The Calm Before the (Litigation) Storm?

By Paul Bubny
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NEW YORK CITY—Veteran real estate attorney **Y. David Scharf**, partner with Morrison Cohen LLP, has gone to court on numerous occasions for parties linked to the Plaza Hotel, the Sears Tower and the General Motors Building, among other well-known properties. His clients as a trial lawyer and litigator have ranged from private equity funds to developers. At the moment, he says, commercial real estate is far from the kind of litigious environment we saw in the aftermath of the 2008 financial crisis. Here, he provides his views on what's behind the comparative lull—and what factors could bring it to an end.

GlobeSt.com: Have you observed any particular types of litigation on the rise in recent months?

Y. David Scharf: Quite the contrary. The past six months or so, including the fourth quarter of 2016 through the first quarter of 2017, has actually been a very quiet period of time for real estate litigation. A very different feel than in the two years before that, which again was a very different feel than during the recession and coming out of it, as well as the two years leading up to the recession. In each of those segments, there really wasn't any quiet period. I don't know whether what I'm seeing is the quiet before the storm, or it's something else.

GlobeSt.com: What's behind this lower-volume environment?

Scharf: I think the quiet we're seeing now is because the market is trying to find a supply-and-demand balance. What I mean by that is, there is a lot of supply that is coming on line, there is development that is happening and there is capital aplenty from many different sources: the private equity world, REITs and traditional lenders as well as local S&Ls that are out there lending. Usually when we see litigation, it's because we see some type of supply/demand displacement, which causes people to either litigate to get access to deals or litigate to get out of deals which in hindsight turned out to be bad ideas. I think the period of quiet that we're in right now is due to capital aplenty, supply-and-demand curves not being out of whack and a generally good feel in New York from a business environment perspective.

GlobeSt.com: Whether or not it leads to any litigation, are you seeing any potential cracks in that armor right now?

Scharf: The first place we're going to see any crack in the armor is if we end up in a rising interest rate environment. Takeout financings on projects that are currently underway are going to feel the pressure, especially projects that have incurred cost overruns or that will be delayed. This will make their break-evens get a little higher and put more pressure on their being able to reach certain sales or development hurdles in order to be able to make takeout

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financing. If we get a rising interest rate environment, the projects that are behind schedule or above cost will be the first ones in distress.

GlobeSt.com: The general understanding is that the Federal Reserve is going to increase the federal funds rate gradually. Do you anticipate that certain projects will feel the pressure on a cumulative basis, after the Fed has implemented several increases of a quarter percentage point?

Scharf: Yes. And I don't think we'll see the effects of that until 2018, if the Fed keeps to what it has said it's going to do with incremental increases. It's going to be a cumulative effect for projects that are coming out of the ground and need more permanent capital as opposed to construction-type capital. They will be coming on line at a time when the cumulative rate increase will be out there in the market for more permanent financing. I think it'll be the confluence of those two events that could be the first line in the distress.

However, I think the first wave of distress is going to be absorbed into the market in a relatively seamless way, meaning that it won't be chaotic. The reason is that there are so many well-capitalized REITs and private equity firms, and they will very seamlessly gobble up that first wave, for a couple of reasons. One, they'll be the first to be well-capitalized and opportunistic, and they'll have the economies of their management teams and so on available. But number two, some of them are already out there and they are the construction lenders. They are the ones that have put some of this capital out there, and while it certainly wasn't intended as a loan-to-own situation, their underwriting was well-conceived and thought-through, so that their basis—if they had to step into the ownership role outside of the lender role—would be a very orderly and market-appropriate move.

GlobeSt.com: But it remains to be seen whether these moves lead to litigation….

Scharf: There are three things I would say about that. One, real estate developers, almost by their nature, are tough and hardened and will fight and claw for whatever they think is theirs. When there will be distress, litigation will follow.

Number two, restructuring—let's call it legal work—is sure to follow. With the capital aplenty that will be available to address the first wave of distress, there will be plenty of room for workouts. Those with the capital will be able to restructure the equity and debt stack to make it a more seamless transition for the old equity to take a back seat. The lender now coming into the equity position will be better able to manage and operate and turn a property in an operational, profitable one.

The third thing I will say is that I believe that, as with any opportunity—and I think we saw this in 2004 and 2005—when opportunity presents itself, whether it's opportunity based on distress or opportunity into a rising market, those who are well-capitalized start fighting amongst themselves. What we may see is jockeying for position in the debt stack on CMBS loans. You

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may see different tranches start to play for the control piece in order to start controlling assets from different debt positions. That always provides for legal analytics and very often a call to arms.

GlobeSt.com: Although it remains to be seen how active the litigation environment becomes over the next 12 to 18 months, certainly the potential is there.

Scharf: That's a very fair assumption. I don't think the quiet that we're seeing right now is the new norm. It's just a period of time that we haven't seen in a while, but it's a retrenching toward the future.

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