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Debt-for-Equity Exchanges: What to Consider When Your Lender Becomes Your Partner (Part 2)

This is an installment in our series on debt-for-equity exchanges. The first article, "[Commercial Real Estate Distress: An Introduction to Debt-for-Equity Exchanges](#)," introduced the basic structure and explained why these transactions may become more common as commercial real estate loans mature in a tighter refinancing market.

As discussed in our [introductory article](#), debt-for-equity exchanges may provide a possible path to resolving some distressed debt scenarios under the right circumstances. However, the dynamics inherent in these transactions require careful analysis on the front-end to ensure the transaction is ultimately workable. This article focuses on the issues that arise when your lender becomes your new joint venture partner.

In a debt-for-equity exchange, the lender agrees to convert some or all of its debt into an equity interest in the property-owning entity. As with any new partnership, questions arise, including who will control, what rights will the minority interest holder have, how will the property be operated and what are the exit scenarios. These points should drive the negotiation from the beginning. A debt-for-equity exchange should not be agreed to in concept while the parties leave governance, management, financing, valuation, existing partner treatment, and exit rights for later. Those are not secondary details. They are the deal.

Valuation Drives the Deal

In a standard joint venture, the parties typically begin by allocating ownership and control between the partners. There are many roles the parties could take (operating partner, passive investor, controlling capital partner), all of which are on the table for a debt-for-equity exchange.

In debt-for-equity transactions, the allocation of ultimate ownership and control will depend heavily on valuation of the property and the amount of the outstanding debt. The parties need to decide up front how the property is being valued, how much debt is being converted, whether a discounted payoff is involved and whether any party is bringing additional equity to the deal. Further, the parties will need to be aligned on the business plan that is intended to drive future value, which is the reason the parties are working together in the first place.

While not a certainty, circumstances will often dictate that the lender will own a majority interest following the exchange. A lender may view its converted debt as the capital contribution that preserves the asset and may demand terms in accordance with that view. The sponsor may believe the property has upside that is not reflected in current market pricing and may seek credit accordingly. Existing investors may have a different view entirely, particularly if the transaction will result in their interests being diluted or bought out. It may be advisable to have the term sheet identify the value, or at least the valuation process, before the parties commence negotiations in full. Valuation determines ownership percentages, dilution, buyout pricing, and sometimes future exit rights.

Control is the Question

Who controls the partnership, and what rights the non-controlling partner has, are central to any joint venture transaction. However, the starting point in a distressed debt-for-equity transaction is unique, with the lender potentially having additional leverage points given the likely existence of enforcement rights under the existing loan documents. However, that does not mean every lender will want day-to-day operating responsibility. Banks, debt funds, private credit lenders, and conduit lenders may have different objectives and constraints. Some may want direct control. Others may want approval rights and economic protection without becoming the operator.

For the borrower, the question is usually not whether it can preserve all prior control rights. Instead, the question becomes which rights matter most. Control is not a single vector, and the borrower team should consider where to focus their negotiation power. They should be prepared to negotiate the items they deem essential into the term sheet, which may include a complete list of major decision approval rights, tax protections, information rights, limits on affiliate transactions, protection against unfair dilution, exit rights or other deal-specific terms. Pushing critical negotiation points to a later date is risky, even more so than on the typical new joint venture, since failure to agree to terms at the late stages may result in a lender's enforcement action against the property.

Property Management May Change Hands

Equity control and property control are related, but they are not the same thing. A lender may become the controlling owner and still leave the sponsor, or the sponsor's affiliate, in place as property manager, leasing agent, construction manager, or asset manager. The lender may also require a change in management as a condition to the exchange.

If the sponsor remains in an operating role, the lender will likely want tighter budget controls, leasing thresholds, capital project approvals, reporting obligations, and removal rights. The lender may also require performance tests that trigger a management change if the property misses agreed metrics.

If the lender installs a new manager, leasing agent, or asset manager, the sponsor will want approval rights over budgets, major leases, capital projects, affiliate fees, future management changes, and related-party arrangements. Again, minimum performance metrics may be negotiated.

Affiliate fees may merit special attention. If sponsor affiliates remain in place, the lender will want market terms and termination rights. If lender affiliates are introduced, the sponsor should apply the same scrutiny.

Legacy Loan Exposure Should Be Resolved

A debt-for-equity exchange does not automatically erase the old loan documents. Existing guaranties, bad-boy carveouts, indemnities, defaults, claims, cash management rights, and cross-default issues need to be released, preserved, or replaced with specific post-closing obligations.

The sponsor will usually want finality. The lender may want protection for fraud, misapplication of rents, environmental matters, unauthorized transfers, and other legacy issues.

Both positions are understandable, and the specifics of each transaction will need to be considered. If a guaranty is being released, it may be desirable that the term sheet say so. If certain claims survive, they should be identified as well, including details regarding how (and how long) they should survive.

New Financing and New Guaranties

Many debt-for-equity exchanges are not the final capital event. The property may need simultaneous replacement financing for the transaction to work for all parties. It will often be a point of contention regarding which party sources that financing, who has approval rights, how much ability each party has to negotiate the definitive loan documents, and how proceeds will be used.

New guaranties are a key part of that discussion. A lender may require carveout guaranties, environmental indemnities, completion guaranties, carry guaranties, payment guaranties, or other credit support. The debt-for-equity documents should say whether the sponsor, the lender, their respective affiliates, or some combination will satisfy those obligations. Whether providing such guaranties will result in the payment of any fees to the guarantors should be negotiated as well.

In addition to the guaranties themselves, the parties will likely need to deal with cross-indemnification between the parties, particularly where any resulting guaranteed obligations arise from the acts or omissions of one partner or the other. These discussions can expose major differences between the parties. The former lender may control the equity but may not want to sign new guaranties, particularly if those guaranties result in recourse related to pre-

existing conditions. The sponsor may stay involved operationally but may not want exposure for a deal it no longer controls. These different points of view will need to be resolved for the deal to move forward.

Disposition and Exit Rights

The parties also need to decide how and when the investment ends. In a standard joint venture, sale rights, buy-sell rights, rights of first offer, rights of first refusal, drag-along rights, tag-along rights, and deadlock procedures are often negotiated in the operating agreement, and the same will be true on a debt-for-equity exchange but will again be impacted by the unique circumstances.

The key questions are practical. Can the lender force a sale? Can the sponsor block a sale? Is there a minimum hold period? What happens if a third-party offer is received? Can either party initiate a buyout process? How is the property valued for that purpose? Does a default, missed performance target, failed refinancing, or unresolved deadlock change the exit rights? All of these questions will need to be resolved.

Existing Partners

As with any recapitalization of a property, existing limited partners will need to be dealt with. They may be diluted or bought out, asked to provide consents or approve existing loan release terms, or any combination thereof, and their interests may not match the sponsor's.

The sponsor may be staying in the deal, retaining a path to future upside. Limited partners may be focused on [tax consequences](#), releases, approval rights, buyout price, or other considerations. Further, limited partners may not be getting the same benefits from the release of a sponsor's existing loan guaranties and may express concerns about that structure. The term sheet may need to account for required consents, release mechanics, tax issues, information rights, and any buyout process. The sponsor will need to determine how to communicate with the limited partners in a manner that ensures cooperation, both in pre-term sheet approvals

and at the final closing table.

Property-Specific Issues May Arise

Finally, the parties should identify third-party consents and asset-specific issues early. A debt-for-equity exchange may trigger change-of-control provisions even if the same sponsor remains visible to tenants and vendors. Potential issues include anchor tenant rights, franchise or brand approvals, and ground lease, condominium, or master association consent rights. Other issues may include transferability of any licenses needed to operate the property, treatment of intellectual property rights, radius restrictions, special relationships with tenants or other third parties, or a variety of other issues. A proactive approach to issue spotting is crucial.

Practical Takeaway

A debt-for-equity exchange can be a useful way to preserve value when a property has upside, yet the existing capital structure no longer works. But these transactions are complex, blending aspects of workouts, recapitalizations, and new joint-venture negotiations.

The most important issues should be resolved up front. If those points are not addressed early, the parties may discover too late that they did not agree on the same deal, with serious consequences for everyone involved.

Please contact the authors or any attorney with FBT Gibbons' [Commercial Real Estate Finance team](#) if you would like to discuss a potential debt-for-equity exchange.

This article is for general informational purposes only and does not constitute tax or legal advice. The legal and tax consequences of any transaction depend on specific facts and circumstances, and readers should consult their own professional advisors before undertaking any transaction.

Commercial Real Estate in Distress Series

- [Part 1 — An Introduction to Debt-for-Equity Exchanges](#)

- **Part 2 — Debt-for-Equity Exchanges: What to Consider When Your Lender Becomes Your Partner**
 - [Part 3 — Practical Tax Considerations for Borrowers and Lenders in Debt-for-Equity Exchanges](#)
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