Commercial Real Estate Loan Defaults and Remedies

Go to: Context and Preliminary Considerations | Default vs. Event of Default in Loan Documentation | Borrower Defaults | Workouts | Lender Remedies
Current as of: ***09/25/2019***

This practice note discusses borrower default and lender remedy provisions in commercial real estate financing documentation. A brief overview of commonly used workout options is also included. Where appropriate, the note includes negotiation tips for counsel to the borrower and the lender.

For further guidance, see Multistate Real Estate Financing Transactions, Foreclosure of Real Property, Bankruptcy Issues Affecting Real Estate Loan Transactions, and Workouts of Commercial Real Estate Loans. For a form of loan agreement, see Loan Agreement (Acquisition Financing).

Context and Preliminary Considerations

Commercial real estate loan documents are often highly negotiated, and the negotiation process can be one of the most difficult aspects of closing a commercial real estate transaction. Borrowers tend to resist a lender's desire for control over the real property via covenants, whether affirmative, negative, or financial. Lenders want to ensure that the real property can service the debt and attempt to impose restrictions via these same types of covenants. Thus, negotiations tend to focus on provisions that can lead to borrower defaults and trigger the lender's remedies. The negotiation leverage of the parties depends on numerous factors, including loan-to-value ratio, the current state of the market, and strength and track record of the property owner.

Lenders typically just want to be repaid. Their end game is not to become the property owner via foreclosure or the enforcement of other remedies. They also do not like to carry defaulted loans on their books, as this can necessitate reserving against their capital which could impact their lending capacity. In significant default scenarios, most loans will eventually result in some form of a workout because the lender will be hesitant to own and operate the real property.

Commercial real estate loans tend to be structured as nonrecourse loans, meaning that the lender's remedies are generally limited to the secured real property and related personal property. Since the majority of borrowers are single purpose entities (SPE) (where the sole asset of the borrower is the real property subject to the lender's first priority mortgage lien), the borrower is already structurally recourse limited. Apart from the real property itself, a lender can only look to any nonrecourse carve-out guarantor when exercising its remedies, and, typically, these remedies are only available following bad acts of the borrower, such as fraud or misappropriation, and when certain environmental issues arise. Construction loans are different. They are generally fully recourse until the construction is complete.

Default vs. Event of Default in Loan Documentation

A default exists from the date the event causing the default occurs until the expiration of any grace period. Once a default occurs, a lender may be required to notify the borrower of the default and the borrower may then have a set period of time to cure the default. More often than not, a lender finds out about the existence of a default from the borrower. The borrower is typically obligated to notify the lender within a very short specified time frame if it has knowledge of the existence of a default.

If a default is not timely cured during the grace period, it becomes an event of default, which triggers the availability of a lender's remedies pursuant to the loan documentation. An event of default cannot technically be cured by the borrower since the grace period has expired. It is only subject to waiver by a lender.

Borrower Defaults

Borrower defaults are generally classified as either monetary or nonmonetary. Each is discussed below.

Monetary Defaults

A monetary default occurs when the borrower fails to pay interest, principal, or other amounts payable to the lender in accordance with the terms of the loan documents. When representing a borrower, you should negotiate for a notice and cure period. Lenders typically hesitate to grant any notice and cure period for monetary defaults since a borrower knows well in advance when these payments are due. If they do grant a notice and cure period, it is usually very short (i.e., five days). It is not uncommon for a lender to refuse to provide notice and the cure period then runs from the date the amount payable was due. Regardless of whether there is a notice requirement, a borrower is typically not permitted to cure a monetary default more than twice during any 12-month period.

Some lenders take the view that any default that can be remedied by the payment of money falls within the ambit of monetary defaults and is therefore subject to minimal notice and cure periods. These include the (1) breach of financial covenants, where the prepayment of principal cures the breach and (2) the failure to make payments to third parties, such as for real estate taxes and insurance policies. This is not the prevailing view amongst lenders, however, and these defaults are discussed below under nonmonetary defaults.

Nonmonetary Defaults

A nonmonetary default occurs when the borrower breaches a covenant. Often, these covenants are labeled affirmative covenants or negative covenants. Affirmative covenants are actions that the borrower agrees to take, while negative covenants prohibit the borrower from taking certain actions.

Typical affirmative covenants include:

- Financial reporting to the lender
- Compliance with financial covenants
- Maintenance of SPE status
- Compliance with applicable law
- Maintaining insurance on the real property
- Paying and complying with third-party obligations, such as other debt, real estate taxes, insurance, and contractual obligations
- Allowing the lender to physically inspect the premises and conduct environmental testing
- Notifying the lender of a default, event of default, or litigation

Typical negative covenants prohibit the borrower from:

- Incurring additional debt
- Incurring any additional liens or encumbrances
- Selling or transferring any ownership interests
- Entering into additional leases or amending existing leases, except pursuant to preapproved guidelines
- Amending its organizational documents

A nonmonetary default can also occur if the borrower has breached a representation and warranty contained in the loan documentation.

Typical representations and warranties include that:

- The borrower has the necessary right, power, and authority to enter into the loan documents.

- The borrower holds the title to the property, free of any liens and encumbrances other than as disclosed to the lender.
- There are no material defaults on the borrower's other indebtedness.
- The borrower has all permits necessary to own, occupy, and operate the real property.
- The real property complies with applicable law.

Lenders are often willing to provide a borrower with notice of a default and a cure period (e.g., 30 days) for nonmonetary defaults. For certain nonmonetary defaults, lenders may even grant extension rights to the cure period, if the borrower is actively pursuing a cure.

Financial Covenants

Prior to the financial crisis of 2008–2012, most commercial real estate loans tended to be soft on financial covenants. Since the financial crisis, there has been an expansion of financial covenants in commercial real estate loans and lenders are now generally more focused on repayment than adequate collateral.

The most common financial covenants include:

- **Debt service coverage ratio (DSCR).** DSCR is the annual net operating income (NOI) produced by the real property divided by the annual debt service (interest and any required principal amortization) due to the lender. This covenant ensures that the property generates sufficient cash flow to service the debt, and lenders typically require at least a 1.2 DSCR. When representing the borrower, you should negotiate to exclude loan receipts and payments from the calculation. Lenders will want to include the debt service on any subordinated debt in the calculations.
- **Guarantor liquidity.** This covenant ensures that a guarantor is sufficiently liquid to pay off the debt. At a set measuring point (i.e., quarterly, semiannually, or annually), the guarantor must hold a certain amount of cash and cash securities. When representing the borrower, you should negotiate to include marketable securities in the calculating formula.
- **Loan-to-value ratio (LTV).** The loan-to-value ratio is the outstanding loan amount divided by the appraised value of the property, expressed as a percentage. This covenant ensures that the loan has adequate collateral. In a typical CRE loan, lenders will not go above 70%–80% LTV. Hard money loans are typically capped at 60% LTV.
- **Debt yield.** Annual NOI divided by the outstanding loan amount, expressed as a percentage. Debt yield shows what the lender's cash-on-cash return on its money would be if it foreclosed on the property at that specific moment. Lenders tend to require debt yields of at least 10%.

When representing a borrower, you should consider any seasonality issues with the borrower's business and their interplay with the testing frequencies when negotiating these provisions.

SPE Status

Lenders often request that a potential borrower form an SPE so that the lender's collateral will be segregated from the parent company's other assets and liabilities. This allows the lender to focus on the financial characteristics of the real estate asset without needing to consider other aspects of the parent's holdings. It also insulates the lender's collateral from claims of the parent's creditors. In addition, lenders typically require a laundry list of SPE covenants in the loan documents and in the SPE's organizational documents to ensure that a borrower's SPE status will be maintained. Examples include covenants that:

- The borrower shall limit the nature, purpose, and conduct of its business to solely acquire, own, hold, lease, operate, manage, maintain, and improve the real property and to contract for the operation, maintenance, management, and improvement of the real property.

- The borrower shall observe all limited liability company formalities necessary to maintain its separate existence.
- The borrower shall not commingle its assets or funds, including without limitation bank accounts, with those of any other person or entity.
- The borrower shall maintain its assets in such a manner that it is not costly or difficult to segregate, identify, or ascertain such assets from those of other persons or entities.
- The borrower shall hold all its assets and conduct all its business in its own name, and not that of any other person or entity.
- The borrower shall not pledge its assets for the benefit of any other person or entity, other than lender pursuant to the loan documents.
- The borrower shall hold itself out to its creditors and the public as a legal entity separate and distinct from any other person or entity.

Failure of the borrower to maintain its SPE status poses a significant risk to the lender as it opens the doors to claims against the borrower by its affiliates, especially in the bankruptcy context where a lender could be barred from exercising its remedies against the borrower's property.

For a more detailed discussion of SPEs, please see Borrower as a Single Purpose Entity and Article VI (Single Purpose, Representations, Warranties and Covenants) in Loan Agreement (Acquisition Financing).

Additional Debt/Liens

Loan documents typically include a negative covenant prohibiting the borrower from incurring additional debt or creating additional liens on the real property, except for any subordinated financing (i.e., mezzanine financing) closed contemporaneously with the senior loan, which would be subject to an intercreditor agreement between the senior lender and the mezzanine lender. For further guidance, see Commercial Real Estate Mezzanine Financings and Intercreditor Agreements (Mortgage Lender and Mezzanine Lender).

Limitations on additional debt and liens prevent the borrower from becoming overextended and provide lenders protections from other creditors. Typical carve-outs include those for brokerage commissions, tenant improvements, certain capital expenditures, and disputes with taxing authorities.

When representing the borrower, you should discuss the potential need for additional indebtedness with the borrower to negotiate the appropriate carve-outs in the loan documentation.

Transfers

It is of paramount importance to lenders that operational control of the borrower remain in the hands of persons that are qualified to manage the real property. Thus, lenders typically prohibit the borrower from allowing or consenting to the transfer of its interests. A lender will also typically require that the borrower include certain provisions to this effect in its organizational documents. Notwithstanding the foregoing, lenders may allow certain transfers of ownership interests to accommodate the typical, complex ownership structures of borrowers. When representing a borrower, you should discuss any anticipated transfers with your client and negotiate any necessary carve-outs. If the borrower views the debt as attractive to a potential purchaser of the ownership interests, it may wish to negotiate preapproved guidelines for a potential acquirer, such as meeting certain financial tests and real estate experience thresholds.

Leases

Rents from tenants are often the primary source of revenue for a borrower. Thus, lenders want to prohibit any changes to this income stream without their consent. A lender may insist that all new leases and all amendments to or terminations of existing leases require its consent, but this is not very common. More often, loan agreements set forth preapproved leasing guidelines and lease forms as exhibits. When representing a borrower, you should

require that the lender's consent not be unreasonably withheld. In addition, if lender does not respond to a consent request within a certain time frame, the lender's consent should be deemed given.

Cross-Default Clauses

Lenders typically seek to include provisions where if the borrower defaults under other debt, it gives rise to an event of default. The rationale is that if the borrower cannot make payments under one agreement, it will also not be able to make payments on the subject loan. When representing a borrower, you should attempt to limit cross-defaults to monetary defaults or material, nonmonetary defaults. An extremely broad cross-default provisions can cause significant headaches for a borrower as it could be forced to deal with multiple lenders in a workout scenario.

Material Adverse Change (MAC) Clauses

Many lenders seek to include MAC clauses in their loan agreements. These clauses typically provide that an event of default will occur under the loan agreement if any specified MAC occurs in the business or financial condition of the borrower. A typical MAC clause reads as follows:

> "Material Adverse Change" means a material adverse change in (a) the condition (financial or otherwise), operations, assets, liabilities, business, or prospects of the borrower or (b) the ability of the Borrower to repay the debt or to perform its obligations under the loan documents, or (c) the rights and remedies of the lender under the loan documents, or (d) the legality, validity; or enforceability of any loan document or (e) the liens granted the lender pursuant to the loan documents.

Prior to the financial crisis of 2008–2012, MAC clauses were not commonly included in commercial real estate loan documentation. They were viewed as a subjective, catchall for the lender that basically allowed it to declare an event of default under most scenarios. Since the financial crisis, however, the use of these clauses in commercial real estate loans has expanded.

When representing a borrower, you should define what is material and negotiate to include as high a threshold as possible. At a minimum, the lender should agree that its determination of materiality be reasonable and not in its sole discretion.

Representations and Warranties

Loan agreements will generally always contain certain representations and warranties that are intended to induce the lender to make the loan to the borrower. The representations and warranties generally focus on matters pertaining to the borrower, including its financial condition, and to the real property collateral. Representations and warranties are made as of a specific date. Typically, it is only the closing date unless there are also further disbursements to be made. For example, in constructions loans, borrowers are required to "bring down" or restate the representations and warranties on the dates of each advance.

When representing the borrower, you should review the representations and warranties with the borrower to confirm their accuracy and to compile a disclosure schedule which sets forth the exceptions to the representations and warranties. You should also attempt to include knowledge qualifiers where appropriate. Knowledge qualifiers are one of the most effective tools in limiting representations and warranties. Lenders tend to allow knowledge qualifiers if they are limited to the knowledge of the individuals who are responsible for the day-to-day operations of the property. For example, a representation as to litigation threatened against the borrower is typically qualified as to knowledge while a representation as to the enforceability of the loan documentation is never qualified as to knowledge.

There is a long-lived, ongoing debate as to whether representations and warranties are curable. Since they are made as of a certain date, technically they cannot be cured. Thus, many lenders will reject a borrower's attempt to negotiate notice and cure periods for representations and warranties. That said, if you represent a borrower, you should always attempt to obtain notice and cure periods for breaches of representations and warranties.

Workouts

As noted above, lenders do not want to hold defaulted loans on their books. Thus, they will typically pursue a workout solution before pursuing other costly and lengthy remedies. The parties may negotiate:

- A restructuring of the loan, such as increasing the term and lowering the interest rate
- A waiver of the event giving rise to the event of default
- A forbearance agreement, in which a lender agrees not to exercise any remedies under the loan agreement for a specified time, subject to certain conditions (e.g., no other events of default occurring or a payment of fixed sum from the borrower)
- An amendment to the loan agreement, revising a provision that may no longer be appropriate, such as a financial covenant

For a detailed discussion of workouts, see Workouts of Commercial Real Estate Loans.

Lender Remedies

If a workout is not feasible, lenders typically have the following remedies available under the loan documents:

- Acceleration
- Setoff
- Lawsuit on the promissory note
- Foreclosure (judicial and nonjudicial)
- Receivership
- Deed in lieu of foreclosure

In addition to the above remedies (each discussed below), there are financial remedies that a lender can impose. For instance, most loan documents specify a default rate of interest and late fees. When coupled with acceleration, these financial remedies can wipe out any theoretical equity in the property.

Most jurisdictions do not permit a lender to utilize the foregoing listed remedies unless the event of default is monetary or, if nonmonetary, then material. If there is any question as to its materiality of an event of default, when representing a lender, you must carefully analyze applicable law to determine which remedies the lender may exercise. For example, the repeated breach of a financial covenant or a reporting covenant is generally considered material.

Typically, lenders can choose one or more remedies to pursue. No remedy is exclusive. When dealing with loans secured by multiple properties in multiple jurisdictions, you must carefully understand any state-specific limitations on lender's remedies. For instance, some states, such as California, will only allow a lender to sue on the promissory note or proceed with a foreclosure, but not both. This is called the one-action rule. If a lender that is subject to this rule decides to proceed with a foreclosure, it is basically giving up any deficiency claims. Practitioners should be careful in spelling out the remedies available to the lender.

Acceleration

Acceleration is typically the lender's first step before proceeding with the other enforcement remedies. The lender should provide notice of default and acceleration of the mortgage debt. The form and manner of this notice will be prescribed in the mortgage and/or by state law. Absent an acceleration provision, a lender would either have to foreclose each installment as it comes due or wait until the amortization period expires to foreclose on account of the entire mortgage obligation.

Important factors to consider at this stage include the following (these factors are applicable in most states and vary depending on the terms of the mortgage):

- Whether, prior to acceleration, the borrower may cure the default and reinstate the mortgage
- Whether, following acceleration, the borrower may only prevent foreclosure by tendering the full mortgage obligation
- Whether the lender has waived its right to accelerate through consistently accepting late payments (A waiver will generally not be found where a creditor accepts a nominal number of late payments. However, if a consistent pattern of acceptance of late payments has been established over time, the lender may be deemed to have waived its right to accelerate the mortgage debt on the basis of a missed or late payment. Such a waiver may be revoked by communicating to the borrower that no further late payments will be accepted.)

Acceleration is not only permitted for failure to make debt-service payments, it may also be based upon breaches of covenants in the mortgage, such as those covenants requiring the mortgagor to maintain insurance, pay taxes, not commit waste, or maintain a certain financial condition.

Setoff

The lender may set off amounts due to it under the loan documents against any and all accounts, credits, money, securities, or other property of borrower on deposit with or in the possession of lender. To the extent that the borrower's operating accounts are with the lender, this remedy can significantly impede the borrower's ability to continue to operate the real estate.

Lawsuit on the Promissory Note

The lender may file a lawsuit to recover the accelerated amount of the promissory note. After receiving a judgment, the lender may seek to attach the judgment to the real property. Except in states with the one-action rule, the lender will then typically proceed with a foreclosure.

Judicial Foreclosure

Judicial foreclosure is available in most states and allows the lender to retake the property and obtain a deficiency judgment. In roughly 40% of states, including New York, it is the only type of foreclosure available, while in others, the lender may choose between judicial and nonjudicial foreclosure. For a detailed discussion of the foreclosure process, see Foreclosure of Real Property.

Commencement of Action

Before beginning a foreclosure action, it is important to review the mortgage, promissory note, guaranty, and other loan documentation to ensure compliance with any contractual notice or other pre-suit requirements contained in these documents. Once all pre-suit requirements are satisfied, the lender may file a lawsuit in the county where the property is located to recover the outstanding amount of the accelerated indebtedness under the promissory note. Lenders typically obtain a foreclosure guaranty from a title company that discloses all the parties that need to be named as defendants in the lawsuit and served.

Appointment of Receiver

In most states, a lender can take control of the real property during the foreclosure process through the appointment of a receiver. The process begins with a petition to the court to appoint a receiver. All necessary parties need to be served. The receiver then runs and operates the property by paying the operating expenses and debt service, collecting rent, and entering into leases. If approved by the court, a receiver can also sell the property. The foreclosure process can be very lengthy, and there may be a risk that the borrower will retain the income it receives from the property without providing for its upkeep. Thus, lenders typically move to appoint a receiver pending the completion of the foreclosure to preserve the property's value.

The process for requesting the appointment of a receiver varies by state. The cost of the appointment of a receiver is usually determined by a percentage of the sums received and disbursed by the receiver. In deciding whether to request the appointment of a receiver, the lender should compare the costs of the appointment with the potential benefits.

Defenses

Common defenses to foreclosure include equitable defenses such as equitable estoppel, waiver, laches, and unclean hands. These defenses can often be overcome by the lender by citing to provisions of the mortgage loan documents and applicable law. Contractual defenses such as failure to comply with the provisions of the loan documents, unless frivolously asserted, can raise bigger problems. Examples of these defenses include lack of notice, defective acceleration, accord and satisfaction, and reinstatement and tender. Refuting these defenses tends to be fact-driven and depends on the conduct of the parties in conjunction with their rights and obligations under the loan documents. A borrower can seek bankruptcy protection, but this is dangerous as it could trigger the recourse provisions of the guaranty.

Calculation of Amount Due

Before a foreclosure judgment can be issued, the amount due to the lender must be determined. The procedure for making this determination varies by state but, typically, the amount consists of:

- The outstanding principal balance of the loan
- Interest to the date of the computation
- Late charges
- Amounts paid by the lender to protect the lien of the mortgage
- Legal fees, costs, and disbursements

Regardless of the method used for computing the amount due under the mortgage obligation, it is standard practice that the borrower be given an opportunity to challenge the figures proposed by the lender.

Foreclosure Judgment and Sale

The foreclosure judgment establishes the amount due to the lender and directs the sale of the property. The judgment may also establish the place of the sale, who is authorized to conduct the sale, and whether the mortgaged property will be sold as one or separate parcels. The procedures for the sale, including any required notice(s), vary by state and are governed by the applicable statute. In most jurisdictions, court confirmation of an officer's report of a foreclosure sale is required to complete the sale. Once confirmation is given, the court gives approval to the sale and authorizes the execution of a deed to the mortgaged property.

Deficiency Judgment

Unless the mortgage is nonrecourse, a lender may be entitled to a deficiency judgment if the sale of the mortgaged property does not satisfy the outstanding balance owed on the debt. In some jurisdictions, a deficiency judgment is available to the full extent of the difference between the foreclosure sale price and the full amount of the mortgage debt, while in other jurisdictions, deficiency judgments are prohibited in certain contexts. The middle ground, adopted by many states, is to limit the potential deficiency to the difference between the mortgage obligation and the higher of the sale price or the fair market value of the mortgaged property at the time of the sale. Counsel to lender should examine state statutes and procedural requirements for deficiency judgments before commencing the foreclosure.

Nonjudicial Foreclosure

Nonjudicial foreclosure is a creature of statute, and the most prevalent form of nonjudicial foreclosure is foreclosure by power of sale. About half the states permit foreclosure by nonjudicial foreclosure. Nonjudicial foreclosure can be appealing to lenders because it is typically less expensive than judicial foreclosure.

While judicial foreclosure actions typically involve a security interest in real property granted pursuant to a mortgage, a nonjudicial foreclosure is usually effectuated pursuant to a private power of sale contained in a deed of trust (although some states do authorize power of sale foreclosures pursuant to a provision in a mortgage). The major difference between a mortgage and a deed of trust is that a mortgage is a two-party agreement between the lender and the borrower, while a deed of trust is a three-party agreement between the borrower/trustor, lender/beneficiary, and the trustee. The trustee is normally a title company, escrow company, or bank whose sole function is to initiate and complete the foreclosure process at the request of the lender.

As with judicial foreclosure, the process for a nonjudicial foreclosure varies by state and it is governed by state statute (as well as the loan documents). A sale pursuant to a regularly executed power of sale is equivalent to a sale in a judicial foreclosure proceeding in that it extinguishes the borrower's right of redemption and divests all junior mortgages and junior encumbrances upon the real property sold. In most states, the lender is required to waive any claim to a deficiency judgment before proceeding with nonjudicial foreclosure.

Deed in Lieu of Foreclosure

A much faster and less expensive method for a lender to take title to the real property is through a deed in lieu of foreclosure (DIL). The lender and borrower negotiate a DIL agreement that sets forth the terms of the borrower's transfer of the property to the lender. Typically, in a DIL agreement, the lender agrees to waiver of a claim seeking a deficiency judgment. In certain instances, a lender may even agree to a cash payment to the borrower. The lender then typically takes title in the name of a SPE affiliate to protect the lender from property-specific liability.

A disadvantage of a DIL is that, unlike a foreclosure, it does not eliminate junior liens, such as judgments, junior mortgages, or mechanic's liens. To protect against junior liens, a lender typically leaves the lien of the underlying mortgage open and includes a non-merger clause in the deed stating that the underlying mortgage does not merge into the deed. This allows the lender to proceed with foreclosure if junior lien holders become problematic. Courts and title companies do not favor DILs because they pose significant creditors' rights risks. Title policies exclude coverage against fraudulent transfer claims by unsecured creditors of the borrower.

End of Document