Tough Options to Save Your Loans

Some commercial mortgage-backed securities borrowers face unpleasant decisions

By Ann Hambly

It can be difficult to make a decision when you are faced with three bad choices and doing nothing is not an option. Many cancer patients are faced with this dilemma all the time. If you have terminal cancer, your choices are fairly limited. You can go through chemotherapy, which can make you sick but perhaps extend your life by six months or more. You can go home, get no treatment and live out your remaining time with your family. Or, you can try an experimental treatment that has serious known side effects, but might allow you to live longer than six months.

Which choice would you make? How do you even make such a choice? Hopefully, you will never have to face this dire scenario. The reality, however, is that many borrowers with commercial mortgage-backed security (CMBS) loans are facing similar choices right now, and many more will be in this situation before they know it. Even if these financial decisions are more akin to choosing between three unpleasant medications than making true life-and-death decisions, they can definitely mean the end of your borrower's commercial project.

To get a better picture of how CMBS borrowers can get into situations where they are faced with choosing between several bad options, let's take a look at an all-too-familiar example.

CMBS loan gone wrong

Let's say that a 10-year CMBS loan was funded in 2007 with a loan-to-value ratio at that time of 80 percent. The retail property had a strong anchor tenant at closing with a lease that didn't expire until early 2017. In 2012, however, the anchor tenant vacated the property and many of the other tenants exercised their co-tenancy clauses, causing the cash flow from the property to drop below the revenue needed to cover the loan payment. The borrower funded the shortfalls to keep the loan current for several years.

By early 2015, with only two years left until the loan matured and no anchor store to shore up the cash flow, the borrower starts to wonder what options — if any — will be available at maturity. Surely, the borrower thinks, the CMBS servicer will understand the circumstances and work to find a solution, especially given that the value of the property is below the current loan amount.

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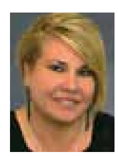

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The borrower contacts the servicer to inquire about options only to learn that the servicer cannot do anything to help at maturity and, even worse, cannot even speak to the borrower about the problem. Completely stumped, the borrower reaches out to a CMBS borrower advocate to try to understand what's going on. At this point, the borrower learns that there are three bad options and that doing nothing will lead to losing the property. These three bad options are:

1. Stop funding the shortfall now. The borrower could stop funding the shortfall and transfer the loan to a special servicer in an attempt to modify the loan well before the maturity date. This may provide time to negotiate a lease buyout with the anchor tenant, get an extension of the maturity date, secure new tenants and hopefully pay off the loan at the extended maturity date. Of course, there is no guarantee that a special servicer will agree to a modification, and there are risks associated with transferring the loan to a special servicer.

2. Continue funding the shortfall. With this course of action, the loan will automatically transfer to a special servicer at maturity for its maturity default. There will likely be fees assessed at that time, including a possible late fee on the unpaid principal balance depending on the details of the loan documents. It is possible to seek an extension and modification at maturity in the hope that a payoff can be achieved at the extended maturity date, but again, there is no guarantee that the special servicer will agree to the modification. Note that a loan can only be transferred to a special servicer upon an actual payment default or an imminent default.

3. Hand back the property now. The borrower may be able to get out from the underwater property via a deed in lieu of foreclosure or a friendly foreclosure. Alternatively, the borrower could just let the loan get foreclosed on. This choice has obvious ramifications for future business.

The "best" bad option

The main point here is that there's no way for CMBS borrowers to talk to anyone before potential transfers to a special servicer, despite the fact that there's a lot at stake. Plus, much like the choices presented to terminal patients, your borrowers will get no assurances of any positive outcome once the loan has been transferred. Doing nothing, meanwhile, will lead to a fatal outcome — the loss of the property.

So, what can a borrower do? Only one thing. No matter how long the borrower tries to deny the problem — no matter how many different opinions are explored or how long the fight is kept up — at some point your borrower must face the facts and accept that one of three bad choices must ultimately be pursued.

The best way to help your borrower make this decision is often to simply pick the "best" bad option from the three choices. It's not fun, it's not pleasant and it's not something your borrower will celebrate after deciding, but it is something that must be done. Making a choice is always smarter than sitting in denial.

Before assisting your borrower in this difficult endeavor, however, the following points should be considered:

- **The potential tax consequences of each option.**
- **The borrower's willingness and desire to put new money toward the solution.** All CMBS modifications require new "skin in the game" from the borrower.
- **The implications of a foreclosure or deed in lieu on your borrower's credit history.**

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At the end of the day, dire decisions like these are personal and can only be made by the person affected by the outcome. The best guidance you can give in these situations is to make sure that your client understands all of the options. Only then can the client make an educated decision about the "terminal" loan, even if it sometimes winds up being the least worst option from three bad choices. ■