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Hancock at Center of 'Tranche Warfare'

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The commercial real-estate storm is starting to hit the top of the skyline.

In Boston, John Hancock Tower is at the center of a fight among a group of lenders and investors, just two years after private-equity firm Broadway Real Estate Partners bought the iconic office building with help from some of the biggest names on Wall Street.

Earlier this month, a Broadway fund defaulted on $700 million of debt tied to the Hancock tower and other buildings. The default triggered a scramble among investors holding debt tied to the acquisition, with some pushing for immediate foreclosure and others pushing to extend the loan in hopes of a real-estate rebound.

The battle for control of the 60-story glass building, New England's tallest skyscraper at 790 feet, could signal how scores of similarly distressed real-estate financing deals will play out this year as the recession sweeps through office buildings, stores, hotels, warehouses and other commercial property.

The commercial real-estate sector has endured plenty of previous busts. But the fallout is likely to be different this time because of all the debt structures developed in the past decade that have never had to ride out a downturn.

Some $700 billion in debt was carved up into commercial mortgage-backed securities, or CMBS, and sold to investors. Another $50 billion to $75 billion of loans were sold as mezzanine debt, which fills the gap between the mortgage and a borrower's equity. Like CMBS, mezzanine debt was often sliced and diced into many pieces with varying degrees of risks.

"Tranche warfare is starting," said John Zizzo, a real-estate lawyer at Cadwalader, Wickersham & Taft LLP, referring to the loan "tranches," or slices, that investors own. "It has never been tested before this current market meltdown."

The disputed $700 million of debt in the Hancock battle is mezzanine debt that was divided up among nine investors. With real-estate values declining, not all of the investors would be paid off in a liquidation.

As a result, investors who believe they would be in the money are pressing for an immediate foreclosure, according to people familiar with the matter.

Such investors include Five Mile Capital Partners, led by former real-estate financier Steven Baum, and Normandy Real Estate Partners, founded by property investor Finn Wentworth. Mr. Wentworth also is a founder of the New York Yankees' YES Network.

Investors likely to lose out in foreclosure want to give Broadway more time to repay the loan. Among those investors is a BlackRock Inc. fund run for outside investors. That fund owns the riskiest slice of the loan.

Also involved in the scrum are Chicago developer John Buck, who owns the most senior portion of the debt; the RBS Greenwich Capital unit of Royal Bank of Scotland Group PLC; Lehman Brothers Holdings Inc.'s bankruptcy estate; and hedge fund Petra Capital Management LLC, run by Andy Stone, a pioneer of commercial real-estate securities.

Complicating things further, State Street Corp. inherited stakes in two tranches from Lehman Brothers, according to a person familiar with the situation. The failed investment bank had pledged the loans to State Street as collateral for a short-term "repo" loan. State Street seized the collateral after Lehman filed for bankruptcy.

These investors had hoped to make fast money on debt tied to the $3.3 billion acquisition, which included the John Hancock Tower and six other properties.

Founded by Scott Lawlor, the son of a Queens, N.Y., cab driver, Broadway was one of the most aggressive real-estate private-equity firms, buying $14 billion of office buildings from 2002 to 2007 in highly leveraged transactions.

Investors in Broadway's funds include the Pennsylvania Public School Employees' Retirement System and Immofinanz AG, a publicly traded real-estate company in Vienna.

The mezzanine debt essentially was a one-year bridge loan with two six-month extensions that Broadway planned to pay off with new debt or additional equity. The credit crunch and recession have prevented Broadway from raising capital.

Meanwhile, cash flow from properties has fallen too low to service the mezzanine debt, according to people familiar with the matter. When the buildings were purchased, Broadway assumed it would be able to fill the space with tenants paying more rent. But the vacancy rate in the John Hancock Tower has risen from practically zero to 15%.

The mezzanine debt was supposed to deal with such a scenario. In case of default, creditors would conduct an appraisal to determine who was in the money and who wasn't. Terms of the agreement call for the most junior creditor still in the money to be the "controlling holder." That creditor gets to decide whether or not to foreclose.

According to people familiar with the matter, Five Mile and Normandy believe that they are the controlling holder and are moving to hire a special servicer that would launch a foreclosure proceeding. That move is expected this week. A joint venture led by the two firms bought the debt in mid-2008 at a discount from Lehman and RBS with seller financing.

But other creditors are arguing over the appraised value and who is in control, according to these people. They may go to court to try to block the foreclosure action.

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