KEY POINTS

- Current market uncertainty means that now is an opportune time for real estate lenders to revisit the enforcement options available to them.
- There are a number of options available to a lender with security over real estate, from appointing a receiver or administrator to exercising step-in rights in respect of a development.
- The rise in alternative lenders, changing approach to hedging products, widespread use of LMA documentation and impact of the 2008 financial crisis mean that there may be a change in the enforcement and restructuring strategies employed in the coming years.

Feature

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Enforcement of real estate loans – options and changing approaches

Weak sterling, political uncertainty, increasing inflation, threat of interest rate rises and insecurity regarding overseas investment – time for real estate lenders to remind themselves of the enforcement avenues available if things go awry? Much has changed since the 2008 financial crisis: a lot for the better. In this article we provide a refresher of the main enforcement options and suggest some factors that we think may result in a new approach to restructuring and enforcing real estate loans.

ENFORCEMENT OPTIONS

A lender's rights to enforce the security it has been granted over a borrower's real estate are set out in statute and common law and will usually be prescribed in the relevant security document. Intercreditor arrangements, standstill agreements and the statutory moratorium in administration will also impact on a lender's ability to enforce its security.

Taking possession

A lender with a legal mortgage over a property has a right to possession of that property. The lender's right to take possession will normally be exercisable once the borrower is in default. A lender becomes a mortgagee in possession either by taking physical possession of the property if it is possible to do so peaceably or by applying to court. Lenders rarely willingly become mortgagees in possession because of valid concerns as to the extent of the responsibilities and liabilities that go with it. For example, the lender may become liable for environmental damage in respect of the property. There are also specific requirements that a lender must comply with before taking possession of a residential property. These risks easily can be avoided by appointing a receiver.

Power of sale

The power of sale can be a very valuable tool to overreach subsequent mortgages and charges (or at least as leverage in negotiations with junior chargeholders). Although exercising the power of sale does not bring with it the same level of potential responsibilities and liabilities as arise for a mortgagee in possession, there are residual duties which have to be addressed, such as to obtain the best price reasonably obtainable and to act with reasonable care and skill. These duties typically are largely mitigated through the marketing processes undertaken by the receiver or administrator, where the power of sale is used simply to effect the conveyance.

Appointing a receiver

The holder of a fixed charge over property may appoint a receiver in order to enforce their security. The purpose of appointing a receiver is for the receiver to take charge of the property, to realise the property (usually by selling the property to a third party) and use the realisation proceeds to repay the monies owed to the lender from the borrower. The powers of a receiver are set out in the Law of Property Act 1925 and will be considerably extended by the security document. A receiver's powers will normally include the power to take possession of and sell the property, collect rent and enter into contracts in respect of the property.

Receivership is a popular enforcement option amongst real estate lenders. A receiver will usually act as agent of the borrower (either under statute or the terms of the security document), which will mean that the lender is protected from liability arising as a result of the receiver's actions – provided that they do not break that agency by acting as principal to the receiver. In addition, although a receiver has a duty to act in good faith and obtain the best price reasonably obtainable when selling the property, it can put the interests of the lender first. Appointing a receiver is also usually quick and relatively inexpensive. However, receivership can be of limited use to lenders that finance development projects given that a receiver is only appointed over the property and not the borrower as a whole.

Receivers can be appointed over any asset that is subject to a fixed charge – including shares. This means that purchasers can be offered the option of acquiring the corporate owner of real estate, and paying stamp duty on the transfer of shares as opposed to higher Stamp Duty Land Tax (and potentially taking the benefit of tax losses in the corporate).

Appointing an administrator or liquidator

Administration is a useful tool for lenders looking to enforce development loans. An administrator will take over the control of the company's affairs from its directors and has wider powers than a receiver. When a company enters administration it becomes subject to a statutory moratorium that restricts creditors enforcing their claims against the company in administration. A disadvantage for a lender who appoints an administrator is that it does not have the power to control the actions of the administrator. An administrator is an agent of the company over which he is appointed and has a duty to act in the interests of the creditors as a whole. A liquidator is required to realise the assets of a company and distribute the proceeds and similarly acts in the interests of all creditors. When dealing with real estate, the tax

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implications of appointing an administrator (or liquidator) must be considered carefully. Appointment of a liquidator breaks a tax group, and both administrators and liquidators must pay certain taxes that they incur (for example, corporation taxes on capital gains) as expenses, before they can draw their fees.

Step-in rights

Step-in rights are a key enforcement option for lenders financing development projects. Where a lender has the benefit of direct agreements and/or collateral warranties with the key development parties, they are likely to have the right to step in to the shoes of the borrower and complete the development themselves. A lender may also have step-in rights under the terms of the finance documents. The process for exercising step-in rights will be set out in the relevant agreement and will usually be exercisable following an event of default or breach under a development document. Lenders are often reluctant to exercise step-in rights, as lenders are usually unfamiliar with the business of running development projects and also have concerns around exposure to liabilities and the risk of becoming a mortgagee in possession, which has various obligations including the burden of covenants and a duty to account for rents and profits. However, step-in rights that allow the lender to provide a nominee to step-in on the lender's behalf may, in certain circumstances, be used to avoid such issues.

WHAT HAS CHANGED SINCE THE 2008 FINANCIAL CRISIS?

The REF lender community is more diversified

The increased regulatory burden and capital requirements placed on banks following the financial crisis, combined with the hangover from dealing with billions of pounds of soured property loans originated pre-financial crisis, significantly reduced bank appetite to lend to the real estate sector. Following the trend we have seen in the leveraged loan market, the gap left by the banks has been filled by alternative lenders such as debt funds. These lenders may have a different attitude to risk and may be willing to adopt more innovative (and aggressive) enforcement strategies.

There are fewer/different hedging products

A large number of the last wave of real estate enforcement and restructurings were driven by over-leveraged structures resulting from depressed asset prices and few if any refinancing options available on loan maturity. The economics of these situations were in many instances distorted by the effect of low interest rates on borrowers holding interest rate swaps entered into when interest rates were much higher. The mark-to-market and cost of servicing those swaps then became a significant obstacle to implementing a restructuring.

A good example of the impact that swaps can have on the economics of a restructuring was the GHG group, which it was reported pre-restructuring had debt of £1.5bn and mark-to-market on its long-dated interest rate swap of £675m. It will take some time for the longer-dated swaps to expire, but many have been resculpted or restructured already, and significantly far fewer have been entered into since the end of the financial crisis, as alternative lenders favour more simple caps or fixed rate products.

Standardisation of documentation

The Loan Markets Association (LMA) has produced a suite of real estate finance (REF) loan documentation which many law firms have adopted for mid-market and big ticket real estate backed loans.

The standardisation of the loan, security and intercreditor documentation brings with it a degree of predictability which we did not have when we restructured or enforced on 2006/7 vintage deals.

This means that loans are more easily tradeable so lenders who do not want or need an exit can more easily take one and that special opportunity funds that have restructuring expertise and more flexibility in their funds can more easily access distressed opportunities. It also means that many of the tools that have been available for years in leveraged deals written on LMA terms will now be available in REF deals. For example, we now have proper intercreditors with carefully crafted stressed and distressed disposal mechanisms.

(Some) lessons have been learnt from the financial crisis

Although the coming years may see a curtailment in legislative reforms in favour of debtors, real estate bank lending policies are now much stricter and have been for some time. It is uncommon for banks to lend on a loan-to-value (LTV) basis at greater than 60%, although alternative lenders looking for higher yields may lend at 70%. Compare this with some of the deals done in 2006/07 where LTVs on origination were not uncommonly at percentages in the high 80s or low 90s and the equity contribution was also leveraged. What this means potentially is that borrowers have a much greater cushion with which to protect themselves from swings in the market. It also means that there could be a greater tension between lenders and borrowers where borrowers continue to have skin in the game and are unwilling to support restructurings which might result in the impairment of their equity value.

We have also seen changes in the way deals are structured as a consequence of the challenges that were encountered post-financial crisis. Greater care goes in to subordination, with structural subordination of mezzanine and junior debt being more commonplace and it being market to take security over sponsor loans, in order to minimise the risk of hold-out by those more junior in the capital structure.

CONCLUSION

Lenders have available to them many options when it comes to restructuring or enforcing their security. The market has changed and many lessons have been learned from the challenges that were encountered after the last financial crisis. In theory, this should make for a more efficient restructuring or enforcement process. ■

Further Reading:

- The death of vanilla lending in real estate? [2015] 1 JIBFL 48.
- Trends in development financing [2014] 10 JIBFL 659.
- LexisNexis Loan Ranger blog: Examining the LMA's recent changes to real estate finance and intercreditor agreements.