The CRE Lender's Guide To Being Prepared

by
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In an increasingly complex and rapidly evolving economic climate, commercial real estate (CRE) lenders need to be prepared to take action to protect existing loan portfolios from broader macroeconomic conditions. A confluence of events culminated in the current state of the market, starting with coronavirus business closures, stay-at-home orders, supply-chain disruption, pandemic work-from-home and, most recently, inflation. The Federal Reserve, during its January 31 to February 1, 2023 meeting,[2] acknowledged a level of concern related to financial stability and vulnerabilities associated with higher interest rates and elevated valuations, "particularly in the CRE sector."[3] Prognosticators are expressing concerns that commercial real estate may be the next sector to disrupt financial markets as lending standards for CRE loans continue to tighten.[4] If these conditions progress, as loans mature, sponsors will have challenges refinancing existing indebtedness. Without viable exit strategies to address pending maturities, loan workouts could be on the horizon in 2023. In light of these turbulent conditions, the prudent lender must be prepared for CRE loan defaults and delinquencies. What will this preparedness look like?

Due Diligence

The goal of a loan workout is to provide the lender with the best potential recovery solution to a challenged loan. Some assets may be more susceptible than others over the course of the coming months, so consideration of a lender's loan portfolio and examination of risk areas are advisable. Loans secured by office buildings, in particular, likely warrant careful scrutiny. High vacancy rates in office buildings[5] have created difficult valuation and financing conundrums for sponsors and lenders, with reports of office loan portfolios being in danger of default.[6] So what can a lender do to plan for potential defaults and delinquencies? Be prepared for workouts. Look for signs of stress to the sponsor and the collateral. A class A office building with amenities in a prime location will likely not have the same challenges as B and C class spaces, as pandemic tenant demands have shifted to quality to entice workers back to the office. Preparedness for a workout will include due diligence. We have created a checklist of important considerations for lenders to be mindful of when evaluating existing loan portfolios. Reviewing the items listed in the following checklist may help to prevent or better prepare lenders for contingencies often associated with delinquent or defaulted loans.

The Lender's Due Diligence Workout Checklist

Task (commentary in gray boxes)
Review of borrower's financial condition, including updated and comprehensive financial information of borrower.
Review of each corporate and individual guarantor's financial condition, including updated and comprehensive financial information of corporate and individual guarantors.
Analysis of borrower's global debt service, reflecting projections of borrower's, corporate guarantor's and individual guarantors' expenses.
Review of existing loan documentation, including notes, amendments, security documents and UCCs.
Determine whether there are any gaps in the loan documents. Are all originals accounted for, fully executed, dated, witnessed and/or notarized as needed?
Determine status of any guaranty agreements.
Is the loan full-recourse? Non-recourse but subject to "bad-boy" carveouts?

Are there other lenders in the capital stack? Review intercreditor and/or subordination agreements.
When multiple lender relationships exist there may be obligations to provide notice and possibly cure rights before exercising remedies. Careful review of any intercreditor agreement is recommended before commencing enforcement actions.
Review of current rent roll.
Have there been vacancies since initial underwriting/closing? Is the asset meeting required DSCR, NOI and related covenants?
Review of leases, estoppels, SNDAs.
Any changes to material/significant leases? Termination or default notices? Have tenants contracted or turned over space? When do major leases terminate? Do tenants have termination rights?
Review status of tenant occupancy and notices of lease defaults and/or terminations.
Assessment of loan performance.
Review of lien status of borrower.
Have mechanics' liens been filed? Is lender's priority senior to any such liens?
Review/determine status of all communications with borrower regarding the current status of the loan.
How has lender addressed past defaults? Is there a history of waivers?
Send default notice letters.
Identify sources of additional collateral.
Determine whether borrower or guarantors have accounts with the bank that could be available for set-off.
Review of condition of the real estate collateral.
Determine nature and value of all collateral securing the loan. Review existing appraisals and determine need for new valuation information. Consider procedures for continuous monitoring to ensure collateral does not go to waste.
Review of property insurance.
If insurance has lapsed, it may be necessary to force place coverage. Loan documents should include protective advance provisions for the payment of insurance to protect the lender's security interest in the collateral.
Determine status of taxes.
Lien priority can be lost to the super-priority rights of federal, state and local taxing authorities. Are escrows being held for taxes? If not, the loan documents should include protective advance provisions for the payment of taxes to protect the lender's security interest in the collateral.
Determine entity standing.
Obtain appraisal.
When ordering a new appraisal, ensure it is obtained from an appraiser qualified to testify as an expert in litigation.
Check files for survey of the property.
Ensure title policy has been issued and review policy for title issues.
Pre-negotiation letter/pre-workout agreement.
Agreement that protects the lender against post-default lender liability resulting from the course of discussions; creates a pathway for negotiation and/or potential restructuring of the loan.

Be proactive. Look for the warning signs of challenges to the borrower and/or the collateral before a default occurs. The items identified on the sample checklist may help identify the early signs of a potential problem. Conducting loan due diligence will arm the lender with information needed for decision-making and potential workout strategies. If an event of default has occurred and remains in existence, under most CRE loan documents the lender will have various rights at its disposal, including, among others, acceleration of the debt, default interest, litigation for past due payment(s), the appointment of a receiver, and the right to foreclose on the property that secures the loan. Borrowers may have cure periods and the cure period for various types of defaults may vary; therefore, a review of the applicable cure periods on a loan-by-loan basis is necessary. Many factors can contribute to troubled loans. With office assets, for example, vacancies, major tenant terminations and financial covenant failures are red flags signaling the possibility of a default. When the signs point to problems, CRE lenders should prepare for the possibility of a workout.

Strategies For Distressed Real Estate

Most borrowers/operators of CRE are experienced, skilled operators who are acutely aware of when and how external conditions are affecting their assets. They want to be proactive in addressing and solving the challenges confronting their properties. While it is exceptionally important for lenders to understand their loan portfolios and know what rights and remedies they may have in the event of default, it is also beneficial for the lender to understand the types of solutions that its borrowers/guarantors may be exploring. In many distressed real estate scenarios, the borrower wants to retain the property, and to do so, borrowers may want to consider a loan modification. When lenders and borrowers can come to terms and document a loan modification in a workout scenario, it is not uncommon to see, among other things, forbearance of the exercise of its remedies, extension of maturity dates and capitalizing of interest. Sometimes there may be value in the lender making an additional advance not contemplated under the original loan terms if the advance will help the property generate or improve cash flow, such as advancing funds to pay a brokerage commissions for a new lease or funds to make tenant improvement allowances to lease a vacant space to a new tenant. A loan modification can take many forms and frequently requires one or more borrower concessions, such as principal curtailment payments, adding additional collateral, equity pledges of membership interests in the borrower, adding or modifying financial covenants and/or liquidity tests, eliminating future funding/revolving or readvance provisions, consenting to the appointment of a receiver, or changes to the property manager.

When documenting an amendment to a loan, it is imperative that any such amendment preserves the lender's lien priority. Amendments of loans, if not properly documented, could have unintended consequences, such as impairing the lender's existing priority position. And when CRE is in distress, if there are other creditors in the capital stack, amendments could open the door to priority loss.

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Another request that borrowers may make when trying to implement a plan to address a floundering asset is for permission to add additional funding to the capital stack. Additional funding could be a mezzanine loan secured by the borrower's equity in the project or preferred equity. While an equity infusion may be what the project needs to survive, adding additional debt to the capital stack presents other concerns to the existing senior mortgage lender, such as how a mezzanine lender's rights affect the senior lender's remedies and enforcement powers. Mezzanine CRE loans are secured by a pledge of the property owner/borrower's ownership of the real estate. Since a mezzanine lender is higher up in the capital stack, it will be concerned about a foreclosure by the senior lender, which would render the mezzanine collateral valueless. Therefore a mezzanine lender, as a condition to making its loan, would likely condition doing so on obtaining an intercreditor agreement with the mortgage lender. An intercreditor agreement typically provides a mezzanine lender with the right to cure a mortgage loan default for a specified period, to allow the transfer of a property to a mezzanine lender or a qualified transferee through a foreclosure of the pledged equity interests in a mortgage borrower, and to purchase a defaulted mortgage loan. When preferred equity is added to a project, the preferred equity provider typically seeks similar protections as a mezzanine lender through the use of a recognition agreement. For a troubled asset, permitting a borrower to add additional sources of funding to the capital stack may save a project, but the implications to additional funding can impair the lender's existing remedies and rights. Therefore, the mortgage lender should carefully review any such request against other potential pathways that may be available to restructure the loan.

Sometimes other pathways are not available and borrowers may be willing to "hand back the keys" through the use of a deed-in-lieu of foreclosure. When this is an option, the lender is entering into a negotiated settlement of the loan whereby the borrower transfers title of the asset to the lender. When negotiating with the lender for a deed-in-lieu of foreclosure, for example, borrowers will usually seek relief from the sponsor's personal guaranty as a condition to their cooperation. When this request is made, the lender needs to consider whether it will be made whole by the property alone or whether it wishes to preserve its right to seek any deficiency[7] from the guarantors.

Be Mindful Of Your Communications

The advice of counsel will be paramount during the process of evaluating and addressing troubled loans. When communicating with counsel, be mindful of the basics of attorney-client privilege. Although the definition of attorney-client privilege varies depending on jurisdiction, it generally attaches to a confidential communication between a client and its counsel made for the purpose of facilitating professional legal services.[8] In a workout situation, it is necessary for the lender to maintain the confidentiality of all communications with its attorney. First, when drafting an email it is imperative that the lender includes on the email only those individuals who are necessary in seeking information from the attorney and with whom the lender intends to maintain confidentiality. Second, the lender should be cautious about forwarding email chains with its attorney. For example, when seeking advice regarding how to respond to a borrower's request for a waiver of default involving a tenant vacancy, a lawyer may craft an email with advice to the lender on how the lender could respond. This advice may be on the same email thread where the lawyer and the client have discussed other, confidential matters. Forwarding the email thread to a party not covered by privilege would break the privilege between the lender/client and its counsel. While not dispositive, it never hurts to place a “privilege” indication on emails to counsel.

Think about what you put in writing—not just to a borrower, but internally. In all communications, the lender's internal communications and documentation should be reasonable and appropriate and, in particular, avoid characterizations that would be damaging if exposed in a courtroom proceeding. Most types of business records and internal business communications, absent a privilege, are discoverable in litigation, so assume that anything you write as a lender could be shown in a courtroom. This goes for emails, text messages and social media posts too. Lenders should avoid any documentation of their actions involving a loan that could be characterized as emotional or unreasonable; rather, all assessments should be factual, appropriate and reasonable.

Likewise, lenders should be consistent in communications with borrowers and should avoid vague or ambiguous statements. For meetings or verbal communications with borrowers, lenders should have more than one person present to help counter a borrower's misconstrued recollection of the conversation. Submitting a memo to the borrower’s file memorializing the meeting or verbal communication may also assist the lender when memories inevitably fade.

Keep in mind that the goal of communications in a workout is to resolve a troubled loan; however, some situations will not be resolved through the workout process and negotiations may fail. When this happens, failed negotiations could form the basis for lender liability claims because a borrower relied on aspects of the negotiations to its detriment. A well-drafted pre-negotiation agreement is therefore advisable before any discussions are held. Lenders should also be in communication with counsel should negotiations fall through and litigation becomes a reality, as there are important requirements to start preserving documentation relating to the potential litigation when it is anticipated.

Now more than ever, lenders must pay careful attention to their loan portfolios and be ready to confront evolving economic conditions. By being proactive and prepared, lenders can address troubled loans and resolve them in a positive manner for all involved.

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Notes:

1- The views expressed in this article are those of the authors and not necessarily those of Richards, Layton & Finger or its clients.

2- "Minutes of the Federal Open Market Committee January 31–February 1, 2023," accessed via FOMC Minutes January 31–February 1, 2023 (federalreserve.gov).

3- *Id* at page 7.

4- *A Credit Crunch Could Worsen the Bank Turmoil and Commercial Real Estate Could Be Next Domino to Fall*, BUSINESS INSIDER, March 27, 2023, by Phil Rosen, accessed via Why Commercial Real Estate Could Tumble As the Next Bank Crisis Domino (businessinsider.com).

5- *Office Vacancy Will Increase By 55% by the End of the Decade as Hybrid and Remote Work Push Real Estate to An 'Inflection Point'*, FORTUNE, February 22, 2023, by Tristan Bove, accessed via Office vacancy rates are soaring because of remote work | Fortune.

6- *20% of M&T's Office Loans in Danger of Default*, THE REAL DEAL, January 19, 2023, by Suzannah Cavanaugh, accessed via M&T Bank Reports Higher Office Default Risk in Fourth Quarter (therealdeal.com).

7- The deficiency is the difference between the sale bid (if mortgagee is successful bidder) or net foreclosure sale proceeds (if third party is successful bidder) and the amount of the judgment entered in the foreclosure action.

8- E.g., Del. R. Evid. 502(b).