice on the widest possible range of options. Often this starts with the negotiation of a standstill agreement with the lenders which can provide the stability to enter into more detailed negotiations aimed at providing a long term solution. The situation is often made more complex as the debt instruments are traded through the negotiations so that new players are introduced into the mix whose motives as investors may be different from the original holders of the debt.

COMMINGLING OF CASH AND ASSETS

One trend that has been present in nearly all of the CRE restructurings with which we have been involved is commingling of cash and assets. Many CRE companies, particularly REITs, possess extremely complicated legal structures and often a considerable number of legal entities that in some cases can outnumber the number of properties by at least five to one. Unfortunately, their cash management systems may not be nearly as sophisticated.

Restructuring advisers must be diligent in tracing which legal entities secure which loans — a basic concept, but a very important one when dealing with dozens of entities, countless

bank accounts, multiple loan facilities, and sometimes several lenders.

In a distressed situation, many CRE developers and operators, however unintentionally, often commingle funds from multiple properties and projects. Companies with dozens of CRE assets may accumulate funds in a few bank accounts, or even a single bank account, in order to pool funds and minimize liquidity issues at individual assets. This can result in a misalignment between the cash-generated and the underlying income-producing assets. It may be extremely difficult to trace the cash attributable to each individual asset. Complicating this scenario is that the structures in place may have been derived from tax-driven strategies, the goals of which differ substantially from that which result in a distressed situation.

In the above scenario, receipts from profitable properties or projects can be used to fund the losses for others — assets which may be collateralized under completely different loans with different lenders. In this way it is possible for a lender's cash collateral to slowly bleed away, largely unnoticed. It is therefore critical to ensure that strong cash controls are in place. This process involves setting up segregated cash accounts which are tied to each individual asset. In many cases, a lockbox arrangement works well for depositing cash receipts and giving a lender ultimate control over how and when those funds are dispersed. This is often supported by a cash control agreement to further protect the lender's position.

Once the cash has been segregated, it is important that fund flow analysis are prepared regularly so that all sources and uses of lender proceeds can be identified, and, more importantly to ensure that the borrower hasn't started to slip into bad habits and funds have started to become comingled again.

THINGS AREN'T ALWAYS WHAT THEY SEEM

Recent case experience has brought to light several instances of operating strategies that were either misaligned with market practices or resulted in confusing or misleading operating statistics.

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When taking a hard look at operations, it is important to calibrate a CRE entity's performance to the overall market. For example, an owner/operator may choose to establish a higher management fee in order to fund internal overhead costs. While on its face this practice may seem sensible, it is essential to benchmark both the management fee and service against those provided by external service providers. The outsourcing of the property management function to a third party specializing in these services could provide significant savings. For properties that may be considerably "under water," this step could be the first in a long haul to improving the value of the asset and immediately start improving the cash position.

It is important to understand the motives and objectives of the parties involved in a restructuring. This divergence of interests can sometimes come to the forefront in a cram-down situation where it is vital to understand the way in which operating results and forecasts have been prepared to ensure that they hold up under scrutiny. For example, the reported net operating income, while used to gauge the profitability of an asset, also impacts key negotiation items such as valuations and break even calculations, which can drive the overall course and outcome of a debt restructuring. An adviser should always exercise proper due diligence when analyzing a CRE entity's operating performance for this reason.

BEWARE THE HIDDEN LIABILITIES

Also in the category of "things aren't always what they seem" are the hidden liabilities that seem to plague many CRE entities undergoing a restructuring effort.

When a CRE entity faces financial distress, usually cash disbursements have been delayed and accounts payable stretched as far as possible. Delinquent real estate taxes, unfunded security deposits, and deferred

maintenance are all hallmarks of a CRE entity in distress; unfortunately, each of these liabilities remains with the asset in question, and often the lender bears the cost. While deferred maintenance may not be a one-to-one chargeback, it usually depreciates the value of an asset such that, upon a sale, the lender's recovery is proportionally decreased.

An adviser should ask targeted questions of management in order to quickly identify any hidden liabilities such as the above.

DEVELOPERS EXPANDING BEYOND THEIR CORE COMPETENCIES

Sticking to core competencies sounds like Business 101, but in the case of the CRE industry, this key business tenant is especially important.

Not all CRE assets are created equal. Included in this category are strip malls, high rises, multi-family properties, and manufacturing facilities, among many others. During the real estate boom, many owners/developers were lured to different assets outside of their comfort zone with the promise of large returns and sizable dividends. Unfortunately, for those developers who also managed these assets, they quickly discovered that while they might be excellent property managers of 12-unit multi-family units, a sprawling industrial park is another story altogether. Similarly, an experienced owner/manager of Class A multi-family units might find that Class C multi-family units require very different operating strategies.

Outsourcing still remains a very useful tool in any restructuring. Those functions that are inefficient in-house are better left to outside, experienced contractors. Improved operations aside, this tactic usually has the added bonus of reducing costs and/or changing a highly variable cost to something more predictable and manageable.

Not only did many developers expand into different assets and asset classes, but many expanded beyond their geographical reach. Some owner/property managers are simply not

structured to effectively manage assets in remote locations, where their onsite presence is either impractical or cost prohibitive.

A restructuring adviser should always approach a CRE restructuring with a sober outlook of fixing what can be fixed, and disposing of problems that cannot. Underperforming CRE assets that do not fit with a client's portfolio, are outside the client's core competency, and/or subject to chronic mismanagement, are assets that should be strongly considered for sale. Even if recoveries are small, eliminating distractions caused by these kinds of assets can create many intangible benefits for an overall restructuring effort.

ACT NOW, NOT LATER

In the current climate, many CRE entities are tempted to bury their heads in the sand and wait for credit markets to improve before implementing restructuring strategies. They may argue that since credit is tight and asset values are so depressed, it's better to initiate a restructuring when the overall business environment is more favorable. But by then it may be too late.

The current liquidity crisis will inevitably end, but when it does there will be extraordinary competition among companies seeking to refinance and/or restructure. Too many entities will be competing for a finite amount of capital, and at that point it will be survival of the fittest. Companies, and particularly CRE entities, must be forward-thinking in their approach to restructuring. Armed with some of the key strategies above, restructuring professionals everywhere should be leading the charge and helping to implement strategic changes that will drive their clients' future growth.



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