CHAPMAN
Focused on Finance

Investing in Distressed U.S. Real Estate

Distressed investments in real estate in the United States present unique opportunities for investors willing to accept increased levels of risk to generate value and higher returns.

The current U.S. real estate market is in a state of flux. On the one hand, commercial office buildings are still experiencing high vacancy rates, financial institutions continue to struggle with their investments in the office sector, and bank-loan delinquencies are climbing as collateral and loan ratios deteriorate.[1] Nevertheless, some see the current market at a potential low point and have begun to look to purchase distressed buildings.[2]

Similarly, the multifamily housing sector, under strain over the last few years due to increasing expenses and rising rates, has remained resilient in some areas of the United States while declining in others.

On a macro level, although the United States Federal Reserve cut interest rates over three consecutive cycles in 2024, raising hopes for lower borrowing costs, interest rates have remained stubbornly high. Yet others see pockets of opportunity and have started to make investments in the sector.

What does this all mean for potential investors?

What challenges will potential investors face when investing in commercial real estate in the U.S.?

Which strategies should investors embrace to mitigate risk?

This article will discuss the current state of the commercial real estate market, focusing on commercial office buildings and multifamily housing, and describe the various challenges and options for distressed real estate investors.

COMMERCIAL OFFICE BUILDINGS

Across the United States, office buildings are exhibiting nationwide distress. Since the outbreak of the Covid-19 Pandemic, the office sector has seen a broad shift to remote and hybrid work. Given their reduced in-office populations, tenants want to occupy smaller footprints. Simultaneously, the wide availability of space in newer buildings with greater amenities has allowed tenants to exert leverage over landlords to extract rent and other concessions. By the end of 2024, the office market reached a national vacancy rate of 19.8%.[3]

In addition to the historically high vacancies, and despite the U.S. Federal Reserve's cautious interest rate cuts at the end of 2024, mortgage and loan interest rates have barely budged and their future remains unclear.

Meanwhile, operating costs for landlords have increased substantially. In extreme cases, building rent rolls are insufficient to cover operating expenses, even before debt service. These factors have led to the deterioration of the underlying value of many properties, as project owners can no longer support the debt on their buildings or refinance debt as loans mature.

[1] *https://rsmus.com/insights/industries/real-estate/navigating-office-sector-distress-in-2025.html*
[2] *Id*
[3] *https://www.commercialedge.com/blog/national-office-report/*

MICHAEL FRIEDMAN
PARTNER, PRACTICE GROUP LEADER – SPECIAL SITUATIONS AND RESTRUCTURING GROUP, HEAD OF ISRAEL PRACTICE

HELENA HONIG
ASSOCIATE
SPECIAL SITUATIONS AND RESTRUCTURING GROUP

Despite these significant challenges, the market has not seen widespread foreclosures or distressed sales. Owners do not want to dispose of their assets in a down market, in the hopes that market conditions will improve to lift the value of their buildings and corresponding equity value. Potential buyers, on the other hand, are unwilling to pay current prices for assets they think are overvalued. Further, the banks and financial institutions holding the debt on these buildings are not motivated to either recognize losses on their loans or foreclose and become responsible for operating the assets.

In the current environment, most deals getting done happen either in the most distressed situations or as the result of forced sales, which further depresses pricing across the office market.

Notwithstanding these hurdles, there are reasons for optimism. Office leasing activity in New York City increased almost 50% from October 2023 to October 2024.[4] A growing number of employers are returning to full-time in-office policies, while some cities are rezoning office and commercial districts to allow for conversion of office space into residential real estate. Indeed, New York City has seen a growing trend of acquisitions of commercial office buildings for conversion into residential use.[5] As of October 2024, the housing vacancy rate was 1.4% and the city is now facing a shortage of more than 500,000 residential units. For enterprising investors, this could be an opportunity to convert real estate from a market with excess supply to a sector with strong demand.

MULTIFAMILY HOUSING

The market for multifamily housing shows greater regional differences. In the northeastern United States, rent growth is still strong. For example, the median asking rent in New York City rose 2.1% from October 2023 to October 2024, according to a report from StreetEasy.[6] Meanwhile, some news outlets are predicting that rents may decline in part because of a "construction boom" of new apartment buildings begun during the Covid-19 Pandemic.[7] Still, the volume of newly built apartments is more concentrated in some areas. For example, the median rent in Austin, Texas is $1,394 as of December 2024, down from $1,482 in August 2024 when the median

[4] *https://therealdeal.com/new-york/2025/02/03/a-strong-opening-shot-for-manhattan-office-leasing-in-january/*

[5] *https://www.forbes.com/sites/shimonshkury/2024/10/22/new-york-city-office-to-residential-conversions-heres-what-we-know/*

[6] *https://www.nytimes.com/2024/12/05/realestate/nyc-rent-prices.html*

[7] *https://www.cnbc.com/2025/01/31/2025-is-a-renters-market-heres-how-to-take-advantage.html*

price fell 17.6% from a year prior.[8] Yet, despite these headwinds, investors who have been on the sidelines are starting to dip their toes into the multifamily market and multifamily housing is predicted by some to be one of the most preferred asset classes for real estate investors in 2025.[9]

LENDERS IN THE CURRENT MARKET

Given this climate, lenders are adjusting their behaviors and market positions. Notably, some U.S. banks are trying to avoid or reduce their commercial real estate holdings. Traditionally, banks were willing to foreclose on real estate assets and run their own turnaround processes to improve performance over a period of years. That approach required a significant investment of time, resources and expertise to turn an underperforming asset into a performing one.

Nowadays, banks prefer to avoid having underperforming assets on their books and are reluctant to foreclose on commercial real estate. Their old playbooks for turning real estate assets around is now more expensive, with a higher cost of capital. When coupled with the competition presented by new buildings, along with lower demand from tenants, getting an office building to a position in which its rent roll supports its debt requires a level of investment and commitment that many banks are unwilling to put in.

OPPORTUNITIES IN THE MARKET

For distressed real estate investors, investments can be structured as either a direct acquisition of property, or as a purchase of loans from the current lender. Investors can purchase properties from the current owners or, in some cases, directly from a bank through a foreclosure process or as part of a bankruptcy sale process.

Investors also have the option of purchasing loans supported by real estate assets from the existing lenders, frequently at a discount to the outstanding loan balance.

[8] *Id*

[9] *https://therealdeal.com/new-york/2025/01/27/lenders-poured-cash-into-multifamily-last-month/*

By purchasing at a discount, the new lender can "reset" the loan to reflect the realities of the underlying real estate. Following the purchase of the loan, the new lender can either negotiate a loan workout with the borrower or foreclose on the mortgage securing the underlying property.

FORECLOSURE AND BANKRUPTCY SALES

For investors looking to purchase property as part of a foreclosure sale, the length of the process depends on the jurisdiction in which the property is located and whether the collateral subject to the foreclosure is the property itself or the equity of the entity that owns the property.

MORTGAGE FORECLOSURE

Where the foreclosure is on the property itself (a "mortgage foreclosure"), in some states, mortgage foreclosure is a nonjudicial process (i.e., a process that does not require a court proceeding) that can take a few months. In these jurisdictions, lenders can foreclose by invoking the "power of sale" clause in the mortgage contract, which authorizes them to seize and sell the property, subject to the borrower's right to cure the default. If the borrower fails to do so, a notice of sale of the property is issued for a 90-day window, after which the property is auctioned.

However, in other states (including New York), mortgage foreclosure is a judicial process that can take 1-2 years before the lender can actually take possession of the property or sell it to a third party.

In a judicial foreclosure, the lender must commence a formal lawsuit against the borrower and obtain a judgement for foreclosure. The judgment is thereafter enforceable against the borrower, which allows the lender to take possession of and sell the property.

UCC FORECLOSURE

Where the lender is foreclosing on the equity of the borrower rather than on the property itself (a "UCC foreclosure"), the Uniform Commercial Code of the applicable state jurisdiction will govern the auction and sale process, which can typically be accomplished in 30-90 days. Secured lenders pursuing their remedy of foreclosure will publish notice to potential purchasers containing the bidding procedures and any other terms governing the sale, including the time and place of any auction to be held and how interested parties become qualified to attend and bid at the auction. Lenders are entitled to "credit bid" (i.e., bid the cancellation of all or a portion of the outstanding debt as opposed to cash), meaning that any third party looking to purchase the property will have to bid in excess of what the lender is owed unless the lender agrees to accept less than its entire debt.

BANKRUPTCY SALES

There are also opportunities to invest in distressed real estate as part of a sale conducted in a bankruptcy proceeding. In a voluntary bankruptcy case filed by the borrower, the borrower and lender cooperate to sell the property through a court-supervised and approved marketing process. Lenders may also file an involuntary bankruptcy case against the borrower to force a sale of its property over the borrower's objection.

The advantages to the purchaser of buying real estate in bankruptcy includes the ability to submit a stalking horse bid that entitles the purchaser to bid protections, which often include a break-up fee and expense reimbursement if the borrower pursues an alternative transaction. The purchaser can also obtain the property free and clear of liens, claims and encumbrances, including mechanics' lien and tax claims. To the extent any such claims exist, they would remain claims against the borrower but could not be pursued against the purchaser of the property. For the lender and the borrower, selling pursuant to a bankruptcy could shorten the sale timeline versus a mortgage foreclosure. In addition, a sale pursuant to a bankruptcy plan of reorganization could potentially be exempt from real estate transfer taxes which could save parties millions of dollars.

Nowadays, banks prefer to avoid having underperforming assets on their books and are reluctant to foreclose on commercial real estate.

LEGAL CONSIDERATIONS

Purchases of Properties

Potential purchasers of properties in a foreclosure sale should keep in mind certain considerations. First, properties sold in a foreclosure are typically sold on an "as is, where is" basis, with limited representations and warranties about the property. Accordingly, the purchaser will have limited recourse to the seller/lender for any issues it discovers following the sale. Purchasers should consider obtaining title insurance and conducting a full title search to uncover any title defects, as any lender policy will not protect a purchaser from those risks. Second, purchasers should consider that the borrower subject to the foreclosure can delay the timing of the sale by raising objections to the lender's conduct of the sale. Finally, a foreclosure sale, like any other sale of real estate, may also be subject to real estate transfer taxes that, depending on the applicable jurisdiction, could be owed on the sale (and pay mortgage recording taxes if the sale is going to be financed with a new mortgage).

Investors looking to purchase the equity of the borrower in a UCC foreclosure sale must keep in mind that, unlike a mortgage foreclosure, a purchaser of the equity in a UCC foreclosure sale would assume all the debts of the borrower including any mortgage debt, mechanics' liens, taxes and any other unsecured debt. Therefore, a purchaser must be comfortable that its purchase price for the equity is low enough to take into account the debts it will be assuming.

Loan Purchases

If opting to purchase real estate-backed loans, potential purchasers should closely review the provisions of the loan and other security documents creating and perfecting the lien, in addition to carefully evaluating the underlying property. This includes obtaining lien and title searches to ensure all liens and mortgages are properly recorded and reviewing the loan file to determine if the borrower has raised defenses or claims against the lender. A purchaser in this scenario will often not have the opportunity to inspect the physical property the same way that a direct purchaser of real estate does. If the note seller is a bank or other financial institution, the lender may not have access to the property or a sufficient level of familiarity with the property to give representations or warranties regarding the property. Accordingly, it is advisable for purchasers to include mechanisms in the purchase agreement to protect against the risks they assume in acquiring the loan. These protections include lender representations regarding (i) its prior conduct with respect to the loan and (ii) its knowledge of claims asserted by the borrower, as well as indemnification by the lender in the event the purchaser suffers a loss as a result of such actions or claims.

KEY RULES FOR INVESTING IN DISTRESSED REAL ESTATE

Understand the Local Market Trends. Do an analysis of the real estate you want to invest in relative to the performance of similar assets in the same market. The best distressed real estate investments are based on a strong understanding of market trends for the kind of asset you are buying.

Due Diligence is Key. Due diligence considerations include (i) whether the real estate is over-leveraged, (ii) whether the real estate has bad management, (iii) whether there are regulatory issues (e.g., zoning or rent regulation concerns), and (iv) what liabilities you would want to avoid as an investor. Evaluating these factors, and a property's prospects generally, are the keys to deciding whether there is enough likelihood that the value of the investment will increase over time.

Recognize that You May Need Help. Distressed investing introduces both challenges and opportunities that are not present in "non distressed" sales. It is important to discuss any such transaction with a professional that is experienced in distressed transactions and can properly advise potential investors as to how to mitigate risks and take advantage of opportunities.

Understand the Mechanics. Most importantly, know what your obligations are, and be familiar with what happens in a worst-case scenario. Being prepared is the best way to monitor and protect your investment.

CONCLUSION

Distressed investments in real estate are not for everyone but present unique opportunities for investors willing to accept increased levels of risk to generate value and higher returns. We believe that the current market will generate significant opportunities to invest in distressed real estate.

Of course, as with any investment but, particularly with distressed investments, legal and financial diligence and structure are key. Chapman invites inquiries and questions on this topic and stands ready to advise on the legal aspects of distressed real estate investing in the U.S. ■

It is advisable for purchasers to include mechanisms in the purchase agreement to protect against the risks they assume in acquiring the loan.

US legal advisor to Israeli investors, financial institutions and fintechs

Chapman's focus on finance, combined with our substantial experience representing Israeli clients, makes us uniquely situated to advise Israeli investment funds, financial institutions, fintechs, and law firms seeking US-based counsel in finance and regulatory related matters, including:

- Loans and debt issuances
- Acquisitions and investments
- Restructuring and litigation matters
- Business entry and operations
- Fund formation and investments in private funds
- Asset securitization and warehouse lines

Chapman is highly ranked in Israel Desk's 2024 League Tables—we are a Top 10 law firm in both the Capital Markets and Real Estate categories and Michael Friedman is listed as a Recognized Practitioner.

Talk to us about your next project:
Michael Friedman
+1 212.655.2508
friedman@chapman.com

CHAPMAN
Focused on Finance®

Chapman and Cutler LLP • chapman.com • Attorney Advertising Material.
Charlotte • Chicago • New York • Salt Lake City • San Francisco • Washington, DC