

Lender's Triage For A Troubled Commercial Real Estate Loan



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When a good loan starts to go bad, what should the lender do first?

ONLY A FEW YEARS AGO, commercial real estate lending looked like a very easy and straightforward business. A typical borrower's terrific building was fully occupied to the point of bloat. Major tenants ran a rich gamut — venerable law firms, an international commercial bank (maybe “banc” depending on circumstances), and perhaps a major electronics retailer, occupying almost the whole ground floor.

Then everything changed. The electronics retailer convulsed in financial atrophy and found its way to bankruptcy court and lease rejection. The law firm? Clients and then partners started to defect, soon producing a less than cordial dissolution. And what happened to the commercial bank (or banc)? When weak commercial real estate loans brought down the house, the FDIC repudiated the above-market lease.

The beleaguered borrower still pays interest and real estate taxes — barely. Vacancies are starting to put a squeeze on the borrower. A generous “interest-only” period on the loan will soon expire. Amortization payments, tied to huge increases in rental income that were projected at the closing, lurk around the corner. Operating expenses keep creeping up. Tenant improvements will have to be funded. Tenants, many facing their own financial ills, want rent concessions. Some threaten to depart. It

doesn't take much prescience to see that this lender might soon face a default.

What can the lender do, beyond worrying, to get ahead of these issues and prepare for that likely default?

THE TRIAGE APPROACH • Every loan has its own story and raises its own issues, but when a default seems likely, one thing is almost always true: The best time for a lender to start dealing with a problem will usually be “as early as possible.” This will often occur before the lender officially labels the loan as a “problem loan” and brings in counsel for the occasion.

In the face of borrower distress, whether already happening, imminent, or just foreseeable, lenders can and should take many steps that go beyond ordinary loan administration and monitoring. These steps can save time and perhaps even produce a better ultimate recovery if and when a default actually occurs. (Borrowers also have steps to take when they see trouble ahead. Those steps are not necessarily intuitive or the converse of the lender's steps. The author discusses the borrower's strategies elsewhere.)

This article will suggest protective steps and actions that a commercial real estate lender may want to take to prepare for a default or distress. Some of these suggestions bear repeating even though they might seem to be obvious. Others are anything but.

What Not To Do

From the very beginning, the lender should realize that the lender's written “internal” communications about the loan and the borrower, including probably all emails — the lender's entire thought process about the loan — will very likely end up in the borrower's hands if the matter ever goes into litigation. Although communications with counsel may stay private, they won't always. It's remarkably easy to lose the attorney-client privilege.

A lender should proceed as if there is no such thing as an internal or confidential communication. The lender team should avoid writing anything down, including electronically, if that written communication might somehow allow the borrower and its counsel to claim the lender acted for evil reasons or wanted to “hurt” the borrower (for example, “What a jerk” or “He's nuts, let's take him down” — statements much like some that have appeared, to the lender's detriment, in actual emails from litigated loans).

If the lender has concerns about weaknesses in its position, mistakes the lender may have made, information the lender does not want to share, or circumstances about the loan that reflect the lender's internal agendas or issues (as opposed to an objective and “reasoned” analysis of the borrower and the collateral), the lender should not create a paper trail (or an email trail) for the borrower, allowing the borrower to spin a web of theories and arguments about motivations. Do not give the borrower a road map for litigation and defenses.

If a particular comment might embarrass the lender if a court saw it — because, for example, it reflects a noncommercial, emotional, or unreasonable approach to dealing with the borrower — the comment should never be reduced to writing, including an email. People often think email is transitory, and they approach it in a flip or inadequately considered way. But email lasts forever and litigators love it.

Although, as a practical matter, anyone in the modern business world can't “just stop emailing,” any lender team does need to know not to send email that could create embarrassment or issues later.

Understand History

Get as much information as possible about the loan and the property — not just any required periodic reports that the borrower has delivered, but also a range of information to help understand the

scope and nature of problems with the property and the surrounding circumstances.

A recent title search, U.C.C. searches, and searches for judgments, litigation, and liens should disclose any mechanic's liens, unexpected second mortgages, pending lawsuits, and judgments against the borrower. The lender should probably expand these searches to cover any guarantors or other principals of the borrower.

A targeted online search can turn up useful information about all these people, any disputes or issues within the group, and their other projects and activities (as well as the collateral itself). And the lender should confirm that it has the right current addresses for the borrower, any guarantors, and any other principals.

The lender will also often want an update on the environmental status of the property.

Road Trip!

If at all possible, the lender should visit the property, and get a sense of how things are going there and the state of the local market. Does the property show signs of disrepair or deferred maintenance? How does the parking lot look? What's going on next door? Down the street?

If the loan covers construction, the lender has probably received regular inspection reports, but an on-site visit (if the lender doesn't already visit the site regularly) will usually shed more light. Does the project seem healthy? Does it show signs of disputes or other problems?

A site visit will almost always reveal useful details that the lender can never glean from all the written reports in the world. If the lender can't actually go to the site, then the lender may want to hire a savvy advisor or consultant, who works in and knows the area where the collateral is located, to go visit the site and report back.

Appraisal?

Valuation of the collateral will always crucially affect the resolution of any troubled loan, especially in bankruptcy. For that reason, appraisals can take on more importance than they really justify.

The act of ordering and obtaining (and then the fact of having) an appraisal can become a central event in any later dispute about the loan, as if the appraiser's estimate of value were some immutable and unassailable fact about the property or the lender's admission of what the property is really worth.

Any lender has good reasons to want a "high" value for the collateral, but also may benefit in other ways from a "low" value. Conversely, both possibilities can give any borrower arguments and theories.

Thus, an appraisal amounts to a hot potato — there is always a downside — and the lender should not necessarily rush to obtain a full appraisal. This is one decision where the lender should involve counsel from the beginning.

The lender should also think carefully about preparing and keeping "valuation write-ups" in its files. These may travel, as part of the lender's collected emails, straight to the borrower's lawyers if the loan goes into litigation.

The same applies to "drafts" of an appraisal. A lender should ideally not even receive written "drafts" of appraisals, as they will just create fodder for interrogations about how and why the "draft" differed from the "final" appraisal. Telephone conversations offer a much better medium to discuss what an appraisal might say.

This doesn't mean the lender's personnel should hide their heads in the sand about value. They should develop a general sense of the market for the collateral, how a buyer might value it, how the lender or a court might, alternative uses and strategies for exploiting or repositioning the collateral, and issues that might impair value.