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Borrowers Beware

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Texas Lawyer

03-15-2004

Over the past seven to eight years, many real estate investors-borrowers have been enticed by lenders and mortgage brokers to eschew the more traditional forms of real estate financings in favor of "securitized" loans. Securitized loans are commercial real estate loans that are pooled with other similar loans and sold as securities. They are sometimes referred to as "commercial mortgage-backed securities."

Lenders and mortgage brokers often promote securitized loans to real estate investors as a cheaper and safer form of financing. They are supposedly cheaper because they offer lower interest rates that result in lower monthly payments. They are supposedly safer because they generally are nonrecourse to the borrower and its principals. Of course, many real estate investors and their attorneys long ago caught on to the fact that any cost-savings associated with lower interest rates are quickly eaten up by the lenders' fees, the mortgage brokers' fees, the lenders' attorneys' fees and due-diligence expenses. Because of securitization requirements, these loans must meet stringent due-diligence requirements that often result in the borrower and its attorney spending a lot of time and money trying to fit a square peg (property) into a round hole (loan).

Despite the additional fees and costs associated with securitized loans, many real estate investors believe these higher fees and costs are worth the price of obtaining a nonrecourse loan. However, in our practice, we are beginning to see first-hand what appears to be a disturbing trend as lenders and their attorneys try to strip away the nonrecourse security blanket and leave the borrower — and most importantly its individual principal(s) — exposed to full recourse liability for the repayment of the loan.

The best way to describe how lenders and their attorneys attempt to turn nonrecourse, securitized loans into full recourse loans is classic bait-and-switch marketing. The lender or mortgage broker convinces the borrower to enter into a securitized loan with promises of low rates, long terms and no personal liability — except, of course, for the "standard carve-outs." The loan application simply describes these standard recourse carve-outs as fraud, misapplication of funds and "other customary items. "

The principal's "limited recourse" obligations subsequently are expanded in the loan commitment, and

the phrase "other customary items" mushrooms into a laundry list of items that, if triggered, will result in personal liability for the borrower's principal. Although most of these triggering events are limited to "bad-boy" events (fraud, misapplication of funds, failure to pay taxes, etc.), sometimes hidden in this lengthy list is an unassuming reference that the borrower will continue to maintain its status as a single-purpose entity. (In a securitized loan, the borrower generally is required to be a single-purpose entity for bankruptcy remoteness purposes.)

Of course, the single-purpose entity requirements are not listed in the loan commitment because the borrower has not yet reached the point of no return. The point of no return usually occurs after the borrower signs the loan commitment and pays the huge commitment fee. After paying the commitment and application fees and the loan's due-diligence costs, and becoming obligated to pay for the lender's attorneys' fees as well as their own, the borrower finds himself in the unenviable position of having to choose between proceeding with the loan or forsaking thousands of dollars of nonrecoverable, out-of-pocket costs.

After the borrower receives the loan documents he may discover, buried in the lengthy loan agreement and/or deed of trust, a list of approximately 15 to 25 single-purpose entity requirements. Toward the end of that list, but never the last item, there may be two seemingly innocuous requirements: 1. that the borrower is and will remain solvent and pay its debts from its assets as the same shall become due; and 2. that the borrower will maintain adequate capital for its normal obligations.

Violations of the borrower's single-purpose entity requirements are then carefully included in the "bad-boy" guaranty signed by the borrower's principal. This guaranty will not actually list the single-purpose entity requirements. Instead, it will reference — usually as an add-on clause to another triggering event — that the principal is personally liable if the borrower fails to maintain its single-purpose entity requirements.

How does this potentially result in personal liability for the borrower's principal? Assume that the borrower owns a 75,000-square-foot shopping center anchored by a large discount retailer occupying 50,000 square feet. Suppose this large discount retailer files for bankruptcy, rejects the lease and the borrower is unable to find a replacement tenant. The borrower, lacking the cash flow to make the payments required under the loan, offers to deliver and convey the property to the lender. The lender, instead of accepting its collateral, counters by asserting that the borrower's principal is personally liable under the loan. The lender reasons that if the borrower cannot pay its debts as they become due, the borrower must be insolvent. If so, the borrower violated its single-purpose status and triggered the principal's personal liability.

Proponents of securitized loans may think that the foregoing example is far-fetched and twisted in its logic. After all, the entire marketing premise of securitized loans is that the borrower and its principals are not personally liable for the economic performance of the property. A few months ago, we probably would have agreed. However, we have seen just such a scenario and fear that more lenders will resort to these tactics to avoid taking back underperforming properties.

In short, with maintaining solvency and adequate capital as single-purpose entity requirements, lenders may attempt to use these requirements as a sword and a shield when faced with the possibility of taking back an underperforming property. Borrowers and their counsel must be steadfast in their resolve to remove such single-purpose requirements or be prepared to walk away from these "cheap and safe" loans.

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