Real Estate Workouts in a "No" Environment: Just Pay Me and Let's Get this Over With

Gary S. Gunn
Hughes Watters Askanase, LLP
333 Clay, 29th Floor
Houston, Texas 77002

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Gary S. Gunn
Hughes Watters Askanase, LLP
Three Allen Center
333 Clay, 29th Floor
Houston, TX 77002
713.759.0818

REPRESENTATIVE WORKOUT TRANSACTIONS

- Represented a financial institution in the successful workout and restructure of five loans to a developer totaling over $15,000,000 and secured by multiple commercial and residential tracts.
- Represented a financial institution in workouts of eight loans to a large homebuilder totaling over $7,000,000 and secured by troubled assets, which culminated in structured foreclosures on all eight loans.
- Represented a financial institution with respect to the workout of three acquisition and development loans totaling over $16,000,000 and secured by troubled assets, which ultimately concluded with partial foreclosure of the financial institution's liens, followed by the sale of two of the three loans.
- Represented a financial institution with respect to the workout of four loans totaling over $3,000,000 and secured by apartment properties, which ultimately concluded with the sale of one property and the foreclosures of the remaining three loans.
- Represented a financial institution in workouts of thirty-six loans to four affiliate homebuilders totaling over $5,200,000 and secured by troubled assets, initially resulting in a forbearance agreement and finally culminating in foreclosures on all thirty-six loans.
- Represented a transportation company in connection with major debt restructuring, workout and consolidation involving over $350,000,000 in secured loans to more than 30 lenders.

EDUCATION

- Bachelor of Science – Economics, University of Texas at Arlington, 1984
- Juris Doctorate, University of Houston Law Center, 1987

PROFESSIONAL MEMBERSHIPS

- Houston Bar Association
- State Bar of Texas – Real Estate, Probate and Trust Law Sections
- Texas Association of Bank Counsel

CERTIFICATIONS

- Board Certified, Commercial Real Estate Law, Texas Board of Legal Specialization, 2004-present

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I. Introduction.

a. History and Background. These are tough economic times by almost any measure. In 2007, we witnessed the birth of a subprime mortgage crisis which quickly evolved into a broader, national financial crisis in 2008. During that time, Americans lost over a quarter of our collective net worth, a loss from which we have yet to recover. Losses have been particularly heavy in the real estate markets, initially in the housing markets, and then in commercial real estate. As of February 2010, almost half of all commercial loans in the United States had balances which exceeded the market values of the properties securing those loans. While Financial Crisis Inquiry Report published by the Financial Crisis Inquiry Commission (established as part of the Fraud Enforcement and Recovery Act [Public Law 111-21] passed by Congress and signed by the President in May 2009) found that our national financial crisis officially ended in 2008, the end of the crisis does not necessarily coincide with economic recovery. In fact, a report issued by the Congressional Oversight Panel has projected the largest commercial real estate loan losses for 2011 and beyond. In addition, nearly $700 billion in commercial real estate debt will mature between 2011 and 2013.

Clearly, the supply of distressed real estate loans has increased drastically over the past four years. During the first few years of the crisis, the banking industry seemed to adopt a cautious, "wait and see" approach to its distressed commercial real estate loan portfolios (more commonly known as the "extend and pretend" model). As a whole, I believe this model was based upon financial institutions' good faith belief that the devaluation of their commercial real estate collateral was a temporary condition which would quickly self-correct, with no further action required of the financial institution. And why employ an aggressive approach, alienate customers and incur legal fees to solve problems which will cure themselves with little time and patience? Unfortunately, the self-correction of the commercial real estate market has yet to occur, and the "extend and pretend" era is dead.

b. Current Status. With traditional exit strategies such as maturity date extensions and refinancing options often unavailable, what are lenders and borrowers in a distressed loan relationship to do? I often see many lenders demand that their borrowers either refinance their distressed loans with another lender or sell their distressed properties. Unfortunately, in today's market, such exit strategies are no longer available to most borrowers. Many (if not most) community and regional banks have limited or no ability to extend new commercial real estate loans due to heavy concentrations of commercial real estate loans in their existing loan portfolios. Cash buyers of distressed commercial real estate do exist, but they are keenly aware of the commercial real estate credit shortage and make their offers accordingly.

In handling distressed loans, many lenders and their counsel tend towards the expected. Upon default, those lenders quickly give defaulting borrowers notice of default and intent to accelerate the maturity of the loan. They increase the interest rate payable on the loan to the default rate and initiate the foreclosure process. If the lender's goal is to assume ownership of the collateral property at the earliest possible date, this is the perfect strategy. However, lenders should have a broader goal in mind. They should be focused on maximizing the recovery on their distressed loans and assets. A quick foreclosure may be the right strategy for some situations, but the worst option in others. Lenders must evaluate their distressed loan portfolios with this in mind.

II. Identifying Distressed Loans - Houston, we have a problem (loan)!

Distressed loans exist in a variety of forms. Some distressed loans are easily identified through payment default or other obvious circumstances. In other situations, loan issues may be more subtle and difficult to identify (e.g., impending bankruptcy of a major tenant of a retail property). In any case, early identification of distressed loans affords lenders the best opportunity to evaluate their options and maximize their recovery.

a. Nonperforming Loans. Distressed loans are frequently identified through the borrower's failure or inability to meet their obligations under their loan documents. Defaults on a borrower's financial obligations under the loan documents are obvious evidence that a loan has developed, or may be developing, issues. Such defaults may include failure to make monthly installment payments, frequent late payments, failure to pay real property taxes and failure to pay property insurance premiums. Distressed loans may also be identified through covenant defaults. For instance, the loan documents may include one or more financial covenants which are intended as leading indicators of the health of a borrower and/or its property. Debt service coverage ratio covenants are particularly common in commercial real estate loans. Such covenants measure the ratio between a borrower's net operating income and its debt service obligations. A borrower with a poor (less than one to one) debt service coverage ratio is a borrower that must rely upon income from sources other than the collateral property to service its debt on the property, a circumstance which is often not sustainable and cause for concern. Commercial real estate loan documents also typically impose a variety of other non-financial covenants upon borrowers. Violation of certain non-financial covenants may also constitute evidence that a loan is distressed or is becoming distressed.

b. Diminished Value of Collateral and Other Economic Factors. In today's real estate market, a variety of economic factors has impaired and continues to impair many borrowers, their properties and their operations. Even if a loan is currently performing in every respect, certain economic factors serve as leading indicators of impending loan problems. Widespread declines in commercial real estate property values have rendered many lenders under-collateralized and their loans distressed. A declining rental market can also be a harbinger of disaster for a property and the loan it secures. Tenant vacancies, lease terminations and other leasing issues often foretell loan difficulties. A borrower's financial statements may provide evidence that it is having operational or cash flow difficulties, or that such difficulties are just around the corner. In all such cases, a lender is well advised to act quickly before its exit strategies deteriorate and ultimately disappear.

c. Other Signs of Trouble. Other indicators that a performing loan may be evolving, or may have developed into a distressed loan include the following:

- Tax liens
- Judgment liens
- Lawsuits filed against the borrower or guarantors
- Late financial reporting, including tax returns and audit reports
- Inaccurate financial reporting
- Financial problems of borrower or guarantor affiliates
- Economic difficulties in related area or industry
- Economic difficulties of major tenant
- Construction delays
- Construction budget overruns
- Loan maturity is approaching but borrow has no refinancing options

III. Distressed Loans as Workout Candidates.

While lenders may be willing to work out virtually all distressed loans, not all distressed loans are good candidates for workout. In my practice, I typically have little or no involvement in the process of determining that a loan is distressed. In most cases, my client contacts me to discuss possible workout solutions and remedies only after they have made a definitive determination that the loan is distressed.

In evaluating whether a distressed loan is susceptible to workout, the lender and its counsel should first work together to determine whether an event of default has occurred under the loan documents. All properly drafted commercial real estate loan documents include a list of occurrences which constitute loan defaults and provide a lender with legal and equitable remedies in the event a default occurs. Failure to make scheduled loan payments always constitutes an event of default under a standard set of loan documents. Failure to pay related property expenses such as property taxes and property insurance premiums are also common events of default under most loan documents. Well-drafted loan documents usually include a number of other non-performance default provisions upon which lenders may rely.

Many circumstances which create or lead to distressed loans are not necessarily events of default under loan documents. For instance, virtually all real estate lenders have portfolio loans which are distressed due to diminished value of the property securing the loan. Diminution in value of the collateral property is not an event of default in the loan documents I typically review. While many commercial real estate loan document forms initially include "insecurity," "material adverse effect," and similar default provisions under which a significant devaluation of collateral would constitute an event of default, savvy borrowers and their counsel routinely request, and lenders routinely agree to, deletion of those default provisions. In addition, savvy borrowers also insist upon inclusion of "notice and cure" provisions in their commercial real estate loan documents, such that no event of default would occur until the lender provided the borrower with written notice of a potential default, and the borrower failed to cure the potential default within the designated time. Finally, experienced counsel will usually try to limit defaults to circumstances which are strictly within the control of their borrower.

Technically, all events of default under a borrower's loan documents are the same, and each affords the lender the ability to exercise its remedies under those loan documents. However, in practice, attorneys place defaults into two categories: material defaults and technical defaults. Material defaults include payment defaults and other defaults which materially impair the loan and the lender's rights in the collateral. Technical defaults, such as a guarantor's failure to timely deliver a personal financial statement, tend not to impair the loan or the collateral. Lenders' attorneys are very hesitant to rely strictly upon technical defaults as the basis for acceleration of the maturity of the loan and subsequent foreclosure. Most lender counsel believe that courts are far more likely to grant injunctive relief with respect to a foreclosure proceeding when the lender's exercise of its remedies is based upon a technical, rather than a monetary or other material default.

The existence of one or more events of default provides a lender with substantial leverage in its workout negotiations with a borrower. Upon the occurrence of an event of default, a lender may accelerate the maturity of the loan and initiate the foreclosure process. Many borrowers are gravely concerned that, because foreclosure documentation is filed in the public records, initiation of foreclosure proceedings will impair their ability to lease or sell their property, thereby limiting their workout options. Borrowers sometimes seek refuge in the bankruptcy courts to stay a lender's foreclosure proceedings. While a bankruptcy filing will stop a pending foreclosure sale, it also subjects that borrower and its property to the jurisdiction (and corresponding uncertainty)

of a bankruptcy court. In addition to exercising their remedies against the borrower and its properties, lenders may also upon the occurrence of an event of default, make demand upon and sue the guarantors. Under these circumstances, borrowers and guarantors have substantial incentive to enter into and conclude workout negotiations prior to initiation of foreclosure activities.

There are always circumstances under which a lender and borrower will simply have no desire to engage in workout discussions. Lenders and borrowers often develop what is traditionally called "deal fatigue." Other lenders and borrower develop relationship issues such as lack of trust. In such circumstances, if an exit strategy is available, it is sometimes best to end the lender/borrower relationship at that time.

IV. Communications with Borrower.

a. Pre-Negotiation Letters and Agreements. Prior to initiation of workout discussions, lenders should first require their borrowers to execute a pre-negotiation agreement. Pre-negotiation agreements are intended to define, in as much detail as possible under the circumstances, the rights and obligations of the lender and borrower as they engage in workout negotiations and establish the rules governing those workout discussions. Pre-negotiation letters are primarily focused on protecting lenders against waiver of their rights and the borrower's corresponding obligations under the loan documents. However, pre-negotiation letters can also serve to facilitate open workout discussions between the lender and borrower.

Pre-negotiation agreements come in many different forms, depending on the circumstances surrounding the loan and the workout negotiations and the preferences of the parties. Some lenders prefer formal, detailed pre-negotiation agreements, particularly in connection with workouts of larger and more complex loans. Other lenders utilize a letter format for all of their pre-negotiation agreements, even for larger and more complex loans. Many lenders prefer the letter format based upon their belief that borrowers are more accepting of, and therefore more likely to execute, a shorter letter agreement. Under some workout scenarios, time is critical, leaving little time for negotiation of a comprehensive pre-negotiation agreement. In such cases, lenders often utilize much shorter pre-negotiation letters which include only the terms deemed vital to the lender and borrower before they can move forward with workout negotiations. The sooner the parties execute a pre-negotiation agreement, the sooner they can commence workout discussions. Pre-negotiation agreements may include some or all of the following provisions:

1. That the content and existence of the workout discussions shall be protected and shall not be admissible as evidence or subject to discovery.

2. An acknowledgment by the borrower of the status of the real property and any other collateral securing the loan.

3. An acknowledgment by the borrower of the status of the loan.

4. An acknowledgment by the borrower that no agreements, amendments to the loan documents, or waivers of any rights or obligations under the loan documents shall be effective unless they are documented in a writing executed by lender and borrower.

5. A designation of persons who shall serve as the representatives of the borrower and lender for the purpose of loan workout discussions.

6. A process for approval of a workout agreement between the parties.

7. An acknowledgment by the borrower that the loan documents and their obligations thereunder remain in full force and effect.

8. An acknowledgment by the borrower that the workout negotiations shall not waive, release or impair lender's rights or borrower's obligations under loan documents absent execution of a definitive workout agreement by lender and borrower.

9. An acknowledgment by the borrower that it requested the workout negotiations, that the negotiations are voluntary, and that it is not relying exclusively upon the workout negotiations as its sole opportunity to address the issues surrounding their loan and the collateral.

10. An agreement that all statutes of limitations are tolled.

11. A release and waiver by borrower of any and all claims it may have against the lender as of the date of execution of the pre-negotiation agreement, and of any claims arising out of oral or written statements made in connection with workout negotiations.

12. That borrower shall pay all fees and expenses incurred by the lender in connection with the workout.

A pre-negotiation agreement may include many other provisions, depending on the circumstances.

In most workout scenarios, some or all guarantors will be required to execute, or at least ratify, any the workout documents resulting from the workout negotiations. To ensure that the borrower includes the guarantors in the workout negotiations process, lenders should require that guarantors also execute the pre-negotiation agreement.

In negotiating the terms of a pre-negotiation agreement, the parties are often tempted to include loan modification, forbearance and other provisions in the pre-negotiation agreement. Lenders should resist this practice. A pre-negotiation agreement is most effectively utilized solely to establish the ground rules for negotiations between the lender and borrower, and should not be used for any other purpose.

As stated above, an effective pre-negotiation agreement will facilitate negotiations and a free flow of information between a lender and a borrower. Workout-related communications between borrower and lenders will take place over a variety of communications media, particularly through telephone calls and email. We advise that, to the extent possible, lenders include in all of their written communications with the borrower a specific reference to the executed pre-negotiation agreement, and a statement that the communications set forth in that writing (whether letter, email or text message) are subject to the pre-negotiation agreement. It is also a good idea to follow up verbal communications with a borrower with a letter or email confirming that the verbal communication is subject to the pre-negotiation agreement.

b. Evidence of Lender Liability Claims. When communicating with borrowers before and during workout negotiations, pay particular attention to any claims they make against the bank. Borrowers regularly deny personal accountability for their loan defaults and shift the blame to others, including the lender. In my experience, lenders often rightfully dismiss their borrowers' denials. However, all lenders should listen closely to their borrowers' allegations. In some cases, their complaints may indicate an underling lender liability claim. Potential lender liability claims could include:

- Lender failed to maintain professional relationship with borrower.
- Lender exercised excessive control over borrower.
- Lender breached its fiduciary duty to borrower.
- A partnership existed between the lender and borrower.
- Bank Tying Act violations

Evaluation of a borrower's lender liability claims is an important component of evaluating the lender's position and developing its strategy in workout negotiations.

V. Analysis and Investigation.

When faced with a potential workout scenario, a careful review and evaluation of the loan documents, the loan file, the collateral, the financial position of the borrower and any guarantors, and the merits of any potential lender liability claims is critical. This review process will often bring to the surface issues which might undermine or enhance the lender's relative bargaining position, or impede the ability of a lender to immediately exercise its rights and remedies – issues best discovered sooner rather than later in the workout process. The following list identifies a number of areas that should be explored and evaluated by the lender and its counsel:

1. Loan Documents and Loan File
   a. What events of default have occurred and are continuing (if any)? Do grace or cure periods exist for those defaults?
   b. Review all "loan documents" (no matter how informal), including, all amendments, letter agreements, and change in term agreements, and make note of any inconsistencies or contradictions.
   c. Do the Deed of Trust and other security instruments cover the intended collateral and effectively create a lien on that collateral? Has any collateral been released by the lender?
   d. Is there a guarantor? Does the guaranty agreement contain any limitations on liability?
   e. Were UCC-1 Financing Statements filed? Were they filed in the proper place? Have the Financing Statements lapsed?
   f. Is this a non-recourse loan? If so, have any "non-recourse carve-outs" been triggered? (**Note**: Would a bankruptcy filing by the borrower give rise to liability on the part of any guarantor?)
   g. Is this loan cross-defaulted or cross-collateralized (whether expressly or implicitly) with any other loan held by the lender?
   h. Do any intercreditor agreements or other agreements exist between the lender and another creditor of the borrower? What sorts of rights does the other creditor have under that agreement? (e.g., notice rights, cure rights, etc.)
   i. Have the borrower and guarantors waived their respective rights under Texas Property Code Sections 51.003 and 51.005?

2. Real Estate and other Collateral

   a. Does the lender have a recent appraisal of the property? When was the property last inspected by the lender?
   b. If the property is income-producing, does the lender have an absolute assignment of rents? Were SNDAs executed by the current tenants?
   c. Is the loan secured by MUD receivables, a ground lease or any other collateral which might necessitate the involvement of a 3rd party in the workout process?
   d. Does the bank have legal access to areas where materials or other personal property may be stored?
   e. If applicable, request a current certified rent roll of the property.
   f. Is the property managed by a management company? Does the bank have an assignment of the management agreement?
   g. Do any environmental issues exist with respect to the property?

3. Status of Title and Title Insurance

   a. Did the bank obtain a Mortgagee's Title Policy insuring its lien? If so, review the property covered by that policy, as well as the exceptions to coverage.
   b. Obtain a Nothing Further Certificate to confirm that the borrower is in fact the current record owner of the property and to determine whether any liens or encumbrances exist on the property.
   c. Have all ad valorem taxes been paid?

4. Bankruptcy Options

   a. Is the borrower capable of having a plan of reorganization confirmed by the Bankruptcy Court?
   b. Has the borrower retained bankruptcy counsel?
   c. Would a bankruptcy filing have negative implications for the guarantor(s)? (e.g., springing liability under the guaranty agreement)
   d. **Note:** If bankruptcy is a likely option for the borrower, then now is the time to consult with bankruptcy attorneys in your firm or to engage bankruptcy counsel.

5. Potential Lender Liability Claims

   a. The lender and its counsel should have a candid discussion regarding the management and servicing history of the loan. (**Note**: Is this loan being handled by the original relationship officer, a special assets officer, or someone else? How much institutional knowledge regarding this loan file exists at the bank?)
   b. Review email correspondence between the lender and the borrower, and evaluate any veiled (or not so veiled) threats of lender liability.
   c. **Note:** Has the borrower or guarantor(s) executed any modification agreements or other documents or agreements which contain a release in favor of the lender?

6. Borrower's and Guarantor's Financial Information and Tax Returns

   a. Request current certified financial statements (income statement, balance sheet) from the borrower and guarantor(s).
   b. Request most recent tax returns from the borrower and guarantor(s).
   c. Conduct a litigation and bankruptcy search on the borrower and guarantor(s).
   d. Consider obtaining an asset search on the guarantor(s).

VI. Negotiating the Workout.

The fact is, traditional workout strategies often don't work in today's distressed environment. I still hear bankers speak wistfully of the days when they made lending decisions based on the three "Cs": Creditworthiness (and Character), Capacity (or ability to pay), and Collateral, with the character of the borrower being the determining, if not the only, factor for credit approval. Those days may not be gone, but they have definitely been suspended until further notice. In the same way, workout strategies which depend on easy access to credit and other factors that do not exist in today's economic environment simply won't work.

A successful loan workout will maximize the lender's recovery (or at least minimize the lender's loss) on its troubled loan. Maximization of recovery, in turn, requires that the lender develop a full understanding of all issues surrounding the distressed loan, including the borrower, guarantor and their financial status, the nature and status of the collateral property, and the legal and business implications arising from different workout scenarios. This allows lender and their counsel to align the workout strategy with the particular challenges faced by the borrower and its collateral property. For instance, when negotiating with a borrower with short term cash flow issues, imposition of default interest and a greater monthly payment obligation only exacerbates the cash flow problem. A good workout strategy should provide the borrower with a plan that is achievable under their current circumstances, but also provide a path under which the borrower can ultimately enhance the performance of their business and assets and move towards an eventual exit strategy.

Maintain an open line of communications with the borrower. In this economy, many borrowers are truly victims of circumstance. They are open, honest and willing to consider any solution for their problems. Listen to those borrowers. They are more familiar with their business and their properties than anybody else, as well as the problems they are facing. Their insights may assist your counsel and you in crafting the best workout strategy possible. Many of these borrowers are far more receptive to an olive branch than a default notice.

However, be warned. As you negotiate with a borrower, be mindful of your role as lender. Under no circumstances should you take any action which could be construed as an exercise of excessive control over a borrower or creating a fiduciary or partnership relationship between the bank and borrower. A well-drafted pre-negotiation agreement will provide substantial protection against any lender liability claims arising from workout negotiations.

In order to properly evaluate a distressed loan, a lender must have access to accurate financial information for the borrower, its property and the guarantors. However, during times of distress, many borrowers devote little effort or resources towards preparation and delivery of complete and accurate financial statements. Under such circumstances, lenders should consider requiring those borrowers to engage an independent financial consultant who can fairly evaluate and report on the current financial condition of the borrower and its properties. There are many qualified financial consultants who provide such services on reasonable terms. Should a lender require engagement of a financial consultant, there should be a clear understanding between the lender, borrower and financial consultant as to the scope of the financial consultant's duties, the lender's requirements regarding content and delivery of financial information, and the borrower's responsibility for payment of the financial consultant's fees.

It has been my experience that borrowers tend to slow the pace of workout negotiations whenever possible. Whatever the reason, we avoid that issue by simply insisting upon promptness by the borrower in all aspects of the workout negotiations. We tend to impose reasonable deadlines upon borrowers for all facets of the workout. There will be a deadline for execution of the pre-negotiation agreement and another deadline for delivery of borrower's comments to workout documents.

In some cases, borrowers will take aggressive, and even combative, positions in workout negotiations. In these cases, deal fatigue often ensues, and some lenders tend to move away from workout solutions and towards exercise of their remedies. Remember, workout negotiations are never personal and the lender's goal is always the same: maximizing its recovery.

The most effective workout strategies require lenders to utilize their best business judgment, creativity, diligence and patience. Lenders must think outside of the box and avoid blind adherence to traditional collection strategies. This approach is never the easiest approach, but it provides lenders with the best opportunity to maximize the recovery on their trouble loans.

VII. Implementation of Workout Arrangement.

Workout arrangements can be implemented using a number of different types of documents, including, without limitation, a forbearance agreement or a modification agreement. Under a forbearance agreement, the lender will agree to forbear from exercising its rights and remedies for a period of time, provided certain terms and conditions are and continue to be satisfied. Alternatively, the parties may enter into a modification agreement whereby the interest rate, the maturity date, the financial covenants or other terms and obligations are modified going forward. Finally, in cases where the borrower will be pledging additional collateral or the lender desires to shore up its existing loan papers, the workout documentation might include additional deeds of trust, additional security agreements, amended and restated loan documents, and the like. And remember, when documenting any sort of workout arrangement, rarely will a form exist which perfectly addresses your situation. Creativity and keen drafting skills are essential.