

Dealing with Troubled Properties

In a recent real estate update, I discussed approaches to working with lenders when a property has gone bad. In this update, I will set out an approach for borrowers who own troubled properties to consider even before discussions with the lender occur. Even though it is very important to maintain good communication with the lender and let the lender know as soon as possible if trouble is on the horizon, the borrower should first investigate certain issues and work on devising an approach to the problem.

The following are the steps a borrower should take upon determining that a property is in trouble:

1. Review your loan documents. Did you enter into the loan personally or as a member of a general partnership? In either case, and unless the loan is nonrecourse (which is unlikely in this situation), you are liable for any deficiency judgment. If you entered into the loan through an entity, did you sign a personal guarantee? Even if the loan is nonrecourse, such as conduit and life insurance loans frequently are, you were probably required to sign a bad boy guarantee. If you did, carefully review that guarantee to make sure you do not fall into the trap of violating one of the covenants that could make the loan fully recourse. "["Bad Boy' Guarantees"](#)" is a real estate update that I wrote last year discussing how the courts have favored lenders in enforcing bad boy guarantees. With any guarantee, you should also review it to see whether there are any limitations on your liability. Any such limitation may put you in a better bargaining position than would be the case with an unlimited guarantee.
2. Review other agreements that may have an impact on the troubled property. For example, if the property at issue is a hotel, there may be a franchise agreement in place. Carefully review that agreement to make sure that none of your actions with the lender will cause that agreement to be in default. If you bought the property with other parties and there is a partnership agreement, a tenancy in common agreement or an LLC operating agreement, review that document to determine the rights and obligations of the various parties. For example, if each member of a limited liability company has signed a bad boy guarantee and if one of your fellow members

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files for bankruptcy, the provisions of your bad boy guarantee may make you liable for the loan. Finally, you should review any leases or listing contracts that may bind the property. A major tenant may have an option to vacate, depending on the circumstances, or a broker may have the right to claim a commission from you if you enter into a deed in lieu of foreclosure.

3. Consider any other agreements, including other loans, that may impact your decision relating to this property. For example, if you have entered into other loan agreements, such as a line of credit, the line of credit documents may require that you notify the lender of a default under the troubled property's loan. The line of credit loan documents may provide that default under the troubled property's loan may accelerate the line of credit.
4. Watch out for swap agreements. If a loan gets called, you will probably have to make whole the counter party to your swap agreement. As I mentioned in my recent update, this liability can be in the millions to tens of millions of dollars. If you did not enter into a swap agreement but your loan documents contain a prepayment penalty, such as a yield maintenance provision, your loan documents probably provide that a prepayment penalty is owing even if there is a foreclosure or if the parties enter into a deed in lieu of foreclosure. Considering how low both LIBOR and Treasury rates are today, the liability can again be significant.
5. Consult your tax advisor and consider the tax consequences of a foreclosure or a deed in lieu of foreclosure. In addition to forgiveness of indebtedness income, which can sometimes be avoided, there may also be a capital gains tax on a foreclosure. For example, if the debt secured by the property is nonrecourse, the borrower will recognize gain on the foreclosure to the extent that the taxpayer's adjusted basis in the property is less than the amount of the outstanding principal amount of the debt. If the debt is recourse, the amount of gain is limited by the fair market value of the property (gain is equal to the fair market value of the property minus the tax basis of the property at issue).

With all of the facts figured out, you will now be in a position to decide how best to approach the lender. Much of the work that we do helps prepare the borrower for these discussions and helps the borrower determine how best to deal with its lender in a way that causes the least amount of collateral damage.



If you are in the unfortunate position of having to work out of the loan, please feel free to call on any one of us and we will be happy to work with you to make sure that your decisions help solve the problem, rather than create a deeper hole.

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