Commentary

Loan Modifications – Lender Liability Issues

by Eric A. Altoon and Marcia Z. Gordon

It has been estimated that between 2010 and 2013, more than a trillion dollars of commercial real estate loans will have matured. In addition, while many economists believe the United States is no longer in a recession, the real estate market has remained weak. Accordingly, if lenders are not prepared to anticipate and deal with borrower defaults and/or borrower requests for extensions or other loan modifications, lenders and/or their directors and officers could be exposed to potential liability. This article shall assume that a lender has done the proper due diligence and determined that a loan modification is preferable to seeking to foreclose on or to approve a short sale of or to take a deed-in-lieu to obtain title to the secured collateral or to enforce any other remedy under the loan documents and/or at law or in equity. This article seeks to provide insight into loan modification documents.

Review of Existing Loan Documents. Prior to agreeing to any loan modification, the lender and its counsel typically review the existing loan documents for any imperfections, omissions or inaccuracies and use the loan modification documents as an opportunity to correct the same. By example, the loan documents should be reviewed to confirm that the lender's lien was properly perfected on the collateral and contain standard borrower representations, warranties and covenants and state-specific enforcement provisions. In addition, if the loan documents include a guaranty made by a married individual who owns property in a community property state or otherwise subject to community property law, the lender and its counsel will want to determine whether a spousal consent was obtained. If not, the lender will want to condition the loan modification on obtaining the spousal consent. The consequence of failing to obtain such spousal consent is that the lender's right to satisfy the judgment against the guarantor will be limited to the guarantor's interest in any community property.

Review of Updated Title Report. Prior to agreeing to any loan modification, a lender customarily orders an updated title report to determine whether there are any: (i) delinquent taxes (which the borrower should be required to pay off prior to entering into the loan modification); (ii) intervening liens since the date of issuance of the original lender's title policy; or (iii) senior liens not reported in the lender's original title policy (in which case, the lender would want to file a claim immediately with, and requesting, the title company to defend the priority assured in the title policy). In addition, the lender should determine if the type of loan modification requested necessitates the recordation of a modification to the deed of trust or mortgage and/or additional title coverage via title endorsements, as any such recorded modification will likely be subject to intervening liens. In determining whether to issue a modification endorsement subject to intervening liens, real estate counsel and the issuing title company will analyze whether the proposed loan modification worsens the likelihood of a junior lienholder being repaid by the borrower.

Review of New and Existing Leases. If the secured collateral is subject to any existing or new leases, the lender should review the same and, assuming the leases require the tenants to provide estoppel certificates, request the tenants to provide such certificates and, if not previously provided, subordination, non-disturbance and attornment agreements ("SNDAs"). Of great interest to the lender are the provisions which are the tenant's certifications of a default under the lease by landlord or tenant or the current amount of rent paid under the lease. SNDAs provide that the lease is subordinate to the lender's deed of trust, as modified, and the tenant will accept the lender as the successor landlord should the lender become the owner of the property encumbered by the lease.

Appraisal of Property and Valuation of Borrower. The lender should confirm the current value of the secured collateral (usually by obtaining an appraisal) and the financial condition of the borrower (usually by obtaining updated financial statements and tax returns) as these will impact the loan modification negotiations and/or whether a loan modification is something the borrower can reasonably perform or if it will merely delay an inevitable borrow default in payment.

Covenant of Good Faith and Fair Dealing. In order to avoid the risk that the lender be deemed "predatory", a lender should negotiate in good faith to work out a loan modification before proceeding with enforcing remedies available to a secured lender. The implied covenant of good faith and fair dealing applies not only to the performance, but also to the enforcement of the contract. The obligation to negotiate in good faith means to make an effort to negotiate a resolution rather than proceed immediately to foreclose, but does not mean that a lender has an affirmative duty to modify the terms of its loan.

Workout Negotiations. During the workout negotiations phase, most, if not all, communications with the borrower should be in writing to avoid any borrower claim of reliance on oral representations made by the lender. In addition, the lender should make it clear whether the loan officer negotiating the modification terms has the authority to bind the lender thereto or if he or she needs to seek lender committee approval. Furthermore, the lender should expressly reserve all of its rights and remedies and make it clear that the lender is not bound by any modification terms except those set forth in a definitive written agreement that has been executed and delivered by all parties thereto.

Acknowledgement of Borrower Defaults. If the borrower is in default under the loan documents, the loan modification documents should provide a specific recital of all borrower defaults, and borrower's acknowledgement of the same in order to prevent the borrower from denying those defaults in the future.

Release of Claims. A lender that is willing to modify a loan should obtain a release of claims and a waiver of California Civil Code Section 1542 from the borrower and any and all guarantors. The release of claims should be drafted broadly enough to cover any and all known and unknown claims that the borrower and/or guarantors may have against the lender arising out of the loan origination, documentation and/or administration up to the effective date of the loan modification.

The foregoing is not intended to be an exhaustive list of lender liability issues. However, it is intended to provide insight into lenders' considerations with regard to a loan modification request.

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