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REAL ESTATE FINANCE news and views

Disposal of Assets to Discharge Debt Ahead of Enforcement by Receivership

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As COVID-19 lockdowns are sustained and business activity deteriorates, loans secured against properties which are reliant on certain business activities will be affected, both from loan covenants and ultimately value perspective. In particular, COVID-19 could exacerbate valuations for sectors that were already seeing signs of distress, such as the retail sector.

Where the income streams are under pressure (due to non-payment of rent or rent reductions otherwise) this may ultimately affect debt service. Where debt service gets close to a critical 1:1 ratio, then risk parameters and strategies are likely to change – negotiations will focus around the viability of deferred amortisation or, in the case where only interest is payable, requesting lenders to consider capitalising interest in the loan and restructuring the facility. At this point in time, it would be prudent for both lender and borrower to consider exit strategies such as disposing the asset.

Understanding and reviewing your security structure

It is important to understand the security around the asset and also the corporate structure, as this would determine how the disposal should be structured. A typical security package for vanilla real estate loans should cover:

(i) mortgage over the property;

(ii) debenture over all assets of the borrower and each guarantor/operating company;

(iii) fixed charge over all receivables and key contracts; and

(iv) most of the time, security over the shares of the borrower/obligor group and any intragroup debts along with full subordination of any such intragroup debt and restrictions around any equity payment (dividends or repayment of subordinated debt).

A security package such as the one set out above is structured in such a way to ensure that on enforcement, sale of the underlying assets as a whole package (*i.e.*, the asset is sold along with the structure which would ensure that any disruptions to the income streams and third-party arrangements are kept to a minimum) can be achieved and therefore maximise value. In addition, any intragroup liabilities or any sponsor debt which are subordinated should be severed so that the package can be sold free of such liabilities to the new purchaser.

Lenders will need to think carefully about their position and have strategies in place if the event of default might warrant enforcement action; it will be prudent for the lender to conduct security reviews of the existing security package to ensure the security taken remains fit for purpose for their enforcement strategies. This would also include confirming all security assignments have been perfected.

Sale strategy: appoint a receiver or borrower-led sale?

Upon enforcement, a legitimate and most common strategy is for the lender group to appoint a receiver to sell the secured assets. Appointment of a receiver is often the last resort because, as a distressed sale, it is often unlikely to achieve maximum value. There are many reasons for this:

- receivers/administrators will need to be engaged, which will involve payment of fees and such fees to be paid out ahead of disbursing proceeds;
- indemnity arrangements in favour of receivers with respect to them undertaking the role;
- appointment of receiver/administrators will take over the existing management, and therefore there will be disruptions to the trading of the business, as well as amendments/assignments which need to take place with

respect to existing contracts (for example, a receiver as the bank's nominee will step into any duty of care arrangements with property managers, and also any third-party contracts and effectively take over the contract);

- sale by receivers often obtain a lower value as there are limited warranties receivers can provide to the purchaser (sales are often provided with limited title guarantee and also limited scope for responses to buyer's queries).

As an alternative to forced sale under receivership, borrowers may seek to negotiate with the lender and enter into an arrangement for the borrower to dispose the asset to repay the loan, whereby the borrower fronts the sale process.

This can be done in many ways. Most common would be to sell the SPV holding the real estate asset along with the entire structure so that the entire package is sold as a whole. In other words, the SPV propco will be sold as a corporate disposal, which will include all its assets – namely the real estate, all the key contracts, leases and receivables. With respect to any intragroup debt and financing, depending on the existing structure, these may need to be re-structured (*e.g.*, intragroup debt that is directly provided by the sponsor will need to be severed), and with the support of the lenders, the existing debt repaid from the purchase, and the lenders may decide to inject new lending into the new structure so that the debt is "stapled" with the asset for sale.

The benefits in having a borrower-fronted sale (as opposed to appointment of a receiver) include:

- for reasons mentioned above, the net disposal proceeds achieved may be higher due to less disruptions by having assistance from the borrower, and costs;
- dealings and issues with third parties with respect to key contracts is also minimised. If a receiver is appointed, the receiver will need to take over the borrower's contractual obligations under the existing contracts, as well as picking up where things were left off before the borrower's exit. In addition, there may be consent requirements to be dealt with before the receiver, as bank's nominee, can step into the relevant contract. As a result, this can prove to be a time-consuming process;
- co-operation of the obligor group and their directors and agents in a consensual plan strategy can avoid a lot of administrative delays and the support of the lenders in such a plan should avoid complications of directors vacating office due to concerns over wrongful/preference trading;
- for the borrower, reputational damage is minimised as it is not a forced sale; and
- for the lenders, opportunity to continue to participate in funding of the new asset by providing packaged debt to move with the asset.

However, there are also points to note with this strategy:

- This is only an option where the borrower still has an opportunity to discuss (and convince) the lenders to reach an agreement with respect to a borrower-led sale. This may not be possible in scenarios where the loan or the market is deteriorating quickly and the lenders are looking to exit at all costs. Therefore, this type of strategy is only available during a narrow window before the lenders commence enforcement and the borrower gets a seat at the table to discuss options. Therefore, for the borrower, it would be prudent to consider whether this is a viable option when there is a Default (*i.e.*, before such Default becomes an Event of Default and therefore triggering enforcement rights).
- This strategy only works if the lenders are of the view that the borrower's interests are sufficiently aligned and the co-operation is possible.
- Lenders may also want to control the sale process relatively tightly to ensure the borrower is taking steps to minimise expenditure and maximising net proceeds from the sale and that the sale is progressing in a timely manner.
- Although the borrower remains in the picture and continues with the day-to-day management of the asset whilst it's being put to the market, the lenders would most likely want to exert higher controls and restrictions. Therefore, the borrower will effectively require consent from the lenders on any non-ordinary items and any additional costs or actions to be taken which is beyond any minimal maintenance of the asset.
- The borrower's directors may wish to obtain independent advice as to their duties and the exercise of their duties. As the loan is in Default (or Event of Default), the question as to whether the company remains solvent is an important issue to consider as directors' duties change when the company is considered insolvent and directors' liabilities and their conduct will come into focus. That said, if the strategy has the full support of the creditors, solvency may not be an issue.

- For borrowers, care should be taken in the process of unwinding the structure and exiting from the sale. There will be many contracts related to the property which will either remain in place (with obligations performed and/or outstanding) and assigned across, or such contracts novated to the purchaser. These will need to be worked through so that the borrower can achieve a clean exit. In addition, any guarantees or investment commitment (whether funded or unfunded) by the sponsor will need to be taken out of the structure.