



nerej

The dual note structure: a performing A Note and a non-performing B Note

April 14, 2011 - Connecticut

In the wake of the financial crisis commercial real estate lenders and borrowers face depreciated collateral values and highly overleveraged transactions. Nonetheless, many borrowers continue to be creditworthy customers with the willingness and capacity to repay their debts. Accordingly, lenders and borrowers may find it mutually beneficial, and in the best interest of each party, to work together to restructure the transaction. In such cases, the parties are encouraged to do so by federal regulators.

One increasingly common means by which to restructure a distressed transaction, which was recently endorsed by federal regulators, is to split the original distressed note into two notes: a performing "A Note" and a non-performing "B Note." The A Note typically represents the portion of the original debt that the lender expects to collect, in full, based upon the then-current operating cash flow and appraised value of the collateral. The A Note may bear interest and be payable as to principal and interest pursuant to the terms of the original note, or based upon terms modified in connection with the restructure. As discussed further below, the A Note may include an equity participation, which provides the lender additional incentive to implement this dual note structure.

Alternatively, the B Note typically represents the portion of the original debt that is expected to be charged-off or forgiven. The B Note may bear interest, a rate equal to or less than that under the A Note, or may even bear no interest at all. The B Note typically defers, temporarily, or excuses, entirely, monthly payments of principal and interest. In either case, upon the stated maturity date the B Note will either be payable in full or forgiven following full and indefeasible payment of the A Note. Both the A Note and the B Note may continue to be secured by a single first-priority lien upon the collateral. However, the security instrument should be modified to reflect existence and terms of the dual note structure.

As noted above, the A Note may include an equity participation for the lender. Structures for equity participations vary, and the following is simply one approach. Under this structure, in addition to monthly payments of principal and interest, the A Note may provide for the lender to share in (i) "net sales proceeds" in connection with a bona fide, arms length sale or other conveyance of the collateral, or (ii) "net residual value" in connection with a refinancing or other repayment of the A Note prior to the stated maturity date (except in connection with a sale or other conveyance).

"Net sales proceeds" is typically defined as the gross proceeds generated by the sale or other conveyance, less the indebtedness due under the A Note and reasonable and customary closing costs. "Net residual value" is typically defined as the current fair market value of the collateral, as determined by agreement or appraisal, less the indebtedness due under the A Note and, in connection with a refinance, reasonable and customary closing costs. Note that, in connection with a refinance, the proceeds generated will invariably be less than the net residual value. Accordingly,

the borrower will be required to contribute additional equity in order to satisfy the equity participation. The A Note should provide that any negative amount resulting from the application of the aforesaid definitions shall be deemed to be equal to zero. This avoids the contention that a negative value in the equity participation may reduce amounts otherwise due and payable under the A Note.

The extent to which the lender may share in the net sales proceeds or net residual value is subject to negotiation. Typically the sharing is on a pari passu, or equal, basis. More complex equity participation structures have been developed, however, where the sharing is unequal or where, in order to induce the borrower to invest additional equity into the transaction, the lender agrees to subordinate the equity participation to the return of the borrower's investment. Thus, the lender would only receive its negotiated share of net sales proceeds or net residual value if any such proceeds or value remain following repayment of the borrower's equity investment. This scenario presents unique issues, particularly in the context of credit bidding in foreclosure, which must be considered fully by all parties and their counsel.

Jaimee Zuboff Newman, Esq. is with Halloran & Sage, LLP, Hartford, Conn.