

## Safeguards in a downturn

**The financial viability** of some debt-funded developments has been brought into question. *Iain Thomas* and *Janan Kanagaratnam* consider what options are available when things go wrong. Illustration by *Ulla Puggaard*

The market turmoil has meant that many development projects have stalled because of rising energy and construction costs, folding property prices and a declining market. This article explores the options available to a lender for managing distressed developments while safeguarding its interests in ongoing projects.

### Scenarios and lender's options

The lender will take security over the developer borrower's title where that developer owns the development site. If the developer is a special purpose vehicle (SPV), the lender will also have taken share security and obtained the benefit of collateral warranties, with step-in rights from the main contractor, the professional team and subcontractors. In addition, the lender will, under the loan agreement, have inspection and monitoring rights, and the borrower will be required, periodically, to provide information on the progress of the project and costs and property valuations.

Any default by the borrower of its obligations under the loan agreement will accelerate the loan, reduce the lender's future commitment to advance, make any security taken enforceable and allow the lender to charge default interest on outstanding sums. If the loan was guaranteed by the borrower's parent company, a claim can be made against it, although if the entire group is struggling, the value of the guarantee will be limited. A default may also allow the lender to exercise its step-in rights to take control of the development.

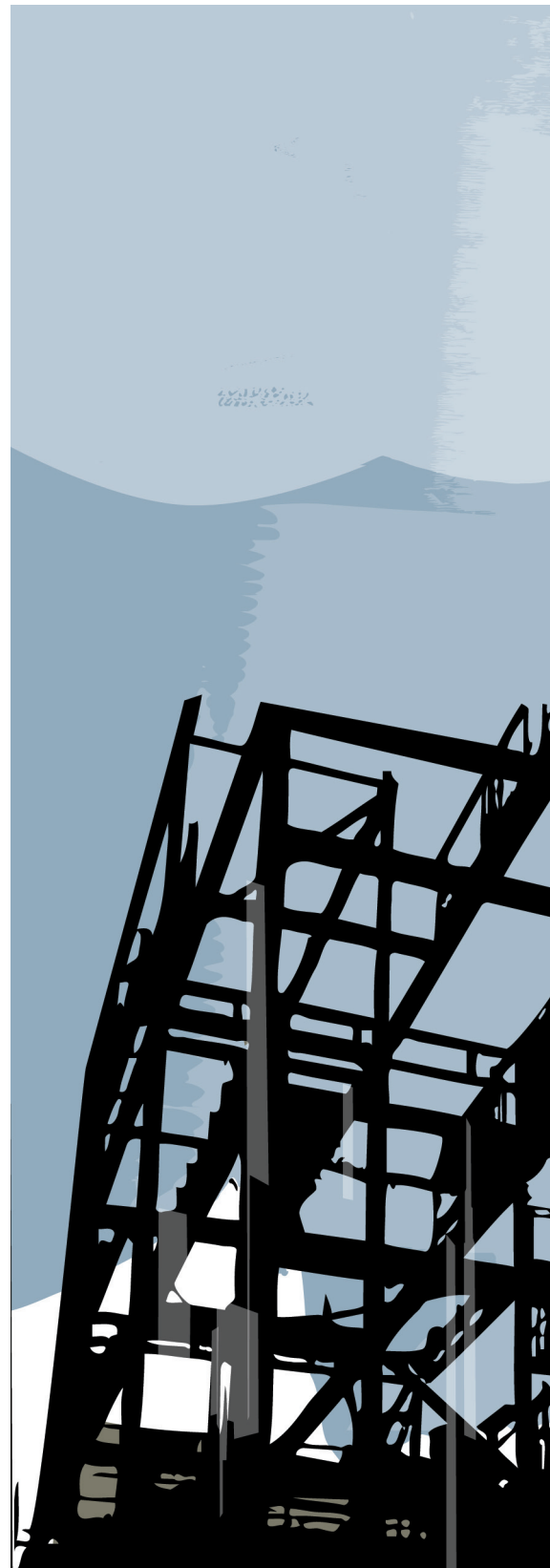
A lender must seek advice on how to manage a distressed development. The

successful completion of a project may be crucial to recover the funds advanced, and a strict enforcement of the loan and related security may leave the lender out of pocket. Moreover, strict enforcement may trigger developer default provisions in prelet agreements or construction documents. These entitle counter-parties to terminate the agreements and expose the lender to risks and liabilities; contractual, environmental and empty rates on a completed but vacant scheme. The lender may then also have to manage an often complicated development with possibly unhappy construction counter-parties. Before taking enforcement action, all the above will need to be assessed.

When faced with a struggling borrower, it may be best for the lender to engage with that borrower to enable it to complete the project. The lender could consider the following options:

- **Refinancing:** This is worth considering, but may be difficult in today's conditions.
- **Additional financing:** The provision of additional finance (perhaps having super-priority), security or other credit enhancement either by the lender or by an outside party. This will ensure that the developer has the funds to pay the construction team, thereby enabling the development to continue and reach a stage at which sufficient value can be extracted.
- **Restructuring:** This might involve an extension of payment terms or, in more serious cases, the writing off or conversion into equity of some of the debt.

In the development context, a debt-to-equity swap may be worth





considering where the future of the project is certain post-completion; if, for example, there is a binding agreement for the sale of the development or prelet agreements with main tenants are in place. If a borrower breaches its financial covenants, a debt-to-equity swap may redress the situation and allow the lender to move the loan from its default balance sheet and advance further funds to complete the scheme and realise full value. However, exchanging debt for equity is not always desirable when faced with a potentially insolvent borrower because the lender will be in a worse position (in an insolvency, shareholders are last in the queue).

The lender may also agree a standstill with all creditors. This may lead to a successful restructuring, whereby the lender can seek to exert greater control over the borrower by bolstering the loan covenants in the loan agreement and/or negotiating extensions of critical dates with contracted tenants/buyers. However, the lender needs to be careful that it does not inadvertently become a shadow director in the borrower company by instructing or directing its affairs; becoming a shadow director could expose the lender to the general and fiduciary liabilities of a director.

Finally, taking an equity stake exposes the lender to the borrower's tax and other liabilities, and may require it to offer incentives to the borrower's shareholders to effect the debt-to-equity swap.

### Formal enforcement

Formal enforcement is not always an easy option. Insolvency law is debtor-friendly and designed to rescue companies in difficulty rather than aid the realisation of security. Moreover, in many cases the borrower is a limited-recourse SPV, and many of the available remedies for enforcing security are either inappropriate or inherently risky. The main remedies available to a lender are as follows:

- **Court proceedings:** Proceedings to recover debt can be made against the borrower and/or any guarantor. This might not be an option if the borrower or the borrower group is struggling and, more significantly, it will almost certainly compromise the project and therefore the value of the security and the chances of recouping the loan. Hence, this is an unusual route for a lender to take.
- **Take possession of and/or exercise powers of sale over the development site:** If the lender has a charge, it will normally have these rights both under statute and the terms of the legal charge. However, taking possession is not straightforward, and if the developer is unwilling to relinquish possession, it will be necessary to go to court. By taking possession, the lender may have to assume certain liabilities, such as the potential liability for clean-up costs



## The successful completion of a project may be crucial to the recovery of the funds advanced, and a strict enforcement of the loan and related security may leave the lender out of pocket

under the Environmental Protection Act 1990, as mortgagee in possession. It will therefore want to avoid possession and instead appoint a receiver under the Law of Property Act 1925 (LPA).

● **Appoint a receiver under the LPA:** This is the most common enforcement route for a lender with security over land. An LPA receiver is considered to be the agent of the mortgagor, but his or her primary duty is to the lender. The latter has to decide whether the receiver should be appointed or whether it would be quicker and cheaper to dispose of the property itself. It may be preferable to appoint a receiver if the development property is partially completed and cannot be disposed of immediately and/or it has potential environmental liabilities.

● **Appointment of an administrator:** The lender can appoint an administrator if the borrower is insolvent (on either a cash-flow or balance-sheet basis) and the lender has an "all assets" security (typically, security over the borrower's shares and assets).

However, the administrator's primary aim will be to rescue the borrower as a going concern, and it will act in the interests of all creditors, rather than those of the lender. In addition, a moratorium will take effect upon the appointment of an administrator. This will prevent (in the absence of either the administrator's consent or the leave of the court) action from being taken to enforce security over the borrower's property and legal processes from being begun or continued.

● **Exercise of step-in rights:** It is common for lenders to have the benefit of collateral warranties from the professional team, main contractor and subcontractors (the building team). The warranties usually contain step-in rights, allowing a lender to

step into the shoes of the developer by serving notice on the relevant building team member. The lender does not require the consent of the building team member or the borrower, although the relevant member of the team may reserve the right to terminate its appointment by giving notice.

The step-in right transfers to the lender the developer's rights under the construction contract. However, the lender needs to be careful because it will assume the developer's obligations under the relevant contracts. It may consider exercising step-in rights to ensure the smooth running of the project, but, before doing so, it will need to understand the potential obligations and should try to renegotiate elements of the construction contracts in order to protect its position.

### Planning consequences of delays

If the parties are considering delaying a development until there are signs of a recovery, they should first consider the life of the planning permission and any conditions precedent. Unless an extension is specifically requested, the life of a planning permission is three years.

If a planning permission lapses, it may prove difficult to renew it, especially where the development plan for the area has changed or planning obligations apply.

Further, planning permissions are often subject to conditions precedent. If a project is mothballed, the developer may be unable to comply with these sufficiently promptly to enable the development to be restarted within the three-year planning window. If the developer tries to circumvent this by carrying out initial works to preserve the permission, it may incur payments under section 106 and 278 agreements. Also in such cases, the local authority has the power (rarely exercised) to serve a planning enforcement notice requiring the completion of the development.

### Getting together

Lenders must carefully monitor ongoing projects and anticipate and identify any problems at an early stage. In many cases, strict enforcement is not desirable and could create rather than solve problems. The lender should seek professional advice on the options available to it and the potential risks.

Developments are often complex and will involve many interested parties – contractors, professional teams, prelet counter-parties, purchasers and local planning authorities. Co-operation and assistance between the parties will be crucial to weather these tough times and to provide the lender with a decent chance of recovering its loan.

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