Defaulting ... on purpose

Some developers and building owners opt to stop paying mortgages to get better loan terms

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By David Jones

575 Lexington Avenue has been transferred to a special servicer in an effort to renegotiate loan terms

As the commercial market continues to struggle in New York, an increasing number of developers here are turning to so-called strategic defaults to force lenders and special servicers to enter into negotiations for loan restructurings.

The trend comes at a time when lenders are under increased pressure to keep their loans current. It also comes as developers are struggling to maintain the cash flow they promised their lenders during original loan negotiations.

And the number of strategic defaults -- where the borrower may technically be capable of making the loan payment, but delays doing so as a way to improve his negotiating hand -- is expected to rise even more in the near future.

"Sometimes [it] literally has to show up as a nonperforming loan to get any movement as a workout from a lender," said Matthew Anderson, a principal at Foresight Analytics, a market research firm. "You can also understand from the lender's standpoint that they don't want to be handing out a loan modification without a valid reason, because that creates a loss on their books."

Another reason for the increased number of strategic defaults has been the rise in mortgage-backed securities, in which loans are bundled up and sold as collateral to outside investors. Unlike unbundled loans, where a local banker often has a relationship with a borrower, bundled loans are often managed by so-called special servicers, hired guns brought in to manage troubled loans. Strategic defaults can be a way of grabbing special servicers' attention, according to analysts and legal experts.

About $7.5 billion of currently outstanding New York City real estate loans have been transferred into special servicing, with $3 billion, or 40 percent of those loans, transferred for the purpose of working out new terms, according to Trepp, a Manhattan-based commercial mortgage research firm.

Among the buildings in that category are Kushner Companies' 666 Fifth Avenue, the Moinian Group's 180 Maiden Lane and Murray Hill Properties' One Park Avenue.

Part of the reason for these strategic defaults is that billions of dollars in loans were written during the boom based on rent projections and residential sales targets that have fallen well short of those bullish expectations. Now, some developers are trying to renegotiate the terms of their loans to make them more affordable and to avoid the even more dire fate of foreclosure.

In some cases, the strategy has worked.

"We had one deal in New York where a project was stalling and the bank told [the borrower] to go jump in a lake," said Herrick, Feinstein attorney Dennis Russo. "[But] all of a sudden when the borrower defaulted, discussions were had, and the loan was worked out to the benefit of both parties."

Attorney Jon Stewart of Cole Schotz explained that when a special servicer is involved, things can be a little more complicated, because servicers do not work on behalf of the lenders and have very little flexibility to negotiate with borrowers.

"When you're talking about securitized loans, you're talking about a situation where there is a servicer," said Stewart. "The lender no longer has a [direct] interest in the loan. The servicer is working on behalf of the bondholders. In that instance, the servicer has very little ability to deal directly with the borrower."

Manhattan attorney Steven Meister said a lot of developers in New York are now choosing between renovating their properties and keeping up with bank payments. For example, in office buildings where rents are less than originally projected, a developer may opt to build out space -- which could help secure a new tenant -- rather than stay current on mortgage payments.

One of the most closely watched negotiations in Manhattan involves 666 Fifth Avenue, which Kushner bought in a record deal for $1.8 billion in 2007.

Kushner declined to comment for this story, but in March, it transferred the $1.2 billion senior mortgage at the building to LNR Partners special servicing as part of an effort to renegotiate. The loan was not scheduled to mature for seven years; however, asking rents at the building have fallen precipitously since the company bought the property.

According to a March report by Deutsche Bank, the building was 86 percent leased, compared to 98 percent full at the time of the deal.

The purchase was based on projected rents of $110 per square foot; asking rents have fallen to $60 to $80 per square foot, and recent leases have been signed at only $55-to-$65-per-square-foot rates, according to the report.

"Given the degree of uncertainty regarding the property's future cash flow, it will be interesting to see what type of modification the borrower requests and, more importantly, what type [if any] LNR accepts," analyst Richard Parkus wrote in the report.

Business has started to pick up at the building since the loan was transferred. In April, a record $300 million deal was signed with Japanese retailer Uniqlo to lease the building's 100,000-square-foot retail condo for 15 years. An existing tenant, Vinson & Elkins, also agreed to renew its lease and take an additional 6,972 square feet, bringing its new lease total to 81,000 square feet.

Meanwhile, as Crain's reported, developer Larry Silverstein has also transferred his $325 million loan at 575 Lexington into special servicing as part of "ongoing negotiations between the lender and the loan holder."

Silverstein and the California State Teachers Retirement System bought the property in October 2006 for $400 million, or $665 per square foot. The property loan, set to mature in 2012, was written based on a debt service coverage ratio of 1.14 and an occupancy rate of 94 percent. However, after the economy went south in 2008, the property's debt service coverage ratio fell to 0.69, while the occupancy rate dropped to 90 percent.

According to Silverstein Properties' listings, the 612,000-square-foot tower has 103,000 square feet available at $45 to $53 a square foot and a 22,000-square-foot lease pending on one floor at $50 a square foot.

Both are well below the $70-a-square-foot asking rents listed before the developer bought the building. A Silverstein spokesperson could not be reached for comment.

Gregg Winter, president of Manhattan-based hard money lender W Financial, said another factor in whether the borrower opts for a strategic default is the financial strength of a lender. "If a lender has 50 loans on its books, 30 are in trouble and 20 are land loans, that's going to be one set of circumstances," said Winter. "If a lender has quality loans and has one borrower with a problem in a cash-flowing property, that's an entirely different circumstance."

Winter faced an unexpected issue with a borrower when 20 Bayard in Williamsburg fell into bankruptcy due to the developer's inability to refinance a one-year bridge loan that his firm refinanced from iStar Financial.