

Dealing with your CRE portfolio (March 23, 2009)

A primer for handling nonperforming commercial real estate loans

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These are challenging times, even for prudent lenders holding commercial real estate loans made utilizing sound underwriting principles. The basic real estate fundamentals of multifamily, retail, office, hospitality, and industrial uses are all facing performance issues.

Adding to the already difficult situation: borrowers are generally unable to refinance existing loans at maturity. As default rates increase, and property values decrease, lenders are weighing their options:

- Foreclosure
- Receivership
- Deed in lieu of foreclosure
- Workout
- Loan sales

Each option has advantages and disadvantages. This article will briefly discuss each option as it relates to troubled commercial real estate loans; some preliminary steps a lender should take; and some factors that a lender should consider prior to selecting a course of action.

It is impossible to discuss every potential scenario, as every project is different and governing law varies from state to state. Regardless of the course selected, the lender should consult with counsel with extensive loan workout and foreclosure experience—a specialty not prevalent during the heady runup to the current crisis.

Start with due diligence

One of a lender's first steps should be to undertake due diligence to review existing loan documentation and obtain necessary property information.

A lender needs to understand the terms of the loan documents, the collateral securing the loan, and the parties involved. Note the exact nature of the default; how, when, and to whom notices of default should be sent; when late charges are

due; and when default interest begins to accrue. It is also important to determine whether the loan is recourse, non-recourse, or non-recourse with limited carveouts; whether there is any collateral other than the property securing the loan (such as reserves, letters of credit, or accounts); and whether the borrower is a single-asset entity. (A single-asset entity is a limited liability company that owns only one commercial property.)

A review of the loan file should be made for any information regarding the financials on the project; borrower and guarantors, if any; and for any documentation modifying the terms of the loan documents.

A lender will also want to determine whether there are third-party agreements associated with the loan, such as intercreditor, participation, or servicing agreements. The lender will also want to see if they must obtain the consent of any other party to pursue a course of action with respect to the loan or the project.

The loan file review should also examine any lender-liability claims borrower may allege.

With respect to the project, the lender should obtain an updated property inspection report; a market analysis and/or appraisal; an updated environmental report; and a foreclosure title commitment or updated title search report. The lender should also obtain a copy of the most recent rent roll for the project, if applicable, and ascertain the status of all tenants, including whether any major tenants are in default or bankruptcy. There should be a review of contracts with all vendors, including the status of payment of all payables and the existence of contracts with long terms which would entail fees and penalties to terminate. If the project is not yet completed, lender will have to determine the estimated cost and time frame necessary to complete the project and whether there are any existing liens for unpaid work. On condominium projects, the lender should determine the total number of condominium units; the number of unsold units; the number of units under contract; the location of deposits under each contract; and the number of contracts in dispute or litigation.

If the project is a hotel, the lender should ascertain, among other things, whether it has a perfected security interest in the personal property at the project; whether such personal property is owned or leased; whether the franchise agreement, if any, is in default; and whether there are any assignable liquor licenses.

With respect to the borrower and any guarantor, the lender should run a judgment, litigation, bankruptcy, and UCC search to the extent not already covered in the title report. The lender should also see whether borrower or any guarantor has any other loans with lender and the status of such loans.

Prior to any formal communications with the borrower and/or any guarantor, the lender should have the borrower and any guarantor execute a "pre-negotiation agreement." Such an agreement will provide that any communications, including any discussions and negotiations, are not binding on the lender and are not admissible in any proceedings. The agreement would also provide that there is no waiver or release by the lender as a result of the communications; that there are no oral agreements; and that the borrower will cooperate with the lender if the lender desires to conduct environmental assessments, property inspections, appraisals, or any other evaluations of the project.

What are the lender's options?

Once due diligence is completed, the lender can more fully analyze options. Some lenders may choose a single course of action, while others may wish to proceed simultaneously, with several expecting to limit their options at a future date.

Some factors influencing a lender's choice of options are timing; cost; project type; condition of project, including any environmental contamination that would discourage ownership of the project; the need for control of the cash flow; the favorability or unfavorability of choice of law provisions; whether or not the borrower and any guarantors are

forthcoming and cooperative; whether a bankruptcy filing by or against borrower is likely; whether any subordinate liens or interests exist; and what course of action will result in the best recovery.

Foreclosure. The advantages of a foreclosure are that subordinate liens and interests can be extinguished, and transfer taxes may be minimized upon acquisition of title, depending on the jurisdiction. In addition, foreclosures can withstand future bankruptcy filings by borrower as the rights of other creditors will not upset title taken by foreclosure. The main disadvantage of foreclosure on a commercial property is that there may be a lengthy process, particularly in a judicial foreclosure state (explained below), when the foreclosure action is contested.

In evaluating foreclosure, the lender should ascertain whether the project is in a judicial or a non-judicial foreclosure state. Generally, the time frame and costs involved in a non-judicial foreclosure are less than that of a judicial foreclosure, whether or not the judicial foreclosure is contested.

A non-judicial foreclosure usually involves a notice to the borrower and setting a sale date for the project.

In a judicial foreclosure action, the borrower and holders of subordinate liens or interests are named as defendants. They must all be served with a copy of the complaint, notice of lis pendens (Latin for "suit pending") and summons. Each defendant then has a period of time to respond and assert any defenses and counterclaims. If any of the defendants file a timely response with defenses that raise a genuine issue of material fact, summary judgment cannot be obtained and the foreclosure process will be substantially extended.

If the lender is planning to assign the loan or if the loan has been assigned to the lender, the lender should confirm that the assignment document is recorded in the appropriate records prior to the filing of the foreclosure action. Otherwise, a motion to the court to substitute the lender as plaintiff in the foreclosure action will be necessary. Similarly, if it is contemplated that title to the project will be taken in another entity, it will be necessary to assign the foreclosure judgment or bid at the foreclosure sale to the extent permissible under the law of the state where the project is located.

Receivership. The lender may seek the appointment of a receiver. This may be in a foreclosure action or in a separate action, to the extent permissible under the law of the state where the project is located. To secure a receiver, the lender must request that the applicable court enter an order appointing a receiver.

The advantage of a receivership: all rental income is directed to the receiver, which prevents dissipation of the project income by the borrower. Because the receiver will maintain an accounting of the income and operating expenses, receivership provides the lender with an accurate snapshot of the project operations. It also prevents potential future deterioration of the physical condition of the project by a borrower no longer interested in maintaining it.

The disadvantages of a receivership are that the appointment is in the discretion of the court, which may appoint a receiver that is not acceptable to the lender (even if the lender suggests an acceptable receiver). And, then, receivership fees are expensive. In addition, a court may deny a request for a discharge of the receiver after its appointment if the lender decides that it no longer wants a receiver.

Deed in lieu. The lender may decide to accept a deed to the project in lieu of foreclosing, particularly if the borrower and the guarantor are cooperative, and there are no subordinate liens or interests that need to be extinguished.

The advantages of accepting a deed are that it permits expedited project ownership—although adequate due

diligence should not be sacrificed for purposes of speed—and may be used to facilitate a foreclosure.

Disadvantages of a deed in lieu transaction are that it will not extinguish subordinate liens or interests and there may be merger and debt extinguishment issues. In addition, deeds in lieu may be subject to attacks by other creditors in a future bankruptcy of the borrower. Finally, significant transfer taxes may be due upon the recording of the deed, depending on the jurisdiction.

When considering the deed in lieu transaction, the lender should ascertain the amount of transfer taxes, if any, and whether any merger/debt extinguishment issues exist in the state where the project is located such that the lender's right to foreclose will no longer exist.

Also, be aware that the borrower and/or guarantor may insist on releases for cooperating with the deed in lieu, thereby resulting in the loss of any claims the lender may have been able to pursue against them. Note that generally, claims for environmental liabilities are intended by the terms of their documents to survive a deed in lieu and should not be released.

Generally, with a deed in lieu of foreclosure, the lender and borrower enter into a written agreement which provides that:

1. The borrower will convey the project and all associated personal property and intangibles, including any bankruptcy claims in tenants' bankruptcies, to the lender (or its assignee).
2. The lender will retain all reserves and escrows with respect to the loan.
3. The borrower will deliver to the lender all funds in its operating accounts and terminate all agreements with respect to the project that the lender does not choose to assume.

In addition, the agreement may contain borrower representations and warranties on the project, its operations and any project-related agreements, as well as a general release from the borrower and any guarantors with respect to the loan and the loan documents.

The lender will want to review all project related agreements, such as property management agreements and service contracts. The purpose is to determine whether it wishes to assume any of them at closing or, if borrower refuses to terminate them, what the lender's obligations are for these agreements after taking title. The lender will further want to ensure that there is a smooth transition of the operations of the project. The new property management and/or leasing company should be on the premises the day of closing to take possession of the project and to take delivery of all project-related documentation.

Finally, even if there are subordinate liens, a lender may want to explore whether the borrower is willing to satisfy such liens to allow the lender and borrower to proceed with delivery of a deed without the necessity of a foreclosure and thereby avoid the potential stigma of a foreclosure.

Workout. The lender may seek to restructure the loan by entering into a forbearance or loan modification agreement. The advantages of a workout agreement are that it permits the lender to obtain from the borrower and the guarantors a

reaffirmation of their obligations under the loan documents and a waiver of certain rights and defenses that may otherwise be impediments to the lender's future remedies.

In addition, the lender may be able to obtain additional collateral or security for the loan.

The disadvantages of a workout are that it may be time-consuming. This is due to extensive negotiations prior to reaching a final agreement, plus the possibility that the workout negotiation may not result in a successful restructuring, since there is a risk that borrower will default under the modified agreement.

Workout as forbearance. Generally, in a forbearance agreement, the lender agrees to forbear from exercising its rights and remedies under the loan documents as a result of an existing default if specified payments are made and certain conditions are met. A forbearance agreement also typically contains an acknowledgement by the borrower that it is in default and a reaffirmation by the borrower and guarantors of their respective obligations under the loan documents, as affected by the forbearance agreement.

Once the forbearance period has expired or, if borrower fails to comply with the terms of the agreement, the forbearance agreement terminates, then the lender may proceed to exercise its rights and remedies under the loan documents.

Workout as loan modification. Under a loan modification agreement, the lender and borrower enter into a written agreement modifying the terms of the loan documents. The borrower and guarantors reaffirm their obligations under the loan documents, as modified by the modification agreement. Sometimes a lender will require additional collateral or security for the loan as part of the consideration for entering into the forbearance or modification agreement.

Loan Sale. The lender may want to proceed with a sale of the loan so that it no longer holds a nonperforming loan on its books. The disadvantages of the loan sale are that there may be extensive negotiations with respect to the purchase price for the loan and representations and warranties that the lender is unwilling or unable to provide, in some cases due to the terms of a servicing agreement.

With a loan sale, the lender enters into a written agreement with a third party. In that agreement the lender agrees to convey the loan and the loan documents to the purchaser in "as is, where is" condition with minimal representations and warranties by the lender.

Typical representations and warranties relate to the outstanding principal balance; escrow and reserve balances; and ownership of the loan and the loan documents.

In negotiating a loan sale agreement, the lender will want the purchaser to provide the lender (and its assignee) with an indemnity releasing and holding them harmless from any and all claims with respect to the loan and the loan documents and an agreement that the lender will have no further servicing obligations with respect to the loan.

In proceeding with a loan sale, the lender should pay close attention to any servicing agreement to confirm that it has authority to sell the loan. Generally, servicing agreements contain restrictions on representations and warranties that a lender can provide to a purchaser and may require the lender to market the defaulted loan prior to selling it.

Some lenders retain a loan sale advisor to locate prospective purchasers and manage a bidding process. If the lender wants to retain an advisor, the lender should have a written agreement with the advisor specifying all of the terms of the engagement and requiring the advisor to maintain the confidentiality of all information and documentation. The agreement should also provide that the advisor obtain executed confidentiality agreements from all prospective purchasers prior to delivering any information or documentation. Such confidentiality agreements should prohibit prospective purchasers from having any contact with the borrower; any principal of borrower (including guarantors); any agent of borrower or guarantor, any tenant at the project; or any property manager. BJ

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