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Morgan Lewis Hedge Fund University™

PART 1: PORTFOLIO COMPANY DISTRESS, WORKOUTS AND RESTRUCTURING

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State of the Market

State of the Market: Overview

- Current market turbulence and uncertainty
  - Interest rates
  - Recent bank failures
  - Recession worries
- Flight to quality
  - High quality assets
  - Prime locations
  - Sustainability
- Increases in cost of capital and decreases in asset values
  - Refinancing challenges
- Active property sectors
  - Value-add and conversions
  - Life sciences and healthcare
  - Multifamily and SFR
  - Urban logistics and last-mile

Broken Deals, Distressed Assets, Workouts

Broken Deals, Distressed Assets, Workouts

- **Currently, the real estate market is adapting to the new post-COVID "normal."** As a result, certain asset classes are struggling, such as office, retail, and business hotel properties, and investors may have an interest in exiting the investment or seek to "turn around" the investment.
- Consider the situation where a partner may "fall out of love" with the asset over the term of the joint venture.
  - For instance, a large institutional investor that is continually acquiring assets may determine that other assets in the relevant market are more attractive and thus seek to sell the Property. An Operating Partner that is unlikely to achieve its "promote" may not be willing to invest additional capital, whether financial or emotional, and want to turn its attention to other investment opportunities.
- In a failed development project, the Capital Partner will probably want to remove the Operating Partner as soon as possible, but may also want to pull the plug on the entire project. The Operating Partner, on the other hand, even if behind in its "promote," may want more time to complete the development and stabilization of the asset.

Remedies/Exit Strategies for Joint Venture Partners

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Remedies/Exit Strategies for Joint Venture Partners

- ✓ Drag along and tag along
- ✓ Buy/sell
- ✓ Forced sale
- ✓ Put/call
- ✓ Permitted Transfers

Remedies/Exit Strategies for Joint Venture Partners

- **Control Mechanisms**
  - Removal and Replacement of Manager of Venture
  - Removal and Replacement of Asset Manager/Property Manager

- **Third-Party Considerations**
  - Rights of Third-Party Contractors/Vendors upon a Change of Control
  - Rights of Lenders upon a Change of Control – Mortgage Lenders / Mezzanine Lenders / Unsecured Lenders
  - Releases of Transferring Venturers

- **Tax Considerations**
  - Treatment of Gains
  - Step-Up in Basis
  - Transfer Taxes
  - Property Tax Reassessments

Real Estate Loan Workouts

Real Estate Loan Workouts: Overview

- Real estate workouts are neither repayment of real estate secured loans on the originally agreed terms nor resolutions achieved by foreclosure remedies. They are negotiated settlements that fall somewhere between these two conventional scenarios and outside the loan documents. Workouts occur when creditors agree to negotiate restructuring of the payment and other terms of debt obligations. By definition they result in the lender receiving less than—or, at the very minimum, something other than—its original bargain.
- Some of the most common modified loan terms include:
  - **Adjust Payment Amount –** reduce temporarily, permanent reduction subject to a back-end payment (either discounted or at par)
  - **Adjust Payment Dates –** suspend current payments for a period, extend payment period, suspend principal payments
  - **Extend Maturity Date**
  - **Adjust Interest Rate –** a permanent reduction, deferral of a portion of debt service
  - **Acceptance of Additional Collateral or Other Credit Support**
  - **Sale of Property –** a forced sale period may be initiated and/or a deed or conveyance in lieu of foreclosure may be demanded

Workout Considerations

Lender and Borrower should consider the strengths and weaknesses of their position before entering the workout process.

1) **Nature of Default:** If the borrower is already in default, how bad is the default? If the loan has matured without payment, obviously the default is significant. But if the default involves a non-monetary or other technical default, there is more room to negotiate. A monetary default based only on the failure to make a monthly payment also may allow more room to negotiate.

2) **Complexity:** How complex is the project? Do the principals have management expertise unique to the project? The more complicated the asset, the less likely it is that the lender will want to inherit it without capable management.

3) **Status of Project:** Has the project been completed? Is the general contractor affiliated with the borrower? How difficult would it be for the lender to complete the project?

4) **Entitlements:** Do the entitlements for the project expire soon? Does the borrower have a strong political connection with the source of such entitlements that cannot be duplicated by the lender?

5) **Equity:** Are there principals of the borrower who are willing and able to invest additional equity?

6) **Guaranties:** Have the principals signed guaranties of the loan? If so, are they full-repayment guaranties or merely nonrecourse carve-out guaranties?

7) **Tenants:** Has the landlord received attornment agreements from all of the tenants, or might some tenants who are junior to the lien of the debt be free to leave the property upon a foreclosure?

8) **Claims:** Will the lender inherit significant claims, such as construction defect claims, from third parties once it has foreclosed on the property?

9) **Lender Liability:** Does the borrower have legitimate liability claims against the lender?

10) **Defenses:** Does the borrower have any legitimate defenses to the lender’s enforcement of the loan documents?

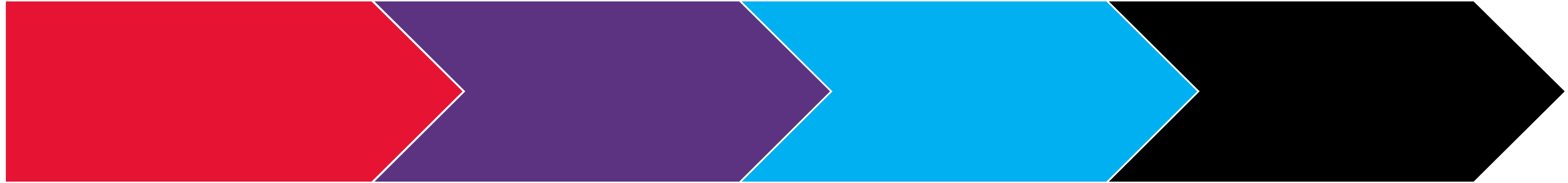
11) **Bankruptcy:** Can the borrower credibly threaten bankruptcy?

Restructuring Considerations

REIT Restructuring Generally

- REIT Chapter 11 filings remain relatively low
  - Hotels
  - Pennsylvania Real Estate Investment Trust (PREIT)
  - Single-asset real estate cases
- Pockets of distress after the pandemic: Retail and office space
- But inflation and increased carrying costs are problematic for the industry
  - Unlike other businesses, cannot retain significant cash because of distribution requirements
  - REITs are significantly more reliant on loans and the capital markets
- Ripples from banking-sector worries have started to impact REITs
- REIT debt structures allow them to avoid bankruptcy better than other industries
- SPE structures isolate distress
- Real estate financings are often on a nonrecourse basis with rights only to the collateral
  - REIT can reduce debt by returning property to lenders
  - Can sell problematic assets or portfolios
  - But lenders may have "bad boy" guaranties that can be enforced
- Loans may be at holding company level and not at the property level, permitting additional financing ahead of existing lenders

Restructuring Alternatives



State law enforcement remedies

- **Foreclosures**
  - Judicial
  - Non-judicial
- **Receiverships** (state or federal)

Out-of-court restructurings and loan modifications

Assignments for the benefit of creditors

Chapter 11/ Chapter 7 filings

Single-Asset Real Estate Cases

Single-Asset Real Estate Rules in a Bankruptcy Proceeding

- Single-Asset Real Estate (SARE) rules are burdensome fast-track rules with respect to single-asset real estate debtors who own real estate:
    1. constituting a single property or project (other than residential property with fewer than four residential units);
    2. generating substantially all of the gross income of the debtor; and
    3. on which no substantial business is conducted other than the business of operating the real property and activities incidental thereto (for example, hotels and golf resorts are often excluded).
- If a debtor qualifies as a SARE, secured creditors may fast-track the bankruptcy (i.e., lift the automatic stay) unless:
    1. a confirmable plan of reorganization is filed either 90 days after the petition date or 30 days after the court determines that the debtor is a SARE; or
    2. the debtor pays monthly payments to the secured creditor at the nondefault interest rate.

Assumption/Rejection of Unexpired Leases

Assumption/Rejection of Executory Contracts & Unexpired Leases

In a regular Chapter 11 case, a debtor is permitted time to evaluate whether to assume or reject executory contracts and unexpired leases, subject only to the debtor's business judgment.

- Executory contracts may be assumed or rejected at any time prior to confirmation of a plan.
- **Nonresidential real property (commercial leases)**: Unexpired leases of nonresidential real property will be deemed rejected unless assumed by the earlier of (i) 210 days after the petition date (subject to a 90-day extension with court approval) or (ii) confirmation of a plan. Any further extensions require consent by the landlord. These tight time frames sometimes make bankruptcy less attractive to commercial lease borrowers.
- **Residential real property**: Residential leases are treated differently. If the lease is deemed residential, a debtor may assume or reject such lease at any time prior to confirmation of a plan. The debtor may also be excused from having to timely perform its lease obligations.

Courts apply two tests to determine whether a lease is residential or nonresidential:

1. **Property Test** (majority) – whether the property is residential based on its use.
2. **Lease Test** (minority) – whether the intent of the lease is to generate income between two commercial parties despite the ultimate residential use.

Sponsor Considerations

- As an insider, actions taken by a sponsor will be subject to heightened scrutiny
  - Usually scrutinized by creditor committees and frequent target of claims as source of recovery for otherwise out-of-the-money creditors
  - Extended preference period for insiders – one year vs. 90 days
- Insider votes do not count toward acceptance of a Chapter 11 plan
- Potential for equitable subordination claims if (a) the sponsor engages in improper conduct and (b) the improper conduct results in harm to one or more creditors
  - Conduct could include breaches of fiduciary duty or violations of the securities laws in the purchase of the debt or purchase of debt with material nonpublic information

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PART 2: ALIGNMENT, RETENTION AND SUCCESSION: STRUCTURING OWNERSHIP AND COMPENSATION ARRANGEMENTS WITH NEXT GENERATION PROFESSIONALS

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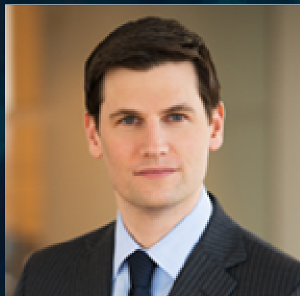

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Institutionalizing a Boutique Investment Manager to Enhance Franchise Value

Ownership, Structure, and Governance

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Introduction

- The franchise value of an asset or wealth manager can be protected and enhanced through a series of steps taken to "institutionalize" its business
- An institutionalized firm is more sustainable, with greater projected longevity, which helps founders and next-generation partners by enhancing:
  - Valuation of the firm by outside investors or acquirers through improved long-term financial projections and reduced discount rate
  - "Tail" value following a partner's departure from the business
  - A lasting independent legacy for the founders

Overview

Institutionalized boutique investment managers have many of the following attributes in common:

- Multiple Generations of Talent with Succession Planning
- Governance Structures Designed to Endure Beyond the Founders
- Broad Equity Ownership with Aligning Terms
- Service-Related Commitments from Partners and Key Professionals
- Complimentary Product Mix and Distribution Channels
- Optimized Middle- and Back-Office Functions
- Independent Directors or Advisory Board Members
- Credible/Branded Outside Vendors and Investors

Multiple Generations of Talent with Succession Planning

- Succession planning at any boutique firm is an ongoing process that begins at the hiring stage and continues through ongoing training, annual reviews. and promotions of next-generation leadership
- Aligning equity terms helps facilitate transparency and cooperation among founders and next-generation professionals in planning succession
- Once anticipated career horizons are known for senior professionals, the resulting time “runways” can be used to identify, cultivate, and elevate successors and effect messaging and the transition of key relationships

Governance Designed to Endure Beyond the Founders

- Formation of operating and investment committees can provide valuable forums for next-generation participation and grooming for leadership
- Establishing firm leadership succession well in advance of an anticipated founder departure helps ensure adequate runway for communications with clients and employees and the transition of management functions and relationships
- Restructuring founder equity arrangements and creating distinctions between “founder equity” and “sweat equity” can often improve alignment around the timing and sequencing of next-generation management transitions

"Trading" Equity Ownership for Service-Related Commitments

- Elevating key individuals to partnership presents a unique opportunity to change their mindsets from those of employees to those of owners while also getting back service-related commitments that protect franchise value
- By equitizing next-generation professionals, it is often possible to recapture EBITDA by converting a portion of annual cash compensation into "below-the-line" equity distributions that also contribute to the firm's terminal value
- Professional partners have a greater tendency to remain with a firm through tough times and to take longer-term views on operations and strategy

Service-Related Commitments

- When spreading equity ownership to key next-generation professionals, it is important to get back individual service-related commitments to the firm, including:
  - Operating Commitments
  - Departure and Transition Commitments
  - Restrictive Covenants
- It is typically easier to obtain these types of service-related commitments from next-generation professionals if a firm's founders simultaneously make the same franchise-protective commitments to the firm
- Once all key professionals are properly equitized and integrated into governance, and have "locked arms" through service-related commitments, the firm is institutionalized from an ownership, structure, and governance perspective

Tax Considerations in Providing Next-Generation Equity Participation

Profits and Capital Interests

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Equity Ownership Types

For tax purposes, there are two basic types of equity ownership in a partnership:

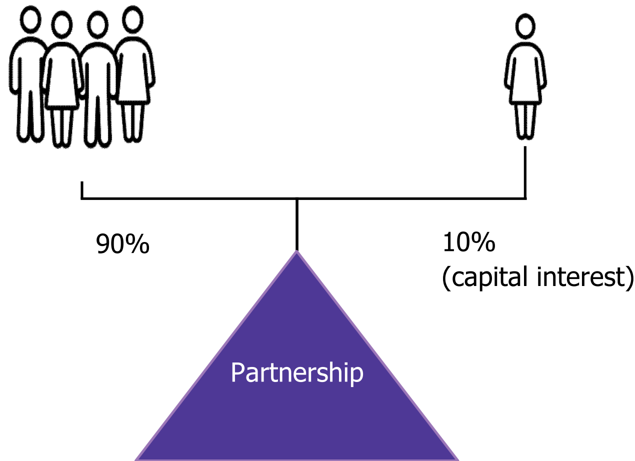
Capital interest

Profit interest

Equity Participation Opportunities in a Fund Complex

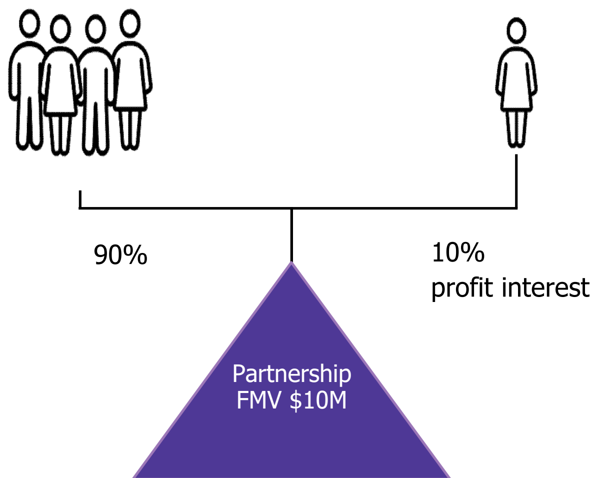
- Fund managers often have a separate management company or companies (earning management fees) and general partners or equivalent (earning carried interest from underlying funds)
- Separate considerations regarding management company interests:
  - May have more concentrated equity ownership than general partner entities (reflecting goodwill and going-concern value of the fund-management complex as a whole)
  - Ordinary income may be subject to tax in jurisdictions where manager operates or is deemed to operate
  - Potential pass-through entity tax, or PTET, planning to in effect provide equivalent of deductible state taxes for federal income tax purposes
  - Potential use of limited partnership and related planning regarding self-employment tax
  - Considerations regarding going-forward K-1 versus W-2 treatment of participants
- General partner carried interest planning depends in part on expected profile of future taxable income
  - Over-three year capital gains
  - 60-40 option income
  - Qualified dividends

Capital Interest



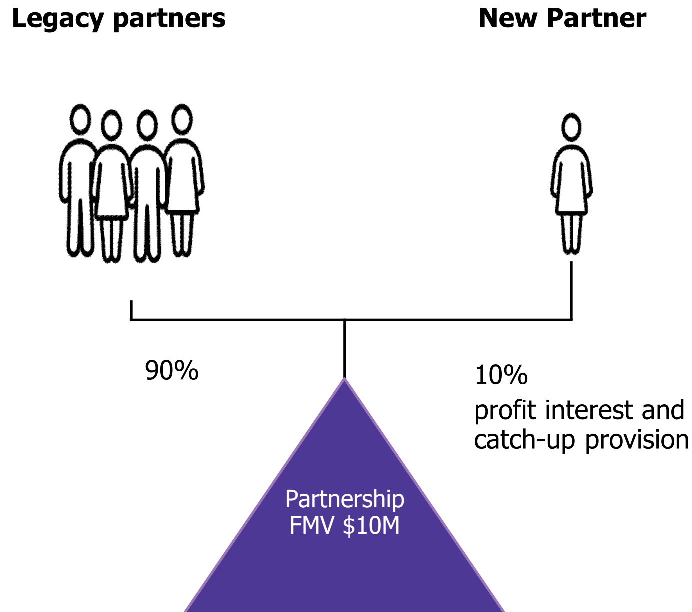
- 10% "capital interest"
- 10% equity ownership of everything
- Not taxable if purchased for FMV
- If purchased in connection with services and not purchased for FMV, this is a "capital shift" and likely taxable as ordinary compensation income
  - Also potential section 409A/457A issues, to be discussed later
- Section 83(b) election relevant if subject to vesting and forfeiture
- If partnership is subsequently sold for $10M, New Partner gets $1M
- Future income and gain would flow through
- Exit would generally be capital gain/loss (other than "hot assets")

Profit Interest



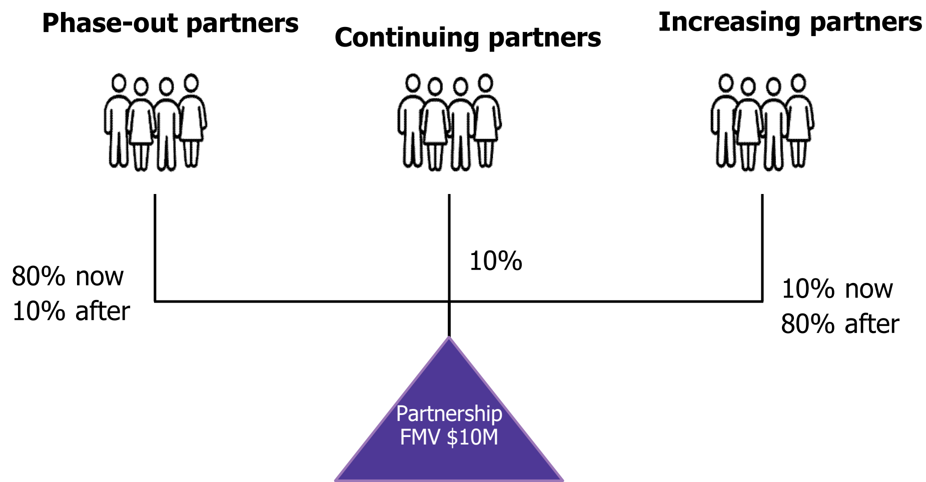
- 10% "profit interest"
- 10% equity ownership of appreciation and income above $10M
  - If partnership is subsequently sold for $11M, New Partner gets only $100K (10% of $1M above threshold)
  - If partnership is subsequently sold for $100M, New Partner gets $9M (10% of $90M above threshold)
- Not taxable on grant – IRS says liquidation value controls
- Future income and gain would flow through
  - "Springing" interest alternative
- Exit would generally be capital gain/loss (again subject to "hot assets")

Profit Interest and Catch-Up Provision



- 10% “profit interest” with a “catch-up”
- 10% equity ownership of appreciation above $10M, but New Partner gets 100% until New Partner gets to 10% interest
  - If partnership is subsequently sold for $11M, New Partner gets $1M
  - If subsequently sold for $11,111,111, New Partner gets $1,111,111.
  - If subsequently sold for $100M, New Partner gets $10M
- Not taxable on grant – IRS says liquidation value controls
- Future income and gain would flow through
- Exit would generally be capital gain/loss

Beyond the Basics



- Can transition ownership with profits interests
- Immediate shift of 70% of partnership's ownership from phase-out partners to increasing partners would be a capital shift
- Consider implementing the transition through a profits interest
- E.g., all value over $10M is distributed 10% to continuing partners and 90% to increasing partners, until increasing partners have received 80% of aggregate distributions
- We can also increase some increasing partners more than others, and decrease some decreasing partners more than others, or tie participation to particular categories of investments or activities

Reinvestments of Carry

- Section 1061 recharacterizes long-term capital gain on assets held for three years or less as short-term capital gain
- But Section 1061 does not apply to a "capital interest"
- What is a capital interest for these purposes?
  - Funding the purchase of an interest with loans from the partnership or another partner does not make the interest a capital interest
  - A full recourse loan may be sufficient as long as:
    - No right to reimbursement from any other person; and
    - Not guaranteed by any other person.
  - An allocation of taxable income or gain on a carried interest that is reinvested (including by retention) is generally eligible

Section 1061 Language

- Treasury Regulations say:
  - Allocations to service providers in respect of purported capital interests are respected only if "determined and calculated in a similar manner" as allocations to partners who contributed significant capital
  - Allocations will be considered to have been made in a "similar manner" *only if*
    - Allocations to the service provider and non-service-provider partners are with respect to, and corresponding to the partners' contributed capital and are "separate and apart from allocations" in respect of the profit interest, and
    - Both the partnership agreement and the partnership's contemporaneous books and records "clearly demonstrate" that the requirements of Treasury Regulations Section 1.1061-3(c)(3) have been met

Tax Considerations for Incentive Compensation Arrangements

Phantom interests and other alternatives

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Section 409A of the Code

Section 409A of the Code

- Applies to nonqualified deferred compensation
  - Deferral of compensation – "legally binding right"
- Requires operational and documentary compliance
- Six permitted payment events
  - Separation from service
  - Specified date
  - Death
  - 409A "disability"
  - 409A "change in control"
  - 409A "unforeseeable emergency"

Section 409A of the Code

Exceptions

- Short-term deferral rule
- Equity interest
  - Restricted stock
  - Profits interest
  - Stock options/SARs relating to "service recipient stock" and exercise price not less than FMV on date of grant
- Qualified employer plans
- Service provider that is "accrual basis" taxpayer

Section 409A of the Code

Failure to comply with Section 409A

- Immediate taxation once "vested"
- 20% penalty tax
- Interest penalty
- Reporting and withholding obligations

Types of Incentive Arrangements

Annual Bonus

- Payment within 2 ½ months
- Continued employment

Deferred Compensation

- Elective deferrals
- Forced deferral

Long-Term Incentive Bonus

- Multi-year performance

Profits Interest (Equity)

- Carried Interest

Phantom Interests

- Restricted Stock Units
- Phantom Carry Interest

Section 457A

- Applies to compensation deferred under a nonqualified deferred compensation plan of a nonqualified entity
  - Taxation when no "substantial risk of forfeiture"
- Substantial risk of forfeiture
  - Right to compensation conditioned on future performance of substantial services
- Nonqualified deferred compensation plan
  - Same meaning as under Section 409A of the Code, but also includes any plan that provides a right to compensation based on the appreciation in value of a specified number of equity units of the service recipient
  - No deferral if the service provider receives payment of such compensation not later than 12 months after the end of the taxable year of the service recipient during which the right to the payment of compensation is not subject to a substantial risk of forfeiture

Section 457A

- **Nonqualified entity**
  - Any foreign corporation, unless substantially all income is
    - Effectively connected with the conduct of a trade or business in the US, or
    - Subject to a comprehensive foreign income tax
  - Any partnership, unless substantially all income is allocated to persons other than
    - Foreign persons with respect to whom such income is not subject to a comprehensive foreign income tax, and
    - Organizations which are exempt from tax under Title 26 of the Code
- "**Comprehensive foreign income tax**," with respect to any foreign person, the income tax of a foreign country if
  - Such person is eligible for benefits of a comprehensive income tax treaty between such foreign country and the U.S. or
  - Such person demonstrates to Secretary of Treasury that such foreign country has a comprehensive tax regime

Section 457A

Penalties

- ✓ Inclusion in income
- ✓ 20% penalty tax
- ✓ Interest penalty

Section 457A and Deferred Compensation

- Deferred compensation in offshore investment entities
- Deferred compensation of certain U.S. partnerships

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Jennifer is a co-leader of the bankruptcy, restructuring, and insolvency practice. Jennifer's primary focus is representing secured creditors, special situations investment funds, private credit providers, and ad hoc groups in bankruptcy proceedings, section 363 sales, and in-court and out-of-court complex corporate debt restructurings and recapitalizations. She also represents troubled corporate debtors in reorganizations, asset sales, loan restructurings, and commercial loan transactions.

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Fred's practice covers all aspects of real estate investment, acquisition and disposition, development, and financing. He regularly represents institutional investors and owners in all aspects of project development, including land acquisition, parcel assemblage, formation, and capitalization of real estate investment joint ventures. His experience includes negotiation and documentation of construction contracts and design and development agreements for all real estate asset classes throughout the United States and the Caribbean. He also handles fund formation, fund investment, and investment management matters.

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Rob serves as co-leader of Morgan Lewis’s investment management transactions practice and as a consultant with Morgan Lewis Consulting. Rob regularly advises a wide variety of industry leaders in the full range of asset and wealth management transactions, including mergers and acquisitions, strategic minority investments, sales, spin-outs and lift-outs, capital markets transactions, and “seed & stake” arrangements. Rob also provides strategic advice as a consultant to established and emerging financial services firms in connection with a range of business initiatives, including institutionalization of their businesses to enhance franchise value, governance and succession matters, product and channel diversification, and similar initiatives. He is a Registered Foreign Lawyer in England & Wales, and is admitted in New York only.

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Nathan advises public and private clients, primarily in the financial services industry, in mergers and acquisitions, joint ventures, and restructuring transactions. He regularly represents a variety of industry leaders in transactions involving traditional and alternative asset management firms, including acquisitions and sales of majority and minority investments, spin-outs, joint ventures, seed investments, and strategic relationships.

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David represents and counsels clients in a range of matters related to employee benefit plans and executive compensation agreements. He advises on the design and implementation of tax-qualified, nonqualified deferred compensation, equity compensation, and health and welfare plans, and he helps clients draft and negotiate executive employment agreements, severance arrangements, and change-in-control arrangements. David's clients include tax-exempt organizations, and public/private Fortune 500 and emerging growth companies in the technology and life sciences fields.

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