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DISTRESSED LOANS

Best Practice for Addressing Defaults of Commercial Real Estate Loans

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With commercial real estate loan defaults at an unprecedented level and more than $1 trillion dollars of loans maturing over the next three years, the commercial real estate industry is likely to face significant turmoil in the coming years.

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To this point, the crisis has been averted due to the so-called ''extend and pretend'' approach of many lenders. With limited or no exit options for many loans, the best approach for lenders has been to continue to receive some interest on loans that they would have quickly pushed out of their portfolio a few years back. Regulators have tacitly approved this approach; they have, at times, been lenient about what loans must be considered nonperforming in order to keep the real estate market from crashing further.

With strengthening of the economy and consolidation by some lenders, however, borrowers are going to face increased pressure to refinance, short sell, or face foreclosure if they are unable to improve performance of their asset(s). Real estate attorneys need to consider best practices in dealing with troubled commercial real estate loans before the crisis starts. A proper workout requires evaluation not only of legal liabilities, but of several leverage issues as well. Set out below are key issues that need to be evaluated, regardless of whether borrower or lender is being represented, prior to negotiating workouts of commercial real estate loans.

1. What Rights Does Each Party Hold? When commercial real estate issues arise, it is critical for both the lender and borrower to understand the rights of the often-times myriad of parties involved in the transaction. These parties may include the purchaser/owner of the property, guarantors of the loan, co-lenders and subordinated lenders, insurance companies, contractors and other lienholders, tenants, and third parties

who hold rights, such as easements, running with the property. There are various sources to identify the respective rights of these parties, including documents relating to their acquisition of these various rights, documents related to title work, surveys, and environmental assessments, and public records related to Uniform Commercial Code (UCC) filings, tax and judgment liens or mechanics, and other statutory liens. A property may have certain unrecorded rights, such as easements rights, set-back restrictions, or other zoning requirements that also must be understood. Without a comprehensive understanding of the property and contractual rights of various parties, it is not possible to negotiate an effective workout solution for a commercial real estate lending problem.

2. What Potential Liabilities Does Each Party Face? Both borrower and lender invariably face significant liability issues in connection with a failed commercial real estate loan.

Pursuant to loan documents, a borrower will face liability for losses suffered by the lender. Loan documents frequently require borrowers to cover a wide range of lender losses arising from the deficiency in payment of the loan, including professional fees for attorneys, and/or any receiver that is appointed, that are incurred to recover losses on the loan.

The borrower may also face liability for mismanagement of the property and negligence in addition to liability for intentional wrongdoing. Most owners of real estate do not obtain director and officer liability insurance; however, a company owning real estate has the same vulnerability to director and officer liability suits for negligence, usurpation of corporate opportunity or breach of loyalty as any other officer or director of other types of companies.

Finally, the owners of a real estate company may have contractual liability pursuant to a guarantee. Most term real estate loans are non-recourse to the borrower, which means that, upon a loan default, the lender's recourse is limited to a borrower's interest in the real estate pledged as collateral for the loan. However, the vast majority of non-recourse loans include some type of guaranty from a borrower's principal. These carve-out guaranties create liability for ''bad'' behavior by the principal. Common bad acts covered in these carve-outs include fraud, misappropriation of funds, and waste committed by borrower. In some instances, the carve-out has been expanded to create a guaranty for losses for failure to pay taxes or properly maintain the property, failure to maintain insurance required by the loan, or environmental contamination.

Guarantors need to understand their obligations and determine whether or not the guarantee is valid or enforceable. In addition, guarantors need to understand how actions of the lender in foreclosing the mortgage may affect enforcement of the guarantee, or how their own actions can trigger a guarantee. Finally, all parties must understand all defenses to enforcement of a guarantee and what assets are subject to collection for a loan default.

Lenders also face liability issues in connection with failed commercial real estate loans. Beginning in the late 1980's as the last real estate recession began, a field of law known as ''lender liability'' burgeoned. Lender liability claims diminished as borrowers were able to refinance their way out of problem lending issues. However, lender liability claims are now resurfacing with a vengeance. Courts are considering again arguments that the lenders breached their implied obligation of good faith and fair dealing by improperly stopping funding, promising to provide additional funds and failing to do so, inducing borrower to take actions that harmed it, or misrepresenting their intent with respect to extending to loan maturity date. Lenders that fail to provide adequate notice of intended actions, make false promises or act based on immaterial defaults can be subject to bad faith claims. In addition, a lender's secured position can be forfeited based on excessive control over the borrower or its property.

3. What Fact Base Should Be Developed? The rights with respect to the collateral cannot be known without a careful review of pertinent documents and records. However, in a real estate workout, due diligence as to facts must go far beyond documents directly related to the property itself.

Financial information on the borrower will, of course, be critical. Also critical will be financial information on the asset itself and the business that operates it. Cash flows and projections are necessary for a borrower to support its workout solution and will likely be required by the lender to accept a proposed solution.

The borrower may wish to buy time for the asset to increase in value. Performance improvement plans related to the asset will be vital in these circumstances. Such plans can include sales efforts to increase rents, modifications, and/or improvements to a building, or repositioning of the tenancy of an asset. Financial projections based on these changes may often need to be compelling to result in a lender forbearing.

Bifurcation of the loan may be another method that needs to be considered. The well known A/B loan restructuring in which a loan is divided in parts to create a performing component of the loan and a nonperforming component can create a win/win for the borrower and lender. The lender is able to write off or write down a smaller loan as nonperforming. The borrower, by putting equity into the loan, may be able to recover that equity on a priority basis. However, to create these A/B loan structures requires financial analysis and support.

4. Can the Borrower Create This Fact Base? There may be instances when the borrower itself can create the fact base to support a loan modification or forestall enforcement of a deficiency or guarantee, but ordinarily

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an independent person is needed to create a credible analysis.

A typical chief financial officer may not have the skill set to supply these analyses, as most accountants have limited capability to project and speculate as to future performance. Their skill set is quantifying what happened, not predicting what could be.

In circumstances when defaults occur, it is not unusual for the lender to lose trust in the borrower. Development, or at least validation, of cash flows and projections, as well as loan restructuring proposals, is frequently necessary for such analyses to have credibility with the lender.

Performance improvement plans also frequently require the validation of an independent turnaround professional. Again, with the loss of trust, an independent persons' support of the turnaround plan will be vital to its acceptance by lender.

5. How Do Rights, Liabilities, and Opportunities Affect Property Value? Assessment of rights, liabilities, and opportunities on a legal, quantitative, and operational basis does not end the pre-negotiation analysis; advisers must take the additional step of determining how these factors affect the value of the collateral as well as leverage in negotiations.

The rights of the owner of the collateral and opportunities for performance improvement will, of course, have significant impact on its value. Particularly with distressed property, rights to develop or complete cannot be assumed. If such rights are not available, then the value of the collateral decreases enormously and viable workout solutions are affected.

Even if potential liability exists because, for example, there is a valid guarantee or a lender faces liability under a potential tort action for lender liability, the degree of leverage, if any, will depend on consideration of a number of other factual issues:

- Does the borrower care that it has deficiency and guarantor liability? Could that liability be quickly wiped out through filing for bankruptcy?
- Has deficiency liability been removed by virtue of bid amounts in a sheriff sale?
- Even if the borrower has liability, does the lender have such a strong need to act quickly in disposing of the loan that its leverage against borrower is minimized?

In short, assessment of value and leverage of the rights and liabilities is a critical step prior to negotiation of a real estate loan workout.

6. Should an Attorney Work With a Financial Adviser or Turnaround Professional? An attorney may do his client a disservice if he or she does not take advantage of a financial adviser to make a far more compelling case for modification or forbearance than attempting pure negotiation tactics (based on perceive leverage) to get the desired result. It is essential that the attorney locate a turnaround professional who has credibility or sophistication so that his opinion is respected.

The turnaround professional, as noted above, will likely be needed to create the fact base of supporting financial analyses and, where appropriate, turnaround or performance improvement plans. A typical chief financial officer may not have the skill set to supply these analyses, as most accountants have limited capability to project and speculate as to future performance. Their skill set is quantifying what happened, not predicting what could be. Turnaround advisers provide these types of analyses routinely, plus have the added credibility of being independent from the company. They may also be needed for plan implementation or to validate plan implementation. Again, the lender may not trust that the borrower can operate the business to improve it, because owner/operators can be slow to accept changes in values and rents, and may be unable to operate effectively in a distressed environment.

Conclusion. Attorneys can expect the amount of work in addressing commercial real estate loan defaults to skyrocket soon. Attorneys, without support of other professionals, cannot ordinarily find optimal solutions for clients because of a likely need for underlying financial analyses, valuations, and, at times, operational plan. Both the attorney and turnaround professional need each other to find the most effective alternatives to assist clients with troubled real estate loans.