

Foreclosure May Not Be The Fix For Distressed Office Loans

By **Howard Koh** (October 6, 2026)

On Aug. 14, a lender commenced a foreclosure action against condominium units leased for office use at 1166 Avenue of the Americas, a prominent Manhattan office tower. The action involved a \$110 million mortgage and followed allegations that the borrower had fallen months behind on its loan obligations.

Viewed in isolation, the case, Wilmington Trust National Association v. 1166 EJM LLC, filed in the Supreme Court of the State of New York, County of New York, might suggest a familiar story: declining office values, a loan default and an inevitable foreclosure. But the events preceding the action tell a more complicated story. The lender sued only after significant efforts to avoid that result.



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Following the departure of major tenants and mounting refinancing pressure, the debt associated with the property was transferred to special servicing. Ownership then pursued workout negotiations, and the lenders discussed restructuring the debt. That is the new normal.

Distressed office loans increasingly do not move directly from default to foreclosure. Instead, they often pass through extended negotiations, restructurings, transfers to special servicing, receivership disputes, leasing campaigns and other workout efforts. Foreclosure is rarely the preferred outcome for either side.

Borrowers seek to preserve value and avoid personal, business and tax consequences. Lenders, meanwhile, often have little interest in taking title to an aging office building requiring substantial capital investment and active management. The result is a complex negotiation. This article examines how the market reached this point and what owners, lenders and borrowers should expect next.

For years, the underlying economics of New York City's commercial office market operated on a relatively straightforward assumption: Real estate values would continue to rise.

An investor would acquire an office building using a commercial mortgage and make scheduled interest payments, but not pay down the principal. When the loan matured, the borrower would refinance based on the assumption that the property would be worth more than when it was purchased. The ability to refinance was the foundation of the model.

In a rising market, the strategy worked. Increased property values supported new lending, and refinancing became a routine part of the ownership cycle.

But real estate markets are cyclical, and values do not always move upward.

The COVID-19 pandemic, the widespread adoption of remote and hybrid work arrangements, and changing tenant demands fundamentally altered the office market. At the same time, rising interest rates increased borrowing costs and reduced the availability of affordable capital. The impact has been particularly severe for older or Class B and Class C office buildings, many of which have experienced significant declines in value.

Now, a significant number of these loans are reaching maturity. Nationally, Trepp reported earlier this year that office loan delinquencies reached 12.34%, and Property Shark has estimated that \$56.7 billion in office loans will mature in Manhattan this year alone.[1] Many well-known Manhattan properties have been named in foreclosure suits.

But the refinancing process that once seemed almost automatic has become far more challenging. In many cases, the property's value no longer supports the outstanding debt, and lenders are requiring borrowers to contribute substantial additional equity to obtain replacement financing.

Many owners are unwilling to invest additional capital into underperforming assets; others simply do not have the ability to do so.

Traditionally, when a borrower does not pay its mortgage, the lender forecloses. But most lenders do not want the property. A lender that takes title through a foreclosure auction by credit bidding its debt or accepting a deed in lieu of foreclosure becomes the owner of a distressed office asset facing declining rents, increased vacancies and substantial capital needs.

That presents two serious problems for the lender. First, most of the time, there's no reason for that lender to think it could do a better job of running the property than the borrower.

Despite the occasional stories of a borrower engaging in criminal conduct, lenders don't give eight- or nine-figure loans without doing enough due diligence to ensure that the borrower knows how to operate the property. And, even if the borrower is a fraudster, lockboxes and cash traps make it difficult for owners to divert funds from the property.

Second, if the lender takes the property, its accountants will require the lender to mark that asset to market on its balance sheet. Most lenders do not want that balance sheet hit.

In many distressed loan cases, the lender is a commercial mortgage-backed securities trust, meaning that interests in the loan have been securitized and sold to investors. When these CMBS loans go into default, they are typically transferred to a special servicer. When a CMBS loan is assigned to a special servicer, the special servicer takes the lead in negotiations with the defaulting borrower and controls any foreclosure suit on the lender's behalf.

A special servicer generally acts under a pooling and servicing agreement that defines its authority and requires it to pursue a resolution intended to maximize recovery for the trust's investors. The special servicer therefore must evaluate competing outcomes, including modification, extension, discounted payoff, foreclosure, a deed in lieu of foreclosure or a sale of the loan.

That analysis may consider not only the amount of outstanding debt, but also the property's current value, the cost and duration of enforcement, the capital required to stabilize the property, and the uncertainty of a later sale.

As a result, a proposal that appears commercially sensible to the borrower may not be immediately acceptable to the special servicer. The borrower must demonstrate that its proposal is likely to produce a better recovery than the available alternatives, while also satisfying the requirements of the governing servicing documents.

Thus, many distressed office situations are not progressing through a traditional foreclosure

path. Instead, they have evolved into complex negotiations among borrowers, lenders, investors and other stakeholders. The current dynamic resembles a poker game in which the stakes are how the economic impact of the market correction is to be allocated.

For example, lenders often seek the appointment of a receiver to operate the property during foreclosure, even when they believe that the borrower is operating the property responsibly given the economic conditions, because many borrowers have affiliate property management companies that receive fees for their property management services.

Thus, the lender seeks to impose pressure on the borrower by cutting off the borrower's affiliate's fee income during the pendency of the foreclosure.

Borrowers, not wanting to invest good money chasing losses, are seeking additional time and hoping lenders, under the pressure of not having their capital working, will agree to modifications, extensions, restructuring arrangements and discounted payoffs.

Lenders, who are watching their capital not perform, want borrowers to contribute additional capital, secure new tenants or implement a plan to restore the property's value. To put borrowers under additional pressure, lenders are aggressively attempting to enforce springing nonrecourse carveout guaranties. To reduce that risk, wise borrowers are carefully examining their loan documents to avoid accidentally triggering guaranty liability.

Borrowers have an additional reason they may not wish to just walk away from an underperforming office building investment: taxes. A foreclosure or deed in lieu of foreclosure may create taxable income or other tax consequences for the property-owning entity and its investors, depending on the structure of the transaction and the applicable tax rules.

For example, most office building investments are held in a limited liability company. When the LLC defaults and does not repay its loan, that loan forgiveness becomes taxable income to the LLC. The LLC may then issue Schedules K-1 allocating the owners' pro rata shares of that income. The result may be so-called phantom income: taxable income without a corresponding cash distribution to pay the associated taxes.

While the ownership structures of these investments can be complex, the result is the same. Phantom income flows up the ownership chain until individual investors may be allocated substantial phantom income reportable to the IRS. This puts pressure on borrowers to develop a tax management strategy designed to have the income reported in a year in which the borrower has losses to offset that income.

The net effect is that the borrower's decision mutates. The issue is no longer whether the borrower should walk away from the office building investment, but when the borrower should walk away.

Nevertheless, while playing for time might benefit both lenders and borrowers, time is not neutral. During a prolonged workout or foreclosure, leases may expire, tenants may relocate and necessary capital projects may be deferred.

Uncertainty over the building's ownership and financing can also complicate negotiations with prospective tenants, contractors and other stakeholders.

A lender may use the prospect of foreclosure, receivership or guaranty enforcement to obtain concessions, but excessive delay may reduce the value of the collateral it is seeking

to protect.

Similarly, a borrower may use litigation or the practical difficulties of foreclosure to gain negotiating leverage, but each additional month may increase default interest, legal expenses, and the amount required to reinstate or refinance the loan.

Finally, special servicers must consider their obligation to maximize investor value, which may not always align with protecting the office building asset.

Thus, although the parties may disagree sharply over who should contribute new capital and absorb existing losses, both may benefit from a resolution that stabilizes the property before its condition deteriorates further.

All these considerations result in both sides using the legal system to allocate the losses created by a fundamental shift in the office market. The next phase of New York City's office real estate cycle will likely be defined not by completed mortgage foreclosures (although there will be some), but by negotiated resolutions and restructurings.

Litigation will be one of many levers both sides will pull in the fight over how to allocate responsibility for the cost of repositioning a changing office landscape. For owners, lenders, investors and their counsel, understanding these dynamics will be critical as the market continues to adjust.

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[1] <https://www.trepp.com/trepptalk/office-cmbs-delinquency-hits-an-all-time-high-what-the-data-is-really-saying>.