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Role of pre-negotiation letters in comm'l. real estate loans

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Pre-negotiation letters state the rights and obligations of both lender and borrower in the context of a loan modification or workout and confirm the ground rules governing modification or workout discussions. Once executed, pre-negotiation letters can facilitate open discussion and negotiation among interested parties with respect to a proposed loan modification or workout before any modification of the loan terms is reduced to a written agreement. With a well drafted pre-negotiation letter, the parties will not unknowingly waive or compromise valuable rights contained in the loan documents.

A construction budget bust, lease-up and rental rates below projections, sales prices below pro-forma, a maturity date approaching without take-out refinancing—any one could mean the construction loan made twenty-four months ago is not in good shape and a commercial borrower may face the impending risk of defaulting on its loan. To potentially avoid this scenario, an existing borrower may prospectively ask its lender the following questions: Would the lender consider refinancing the debt or would the lender consider amending the loan terms to help avoid a default? Since most traditional lenders are not in the business of acquiring real estate, when a borrower approaches, most lenders should entertain a mutually satisfactory resolution with a borrower but not before the parties have entered into a pre-negotiation letter.

Pre-negotiation letters state the rights and obligations of both lender and borrower in light of the status of the loan, and confirm the ground rules governing loan discussions, several of which may already exist in the loan documents. Once executed, pre-negotiation letters can facilitate open discussion and negotiation among interested parties to a proposed loan modification or workout before any modification of the loan terms is reduced to a written agreement. It is important for the borrower and lender to discuss a pre-negotiation letter as early as possible in the modification or workout process in order to help achieve a more efficient result.

Among some of the common provisions that most lenders seek in a pre-negotiation letter are:

1. That the negotiations were requested by borrower, are completely voluntarily, and may be terminated by either party at any time, without recourse or obligation. This provision permits both parties to maintain all viable options, whether it be borrower pursuing other refinancing opportunities or lender ceasing negotiations and either selling the loan, declaring a default, accelerating the debt, or exercising other remedies.
2. That borrower acknowledges the status of its current obligations under the loan. This provision would acknowledge any late payments which may be deemed a default or any other circumstances that necessitate a loan modification or workout. While it is unlikely that a borrower would expressly acknowledge a default in a pre-negotiation letter, a lender might require a simple acknowledgment of the facts contributing to a possible loan modification, such as missed or late payments.
3. That all parties agree that any loan modification will not be binding until all terms are reduced to

writing. All parties should understand that no modifications of terms which may be discussed will be effective until they enter into a formal written modification. It should also be clear that there is no obligation of either party to modify, amend or restructure the loan or the transaction in any manner.

4. That the loan documents remain in full force and effect, unmodified except as provided in writing. A lender traditionally reserves all rights under the loan documents so that loan modification negotiations do not impair lender's ability to exercise any rights or remedies under the loan documents. It is also important that no implied or deemed waiver of any of lender's rights occurs.

5. That the borrower retain the right to possess the collateral prior to a default. Since borrower already possesses the collateral and the lender is not waiving its right to foreclose on the collateral and obtain possession in the future, this provision provides needed certainty to the borrower.

6. That borrower pay all of lender's fees in connection with any modification or workout, or related negotiations. Borrower's early agreement to pay lender's fees avoids the issue arising at a more sensitive point in the negotiations, when any surprise could derail a positive resolution.

7. That the underlying collateral securing the loan remains unencumbered by any lien other than the mortgage. A lender has an interest in protecting the priority of its rights in the real property and ensuring that the property is maintained free from liens. This assurance would most likely be available in the context of a permanent loan rather than a construction loan since presumably real property subject to a permanent loan would be generating some current cash flow to pay expenses and avoid liens.

8. That the content and mere existence of negotiations is inadmissible in court. A lender may want to include such a provision consistent with the rules of evidence as generally applied to avoid a borrower's attempt to introduce as evidence in legal proceedings lender's negotiation of certain terms prior to cessation of talks and initiation of lender's remedies.

9. That all future claims relating to oral or written statements made during negotiations are waived and released. The parties should be free to speak openly and put forth any reasonable offer, proposal, or counteroffer without fear of any binding statements prior to any verbal agreements being reduced to writing.

10. That certain individuals in the negotiations are the authorized representatives of borrower and lender, respectively. The parties should avoid creating a situation where one party may speak with different personnel of the other and either receive inconsistent information or negotiate with a person who lacks ultimate authority to agree to deal terms.

11. If the loan is guaranteed, the guarantor should execute or acknowledge the pre-negotiation letter. It is important to ensure that the guarantor is aware of the loan's and/or borrower's status, as the guarantor may bear ultimate responsibility for the debt and a lender will want to avoid guarantor's assertion of any suretyship defenses.

While this list is by no means exhaustive, it is meant as a guide for loan parties to consider issues that should be expressly stated in writing and agreed upon prior to a loan modification or workout. For the lender, it is important to include these provisions in the pre-negotiation letter to avoid pitfalls that might compromise its objectives and to clearly retain all rights and remedies afforded by the loan documents.

A sophisticated borrower's counsel may request that the lender expressly forbear from foreclosing on the collateral and negotiate for a forbearance provision in the pre-negotiation letter. A lender should avoid including any forbearance provisions in the pre-negotiation letter. The pre-negotiation

letter and the forbearance agreement are typically executed independently at different stages of the process. The pre-negotiation letter sets the ground rules for the loan modification or workout negotiation, with the loan parties possibly entering into a forbearance agreement as a result of such negotiation.

With a well drafted pre-negotiation letter, the parties will not unknowingly waive or compromise valuable rights in the loan documents and only forebear from exercising, or waive, rights or remedies once each has obtained terms satisfactory to it through the modification or workout negotiation.

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