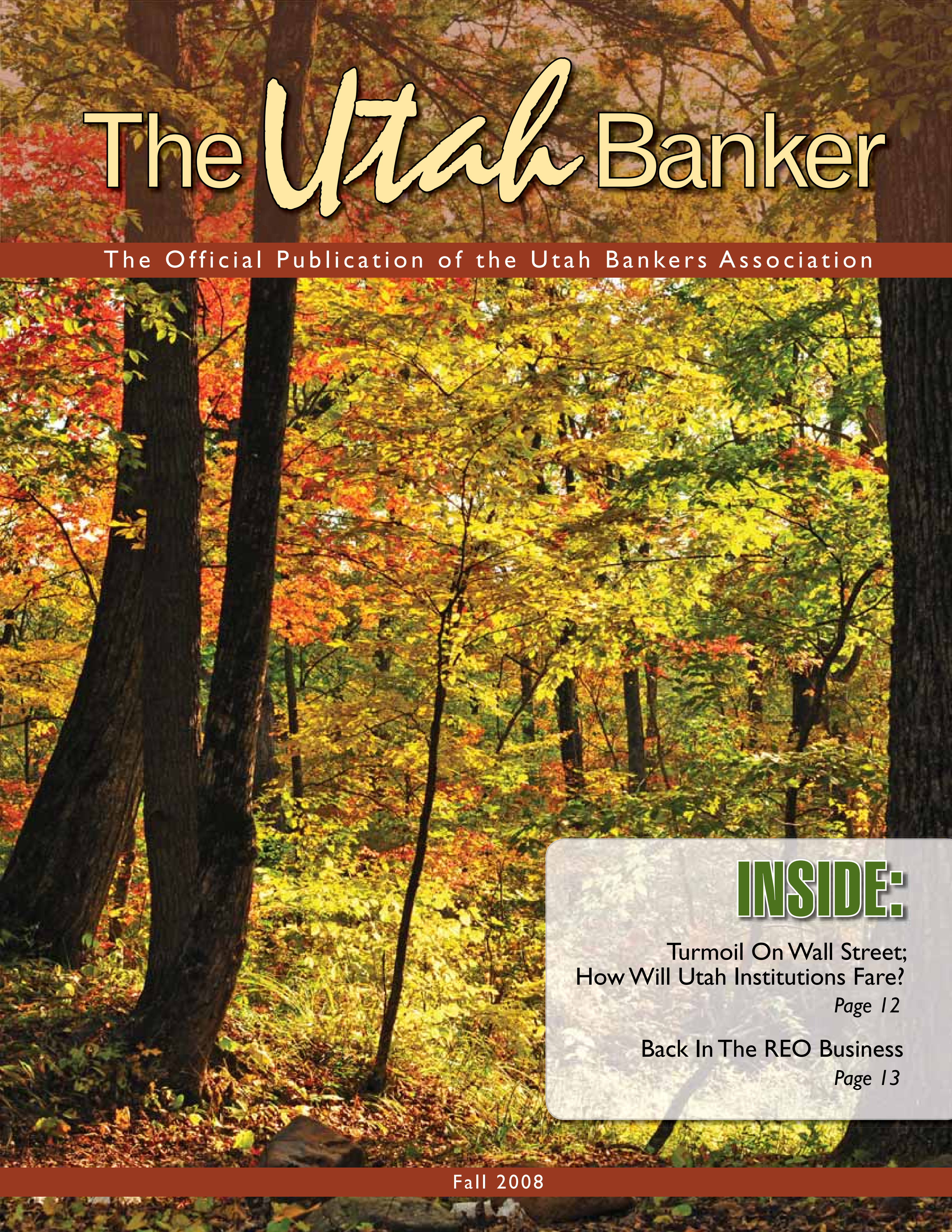
The Utah Banker

The Official Publication of the Utah Bankers Association



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Fall 2008

BACK IN THE REO BUSINESS

ASSESSING THE VALUE OF REAL ESTATE LOANS AND BANK OWNED REAL ESTATE

In a world where real property values are falling and replacement financing is disappearing at an alarming rate, banks are carefully scrutinizing the quality of the real estate loans in their portfolios and perhaps more importantly, the underlying value of the property securing those loans. Banks are looking beyond the typical considerations regarding borrower and guarantor financial status and solvency since the reality is that today's real estate collateral is fast becoming tomorrow's REO assets. Just as each property is unique, so is each real estate secured loan in a bank's portfolio. While this makes the evaluation process for each troubled loan and related property different, there are some general guidelines that banks should keep in mind in conducting a review of any real property secured loan.

• Recognizing Problems.

Recognizing a "troubled" loan requires both an understanding of early warning signs which are often project related (e.g. loss of tenants, late payment of rent, delays in construction, mechanic's liens, etc.) and sensitive monitoring of the loan and collateral for evidence of those conditions.

• Loan Document Review.

At the outset, the bank must clearly understand what was agreed to between the bank and the borrower in the loan documents. A complete review of the loan documents should be conducted including all side letters and ancillary agreements executed at closing together with post-closing modifications. This allows the bank to not only understand the initial transaction but also allows the bank to address material deficiencies in the loan documentation and to see the loan from the perspective of the borrower or a judge looking in from the outside.

• Original Collateral Valuation.

The bank should carefully evaluate all financial reports, appraisals and collateral inspections. Given the current turbulent economic times and in particular the troubled real estate market, the bank should review the assumptions used by the appraiser in the original real estate appraisal obtained at closing. The assumptions and value conclusions simply may no longer be consistent with current market conditions on absorption, lease rates, vacancy factors, etc.

• Status of Liens and Security Interests.

The bank should also verify that there are en-

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forceable liens on the intended collateral and that those liens are perfected and valid against third parties. This review should include executed security agreements, deeds of trust and other collateral assignments together with the filing records for all UCC financing statements and recording information for deeds of trust and other recorded assignments (e.g. assignments of development agreements, assignments of leases and rents, etc.). If the bank's review indicates serious problems or if the Borrower is unwilling or is unable to provide information, then the situation becomes more serious and pressing.

• Third Party Claims.

Assuming the valid existence and perfection of the intended liens and security interests, the next step is to ascertain the bank's lien priority vis-à-vis third parties. For personal property, this will include updating UCC and tax lien searches for the borrower, all guarantors, and any other pledgors of collateral. For real property, title companies can provide reports showing the priority of the lien in the form of foreclosure reports, trustee sale guarantees, or new title commitments depending upon the type of insurance desired, if any, and the search costs the bank is willing to incur. The bank should carefully compare the results of any such reports with their title policy and pre-closing searches. If any claims under the title policy or errors or inconsistencies in the title policy are discovered, the bank should provide prompt notice to the title company in accordance with the title policy to avoid losing or waiving coverage. As rights of third parties are analyzed, the bank should ensure that appropriate intercreditor agreements, lien waivers, sndas, control agreements, consents, estoppels, and other documents were obtained as part of the loan closing.

• Default, Notice and Cure.

The bank must next examine the default and cure provisions set forth in the loan documents. For example, in the event there is an intercreditor agreement, it is very likely that the other lender must be notified of any event of default. The bank should also review the borrower's payment history, including all correspondence and file notes, in order to determine whether or not a course of dealing has been established by continued variance from the terms of the loan documents.

• Insurance.

In reviewing the loan file, the bank should also verify that all required property insurance policies are in full force and effect and that the bank is properly named as an additional insured or loss payee as required per the loan documents. The review process also provides an opportunity to confirm that the bank has received the title policy it bargained for at closing and that the title policy complies with the negotiated terms. If loan disbursements were made after the issuance of the title insurance policy, the bank must ensure that the policy has been properly "dated down" through the issuance of endorsements to the policy.

• Liquidation Analysis.

The final step is often the preparation of a realistic liquidation analysis. Values of the real property collateral and other assets should be reviewed, updated, and adjusted based upon the possibility of a quick sale and in light of current market conditions. The bank may consider using the services of a consultant in order to review the property and conduct this analysis. Throughout the liquidation analysis, the bank should keep in mind that it may soon be the owner of the property.

A thorough analysis by the bank will require an inspection of the real property by the bank or the bank's inspector to reconcile the actual status and condition of the collateral with the bank's current understanding. Unfortunately, the two often differ. An understanding of the project will also entail determining what, if anything, must be done to complete the project if construction is ongoing, what entitlements have been obtained with respect to the property, what the current market conditions are, and whether the borrower is current in its obligations to tenants and contractors. The bank should also make a careful investigation to uncover any hidden problems such as environmental hazards.

An updated real property appraisal should be obtained. The loan documents normally allow for the bank to retain an appraiser at the borrower's cost and require that the borrower provide any appraisers with access to the property. Again, the assumptions used in the appraisal should be carefully scrutinized.

Finally, the bank should also review all property leases and related sndas to determine whether such leases will survive a foreclosure so that the bank clearly understands the net income that can be expected from the property after foreclosure.

The foregoing steps are certainly not comprehensive but will provide a basic understanding of a real estate loan and its related collateral and will allow a bank to formulate a basic strategy going forward. As the old saying goes, "There is nothing more frightening than the unknown."

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