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.

The lender should think about which appraiser it will ultimately use and the information the appraiser will want when starting work. Collecting that information may take time. The lender may save time later by starting that process early, especially if it will need the borrower's cooperation.

Good Housekeeping

As a loan heads toward default, "routine" housekeeping becomes more important than ever. The lender should review the loan file and look for possible issues:

- Do any "loose ends" remain from the closing? Did the borrower agree to provide any post-closing deliveries? Did they arrive?
- Does the lender have the original promissory note, and know where it is? What about any necessary endorsements of the note?
- If the lender retained any reserves or created a lockbox at closing, are all the blocked account and other third-party agreements in place? Do they refer to all the right accounts? Do they still need any signatures? If the parties were supposed to set up any new pledged accounts at some later point after closing, ask the same questions.
- Letters of credit in particular create all kinds of opportunities for trouble. Where exactly is the original letter of credit? Any amendments? Does the letter of credit name the right beneficiary? When does it expire?
- What about insurance coverage?
- What about all the other original loan documents not already listed? And any amendments, side letters, and consents that might become relevant?
- Did the parties ever add any collateral? Did they leave any loose ends or missing documents?
- Think about any upcoming deadlines or important dates, such as expiring letters of credit, insurance, or U.C.C.-1 financing statements, tax protest filing deadlines, or construction-related deadlines to obtain tax benefits for a project. Within reason, try to make sure these deadlines get met. The borrower might not pay enough attention. At a minimum, try to identify the problem and get ahead of it.
- If the lender identifies any deficiencies in the loan or the loan file, the lender can sometimes repair them before the loan goes into default — but this requires figuring out that a problem exists and then doing something about it quickly. The lender should strategically control how much the borrower knows about the lender's problem.
- If the lender has moved recently, has it given the borrower and other third parties (e.g., a ground lessor or hotel manager) formal notice of the lender's new address?
- If the lender filed a request for notice of delinquent taxes and tax sales, did the lender update its address for that filing too?
- Have all U.C.C. financing statements, mortgages, and other documents been properly filed and recorded? If the lender acquired the loan through an assignment, does the lender hold the loan and the mortgage of record?
- The lender or its counsel should check that the lender has qualified to do business in the state where the collateral is located. Some states require qualification as a condition to starting a foreclosure. Don't assume it's been done, particularly if the lender doesn't have many loans in the particular state. Qualification to do business can often be confirmed online in a couple of minutes.

Problems with details like these can often delay foreclosure. In occasional extreme cases, they can even prevent foreclosure entirely.

Don't "Waive" Goodbye To Lender's Rights

Has the lender administered the loan in a way that varies from the documents, such as by overlooking payments that are only a little bit late or by waiving some reporting requirements? If so, the courts may treat the lender's accommodations as a "course of dealing," and let the borrower assert it as a defense.

If a loan goes into default, the courts will not necessarily allow the lender to suddenly start enforcing the documents strictly. Instead, the lender may first need to give the borrower some reasonable notice. Try to identify any problems along these lines and think about how to fix them before the default occurs.

Bring In The Bookkeepers

The lender should figure out just how much the borrower owes. Aside from principal and interest, what about reimbursable items? Late charges? Legal bills? Other out-of-pocket expenses?

This information will become quite important once the loan goes into default, particularly when the lender serves a formal notice of default, notice to cure, or demand for payment. The lender will not want to lose a week pulling the numbers together. And without the numbers, it's hard to communicate exactly what it is the borrower hasn't paid or must cure.

If errors or issues have arisen in administering any escrow or reserve account for the loan, the lender should try to focus on them and get them cleaned up, so they don't slow enforcement of the loan by creating highly fact-sensitive and complex calculations, distractions, and defenses.

Be Reasonably Reasonable

If the borrower asks for any accommodations — even the slightest waiver or deferral — the lender should not reject the request out of hand, but should at least consider it, and be able to show the lender did so.

If the lender is inclined to cooperate, the lender should consider getting something in exchange for going along with the borrower's request — at a minimum, the borrower's confirmation of the status of the loan; the lack of waivers, defenses, or oral understandings about the loan; releases of the lender (if possible); and similar forms of comfort. Just how much comfort the lender can get depends on how badly the borrower wants the lender's cooperation.

Lender Liability?

Any commercial real estate lender will often worry about the risk of "lender liability," claims that a borrower might make against the lender, or defenses the borrower might assert, based on what the lender does in enforcing the loan, and how the lender has dealt with and currently deals with the borrower.

Although the risk of lender liability does exist, many lenders probably fear it more than they should. The courts have increasingly recognized that when a loan goes into distress or default, the borrower is not the only party entitled to rights and protections, and both parties have legitimate interests and the right to assert them.

On the other hand, today's meltdown of the financial and commercial real estate markets has already started to lead to creative lawyering — particularly in bankruptcy court — and may produce some revival of lender liability (or other judicial surprises) for lenders.

Lenders should always keep some basic protective principles in the back of their minds:

- A lender can mitigate lender liability risk by dealing with the borrower in a professional, reasonable, and consistent way, without making promises or leading the borrower on in a way that might look tricky or questionable after the fact.

- For consistency, the same one or two lender employees should handle all negotiations with the borrower. Those representatives should never suggest that the parties will be able to "work it out." And the lender should avoid doing anything that a court might interpret as taking advantage of the borrower. For example, if the borrower brings in a possible purchaser for the property, the lender should proceed very carefully (and with advice of counsel) before having any conversations with that person about their possibly buying the loan instead.
- If the borrower has its own internal conflicts — the "money" partner vs the "developer" partner, for example — the lender should avoid taking sides. If the money partner's parent company has guarantied the loan, that guarantor may represent the most likely purchaser of the loan but any such conversations require extreme caution, and legal advice.
- The lender should avoid exercising any kind of control — or even pressure — about the borrower's business decisions. Let the borrower decide how to run its business. If some decision requires lender approval, then the lender should consider the matter when asked and either grant or withhold approval in accordance with the loan documents.
- The lender (in particular, its origination staff) will probably have a natural urge to talk with the borrower about things the lender and borrower could do together, to improve the situation for the borrower, the property, and the loan. Hypothetical discussions may, in the borrower's head, become agreements, commitments, or assurances. The borrower won't think about technical niceties such as the need for credit committee approval. If the lender chooses to have these conversations, they must be confirmed in writing. Any such confirmation must confirm, above all, that the discussion is hypothetical and does not bind the lender.
- Before having any substantive conversations about the troubled nature of the loan or what to do about it, many lenders insist (for very good reasons) on having the borrower sign a prenegotiation letter, particularly if the conversations will occur without lawyers. A prenegotiation letter will reconfirm that any discussions aren't binding until the parties agree on and sign final documents. It will cover a few other similar bases. It need not talk about default or distress, although lenders sometimes try (usually unsuccessfully) to use these letters as an opportunity to obtain releases, confirmations, and waivers from borrowers. Without a document like this, any conversations about the loan will end up being woven into the borrower's claims or defenses if the loan ever goes into litigation.
- Borrowers are not the only parties that might assert lender liability and similar claims. Other creditors, particularly junior lien holders and even unsecured creditors, could make similar assertions. If the borrower is hopelessly out of the money (the norm in 2009), those other creditors may be far more likely and able than the borrower to invest the time, money, and effort to identify and assert claims against secured lenders. (Conversely, conversations with those other creditors may turn out to be more fruitful than conversations with the borrower in resolving the loan.) Thus, the lender should keep similar principles of "lender liability prevention" in mind when dealing with other creditors. If an intercreditor agreement defines the rights and obligations between creditors, though, careful compliance with that agreement should minimize any risk as against that particular creditor.

Watch For Stop Signs (a/k/a Intercreditors, Co-Lenders, And Other Third Parties)

As the lender looks ahead toward enforcing the loan, the lender should pay close attention to a few flashing red lights:

- **Third-party notices.** Before giving any notice of default, the lender must determine whether it has agreed to notify anyone else of problems with the loan before starting to do anything to enforce its rights. For example, in a hotel loan, the lender has probably agreed to notify the hotel manager or franchisor of any default, either before notifying the borrower or at least simultaneously.
- **Other lenders.** If the lender knows another lender exists with an interest in the same transaction — a mezzanine lender, a subordinated tranche, participants, etc. — the lender should do nothing at all toward enforcing the loan until the lender understands exactly how the intercreditor or co-lending arrangements work. Other parties may have rights to control the situation, or at least to approve certain actions. If a senior lender doesn't comply with these requirements, that failure may hand the junior lenders on a silver platter an action for damages and possibly an easy exit from a bad loan, based on the senior lender's breach of contract. The multiple-lender issues suggested in this paragraph may turn out to be the main event — even more important than the borrower-lender issues — in dealing with troubled loans originated near the peak of the recent lending boom.
- **Take the money and run?** If the lender holds bank deposits of the borrower or a letter of credit, the lender may want to grab that money or draw the letter of credit and apply it against the loan; Not so fast! In some states, exercise of "banker's setoff rights" or other quick and tempting remedies can limit or destroy the lender's other rights and remedies against the borrower and potentially even against guarantors.
- **Revenue capture.** If the loan allows the lender, upon default, to direct tenants or credit card companies to make payments directly to the lender or a lockbox, the lender should again think about the possible impact on other rights and remedies under state law. If revenue redirection won't create a problem, then the lender should act as soon as the loan goes into default. This means planning ahead to prepare the right notices, specify all the right details and information, get the notices signed, and figure out where to send them. It can also mean opening a new bank account. None of this will necessarily go quickly or easily. A lender can do it all before the loan actually goes into default. But the lender should not actually activate any of it without checking with counsel.
- **Lawyer behind the curtain.** Watch for any communications from the borrower (or other creditors) that sound as if they were written by a lawyer. They probably were. They may suggest theories of liability, or may strategically try to place the lender "on notice" of something. If you see words like "good faith," or "we relied," or "you agreed," it's time to start planning for a fight.

Call Counsel!

Once the lender starts to think about these issues, the lender should probably not proceed without involving counsel, to make sure these and other issues are adequately thought through before the lender makes a mistake — potentially an irreversible and expensive one.

Some lenders make a practice of bringing in new counsel whenever a loan heads toward trouble. These lenders fear that the counsel that closed the loan may hesitate to fully advise the lender if the closing documents have any problems or deficiencies. Moreover, just as the lender will often bring in a new team within its organization when a loan gets into trouble, the lender may want the objectivity of a new pair of legal eyes.

On the other hand, new counsel will need to get up to speed. That process can take a while and cost money. The lender should decide on and implement its approach before the loan actually goes into default. That decision will often reflect an overall policy rather than a loan-by-loan determination.

CONCLUSION • With luck and care, the suggestions in this article should help any commercial mortgage lender achieve the best possible ultimate recovery or resolution under a troubled loan, while minimizing pitfalls that can produce headaches and trouble down the road. Don't forget the basics: workouts and defaults require information and time; lenders should try to get ahead of the situation; and a consistent, thoughtful, and well informed strategy for each loan (and the portfolio as a whole) will help win the day.