

Ten Steps a Mortgage Lender Should Take before the Workout Starts

By: Susan J. Booth

Commercial real estate loan defaults are on the rise. If you, a mortgage lender, find yourself in this situation, and payoff is not forthcoming, you will probably discuss workout options with your borrower. Following is a brief summary of 10 important steps you should take before commencing workout discussions:

Physical Condition. Physically inspect the property. Is construction complete? Is there material damage? Is there deferred maintenance, and could it affect the revenue stream (*e.g.*, inhibit future leasing or constitute a default under a franchise agreement or lease)? Is occupancy as expected?

Title Condition. Real Property. Confirm that you have the *complete original* title policy and endorsements. Obtain an updated title report. Does your borrower still own the property? Are there liens besides yours? Even if you are in a first priority position, property taxes prime your lien, and junior lienholders can challenge the priority of your lien, assert rights under CCP § 726 and play a role in the borrower's bankruptcy proceeding. Does the title report identify any exceptions (whether before or after your lien recorded) that are not on your title policy? Are there any exceptions that could impact your decision-making (*e.g.*, unperformed covenants with a governmental authority)? *Personal Property.* Confirm that your borrower owns all of the personal property. Order UCC searches. Are there equipment leases that cover property material to the project's operations (*e.g.*, HVAC system)?

Environmental Condition. Order an updated Phase I and (if applicable) Phase II ESA. Are there any new environmental issues? Has the borrower performed any required remediation? Is there any ongoing remediation or monitoring?

Operating Statements. Obtain current property operating statements. Do the statements present a detailed picture, prepared in accordance with a recognized accounting method, or is there the potential for gamesmanship (*e.g.*, combining cash and accrual)? Is it clear what is happening to the cash? Does borrower or a third party manager control the cash?

Financial Statements. Request financial statements for each of the principals. Do the financial statements of individuals include community property or trust assets? How much liquidity do the principals have? Do they have unencumbered assets? Does it appear that the principals' financial difficulties are property-specific or global?

Litigation Searches. Obtain litigation, judgment and bankruptcy searches on the borrower and the guarantors. Do there appear to be creditors preparing to attach assets of the principals?

Loan File. Confirm that you have all *original* loan documents and amendments, fully executed with exhibits and any original letters of credit. Review the loan documents and remaining file. What are your rights when the borrower defaults? Are there any matters that could give rise to a legitimate lender liability claim? Do you have an assignment of the material third-party agreements (*e.g.*, franchise agreement or construction contracts)? What actions must you take to preserve your rights under the material agreements (*e.g.*, copy on default notices)?

Lender Agreements. Identify all loan-related agreements to which you are a party (*e.g.*, participation agreement or intercreditor agreement). What are your obligations with respect to the existing default and in connection with a workout (*e.g.*, default notices or consent to loan acceleration)? What cure rights and approval rights does the other party have?

Default Notice. Send the borrower (copy to all applicable parties) a notice identifying all defaults. Determine whether acceleration of the loan is appropriate at this time.

Pre-Workout Agreement. Enter into a short agreement with the borrower and any guarantors that outlines the terms of your discussions, including that (a) the discussions are settlement discussions within the meaning of Rule 408 of the Federal Rules of Evidence and Section 1152 of the California Evidence Code; (b) no loan modification is binding unless and until an agreement is executed by all parties; (c) any party may terminate the agreement at any time; and (d) the negotiations do not create a waiver of any rights or obligations of any party under the loan documents.

About the Author: *Susan J. Booth is the head of the West Coast Real Estate Group of Holland & Knight LLP.* She can be reached at (213) 896-2540 or susan.booth@hklaw.com

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