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Lenders seek alternatives to foreclosures

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More commercial real estate loans are expected to default by the end of this year, and most predict loan defaults and sales volumes have not yet bottomed out.

According to credit reporting agency Fitch Ratings, as of May 31, 4,500-plus loans totaling $81.3 billion dollars were in special servicing, meaning they've been designated as distressed loans that must be resolved or disposed of for the protection of the lender. According to Deutsche Bank, the balance of loans that are at least 90-days delinquent has increased every single month this year. Defaults are universally projected to increase.

As commercial real estate defaults continue to rise, some lenders are looking to employ strategies to avoid taking ownership of their collateral through foreclosure.

Simply stated, lenders are not in the business of property management and sale — their business is to make money by collecting interest, and a foreclosure puts an end to that interest income.

If a lender takes title to the real estate, it's usually responsible for significant new costs, including the operational costs (including taxes) associated with the real estate, creditor claims, and potential liability for environmental issues.

Ownership often subjects a lender to the same problems that its borrower faced in managing the property for profit, plus the costs of marketing the property. Finally, commercial real estate prices remain extremely depressed. So, in many cases, taking title will not achieve a lender's goals.

In light of this, lenders are increasingly employing one or more of the following strategies to limit their losses from distressed commercial loans.

Consensual loan workouts

It appears that given the current economic circumstances, some lenders are considering restructuring loans through consensual workouts. In exchange for some concessions, a lender may choose to forbear from exercising its default enforcement remedies.

Once a short-term loan modification is achieved (often memorialized in a forbearance agreement), then the lender and borrower have additional time to explore a long-term solution that meets the needs of both parties. This gives the borrower some breathing room to try to find a substitute lender, or buyer for the property, or to enable the parties to negotiate a long-term solution under a restructured loan.

Depending on the situation, a loan modification may be achieved, enabling the borrower to retain the property while maintaining cash flow, and the lender to continue making money from the loan rather than suffering an expensive foreclosure.

Given the grim outlook for the commercial real estate market, some lenders are considering terms that may not have seemed achievable in the past. Among them: an extension of the maturity date, deferred payments, interest rate modifications, or even principal reduction in the form of a discounted payoff.

In exchange for flexibility in the workout, the lender may seek benefits from the borrower, including additional capital investment or credit support (such as further guarantees or collateral) from the borrower's principals or affiliates, additional principal payments where possible, and advance funding of reserves for upcoming tax and insurance payments. These benefits also may include a right of access by the lender in the event of a further default, or the appointment of a third-party manager for the real estate.

Note sales

These are becoming an increasingly popular alternative to foreclosure, as the purchase of distressed debt presents substantial opportunity and risk for each of the parties involved in the transaction. Through a note sale, the seller-lender can divest itself of the continuing risk of a loan and monetize the loan for a set amount, usually at a discount.

The purchaser of the loan acquires the note and the rights of the original lender (including rights to the cash flow and rights against the collateral such as a right to foreclose and own the property), at a price that is more reflective of current market conditions as compared with those in place when the loan was originally made.

If a buyer exists, a loan sale may be the fastest process for a lender to monetize and exit from an underperforming loan.

Appointment of receiver

In cases where a defaulted borrower is interfering with the effective maintenance, operation and/or potential sale of the collateral, a lender may seek the appointment of a receiver for the property.

In order to obtain a court order appointing a receiver, a lender may in certain jurisdictions be required to show that a receiver is necessary to prevent waste to the property (e.g., through failure to pay taxes and insurance), for the lender to receive rents under an assignment of rents, or to protect the public health, safety and welfare.

Through the use of a receiver, a lender may in some circumstances effect a faster and less expensive sale of the property (without the stigma associated with a foreclosure sale), while ensuring the property is maintained pending sale. Receivers also may be used to prevent mortgagee in possession issues.

Deeds in lieu

In the event alternatives fail and the lender must take title to the property, the use of a deed in lieu of foreclosure may be an attractive option for lenders. Through a deed in lieu, the borrower voluntarily "hands over the keys" to the lender in satisfaction of the debt.

The use of deeds in lieu is most effective where the value of the property is plainly less than the amount of the debt, because neither the lender nor the borrower then has an interest in litigating a dispute over the negative equity in the property.

A deed in lieu can provide numerous benefits over a traditional foreclosure, including, chiefly, a speedy and more cost-effective title transfer. But it may not fit all cases; it does not clear junior or competing interests like a judicial foreclosure action would, and it may be subject to certain transfer taxes depending on the jurisdiction.

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