• Jun. 01, 2009

Your Loan Is In or Near Default? Here's What You Should Do

By SCOTT C. SMITH and

ANNETTE MATHAI-JACKSON

Credit is exceptionally tight. Loans are nearly impossible to get and difficult to keep. To make matters worse, borrowers in trouble with their loans tend to freeze in the headlights, often allowing a bad situation to become catastrophic.

This column provides guidance to commercial real estate borrowers on how to prevent loan defaults in the first place and what to do if one occurs.

Read Your Loan Documents

Most often loan documents are written by and for lenders. As a result, many borrowers conclude that they can do nothing about the legalese or boilerplate language in their loan documents and do not bother to read them in any detail. This is a mistake. Even in a market in which borrowers have little leverage, prudent borrowers read loan documents from cover to cover and, more importantly, re-visit the agreements to ensure continued compliance. How can you know if you have or are approaching a problem if you don't even know what your loan documents require?

Pay Attention to What Constitutes an Event of Default, Even If One Has Not Occurred

In this market, there is no such thing as a "technical default," so you need to be aware of how your acts/omissions can be construed as events of default. For example, lenders often search county tax lien records to check up on their borrowers. Thus, the non-payment or delayed payment of real property taxes - which is likely to constitute a default under your loan documents - might come to your lender's attention sooner than you realize. Worse yet, if you fail to pay property taxes while collecting rent, you could be guilty of "financial waste" and subject to new or higher levels of personal liability. Also, keep your loan covenants in mind if your tenants ask for rent relief. Even if you can maintain your loan payment obligations with reduced rents, you will be in default if you reduce rents or revise your form lease documents in violation of loan covenants. Finally, pay close attention to your reporting requirements. Map out for an entire year exactly what information you are required to provide to your lender and when. Your CFO or controller should be included in this process, but include outside accountants and auditors as well so that everyone is in the know as far as your obligations. In times such as these, even the most innocent errors or omissions may not go unpunished.

Ask For Permission Rather

Than Forgiveness

Bring potential problems to your lender's attention early. Once a covenant is blown, the cost to fix it is usually high since penalties and fees exacted for covenant defaults are one of few revenue sources for lenders today. By consulting with your lender before you breach a covenant, you may be able to avoid a breach in the first place. The more lead time you provide, the more likely you are to receive constructive input. Negotiations over avoiding or remediating a potential breach will almost certainly go easier than those concerning an actual breach.

Propose a Solution

Before you ask for permission, be prepared to tell your lender how you plan to fix the problem - without over-promising - and have a proposal for how your lender can assist. This may include a discussion regarding the modification of particular loan terms. Yes, credit is tight, and lenders are in an unforgiving mood, but if a slight modification of your terms prevents a breach and another bad debt on their books, you may find your lender willing to listen.

Be Aware of Your Rights

Keep your lender honest. Did the lender give you notice as required? Is the lender seeking penalties in excess of what the loan documents provide? Did you have a chance (and enough time) to cure the default as required under your loan documents? In addition to making sure you are aware of your rights under the loan documents, make sure that you are aware of your rights under applicable law. California law, for instance, places numerous limits on remedies available to lenders that cannot be modified by contract.

Consider an Assignment for the

Benefit of Creditors

If you are unable to reach any solution with your lender, consider transferring title to the secured asset to the lender to satisfy the debt. This can be done through a "deed in lieu of foreclosure." This will provide for the transfer and will specify how the asset will be sold and the proceeds divided, with the bulk going toward your outstanding loan obligations. The benefit of this approach is that you avoid many of the administrative costs of foreclosure. If you have guaranteed your loan, make sure to negotiate relief from the guaranty at the same time that you assign the asset, otherwise the guarantor will still be on the hook for any shortfall between the loan amount and the value of the asset. Note that there may be tax consequences if any of the debt is canceled and your basis in the property (the amount you initially paid, less depreciation and other losses) is less than the value of the asset. Real property involves numerous unique issues, and you are well advised to involve both legal and tax counsel.

Consider Bankruptcy

If all else fails, consider filing for bankruptcy. Bankruptcy may afford protections that are not otherwise available. Once commenced, the bankruptcy court will typically order a "stay," which seeks to maintain the status quo until you and your creditors can create a plan that establishes how creditors will be paid while keeping your business alive. Lenders and other creditors will be prevented from exercising certain legal or contractual remedies. Weigh these benefits, though, against the costs. You may lose control over your business if the bankruptcy court decides to appoint a trustee to oversee your assets rather than allowing you to do so. Once you file for bankruptcy, the bankruptcy court will have discretion over if, when and how you get out of bankruptcy. Finally, bankruptcy is expensive. The proceedings themselves and attorney fees are likely to consume a considerable amount of your resources as well as your time and energy.

Scott C. Smith is a corporate and tax partner with the law firm Hanson Bridgett. ***Annette Mathai-Jackson*** is a LEED AP senior counsel in the Real Estate Group with Hanson Bridgett.

By Scott C. Smith and

Annette Mathai-Jackson

Credit is exceptionally tight. Loans are nearly impossible to get and difficult to keep. To make matters worse, borrowers in trouble with their loans tend to freeze in the headlights, often allowing a bad situation to become catastrophic. This column provides guidance to commercial real estate borrowers on how to prevent loan defaults in the first place and what to do if one occurs.

Read Your Loan Documents

Most often loan documents are written by and for lenders. As a result, many borrowers conclude that they can do nothing about the legalese or boilerplate language in their loan documents and do not bother to read them in any detail. This is a mistake. Even in a market in which borrowers have little leverage, prudent borrowers read loan documents from cover to cover and, more importantly, re-visit the agreements to ensure continued compliance. How can you know if you have or are approaching a problem if you don't even know what your loan documents require?

Pay Attention to What Constitutes an Event of Default, Even If One Has Not Occurred

In this market, there is no such thing as a "technical default," so you need to be aware of how your acts/omissions can be construed as events of default. For example, lenders often search county tax lien records to check up on their borrowers. Thus, the non-payment or delayed payment of real property taxes - which is likely to constitute a default under your loan documents - might come to your lender's attention sooner than you realize.