nerej
CELEBRATING 55 YEARS

Where's the money? Some borrowers and investors are finding creative financing methods

January 27, 2010 - Spotlights

It is no secret that our country has been mired in a financial crisis. While there have been a few positive signs from some institutional lenders and regional and local banks, frozen credit markets and traditional lending sources generally have not thawed. Though our executive and legislative branches continue to attempt to stimulate the economy and free-up credit, many lenders and investors still sit on the sidelines waiting for better deals and greater signs of improvement.

However, not all borrowers and investors are sitting idly by. Some borrowers are finding creative financing alternatives. Among the several financial arrangements that have appeared in the last few years, two may be of particular interest.

First, some institutional lenders are looking to add cash to their bottom line and are willing to sell their loans at a substantial discount. The following steps are sometimes taken by a borrower to coordinate the purchase of the loan: (i) the borrower finds an investor to purchase the loan, which investor will permit the borrower to gain the potential benefit of all or substantially all of the discount price if the borrower pays off the loan within a window of time, with the caveat that the investor receives an agreed upon rate of return on its funds; (ii) the investor purchases the loan either with its own funds or a combination of its funds and third-party funds; and (iii) the investor secures any third-party loan by pledging its position in the purchased loan to the third-party lender, subject to negotiated cure rights by the investor.

Whether the source of the funds is a private investor, a bank or a combination of the two, the investor and third-party lender will look for a return on their investments that reflects the underlying financial viability of the property and the other risks associated with their respective investments. For borrowers, paying a higher interest rate on a discounted loan may be a small price to pay in exchange for the potential long term benefits of a substantial reduction in the principal balance of a loan, even if the source of funds to refinance the discounted loan is not readily apparent. Also, because an institutional lender seeking cash could sell its loans to a "loan to own" investor, a party just looking for opportunities to own such loans' collateral, a borrower might be wise to aggressively pursue a repurchase of its loan by an investor any time an option to purchase at discount is presented. As a cautionary note, the borrower should understand that a discounted loan payoff may result in the discount being considered and taxed as forgiveness of indebtedness.

Second, borrowers might seek funds via a preferred equity arrangement. This situation often arises when the debt is advantageously "priced" but refinancing is not available or the existing loan documents prohibit another layer of additional debt. In a preferred equity transaction, an investor provides funds to a borrowing entity in exchange for a preferred equity interest in that entity. The new preferred equity interest party only will be entitled to certain preferential rights and interests that might include required monthly distributions, the right to receive all distributable cash and/or the right to force a refinancing, sale or liquidation of the borrower's assets if the borrower defaults on its obligations to the preferred interest. Pricing will vary based on the risk to the preferred interest party. Factors to be considered will include the following: the equity in the underlying collateral; property management issues (e.g., a single, credit tenant scenario is easier to address than a multi-tenant, retail use); and whether the preferred equity structure can be implemented without the consent of any senior or mezzanine lender. Consequently, a borrower should anticipate a full review of the existing loan documents, a general underwriting of the property and the modification of the borrower's existing organizational documents.

Some savvy borrowers have found these new financial vehicles to be necessary to secure capital, and several investors have found the returns to be worth the risk.

Eric Allon and Jason Manekas are partners at Bernkopf Goodman LLP, Boston.