GULF COAST
Business Review
The Daily News Source for Gulf Coast Business Leaders

How to Stave Off the Commercial Crisis

By Gulf Coast Business Review - Thursday, April 01, 2010

Like a rudderless ship adrift in an unforgiving sea of debt, our real estate economy is on course toward a second disaster — commercial foreclosures.

There are positive and proactive ways to avert the crisis, but it will take intelligence and bold planning to avoid another devastation.

By all economic indicators and projections, the commercial real estate economy is heading on a course strikingly similar to the path of our residential real estate economy.

A vast oversupply of commercial property was financed and constructed from 2004 through 2008. And like the residential sector, commercial buildings constructed and financed were overvalued, exposing lenders to the extreme risks that come from unsustainable debt levels predicated on high occupancy and unrealistic projections for high rental rates.

Instead, commercial occupancy rates in Florida have been dropping dramatically because of increased unemployment as a result of the collapse in residential real estate and the ripples from that. Lee County, for instance, is now at the bottom of 100 U.S. metropolitan areas in unemployment, leading the nation with more than 16% unemployment.

It's a vicious cycle. As vacancies increase, commercial property owners struggle to service mortgage debt, heightening more and more defaults. Nationally, $814 billion in commercial real estate loans will mature over the next three or four years, yet there are few if any sources for financing and refinancing.

And as more loans default, foreclosures result, further creating a downward spiral of commercial real estate prices, further putting out of reach any possible refinancing scenarios.

In the residential sector, neither lenders, the courts nor legislators addressed the crisis properly. With the impending storm in commercial real estate, we still have time to enact rational corrective measures. But rather than our government initiating spending bills to "stimulate" our economy, elected officials and leaders need to focus on addressing this coming real estate crisis with a free-market based model.

What not to do

To date, almost all of the government programs dealing with the residential crisis have been flops. After almost one year of the Obama Administration's mortgage modification program, fewer than 32,000 of these mortgages were converted into permanent modifications.

On the state level, Florida Gov. Charlie Crist and Chief Financial Officer Alex Sink have formed task forces and conducted seminars statewide for affected borrowers. But neither of their efforts has matured into a viable means for addressing the state's flood of residential foreclosure. Nor should we expect the state will be any better equipped to address the forthcoming commercial mortgage foreclosure crisis.

The Florida Supreme Court even issued an administrative order requiring mediation for foreclosure of residential properties. But as of early 2010, after more than three years of the raging residential mortgage foreclosures, there are no true uniform statewide guidelines being implemented by all jurisdictions.

Florida's bankers, meanwhile, are not helping the situation. Rather than provide a proactive solution, the Florida Bankers Association has lobbied for a 53-page bill that eliminates judicial foreclosures and allows lenders to dispose of a borrower's property unilaterally by "auction, negotiated sale or by appraisal."

FBA lobbyists have named the proposed new law the "Florida Consumer Protection and Homeowner Credit Rehabilitation Act," an example of George Orwell's critique on political prose — " … to make lies sound truthful …" This bill neither protects consumers nor rehabilitates credit. It does wrest inherent jurisdiction from the courts and cedes that authority unilaterally to lenders.

Another pending bill, inappropriately titled the "Homeowner Relief and Housing Recovery Act" (HB 1523/SB 2270) will accomplish neither goal in its title. This bill is designed to eliminate judicial foreclosures but only where "the debtor has agreed that this process may be used.

Think about that. If this bill is passed, when a debtor is seeking a loan, what will the debtor's negotiating position be when all lenders require that the debtor agree to waive judicial foreclosures?

This bill also indicates that " a debtor will not be liable for a deficiency if the debtor acted in good faith in the process." Ostensibly, if the borrower doesn't protest that he is being stripped of procedural due process and the borrower's constitutional rights to its property, the borrower will be rewarded by not being further sued.

Another proposal being floated in the Legislature is the elimination of guarantor liability, purportedly for the benefit of relieving commercial borrowers from exposure to large loan losses. How total non-recourse loan transactions for all commercial real estate in Florida would aid the commercial lending marketplace is not explained.

The apparent result from eliminating guarantor liability would be the proliferation of "hard-money lenders" who loan only on perceived future value with significant down payments, loan reserves, sizable loan-initiation fees and interest rates far in excess of market rate to protect against the enhanced non-recourse risk. What legislator actually believes this would be good for the Florida real estate economy?

How to address issue

Surely, there are better alternatives. My solutions to help mitigate, if not avoid, the impending commercial-loan failures are a two-pronged strategy:

A. Smart business-model assistance

1. Identify those loans on real-estate projects in which the commercial borrower is struggling but has still been maintaining mortgage payments.

For these loans, provide limited government guarantees to ease tight credit and encourage financing for these non-toxic projects. The federal government through either the SBA or FHA can provide calculated reasonable guarantees that assist the free market in overcoming present tight-credit conditions.

These guarantees would be extended to portions of the commercial loans and only after a smart business-model review that determines the property's actual or anticipated revenues. This calculated guarantee would encourage bank lending but not cede control over the commercial lending market to the federal government.

2. Provide tax credits or subsidies to private investors on truly toxic debts. In assuming the risks of troubled commercial properties or nonperforming loans, private investors are going to request a substantial discount in the purchase of the mortgage paper or real property to increase their yield or can gain some of the upside by receiving governmental tax credits or subsidies for such acquisition.

Encourage these investments rather than spend more bailout money on troubled banks which may have been inefficient in their lending practices.

3. Structure the loan guarantees to provide for return on investment for the guarantee. Government loan guarantees should provide the incentive for banks to loan but should not

overextend the credit risk of the government.
The guarantee should also allow for recapture of a percentage of the investment based upon the sound business approach outlined above so that the taxpayers could share in some of the return, such as a prepayment penalty to encourage long-term hold by the borrower.
The government needs to act as the steward of the taxpayer and perform its fiduciary duties to protect the taxpayer from losses, rather than focusing on bailing out poorly run lending institutions

B. Create efficient foreclosures
Rather than go through a protracted and delayed foreclosure process, the borrower and lender can take a proactive and positive approach. Allow them to opt into a statutory procedure to allow the borrower to tender an unconditional, fee-simple deed to the lender of the lender's collateral to avoid foreclosure. In other words, voluntarily surrender title to the lender to minimize damages to the borrower and lender when no other viable option exists.

The unconditional transfer of title to the lender nonetheless still allows the lender to preserve its claim for a deficiency judgment in this process termed "Deed in Reduction" By transferring a "Deed in Reduction" to the lender, the borrower enables the lender to:

• Recapture the lender's collateral immediately without any further court costs or litigation expense;
• Avoid the expense of court delays;
• Avoid the increased damages that accrue during the long foreclosure process, including interest accrual, attorney fees, court costs, taxes and other related expenses.

Another option would be to open the possibility that the lender in such a situation may elect to modify the mortgage.

At the time the lender receives the "Deed in Reduction," the effectiveness of the tender and conveyance of the deed to the lender would be conditioned upon the lender and borrower promptly submitting to non-binding mediation. Non-binding mediation in Florida is one of the most effective procedures to resolve disputes, having a success rate of more than 80% overall and 73% for mortgage foreclosure actions in Florida.

Non-binding mediation would allow the borrower and lender an opportunity to create remedies not available through court proceedings. The outcomes could include:

• Modification of the mortgage loan by interest rate or payment amount
• Forbearance of the action
• A structured short sale of the property to a third party
• A structured sale of the mortgage paper to a third party
• A voluntary surrender of the title to the collateral and an agreed-upon balance of the loan amount with a payment arrangement to satisfy the borrower and lender.

If the mediation proved unsuccessful, the next step would be that the unconditional tender of the "Deed in Reduction" would be accepted by the lender and the borrower, and the lender promptly

would submit to binding arbitration on the issue of the amount of the deficiency owed by the borrower to the lender. If it is necessary to eliminate junior liens or encumbrances, the lender could still foreclose but would be in title, possession and control of the collateral.

The expedited procedure under the proposed "Deed in Reduction" legislation would result in the following:

• The lender and borrower would have an efficient proven dispute resolution procedure immediately available to them.
• The carrying costs, including interest, taxes, insurance, maintenance, court costs, would be greatly reduced and in some cases attorney fees not only reduced but eliminated.
• Market and functional depreciation would be minimized.
• The lender would reserve its rights to pursue a deficiency decree.
• There would be an elimination of a foreclosure action, elimination of the current inherent delay in the foreclosure process as well as relieving our overcrowded court dockets of yet another foreclosure suit.

Commercial guarantors
The "Deed in Reduction" program would incorporate the "one-action rule" as utilized in some states. The reason for some needed relief for commercial guarantors is there is an inherent inequity in commercial loan guarantees, since the lender can initiate a suit against the guarantor for 100% of the loan obligation, without the lender giving the guarantor credit for the value of the underlying collateral.

For example, a borrower and guarantor of a $700,000 mortgage loan on a $1 million property would normally expect that the borrower and guarantor's exposure would only arise if the lender pursued foreclosure and recaptured the $1,000,000 property and was able to prove that the value of the $1,000,000 property was worth less than the $700,000 mortgage.

But inequity occurs if a commercial lender pursues the borrower and the guarantor first rather than pursuing foreclosure on its collateral. In such a case, the borrower and guarantor are exposed to 100% of the repayment on the full $700,000 debt plus interest costs and attorney fees, rather than getting credit for the collateral value of the underlying real property.

By implementing the "Deed in Reduction" approach and requiring the lender to accept its collateral and give credit to the borrower and the guarantor for the then current value of the commercial property, the one-action rule results in an inherently fairer and equitable treatment of the borrower and guarantor.

Such a format also does not harm the lender. The lender still can recapture value in its collateral and still has a claim for the remaining deficiency against the borrower and guarantor.

This is also not as harmful to the lender as would be the statutory suggestion that all borrowers and guarantors be fully released of all recourse liability.

As you can see, the “Deed in Reduction” can be a win-win-win scenario for the lender, borrower and court system. This entire procedure can be conducted outside of the court system with court supervision over any ultimate settlement and with statutory guideline and procedures already in place to enforce the arbitration ruling.

There’s no denying: We’re going to have a commercial real estate crisis. To minimize its devastation and the adverse effects on Florida’s economy and taxpayers, our lawmakers would be wise this session to adopt the proactive, 21st century foreclosure model outlined above.

Kevin F. Jursinski is a Florida Bar Board Certified Real Estate attorney based in Fort Myers.