



The Game Theory of Loan Workouts

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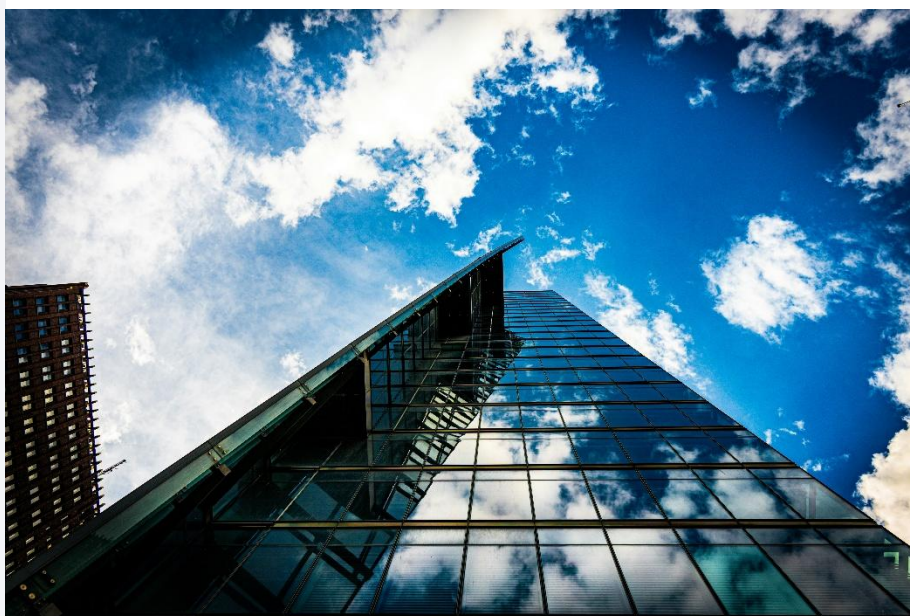
Why a workout is a process, not a deal.

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Key takeaways

- A lender weighs every proposal against its own enforcement recovery. A modification wins only when the borrower shows it beats foreclosure and that leaving the borrower in control is safe.
- Every exchange is evidence. Diligence responses, consents, vendor payments and the tone of each call shape the lender's view of the borrower well before credit committee votes.
- Leverage in a workout is built through preparation rather than posture. Early property knowledge, credible commitments and a first offer designed backward from the final decision do more than relationships or litigation threats.

Introduction

Borrowers hire us to restructure commercial real estate loans, and that often requires the lender to accept a discount. This booking of a loss, even when it is the lender's best available outcome, isn't something that comes easily. Asking politely or going over an asset manager's head is not the path to have an institution accept reality. The borrower must show why the discount serves the lender better than the alternative, and why doubling down on a failed borrower is reputationally sound for the asset manager.

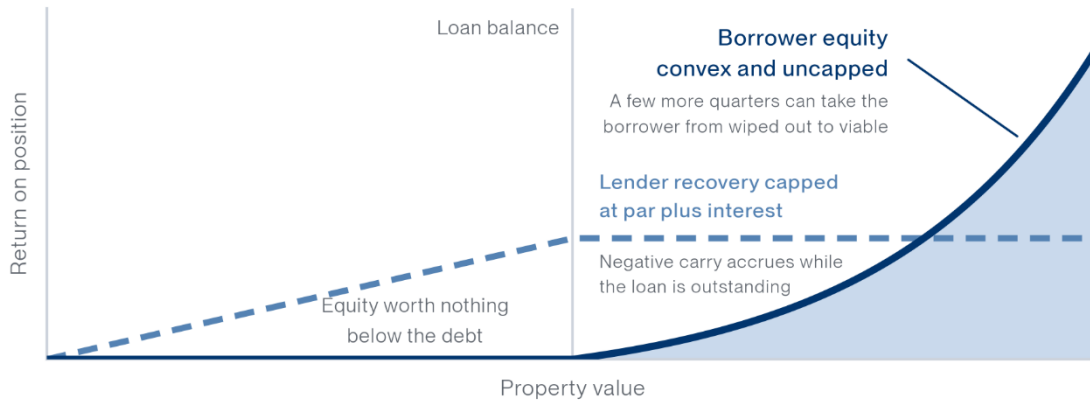
Game theory is the study of decisions in which the result depends on what the other party decides, so neither side can choose well until it has worked out what the other will do. In a workout, the lender decides whether to modify or foreclose based on what it expects from the borrower, and the borrower's proposal only works if it reads the lender correctly.

The borrower is long an option that gains value with time; the lender is short the same option and paying to stay in it.

Waiting impacts the two sides of a workout differently. The borrower's equity is a call option on the property struck at the loan balance. It is worth nothing while the asset trades below the debt, and it captures every dollar of recovery above it. If the market recovers, that payoff is convex, so a few more quarters can take the borrower from a wiped-out position to a viable one. A discount does the same thing from the other direction, because lowering the debt moves the option back into the money, which is why a restructuring that costs the lender a little can be worth a great deal to the borrower.

The lender holds the opposite position. Its payoff is capped at par plus interest however far the asset recovers, and its cost of funds accrues every month the loan is outstanding, so waiting is a negative carry on a non-performing loan. The borrower is long an option that gains value with time; the lender is short the same option and paying to stay in it.

Who gains when the property recovers



Here's a game theory example proving economics alone isn't enough. The Ultimatum Game is when one player holds \$100 and proposes a split. If the second player accepts, both keep their shares. If the second player rejects, neither gets anything. A purely rational second player would accept \$10, since \$10 beats zero. In practice, people reject offers they consider unfair, giving up their own share to deny the other side its \$90.¹

Lenders focus on more than numbers. While rejecting a borrower's discount offer can be wrong economically, a bad borrower, especially under a modification, can be politically damaging to the individual and the firm. Some resolutions leave the borrower visibly better off at the lender's expense, or make the lender look wrong for having made the loan to begin with.

Commercial real estate usually measures success by closed deals. For a loan workout, success is built to a crescendo and every decision impacts the next one in a process, even to the extent that consequences may appear several moves later.

A borrower skilled in operations is unlikely to also be skilled in loan workout negotiations, and in fairness, an operator skilled in loan workout negotiations is likely not the type of operator that instills confidence in their lender. Out-of-court commercial real estate restructuring is a small and unusual corner of the industry, and its many moving parts are often underappreciated. Its perceived simplicity belies its complexity.

Bankruptcy, on the other hand, is plainly complex and includes a legal venue. Loan documents, however, put protections against bankruptcy filings, and the statute itself is positioned to deter single asset real estate filings.

In out-of-court commercial real estate loan workouts, the best way for the borrower to manufacture leverage is to share its institutional knowledge of the property, tenants, market and future potential. Any lender stepping in must start from scratch. Helping the lender with transparency helps frame the negotiation in realistic terms to produce better chances of borrower success.

What follows examines the simplest workout form. One lender, one borrower, one property, and no court.

Buckle up, this is not simple.



1. Asymmetric Bargaining

The highest form of strategy is to resolve conflict before it becomes a contest.

Borrowers often reach out to us after they have received a notice of default or tried every form of reasoning, bargaining, and begging with what they call an inflexible lender. That is akin to visiting the surgeon once someone has already opened themselves up.

Borrowers also arrive equipped with a plan and their opinions on how to get there. Then they ask whether we know the lender and have a relationship. We typically do, but that's the wrong question. In a workout, the door is open because you're the borrower, but the goal is the right number and that takes more than a relationship. The time for relationships is when there is a proposal that is seemingly the best possible outcome for the lender, and the borrower has checked all the boxes discussed below, but nonetheless seems to be coming up against a brick wall.

When lenders decide how to resolve a distressed loan, they compare the cost of a proposed modification with the expected recovery they would receive from foreclosure and liquidation. John Forbes Nash Jr. modeled the general form of that comparison in “The Bargaining Problem,” published in *Econometrica* in April 1950 while he was a graduate student at Princeton.²

Nash explored how two parties split a gain they can obtain only by agreeing. The split depends on what each party gains over its fallback option, and the side with the better alternative wins.

In most real estate deals, both sides want the trade to close. A workout has no FOMO on the lender’s side.

Other economists added bargaining power to the model. John Harsanyi and Reinhard Selten, who shared the 1994 Nobel Prize with Nash, published a generalized version of his solution in 1972. Ehud Kalai built on it in 1977, in his paper exploring parties with unequal strength. In such an asymmetric version, the lender almost always carries the heavier weight (leverage). Part of that weight is the lender’s sense that the borrower is desperate to avoid the foreclosure alternative.³

In most real estate deals, both sides want the trade to close. A buyer who pulls back creates leverage because the seller fears missing out and may soften its position. A workout has no FOMO on the lender’s side. The lender doesn’t want the modification, it wants its money, and foreclosure and liquidation is one way to get at least some of it. A lender, on the other hand, can reject proposals and force the borrower to negotiate against itself. The borrower’s leverage, in some cases, may simply be the lender’s reluctance to take back a cash-draining asset. Don’t rely on that.

Sonja Brangewitz and Jan-Philip Gamp showed in a 2011 working paper that “every bargaining game is a market game.” While their results were more technical, the core result applies to a workout. The borrower’s proposal competes in a market with the lender’s enforcement recovery. If enforcement seems it will produce a better outcome, the lender will reject the proposal.⁴

Borrowers rarely see the lender’s analysis, so it must help develop it as much as possible. This includes presenting an abundance of information, processed and analyzed to conclusion. The earlier this is presented, with a credible solution, the less chance a borrower runs up against difficult lender conclusions.

2. Best Response

Reply to Influence

A one-way negotiation with a lender that seems unwilling to “negotiate in good faith” (as many borrowers often suggest) can test even a seasoned investor. But the anger is usually unfounded and, frankly, not a productive use of energy. The counterparty has the economic equivalent of a loaded gun, and the lender has no obligation to act in good faith beyond what the documents require.

Fairness does not change the immediate payoff, and if being right is so important, go ahead and be dead right.

Game theory calls the rational reply a Best Response. This means the choice that produces the best result given the other player’s move. Each player treats the other’s move as fixed and asks, “Given that, what is my best option?” Think of vehicles at a four-way stop. If the other driver is already rolling through, braking is the best response even when you have the right of way. Fairness does not change the immediate payoff, and if being right is so important, go ahead and be dead right.⁵

The Best Response advances the borrower’s objective, whatever the lender’s conduct. Some lender asset managers speak sharply, respond

slowly, and still demand speed and cooperation. Between parties with comparable leverage, matching that posture may sometimes be rational.

Most real estate professionals have a sharp negotiation style. A lender that refuses to initially concede a single point can seem, to a real estate negotiator skilled in deal closings, like a “waste of time,” “not real,” and decide to “let’s just move on and call counsel.” These are bad assessments and a potential legal case where only the attorneys make money.

The better move is to ignore the drama and understand that you need to sell them on yourself. Browbeating the lender’s asset manager will likely hurt the outcome, because even if it works, what looks like intransigence is likely just an asset manager still figuring out the asset and not yet ready to reveal their hand.

A good call with an asset manager is not approval.

It takes a combination of patience and the ability to feel vulnerable, something most real estate Type As are not used to. The asset manager may be working from a script, fighting for the borrower’s position against a strong senior party, or just moving slowly. A sharp reply alienates the

front line, while a civil, timely, good-faith response can keep temperatures where they need to be.

But here's a mistake many borrowers make: a good call with an asset manager is not approval.

The deal must survive each level of decision-making. Even once approved, non-controlling beneficiaries, such as upper-tranche bondholders, may also send a legal letter and try to jettison a modification by threatening suit.

3. Outside Options

A Threat to Walk Counts Only If Walking Pays

“only when dealing himself out gives the bargainer a bigger payoff than dealing himself in.”

Ken Binmore, Avner Shaked and John Sutton, 1989

In a workout, the lender's fallback (and often its easier option) is foreclosure. While the borrower cannot remove this ace, it can suggest, or rather prove, that enforcement isn't as attractive an option as the lender assumes. Foreclosure may leave the lender with operating deficits, deferred repairs, leasing risks, and a timetable controlled by the market and third-party providers, along with other problems outside its usual scope. Lenders are not operators.

Game theory calls each side's alternative to a deal its “outside option.” The Outside Option principle says that an alternative impacts a deal only when it pays more than the deal itself. Ken Binmore, Avner Shaked, and John Sutton tested the principle in 1989, and found that a threat to walk away is credible “only when dealing himself out gives the bargainer a bigger payoff than dealing himself in.”⁶

Take a car buyer with a written offer from a second dealer. If that offer is worse than what the first dealer is already offering, it's useless for the buyer. If it's better, the first dealer has to beat it or lose the sale, which sets the floor for the negotiation.

In distressed debt, facts on the ground are the borrower's best ally and can influence the lender's decision to foreclose more than theatrics and litigation.

The borrower doesn't know how the lender values its Outside Option, but it knows what those options involve. The borrower also knows the property better than anyone and can persuade the lender of such especially when it moves quickly.

If the borrower arrives late to the negotiation, and the lender already has a framework in mind, every story, plan, and proposal is then tested against the lender's already-completed fact-finding. In distressed debt, facts on the ground are the borrower's best ally and can influence the lender's decision to foreclose more than theatrics and litigation.

Showing that a takeover is expensive is not enough. Modifying the loan but leaving a weak operator in place doesn't solve market or borrower problems. A proposal that ignores operations, capital, or governance, or a borrower that pushes too hard, gives the lender reason to doubt the whole approach.

In our process, we show why a modification improves the lender's recovery, backed by a credible operating plan that the lender can underwrite and take to committee. We compare current performance with the original underwriting, separating market-driven problems, which help the borrower, from execution problems, which the plan must address directly.

A good example of why understanding how operational competence plays into the bigger picture is deferred repairs. They cut both ways, increasing the lender's cost of taking control, and can make a modification more attractive. But disclosing these deferred repairs allows the lender to make the borrower's addressing them a condition of doing a deal.

On the other hand, if the borrower distributed cash while property systems deteriorated, the lender may reasonably question whether the borrower will behave differently after receiving relief. Even when that sort of borrower reaches a deal, the lender pays a substantial credibility premium, colloquially known in the industry as schmuck insurance.

Finally, the borrower too has an Outside Option. Sometimes the right move is to walk from the property, and the willingness to do so may weaken the lender's perceived leverage. When the deal on the table is worth less than leaving, a consensual exit can be the better choice.

4. Incomplete Information

The Lender Works With What It Believes.

Lenders do not make instant decisions. Many borrowers think that emailing a set of facts will yield a modification proposal neatly packaged, but lenders are businesses with set processes. No matter the distress, they have to learn the asset, the borrower, and the situation, all while pursuing collection and enforcement. A deal, when it comes, is the product of the lender's work.

Thomas Bayes was an English Presbyterian minister and mathematician. In 1763, two years after his death, his friend Richard Price presented Bayes' manuscript, "An Essay Towards Solving a Problem in the Doctrine of Chances," to the Royal Society.⁷ The essay discussed inverse probability, or the process of reasoning backward from what you have observed to the unknown cause behind it and the chances of its accuracy.

"Games with Incomplete Information Played by 'Bayesian' Players" was a three-part paper published in Management Science in 1967 and 1968 by John Harsanyi, a Hungarian-born economist. It deals with a player that may not know the other player's goals, the moves available, or what the other player knows.⁸ Each player still estimates its odds for every possibility, acts on that estimate, and revises it as the other side's conduct reveals more. A Bayesian game is

one in which a party acts without knowing all the facts, which changes the payoff.

The borrower, therefore, must manage the evidence that shapes the lender's view.

In a workout, the lender models two uncertain recoveries. It compares what it gets if it takes the property in foreclosure versus leaving the borrower in control, with or without a discounted payoff. It cannot know whether vacancy or distress reflects the market, the asset, or the operator. Lender diligence involves evidence gathering about both property and borrower, and uses that evidence to update its recovery cases.

If the lender decides that the borrower caused the distress, it may view foreclosure as the better recovery, even when the real problem is the floor plate or weak market demand. If the borrower then proves it can attract tenants, the lender may model modification as the better outcome. The borrower, therefore, must manage the evidence that shapes the lender's view.



5. Repeated Games

Repeated Opportunity.

The lender forms those beliefs through what game theory calls a Repeated Game. Each side sees the previous actions, and based on observations chooses the next move. Observable, reliable behavior can build trust and improve later treatment, while opportunistic undercutting erodes good will.⁹

Each stage of a workout builds on the one before it. Diligence, modification negotiations, closing, and post-closing performance involve different choices and consequences. The Repeated Game still applies because each phase produces evidence about how the borrower will behave in the next one, including the next loan.

A lack of preparation may be the cause, but to the lender, it looks like an unwillingness or inability to cooperate.

If the lender believes the borrower caused the original default, it may also assume the borrower will fail under modified terms. The process of a workout lets the lender test that belief before it commits.

Responsiveness and candor are part of this test because the lender will require both after closing. If a routine question produces delay and repeated follow-up during negotiations, the lender may expect the same behavior after modification. A lack of preparation may be the cause, but to the lender, it looks like an unwillingness or inability to cooperate.

6. Principal-Agent Problems

Alignment of Incentives.

A Principal-Agent problem occurs when the person acting has different information and often a different incentive, from the person bearing the consequences of the action.¹⁰ A property manager whose fee is unpaid may cut staff, while the owner thinks bills and vendors are being managed during the crisis, which is seldom the case. We therefore help oversee the day-to-day operating issues because a property-management failure is a borrower failure, which confirms the lender's worst possible assumptions about the borrower.

Despite being in default, a borrower can still show reliability and competence under pressure.

Much of our work is managing communications with the lender so that they receive prompt, accurate answers about the property, and if a request needs follow-up or the answer isn't clear-cut, we provide a clear timetable and then send the best true answer with backup. Despite being in default, a borrower can still show reliability and competence under pressure.

We help avoid last-minute emergencies, keep the lender informed of leases and capital needs, and create time for decisions while options remain. Promptness and transparency protect asset value, show the borrower's involvement, and

convince the lender to forgo a receiver. Keeping the lender informed also prevents the borrower from wasting time and money on unapproved initiatives and helps push through live deals with lender guidance.

But with cash being trapped and lenders being slow to release funds, emergencies and utility shutoff notices will happen. Borrowers must therefore have a protocol in place to keep operational expenses flowing, and we bring that to the table.

We are transparent with what is owed, why it remains unpaid, why payment is necessary, and when it must occur. After the release, we confirm that the vendor received the funds and prepare the next request to the same standard. We also keep the lender involved in the decision-making around major repairs and replacements so that they are pre-approved and then funded.

The riskier it looks to leave the borrower in control, the more attractive foreclosure becomes.

We ask borrowers to engage us at least 60 to 90 days before default so we can do all the work, and more, described above, so that we can avoid bad valuations and operational failures, and deliver a documented story and plan on day one that will

survive scrutiny. Raw reporting, inconsistencies, and unanswered follow-ups create credibility risk. Instead, we guide the borrower to present as institutional, prepared, and proactive, qualities that seldom appear together on a distressed property.

An advisor focused only on making a deal is playing a numbers game. They often miss the credibility issue and leave the borrower relying on flimsy leverage and uninformed operations. The riskier it looks to leave the borrower in control, the more attractive foreclosure becomes.

7. Credible Commitments

Costly Commitments are Valuable

A promise is only as good as the promiser's motivation to keep it when the time comes, a problem game theory calls the Commitment Problem. One side acts first and the other acts later.

If breaking the promise is the second side's best move when its turn comes, the first side should expect it to be broken. The Stanford Encyclopedia of Philosophy's entry on Game Theory calls a promise or threat like that "cheap talk."¹¹

Suppose I want to buy your land, but you won't accept my price. I threaten to build a foul-smelling sewage plant next door unless you sell. You know the plant would damage my property too, so you have a reason to call my bluff. If you refuse, I would rather abandon the threat than carry it out.

Now suppose I sign a binding contract to supply fertilizer from that plant, with a provision allowing me to cancel if you sell me your land. Backing down now means breaking another agreement. If that obligation makes backing out more costly for me, you have a reason to take the threat seriously. That

is a commitment: I changed my future choices through an action you can see.

A party can make a promise credible by visibly surrendering its option to break it. Thomas Schelling, who shared the 2005 Nobel Prize in economics, showed that "a party can strengthen its position by overtly worsening its own options." The other side can rely on the commitment because breach no longer pays.

"A party can strengthen its position by overtly worsening its own options."

Thomas Schelling, 2005 Nobel Prize in economics

This is where borrowers go wrong all the time.

The lender might make a demand that plainly worsens the borrower's options, like tough language in the pre-negotiation agreement or consent to a receiver. Borrowers with a decisive posture often take a hard line without understanding the request. The lender is asking for a commitment with teeth. Save the fight for when it counts and you can point to the easy gives you already committed to down the line.

A pre-negotiation agreement may waive defenses the borrower could assert in court, but lender counsel often attempts to protect those rights despite their shelf life being the time between the defendant's submission of a response and the judge's ruling on summary judgment. Let me be clear, if a defense is viable,

preserving it and perhaps leading with it may help for leverage purposes. If it is not, trade it for whatever stipulations the lender values.

A request for a receiver means the lender has lost confidence in the borrower. Many loan documents already include consent to a receiver after default, and the lender may be able to obtain one without the borrower's cooperation. Counsel can say how strong that position is under the documents and in the jurisdiction. Where it is strong, consenting costs the borrower little, and the lender will read the consent as a credible commitment to act in good faith, a good first step toward revising the lender's assumptions about the borrower.

8. Assurance Games

Who goes first?

An operating shortfall creates what game theory calls an Assurance Game, where each side funds only if the other does.¹² The lender can let payables pile up, foreclose, and leave the vendors behind. The borrower cannot, because it needs those vendors, especially if it keeps the property. If the lender agrees to fund part of the shortfall when the borrower covers part, it has made a visible commitment, an assurance of its own.

Reciprocal performance, however, means each side funds its agreed share. In an Assurance Game, a commitment the other side can rely on can change the future outcome in favor of the initiating party. That tells the borrower the lender is committed to the negotiation, even if only to keep its own options open.

It does not bind the lender to another advance. None of this means accepting every lender demand, but a borrower that has not repaid its loan has to rebuild a pattern of good faith. We reserve conflict for positions that can be defended, and mostly for items involving capital, releases, economics, and concessions the borrower actually needs to succeed.

An operating shortfall as an assurance game

	Lender funds its share	Lender does not fund
Borrower funds its share	Both sides commit Each funds its share. Both are signaling they want the property to work.	Borrower carries it alone The borrower is telegraphing that it needs a deal. The lender gives up nothing.
Borrower does not fund	Lender carries it alone The lender takes the risk either way. Foreclosure could wipe out the payables, so it is keeping a deal open.	Payables pile up The lender is on track to foreclose and is concerned only with recovery.

This is not the prisoner's dilemma, where refusing may be the better move no matter what the other party does.¹³ It also doesn't mean that the borrower must choose only between fighting and walking away. They can reject a bad claim on Monday and professionally deliver complete backup on Tuesday. The lender may still reject the proposal, but it won't question whether the borrower will honor an agreement it would sign.



9. Backward Induction

Design the First Move Last

Backward induction begins with identifying the last decision required for the goal and working backward, assuming each party will act in its own interest at every later step.¹⁴

At CASE, we use this theory to stress-test an offer before recommending it. Based on what the lender will expect and what the borrower will need, we trace the offer through the likely responses at later decisions, and see where it leaves the borrower.

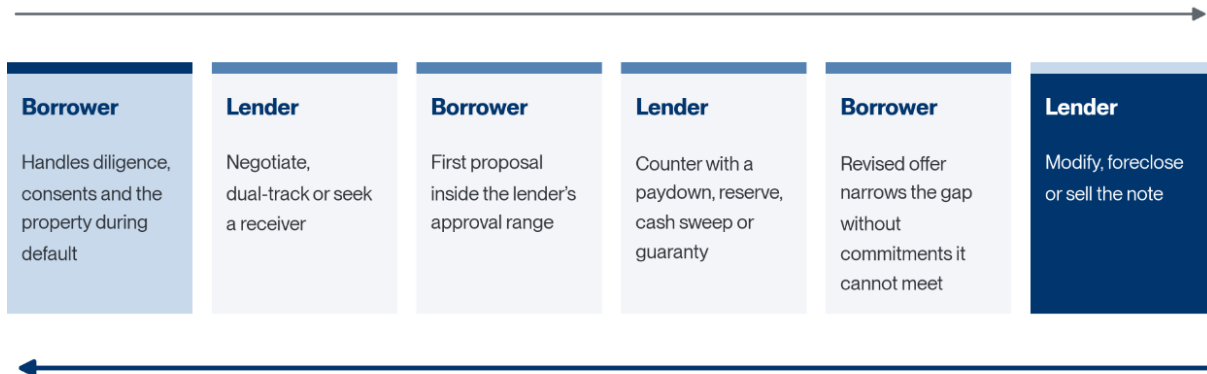
The lender's final choices are whether to modify, foreclose, or sell the note. The borrower accepts only terms it can perform and that are better than losing the property. The lender's final term sheet is limited to what committee approved.

Therefore, the sequence works backward:

- In reaching a deal, the borrower's revised offer will have to narrow the gap without commitments it cannot meet.
- The lender's previous counter may require a paydown, reserve, cash sweep, or guaranty.
- The borrower's first proposal must fall within the lender's approval range for it to consider negotiating a modification.
- The lender decided whether to negotiate, dual-track, or seek a receiver.

The workout is designed from the last decision back

Order of play



The borrower moves first, but that move is designed last

Order of design: start with the final decision

That decision tree will turn on how the borrower handles diligence, consents, and the property during default. The borrower acts first when it opens the workout negotiations, but that first move is the last one designed. Without that see-through visibility, the negotiation can pass the range the borrower can accept before the borrower notices.

10. Threat and Execution

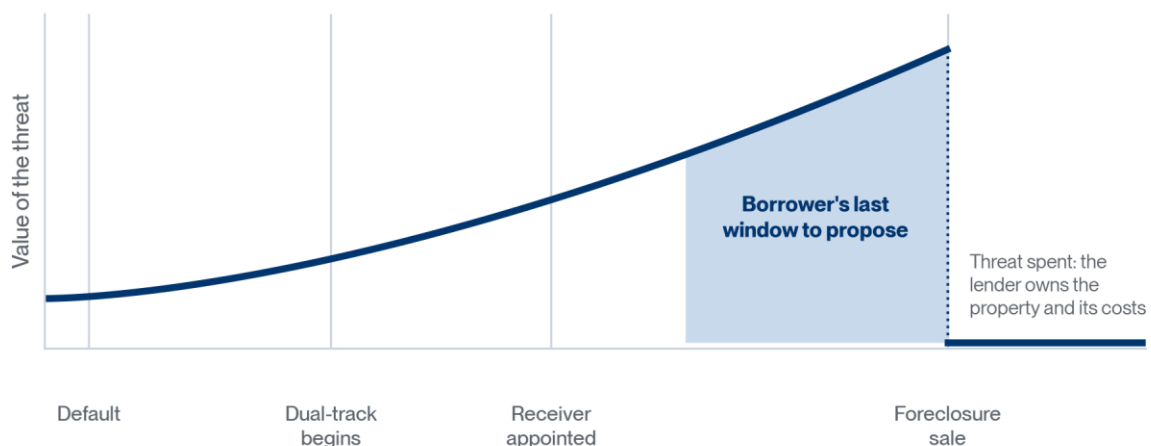
Be Careful What You Wish For

A lender raises the stakes by dual-tracking negotiations while pursuing foreclosure. Each step in the foreclosure tells the borrower how much time remains. The lender may also ask the court to appoint a receiver, which removes the borrower from control of the property and can discourage the borrower.

To a lender with a viable alternative, the foreclosure option can lose its attractiveness as it becomes real.

Foreclosure pressure squeezes the borrower until a sale, but it also ends the lender's chance at a better resolution with the borrower. In Ariel Rubinstein's bargaining model, two parties divide a fixed sum by trading offers, and each round of delay makes the eventual share worth less to both (Ariel Rubinstein, "Perfect Equilibrium in a Bargaining Model," *Econometrica*, 1982). The party that has more time to wait gets the larger share. Each side, therefore, has a reason to raise the other's cost of waiting.¹⁵

The threat of foreclosure peaks just before the sale



But this pressure runs both ways. The foreclosure process costs the lender legal fees, receiver fees, protective advances, and whatever value the property loses in the meantime through “placeholder management.” To a lender with a viable alternative, the foreclosure option can lose its attractiveness as it becomes real. When the lender actually forecloses, it loses its other options. The borrower can no longer offer a paydown, new capital, or a negotiated exit. The lender owns the property, its costs, and whatever price the market will pay, which might be less than a potential workout.

That gives the borrower one last window to propose a solution. By that time, the lender knows more about the property-level challenges and has seen the issues firsthand, including those that it may have previously dismissed as excuses. A borrower that kept the property operating, within its means, and then presents a credible proposal may give the lender a good reason to stop the clock. A borrower that spent the period stalling or railing against the lender is viewed as a time waster.

11. Hold-Up and Negotiation Arithmetic

Commitment can trigger a renegotiation

Hold-up begins when one party commits money or effort that is worth much less outside the relationship, and the other party uses that commitment to renegotiate. Consider a homeowner who hires a contractor to gut a kitchen. Once the cabinets are gutted, the contractor can demand more money to finish. The homeowner can refuse, but changing contractors costs time and money, and the kitchen is unusable. The contractor’s leverage comes from the homeowner’s sunk investment, not from any change in the work.

Benjamin Klein, Robert Crawford and Armen Alchian described the problem in 1978 in the *Journal of Law and Economics*.¹⁶ Oliver Hart’s Nobel lecture¹⁷ uses the example of a coal-fired power plant beside a coal mine. Before construction, the plant could have built near any mine. Once built, it depends on that mine, which can demand a higher price or threaten to ship poor coal. The plant pays because its alternatives disappeared when it committed to the mine. The threat works in advance, too; a party expecting to be held up invests less or refuses to invest at all.

A lender holding up a borrower, doesn’t automatically signal bad intent.

A modification creates the same exposure between term sheet and closing. Consider a hypothetical borrower with a \$40 million loan. The lender agrees to a nonbinding term sheet for a three-year extension in exchange for a \$2 million paydown and a \$1 million borrower-funded leasing reserve. To close, the borrower pays the lender's appraisal and legal fees, calls investor capital, and lets a refinance quote expire. It also signs a letter of intent with a tenant for a vacant floor, with improvements paid from the reserve. None of those steps can be undone, and each narrows the borrower's room to move.

Then the lender's draft arrives, riddled with terms. Every reserve release is subject to the lender's sole discretion, and the draft adds cash-management provisions the term sheet never mentioned. Each change can be defended as ordinary lender protection, but packed together they mean the reserve may never reach the tenant and the property's cash may never reach the borrower. The borrower can still walk, but its investors have funded, the refinance is gone, and the tenant is waiting.

A lender holding up a borrower, doesn't automatically signal bad intent. Its counsel often creates the hold-up without being asked, protecting the lender against every identified risk. The asset manager may defer on points called legal, even when those points move the economics. Every round adds time and legal fees, and the borrower usually pays both.

In negotiating open points, the lender may also tie any concessions to new asks. In 1983, James Sebenius called this Negotiation Arithmetic, adding or removing issues to change what each side will accept.¹⁸ A lender term that ties reserve language to a broader guaranty or new reporting obligation has turned one drafting point into a package that is harder to refuse piecemeal.

Pressing a hold-up costs the lender time, and in finance, time value is everything. Each new demand tells the borrower what the lender values and how much it wants the deal.

The borrower has to answer with equal care. Its alternatives have narrowed, so a threat to walk from a deal that still makes sense despite the lender's new ask may not be credible. An overreaction, however warranted, can unfairly raise doubts about how the borrower will behave after closing, especially if the lender's ask is fair. Challenging items in retaliation gives the lender a reason to stop.

The best way to deal with shifting negotiation arithmetic, which we do, is to be judicious in negotiating expected terms before any hold-up occurs. We also work through calling investor capital ahead of the closing date, as the normal process can make it challenging to close on time. This is because there are notice times and waiting periods, and when an investor won't fund, the process can get complicated and time consuming, potentially blowing through a closing deadline and triggering a quick foreclosure.

12. Residual Control Rights

The Control Party Governs Ambiguity

Sanford Grossman and Oliver Hart defined ownership in 1986 as the residual right of control, the right to decide how an asset is used when the contract does not say.¹⁹ In his Nobel lecture, Hart put it this way, “The owner of an asset has the right to decide on how the asset is used to the extent that its use is not contractually specified.”²⁰ Every contract leaves gaps, and the party holding that right decides what’s not addressed.

The residual right is leverage.

Consider a hypothetical office building whose tenants park in an adjacent lot owned by a borrower affiliate. There is no recorded easement or written lease, and the lot was never pledged to the lender. The lender’s appraisal at origination assumed the parking. During the workout, the lender learns that foreclosure would not include it with the building. Thus, the foreclosed value falls, and so does the recovery compared with modification. The documents do not say whether the lot remains available. The borrower’s affiliate decides.

The residual right is leverage. If the lender finds the gap on its own, it sees hidden leverage, and the asset manager has to explain why the collateral was not what the committee understood. If the borrower raises it early, the lot becomes part of the deal. The modification can add a recorded easement or long-term lease, and the borrower can ask for that value in return. The documents then turn the borrower’s residual right into a specific right the lender can rely on.

13. War of Attrition

Match the Lender’s Force, Not its Manner

Some lenders, especially CMBS, may not wait for a default to apply pressure. A performing borrower may find its cash trapped, its consents delayed, and its sponsor put on notice over positions the

documents only tenuously support. These positions may be determined by a manager at the Master Servicer, and the lender may not be totally wrong about the documents. It can, however, be using a creative interpretation and at times, err on the side of being aggressive.

In most modern loan documents, the borrower's remedy is weak. They commonly waive damages, jury trials and limit lender liability. A borrower that prevails in court may only win a declaratory judgment that it is entitled to what it should have gotten to begin with but nothing more. Counsel should confirm the documents and available remedies, but the lender's downside from overreaching is typically limited, and it knows it.

In CMBS, that downside may approach zero. The special servicer acts for the trust, and the trust indemnifies it for ordinary enforcement costs, short of its own negligence or bad faith, so the expense of a dispute is paid from the certificate holders' recoveries, not the servicer's own pocket.

If the issue arises from a defect in the loan documents or a breach of the originating lender's representations, the trust may demand that the originator repurchase the loan at par, plus accrued interest and enforcement costs. In origination loan agreement mistakes, the repurchase right turns litigation into a reason to fight rather than a reason to settle. If the servicer wins, the trust keeps the loan on its terms, and if it loses, the originator buys the loan back and pays the bill.

A borrower expecting litigation to pressure the servicer, however, is misreading the power dynamics. The servicer's exposure runs to the trust and the originator, not the borrower, and the trust may be made whole whether or not the servicer's position was correct.

Game theory calls this a War of Attrition. John Maynard Smith described it in 1974 as a contest without physical contact in which victory goes to the contestant willing to remain longer, while each side bears the time and cost of staying in.²¹ A party that expects the other to tire first has no reason to concede early. A lender that believes the borrower cannot fund a fight, or will not risk having one, will keep pressing until the borrower sues for peace.

The lender also has a second move that borrowers rarely anticipate. Even if the borrower proves there was no default, the lender may not retreat and it may look for another one. This is because modern loan documents do not easily fit with most borrowers' property operations, and we've seen a few loans that were in default from the day they closed. So, sure, you won, but we had you all along on another count. This can be a late report, an unapproved lease amendment, or accounts payable above a threshold. A borrower that wins the first argument and loses the second has gained nothing. So, before contesting the lender's position, we audit the borrower's compliance against the loan documents so its flank is covered when the lender turns.

Borrowers usually posture wrong in one of two ways. Some remain accommodating for way too long because they expect the relationship to protect them or have not recognized how limited their remedies are. Others answer aggression with aggression, and give the lender the dispute it is well-prepared to

fight, while damaging the good-faith record, perhaps an unfair standard, but one that they will need when that same lender must approve a consent or modification. Even if dealing with a bully requires comparable force, it must be a reasonable reaction to everyone who counts, including a judge.

From the first exchanges, we show that we read the documents as closely as lender's counsel, that the borrower has the resources to remain in the contest, and that neither fact changes our tone. We state each position clearly, in writing, with the document reference attached, and take the next step on the stated date. A servicer may answer to nobody on a day-to-day basis, but it still answers to the rating agencies and to the trust parties whose recoveries fund the dispute. When it serves the borrower, we make sure those parties understand what is happening.

Kreps and Wilson showed in 1982 that a reputation for toughness, established early in a multistage game, changes the other side's later decisions.²² CASE does not seek out these disputes, because it typically doesn't have to. That being said, we are retained as outside advisor to major law firms and their clients in several matters, and the work we do follows the path above.

Borrowers also overestimate what reasoning alone can accomplish. The borrower argues from the property perspective, but the servicer is administering a loan under its documents. If the documents do not permit the ask clearly, the servicer will say no, until compelled otherwise, as the strength of the business case never enters the decision when the documents don't support it. If the documents are ambiguous, the argument sounds like a borrower looking for an exception. The better move is to find the course the documents already permit, or change what the servicer is being asked to approve.

Even if dealing with a bully requires comparable force, it must be a reasonable reaction to everyone who counts, including a judge.



Conclusion

A workout is decided long before the term sheet. By the time the lender's credit committee votes, the asset manager has formed a view of the borrower from the diligence responses, the consents, the vendor payments, and the tone of every exchange, and the committee judges the proposal against that view, even when the numbers support it.

The borrower's one durable advantage is its knowledge of the property, and that advantage shrinks as the lender's own diligence catches up.

The borrower's one durable advantage is its knowledge of the property, and that advantage shrinks as the lender's own diligence catches up. A borrower that brings the knowledge early, organized to a conclusion the asset manager can take to committee, shapes the lender's beliefs before they harden. A borrower that arrives after the notice of default spends the workout trying to correct them.

Borrowers should call us before the notice of default, at the point where the property's financials show a decline that isn't reversing and the borrower has to decide whether to put in new capital. That decision

shapes everything the lender later sees, because new money either buys time for a plan the lender can underwrite or disappears into the shortfall. With the analysis done early, the borrower can weigh the injection against a workout or a consensual exit while both are still available, and at a minimum, it decides with better information. □

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About the Author

Shlomo Chopp is the Managing Partner of Case Equity Partners, bringing over 20 years of commercial real estate investment and advisory experience. He specializes in crafting solutions for distressed property and debt situations while developing innovative strategies for repositioning assets and asset classes.

The son of a computer programmer, Shlomo's foray into commercial real estate began in 2003 when he sold PropTech software to real estate finance brokerages. Since then, he has invested in, structured, or advised on nearly \$5 billion in commercial real estate.

In 2010, Shlomo founded Case Property Services (CPS) to help borrowers and guarantors navigate the challenges of distressed real estate loans in today's complex and interconnected capital markets. With expertise at the highest levels of structured finance and CMBS, his approach combines strategic analysis, planning, and diligence to create leverage for his clients and foster proactive communication between borrowers and lenders.

On the investment side, Shlomo is part of a family office that owns and operates ±70 properties across the US, and multiple asset classes. Focused on value-add opportunities, he leverages his distressed debt expertise to invest across all levels of the capital stack, including bonds, loans, properties, and other derivative interests in commercial real estate.

Beyond distressed debt, Shlomo has secured four commercial real estate-related patents in the areas of shopping centers, e-commerce, and fulfillment. His invention, retailOS™, is a platform designed to enhance shopping center value and improve retail operations profitability. He has been recognized by RETHINK RETAIL as a "Top Retail Expert" for three consecutive years, alongside other industry accolades.

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About CASE

Since 2010, CASE has guided institutional investors, family offices and hands-on property owners through the complexities of distressed commercial real estate finance. We combine deep CMBS, structured finance and capital stack expertise with real-world operational experience, having sat in the borrower's, lender's and bondholder's seats. Working hand-in-hand with your counsel, we craft clear, custom strategies and solutions to demystify the process, enable effective risk mitigation and put you in control.

Our Loan Workout Advisory is geared for loans typically exceeding \$25 million, and in our experience we have advised on capital stacks as high as \$1 billion. Our method mirrors the lender's own approach, prepared in accordance with a systematic strategy that spans from diligence through resolution. We begin by conducting comprehensive property and covenant analysis to establish your negotiation baseline. As lenders progress through appraisal and valuation, we refine your value-creation story, surface hidden risks and develop solution focused scenarios—whether discounted payoffs or covenant modifications. We then lead negotiations with servicers and special servicers, coordinating closely with your legal team to prioritize battles that drive results and optimize risk mitigation.

Pre-Workout & Small-Balance Advisory: Built to guide hands-on property owners and small family offices through the early warning signs of loan distress—before special servicing or full workouts kick in. This service provides actionable guidance within 1–4 weeks. We collaborate with the borrower in developing a concise action roadmap, by developing a strategy based on property and loan review, including, identifying often misunderstood issues such as lockbox triggers and recourse carve-outs before they escalate. We also help interview and identify the right counsel to assist in executing a viable strategy. This solution-oriented approach ensures you know precisely where risks lie, which steps to take and how to negotiate confidently, all without committing to a full workout.