Valuation and regulation risks and opportunities in commercial real estate

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SEPTEMBER 21, 2023

Adverse market conditions and lower valuations are creating litigation risks for commercial real estate (CRE) deal parties, particularly in the office sector. At the same time, opportunities exist for refinancing and a rebound in value where regulations can be eased or adapted to help CRE survive and thrive through the post-pandemic storm.

Market risks and the regulatory response

A significant number of mortgages are maturing in the near-term, requiring refinancing at a time of relatively higher interest rates and lower occupancy. These are factors that tend to reduce valuations. Reduced valuations, in turn, increase the risk of losses and litigation.

Local governments have started to recognize two fundamental problems with their city centers — there is simultaneously both a lack of housing and a massive amount of unused, unwanted office space.

Older office buildings are most vulnerable during this period as many tenants seeking to get their employees back in the office are demanding updated spaces.

In response, local governments have started to recognize two fundamental problems with their city centers — there is simultaneously both a lack of housing and a massive amount of unused, unwanted office space. Even so, commercial-to-residential building conversions often gain public support but are more rarely successfully executed.

Significant reconfiguration needed for an office building to meet residential building codes can be exceedingly difficult in an inflationary and rising interest rate environment. In addition, regional banks have struggled of late, limiting a traditional source of funding in the CRE space. As a result of these headwinds, the regulatory and financial hurdles are often too high for conversions to make sense.

But some government officials are taking steps to make a more hospitable market for residential conversions. New York City Mayor, Eric Adams, for instance, has proposed changes to zoning which would allow buildings that were built before 1990, rather than 1961 or 1977 under current laws, to be eligible for conversion. In addition, the city would re-zone manufacturing zones in midtown Manhattan to allow for mixed-use.

A new office of city government experts on city buildings' regulation would be available to foster conversion projects, furthering the commitment to overcome regulatory hurdles.

A new purpose for C-PACE

On the financing side, there may be pre-existing programs that could be used for residential conversions.

For instance, before the pandemic, certain New York City building owners already faced a significant legal hurdle — preparing for the implementation of Local Law 97 (LL 97).

Under LL 97, there are increasingly rigorous requirements for buildings to reduce their carbon emissions. The first major milestone is in 2024 when buildings must begin to limit emissions based on a certain cap and those limits become stricter over time. To help finance these changes, a local C-PACE (Commercial Property Assessed Clean Energy) program was implemented.

Broadly speaking, C-PACE is long-term, fixed-rate financing available through qualified lenders which operate through municipal programs. The loan is paid back through a tax assessment. Accordingly, it operates as a lien on the property and runs with the property regardless of any transfer of ownership.

Building owners struggling to find funds for conversions could turn to C-PACE to relieve some pressure. C-PACE can only be used for eligible energy efficiency improvements or renewable energy systems but these aging buildings that are candidates for conversion likely need to make changes in any event to comply with LL 97. If those improvements were folded into a larger conversion plan, then C-PACE could be a resource alongside traditional financing.

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Valuation and litigation risks

Meanwhile, CRE valuations for offices have been falling.

Under CRE deals where certain events of default trigger re-appraisal of the subject property, the combination of stress in the market and lower values can be a volatile mix. Higher operating costs and vacancies increase the risk of default, which can become the catalyst for a reappraisal that reveals lower valuation. Lower valuation could result in an appraisal reduction amount (ARA) which sets off a battle for control of the loan servicing.

For example, following an event of default, a servicer may obtain a new appraisal that indicates there are unrealized losses. While the exact contractual formula may vary, the ARA may equal the excess of the outstanding principal balance of the loan minus 90% of the adjusted appraised values of the mortgaged properties securing the loan.

If the value of the property has dropped to a certain degree set by the contract, the rights to control the loan's servicing (collecting principal and interest) and make decisions regarding loan enforcement (modifications, foreclosures) can change hands. These rights are significant at any time and are especially highly prized when a mortgage is in distress as they determine the actions taken to preserve or maximize value.

In distress situations, a special servicer is usually called upon to make major decisions or obtain consents from the controlling certificateholders to intended actions. Special servicers are often involved in overseeing loan modifications to avoid default, granting loan extensions, or pursuing foreclosures and sales.

Generally, the controlling certificateholders are the most junior class that has 25% or more of its initial balance remaining. The junior holder has the most credit risk so they are given decision-making control over the loan.

The goal is for the party with a meaningful economic interest in the loan to enforce the loan for the interests of all. When the value of the loan changes to such a degree the junior class's stake has been steeply reduced, the control shifts to a more senior holder.

As one would expect, shifting value and control rights are fertile ground for litigation to determine who has the decision-making power to govern the loan servicing and enforcement. The first step to assess this risk is looking to the underlying deal documents and understanding the definitions and operative terms.

In the 2011 case *FCCD Ltd. v. State St. Bank & Trust Co.*, in the Southern District of New York, at issue was whether a triggering event had occurred which shifted control from the subordinate to the senior interest holder. The underlying agreement provided that the servicing rights would be transferred to the senior interest holder if the subordinate interest holder's prospect of recovery was so diminished it no longer had a sufficient economic stake in the loan.

The court reviewed the agreement to determine the parties' intent regarding the ARA allocation and found the contract to be unambiguous, resulting in the entire amount of the ARA being assigned to the subordinate interest. As a result, control shifted to the plaintiff.

Similarly, in the 2019 case, *In re Trusts Established Under the Pooling & Servicing Agreements*, the Southern District of New York court analyzed the text of the Pooling and Servicing Agreement (PSA) and how the voting rights were calculated. The PSA required that certificateholders holding 25% of the voting rights supported bringing an action. Whether a party reached that threshold to bring a cross-claim depended, in part, on the calculation of the ARA.

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Attainment of the voting rights threshold was based on a fraction where the numerator was the balance of the relevant class of certificates and the denominator was the overall balance of all certificates. The question raised was whether both numerator and denominator balances should be adjusted by the ARA. The court concluded that the unambiguous language of the contract intended that only the numerator should be adjusted by the ARA.

Based on the ARA balance reduction so calculated, one of the certificateholders did not have the required 25% voting rights to bring a cross-claim.

In contrast, in the 2014 case, *LNR Partners, LLC v. C-III Asset Mgmt.*, the Court of Chancery in Delaware denied the motion for summary judgment because the PSA there was ambiguous as to how the ARA would impact voting rights.

The dispute was between servicers regarding who had the proper authority to be the special servicer. Under the PSA, the controlling class with a certain percentage of voting rights could replace or designate the special servicer.

Plaintiff LNR Partners' affiliate obtained ownership in the controlling class and attempted to replace C-III as the special servicer with the plaintiff. In response, C-III argued even if the affiliate had a majority interest in the controlling class, it did not meet the requisite voting rights percentage after taking into account the ARA calculation.

If C-III was correct, the affiliate would not be able to vote to designate a new servicer and replace it. The court found the contractual interpretations from both parties on the ARA and voting rights to be plausible. Therefore, the contract was ambiguous and could not be determined on a motion for summary judgment.

Conclusion

Regulation and litigation will likely shape the landscape for commercial real estate in the coming years. Whether it's a greener

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more modernized future with more housing in city centers depends on the resilience of the market, the commitment of local officials to foster change through regulation and the efficacy and availability of creative financing.

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This article was first published on Reuters Legal News and Westlaw Today on September 21, 2023.

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