Advice To Commercial Lenders For The Long Road Ahead

David P. Vallas

According to the Congressional Oversight Panel (COP) February report on the current state of the commercial real estate market, the end of the recent real estate crisis may be in sight, but things are likely to get worse before they get better. The report points to rising commercial real estate defaults, and $1.4 trillion in commercial loans maturing between 2010 and 2014. Many of these loans are presently "underwater" with borrowers owing more than the underlying property is worth. In addition to the COP report, others predict the volume of nonperforming commercial, construction, and land loans will jump to $165 billion in 2010, up from $135.7 billion last year. Since many of these loans will have an outstanding balance that is underwater when they mature and with no source of refinancing for borrowers, lenders will have difficult decisions to make in the coming years.

Faced with a borrower unable or unwilling to refinance, lenders have two options, both problematic. Either they can take back the property (through a foreclosure or by agreement with the borrower) or negotiate an extension of the loan that allows the borrower to maintain ownership. Historically, lenders could dictate terms to a defaulting borrower. Times have changed, however, and current market conditions sometimes wrest control over this process from the lender's hands. Re-taking properties with negative equity and insufficient cash flow to service the debt will almost certainly result in an adverse reclassification of the loans, to the detriment of the bank's lending base. Assuming control of a property also means having to address problems such as building code violations, incomplete construction, liens and other clouds on the title.

Financial regulators have recently taken steps to facilitate cooperation between lenders and borrowers. On October 30, 2009, a Policy Statement on Prudent Commercial Loan Workouts was released, providing guidance for bank examiners and lenders working with commercial real estate borrowers with diminished cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties. The statement outlined some constraints imposed on lenders when negotiating a commercial real estate loan workout and risk-manage procedures.

It assured that performing loans made to creditworthy borrowers would not be subject to adverse reclassification solely because the value of the collateral has declined. The policy statement also suggested approval of workout plans in which a loan is divided into slices, with a primary loan at the market interest rate and other terms that can be serviced by the borrower, and the balance as a second loan that is charged off by the lender. Using this multiple note structure might enable a lender to obtain a better credit classification for the loan and limit the amount of bad debt reported in future periods. These new policies support lenders in their efforts to cooperate with borrowers, and increase the likelihood of a productive workout.

If a lender and borrower are unable to negotiate terms that maintain a favorable characterization of the loan, the lender may seek to re-take the property. This can have benefits for the lender, particularly in the case of quality, income-producing properties.

It does not need to be an adversarial process. Indeed, a properly prepared deed in lieu of foreclosure will not affect a merger of the mortgage into the property's title. A lender that has accepted a deed can, therefore, proceed with the foreclosure process to clear title to the property, free of all junior encumbrances. This process is particularly effective when the property is burdened with junior mortgages, judgments liens, and mechanics liens.

While the foreclosure process offers lenders many benefits, it is not without its own set of perils. It can take twelve months or even longer for a deed through foreclosure to be issued, even if the matter is uncontested. The same courts often hear both commercial and residential foreclosures, and have clogged dockets, which slows the process down. Junior lien holders can often take advantage of these delays to create obstacles in an effort to extract some recovery from the senior lender on what would otherwise be an unrecoverable lien. Property encumbered with mechanics liens pose even greater difficulties, especially with uncooperative borrowers, who are often one of the only sources of information about the validity and proper amount of these liens. Lenders forced to litigate or negotiate with mechanics lien claimants without ample information about the underlying construction are at a serious disadvantage and may find it difficult and expensive to undermine an apparently valid lien.

Although many borrowers in the current economic environment are willing to succumb to lenders' demands, it would be an overstatement to suggest the vast majority of commercial real estate borrowers are cooperative.

Indeed, not all commercial property is underwater. According to the COP report, commercial real estate loans between 1999 and 2000 are more likely to have experienced price appreciation and qualify for refinancing under stricter underwriting guidelines.

Even these borrowers are experiencing difficulty refinancing because credit markets are operating at dramatically reduced levels and market values are depressed. Lenders faced with these types of real estate loans are sometimes unwilling to negotiate amicable workouts, believing they are in a position of strength. A hard-line approach to a loan workout, however, can drive a borrower into bankruptcy to reorganize, a process generally designed to protect and aid the borrower. It offers commercial real estate borrowers a safe haven, in which they can control their properties and reorganize their business. All enforcement and foreclosure proceedings must stop and any receiver appointed in a prior filed foreclosure suit to manage the properties must return control and all income from the property back to the borrower.

While there are limitations on the borrower's use of these funds, a bankruptcy filing often marks a shift in negotiating leverage. In some instances, a bankruptcy court may also re-write portions of a commercial loan and prevent the lender from foreclosing unless these new terms are violated.

This is not to say lenders are without any recourse, or that bankruptcy is a desirable option for borrowers. An aggressive lender can petition the bankruptcy court for relief from the borrower's protections by showing some wrongdoing by the borrower, that the lender's interest in the commercial property is not "adequately protected" during the bankruptcy process, or there is no equity in the property and continued ownership is not necessary for the borrower to reorganize successfully. Protection is more limited for a borrower with only a single commercial property. Borrowers in "single asset real estate cases" are subject to "pay to play" rules and must generally pay the lender interest at the non-default rate if the bankruptcy process extends beyond 90 days. Lenders have other rights as well.

In the end, however, these fights are often contentious and expensive for lenders and borrowers alike, and will erode the already limited assets available to the parties.

The economic crisis has created a perfect storm that lenders and borrowers will both want to avoid. Lenders and borrowers alike must recognize the old rules no longer apply and carefully evaluate the costs and benefits of a conference room versus a courtroom.

The goal in this market should be weathering the storm and coming out the other side.