Planning for the Rescue Capital Wave

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In this article, the authors explain that parties engaging in rescue capital transactions should prepare to meet the recapitalization demands of real estate entities.

As the new year progresses, it is clear that inflation, interest rates, decreased valuations and geopolitical unrest, together with the uncertain future of major asset classes (particularly office and retail), will lead to a wave of distressed real estate transactions. This may result in a familiar pattern of workouts, bankruptcies and foreclosures relating to existing indebtedness.

However, there is a less familiar trend emerging, one that harkens back to the stagflation era of the early 1980s: rescue capital transactions.

Many real estate ventures with positive cash flows will find it necessary to recapitalize due to the current market environment, where refinancing is unavailable, debt maturity may be approaching and current valuations make dispositions unattractive and impracticable. At the same time, private equity firms and other alternative sources of capital, including family offices, have an unprecedented amount of “dry powder” in their reserves and an interest in filling the gap.

These developments are generating great interest, both by existing owners and potential investors, in so-called “rescue capital” real estate transactions. As discussed below, rescue capital real estate transactions, often structured as a hybrid between equity and debt, may present a number of important considerations for both existing real estate investors and the investment sources looking to opportunistically provide such rescue capital.

RECAPITALIZATION OF WATERFALL AND CAPITAL STACK

Generally, rescue capital will be structured as preferred equity, intended to be treated as true equity for both Generally Accepted Accounting Principles (GAAP) and tax purposes (see discussion below for more detail), but with more debt-like features than traditional equity.

To accommodate this, a rescue capital infusion will likely involve a substantial recapitalization of the existing waterfall and capital stack of the target real estate venture.

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As a result, a rescue capital transaction will likely result in an entirely "new deal" among the investors, both new and old. Further, certain investors within the capital stack may see both their voting and economic rights diluted because of such recapitalizations. For example, an investor with an existing waterfall preference may see its interest recapitalized into an "ordinary" interest, pari passu with all other common interest holders.

At the extreme, existing investors will be relegated to the bottom of the capital stack, as "hope note" investors. Some aggressive structures may also have preferred equity rights that resemble foreclosure remedies of lenders. There may also be "put" or "call" rights and deadlock provisions which may require delicate negotiations.

Finally, although substantial negotiations with existing lenders may be required, rescue capital may also be injected, not by preferred equity, but by means of "equity-flavored" debt (with cash-flow and equity "kickers") with possible conversion features reminiscent of the Reagan years. In certain instances discussed below, structuring rescue capital as "equity-flavored" debt may present certain tax benefits for foreign investors.

MODIFICATIONS TO EXISTING VOTING RIGHTS

As mentioned above, rescue capital investors are likely to negotiate for voting or control rights to protect their investments. In this way, unlike traditional debt, rescue capital will take on a very "equity-like" feel as investors attempt to protect their investments due to the uncertain economic conditions affecting real estate ventures.

In many instances, existing investors may lose protections under "major decision" provisions as rescue capital investors look to drive decision making post-investment. Rescue capital investors are also likely to be more "active" and may negotiate for rights that supersede current management.

FUTURE REFINANCINGS

A rescue capital investment may also include certain rights with respect to future refinancings and capitalizations to ensure that a rescue capital investor's interests are protected, both from an economic and tax perspective. For example, if, in a future lower interest rate environment, a real estate venture can redeem a rescue capital investor's preferred interest using low interest rate debt, a rescue capital investor may require that such redemption be structured as a tax-free redemption, thereby deferring gain on its redeemed interest. In certain instances, structuring a redemption in this manner may present tax consequences which are adverse to the interests of the remaining investors.

GENERAL TAX CONSIDERATIONS

In addition to maximizing economic and voting rights, a rescue capital investor will likely want to maximize its tax profile in any investment. This will likely include the ability to determine certain elections and decisions of the real estate venture, including decisions affecting depreciation deductions.

In certain instances, a rescue capital investor's ability to take maximum depreciation deductions will require existing investors to absorb "phantom income" with little or no cash distributions to pay for resulting tax obligations. For existing investors, this may add insult to injury as rescue capital investors may appear to benefit from the economic protections of a preferred investment that appears debt-like in many respects, while at the same time benefiting from optimized tax economics (e.g., depreciation) that are not available to debt investors.

STATE AND LOCAL TAX CONSIDERATIONS

Transfers of equity interests, particularly transfers of controlling interests, may result in the imposition of state and local transfer taxes and even a reassessment of the property for real estate tax purposes.

DEBT VERSUS EQUITY RECHARACTERIZATION

Given that rescue capital investments will be structured to include both debt and equity features, characterization (and recharacterization) for GAAP and tax purposes will be hugely important.

On the GAAP side, existing loan agreements of a real estate joint venture may restrict the venture's ability to incur additional debt, with risk of default if restrictive covenants are broken.

For this reason, GAAP equity characterization may be critical to ensure that a rescue capital infusion is successful. U.S. rescue capital investors will likely want equity characterization for tax purposes in order to benefit from tax economics (e.g., depreciation) discussed above.

On the other hand, if a rescue capital investor is a non-U.S. person, such rescue capital investor may prefer debt characterization for tax purposes to benefit from the portfolio debt exception. In such instances, with mindful structuring, it may be possible to structure an investment as both equity for GAAP and debt for tax purposes, thereby accommodating the interests of all parties. As noted above, some rescue capital sources may elect to structure their infusions entirely as debt and will want to ensure such characterization.

Given the integral need to properly structure and characterize a rescue capital investment, parties (including existing lenders) may require certain tax and legal opinions in order to close a rescue capital transaction. Further, risk shifting and indemnifications will likely play an important part in any rescue capital transaction. To that end, parties may find tax insurance attractive and indispensable when reaching a deal.

DEALING WITH EXISTING LENDERS

Rescue capital transactions are often undertaken in lieu of a refinancing or sale of the asset. As a result, existing mortgage and mezzanine loans must be considered and existing lenders may be at the negotiating table due to certain lender consent rights. Changes in control rights or creation of any new indebtedness will be of concern to existing lenders, and as a result, due-on-sale and due-on-encumbrance clauses must be complied with or modified.

Existing equity will be particularly concerned that non-recourse carve-out guaranties are not triggered due to any rescue capital infusion, and existing lenders may want the rescue capital provider to have some responsibility under these guaranties.

Further, special issues arise in Commercial Mortgage-Backed Securities (CMBS) structures where a special servicer is in the mix.

BANKRUPTCY AND INSOLVENCY

Rescue capital transactions may also give rise to bankruptcy and insolvency risks that will need to be analyzed and addressed accordingly. In some instances, bankruptcy may be a feature of the rescue capital transaction, particularly so-called "friendly foreclosures." Any rescue capital source, at a minimum, should analyze the post-investment bankruptcy risks, if any, that will remain pertinent.

TAKEAWAYS

- Many real estate investment vehicles are suffering from an "equity gap" in their capital structure due to inflation, higher interest rates, economic uncertainties and changing real estate usage.
- As a result, many properties with solid fundamentals are no longer financeable without an infusion of equity or equity-flavored debt. Lenders are much less willing to "extend and pretend" and many existing owners do not want to sell based on current valuations but will accept a "squeeze-down" to survive.
- "Rescue capital" is aggregating to provide the missing capital, but these transactions will require an understanding of complex "dirt," tax, finance and insolvency issues.

CONCLUSION

Rescue capital real estate transactions will play a critical role this year and beyond. Parties engaging in these transactions should consider, evaluate and negotiate such transactions holistically, considering the issues discussed above.