

# Commercial Loan Recovery 101: How to Obtain Maximum Returns, Part I

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*The options for dealing with nonperforming commercial loans are many.*

Despite the rising tide of commercial loan delinquencies and defaults, there are many effective and inventive ways lenders can mitigate losses. These methods apply to loans secured by traditional properties – such as office buildings and shopping centers – as well as by condos, residential subdivisions and properties with a business enterprise, such as hotels and restaurants. This article will provide an overview of the basics of commercial loan recovery.

## Preliminary Matters

### Early Warning Signs

Prior to a missed mortgage payment, there are often signs that a loan may be headed for trouble. These include:

- Compliance certificates, financial reports and the like are not provided when required under the loan documents.
- Financial covenants (for example, maintenance of a minimum fixed charge coverage ratio) are not satisfied.
- Taxes (for example, property, sales and payroll) are not paid when due.
- Insurance coverages are reduced or cancelled.
- Payments under key franchise agreements (for example, royalties and advertising contributions) are not paid in full or on time.
- Marketing expenditures are reduced.
- Ordinary maintenance and capital expenditures are deferred.
- Vendors and suppliers complain about late payments.

- There is a significant increase in employee turnover and/or a noticeable decline in employee morale.
- The borrower experiences a decline in its competitive position.
- Changes occur in the relevant market (*e.g.*, there is an increase in vacancy rates).
- The borrower becomes more difficult to reach and is not as communicative.
- Suits are filed against the borrower by vendors, suppliers or other creditors.

It is also critical to watch for changes that the borrower might not reveal, *e.g.*, transfers of assets to related entities, changes in the name of the ownership entity, undisclosed sales of all or a portion of the business, stock transfers and other “below the radar” changes in management and ownership. In addition, the acquisition of additional subordinate debt, jurisdictional moves of the corporate office, new leases of property or equipment, and changes in existing contracts or leases should be carefully scrutinized.

### Action Steps

Assuming an initial investigation has raised serious concerns – or perhaps uncovered defaults under the loan documents – one of the earliest steps for the diligent lender is to review the loan documents for completeness and available remedies and options. In addition, the lender needs to make sure that insurance is in place with appropriate coverage amounts. If not, the lender should determine whether, based on the loan documents, forced-placement of insurance is permitted and in what amounts. For example, the lender needs to ascertain whether the loan documents allow forced placement of insurance

for all aspects of the borrower's business, or merely casualty coverage for the lender's collateral.

Lenders and servicers should remain proactive in this phase, increasing communication and closely monitoring the borrower's operations, while remaining sensitive to lender liability issues and staying abreast of current valuation and appraisal.

In the case of franchised operations, non-payment of royalty fees, like non-payment of a debt service, is usually the last step for a property in trouble. All franchises have standards of operation, reporting requirements and capital improvement mandates, which are likely to be neglected prior to any monetary default.

Lenders need to determine when to bring in the experts and who they will be – legal counsel, management, receivers, note sale advisors and/or brokerage firms. Lenders should also carefully review the loan documents, checking the security documents first. In the case of a mezzanine loan, this includes the intercreditor agreement and the mortgage securing the senior loan.

New UCC financing statements should be filed as necessary (note that the borrower's signature is no longer required). It is important to obtain the borrower's cooperation to record any mortgages, leasehold mortgages, memoranda of lease or other real property security documents that were misfiled or not filed and to keep notes regarding deficiencies in loan documents for use in any subsequent restructuring (*e.g.*, collateral "step backs" in pre-2001 loan documents, omission of suretyship waivers in non-borrower security agreements, perfection issues, and ineffective jury trial waivers).

### **The High Cost of Delay**

Lenders must realize that time is of the essence – staying proactive and in control of the situation will help minimize losses. A turnaround is unlikely to happen by itself – delays mean that cash will continue to dissipate or, in many cases, be retained for the purpose of building up a "war chest" for a possible bankruptcy filing. Lengthy delays also mean that unpaid trade and other

obligations will continue to mount, and assets may be sold at unfavorable prices to generate cash. Also, other creditors may declare defaults or begin enforcement actions.

### **Out-of-Court Options**

Lenders have five basic actions that do not require a court action. These are:

- Forbearance
- Workout – restructuring the borrower's obligations
- Deed in lieu of foreclosure (real property) and acceptance (personal property)
- Enforcement (collection or foreclosure – in those states which permit non-judicial foreclosure)
- Sale of rights (for example, a note sale or a sale of a judgment or bid)

In choosing the most effective path, a lender must carefully evaluate the prospects of recovery. In so doing, it is important to keep in mind that some facts may be distorted by the borrower. For instance, accounts payable may be significantly greater than represented by the borrower, and accounts receivable may be only partially collectible.

A lender should start with a full review of the loan documents, paying particular attention to the following:

- Security and security-related documents like mortgages, security agreements, control agreements, pledge agreements, UCC filings, security certificates and the borrower's or any guarantor's organizational documents.
- Guaranties, whether full recourse guaranties or "bad boy" or "carve out" guaranties.
- Cross-default and cross-collateralization provisions.
- Intercreditor agreements between the various lenders.
- Documents critical to the borrower's business, considering whether the lender may need estoppels, comfort letters and the like. These include leases, management, franchise and supply agreements, and liquor/gaming licenses.

Before negotiating with the borrower, it is generally advisable to obtain a *prenegotiation agreement*, which addresses potential lender liability issues.

When determining the best recovery strategy, the lender generally should consider four critical objectives:

- Control of the cash
- Control of the business operation
- Maintaining or enhancing value
- Positioning for sale or refinancing

## **Forbearance**

In its simplest terms, a forbearance is an agreement in which the lender agrees that it will refrain from exercising its default remedies in return for certain specified performances by the borrower and any guarantors. The terms of the agreement (including the required performances) are limited only by the imagination of the lender and the borrower.

In general, the advantages of a forbearance for the borrower are:

- Time to solve the problems which led to the event(s) of default.
- Avoiding the stigma of litigation.
- Relief from various financial covenants and payment terms which cannot be met at present.
- Avoiding litigation or bankruptcy, affording the borrower an opportunity to control its own destiny through refinancing, sale of the business, infusion of equity, business reorganization, and the like.

For the lender, the benefits are:

- Any deficiencies in the loan documents can be eliminated through the forbearance terms.
- The forbearance agreement can contain a variety of clauses of benefit to the lender in later litigation or bankruptcy, including a confirmation that the borrower owes the indebtedness, an acknowledgment of the amount of the indebtedness, a release of various claims and defenses, statements of fact regarding the debtor's financial condition and the borrower's consent to relief from the automatic stay in any bankruptcy filing.

- The lender is positioned to continue receiving payments from the borrower, while at the same time protecting or enhancing the lender's collateral position, and without having to resort to the more drastic step of litigation or non-judicial foreclosure.

## **Workout**

A workout is a restructuring of the borrower's obligations. The goals are twofold: to allow the borrower to continue operations, and to return the loan to performing status. Workouts can be simple, incorporating a single-party borrower, or extremely complex, involving multiple parties – and range from a modification of some portions of the loan to a complete restatement of the fundamental terms of the loan, including possibly the consolidation of the loan with other related, or unrelated, loans.

The primary goal of a workout is usually to arrive at a loan structure under which the borrower will be able to perform, while at the same time protecting or enhancing the lender's collateral position, ultimately correcting any deficiencies or weaknesses in the existing loan documents.

## **Deed in Lieu of Foreclosure**

In some situations, it may be advisable for the lender to accept a deed in lieu of foreclosure, thereby gaining immediate control of the property to protect its value. While this process can be speedy and inexpensive, the deed may not automatically merge with the mortgage, and poses many risks. Title issues – such as the presence of junior lienholders, boundary problems, competing ownership claims, zoning and land use restrictions, transfer taxes and recording fees – as well as other surprises such as environmental contamination of the premises, can make this “simple” action surprisingly complex.

When pursuing a deed in lieu of foreclosure, it is important to set reasonable expectations; a friendly turnover of assets is frequently unrealistic, so the threat of foreclosure and other actions must be on the table during the negotiation process. In any consideration of a deed in lieu, the lender should fully understand the advantages

and disadvantages of a deed in lieu vis-à-vis a foreclosure. One deal may be perfect for a deed in lieu, while another may not.

To the extent that significant personal property is involved, the lender may wish to propose a similar procedure under Article 9 of the UCC called “acceptance” since such a procedure would discharge any junior liens on the personal property.

## Enforcement

The first type of enforcement is *collection*. If the security for the loan is real property, this would include enforcing the lender’s rights under the assignment of rents provisions in its mortgage. In the case of personal property, it would include enforcing the lender’s collection rights under Article 9 of the UCC.

The other category under enforcement is *foreclosure*. While every state, and federal, law has unique rules and procedures, there are a number of common concepts.

State foreclosure schemes generally fall into two primary categories: *judicial* and *non-judicial*. A judicial foreclosure can be broadly described as a lawsuit in which the lender seeks entry of a judgment scheduling a foreclosure sale of the collateral, and also pursues what is often referred to as a deficiency claim for any amount not recovered in a sale of the property. In contrast, a non-judicial foreclosure affords the lender a ministerial process under which the lender can obtain payment by selling the property without resort to a court. Generally, the non-judicial action will be quicker and more economical and is most often used when no additional recourse is available.

The terms *cure*, *reinstatement* and *redemption* are sometimes used interchangeably and have different meanings, depending on the state. Redemption is used to refer to the borrower’s right to redeem a property by paying the lender in full after it has been foreclosed by judicial action. The redemption period can range from a few months to a year and, if effective, has an

obviously chilling effect on a sale during that period.

Redemption usually involves the borrower or other interested party paying the full-accelerated indebtedness owed to the lender, and thus becoming subrogated to the lender’s rights under the loan documents or the pending foreclosure suit. In contrast, the concepts of reinstatement or cure generally refer to the right of a borrower to bring the loan current by paying any defaulted amount prior to a foreclosure or trustee’s sale.

## Sales of Notes, Judgments and Bids

As lenders increasingly seek to avoid bringing more REO into their portfolios, they have begun to look closely at opportunities to sell non-performing loans, their lawsuits or final judgments, or their winning foreclosure bids. Such sales are often arranged through a loan broker, and the complexity and marketability of the loan will determine the discount rate and the time it takes to complete the sale. Some of the issues to be considered in such a transaction include:

- The due diligence difficulties posed by the fact that the purchaser is *not* purchasing the real property or other underlying collateral, but is instead purchasing a loan or a note. In the current economy, prospective buyers of loans or notes are often novices to such transactions, and are more familiar with real estate transactions. The differences between the purchase of a real estate parcel and the purchase of a loan secured by a real estate parcel are vast. The due diligence appropriate in the purchase of a loan is similar to that exercised by a lender in making a loan as opposed to a buyer making a real estate purchase.
- The tax implications of the purchase must be understood, and differ from those involved in the purchase of a real estate parcel. In addition, there may be transfer taxes associated with the sale of the loan, as well as the necessity of recording documentation in the public record.
- The overlay of pursuing a foreclosure, or workout or forbearance negotiations, after acquisition of the loan adds time and effort to

the process of converting the ownership of a non-performing loan into ownership of the underlying collateral.

- Any loan purchase carries the risk of a lender liability claim being asserted by the borrower. While the loan purchaser may hedge against this risk by due diligence at the outset of the purchase and through an indemnity agreement with the selling lender, the lender liability claim may result in unanticipated delays and expense, even if not valid.

The issues arising in the purchase and sale of a final judgment of foreclosure include some of those listed above regarding the sale of a note or loan. However, the entry of a final judgment often has the effect of eliminating some of the risk of a lender liability claim and reducing the chance that the loan documents may be defective. The final judgment usually signifies that the lender is entitled to enforce its loan documents, enabling it to pursue a foreclosure. However, additional issues may surface, such as:

- In many states, foreclosure sales are public auctions. The purchase of the final judgment may not equate into an absolute right to obtain the underlying collateral at the foreclosure sale. A third-party bidder may outbid the plaintiff at the foreclosure sale. The purchaser of the final judgment needs to understand the foreclosure mechanisms at work in the specific state, and in the particular case in which the final judgment was entered, to determine if the purchase of the final judgment is likely to result in the purchaser actually acquiring the underlying collateral.
- There may be a documentary stamp tax or other transfer tax applicable to the purchase of the real property collateral at the foreclosure sale.
- There may be redemption or reinstatement/cure rights available to the borrower or other interested parties which may impact the judgment holder's right to conduct the foreclosure sale and to acquire and resell the underlying collateral.

Because of the risks associated with the purchase of a final judgment, some interested purchasers instead seek to acquire the foreclosing plaintiff's winning bid after the conclusion of the foreclosure sale. Such an acquisition may have the benefit of eliminating the risk of a third-party bidder acquiring the property, but may still carry the risks associated with redemption, reinstatement/cure, and stamp or transfer taxes.

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