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Lender Default

Borrowers Must Act Quickly to Replace Lost Funds

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In a weak real estate market, most discussions of loan defaults and remedies focus on the borrower's defaults and the lender's remedies.[1] But in the current credit crisis, where the major lending institutions are under tremendous financial stress, concerns about defaults and remedies also run the other way—borrowers worry about what rights, remedies and obligations they will have if their lenders become insolvent and fail to fund required loan advances. Certainly, the bankruptcy filing of Lehman Brothers, which was a major lender in the commercial real estate market, has given these concerns a new urgency.

The problems caused by a lender insolvency impact all situations where a lender has future advance obligations. The most significant concerns for borrowers arise where the insolvent lender is funding a construction loan, where borrowers depend on timely funding of progress payment requisitions to keep a construction project moving ahead. Since a borrower's equity is typically fully invested in a construction project before loan proceeds are drawn, the borrower depends on the lender to fund timely the entire balance of the project budget. The risk to a borrower of lender failure is multiplied where a large construction loan is syndicated among many lenders, each of which is liable to fund only its proportionate share of the loan. Just as a lender must act quickly to preserve a project if a borrower defaults on a construction loan, a borrower must act quickly in the face of a lender default to ensure the continued flow of loan funds for construction of its project, to ensure that contractors are paid and work continues on schedule despite a lender's financial difficulties.

Faced with a potential lender insolvency situation, a borrower's analysis should focus on the following issues:

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Construction Loans

• By what process, and how quickly, can the lost funding be replaced, either by the other lenders, by a replacement lender, or by the borrower itself? What rights and/or obligations do the other lenders have to continue to fund or to withhold funding in this instance?

• What obligations and liabilities does the borrower potentially face in a loan shortfall caused by a failure to fund? Does it require a loan balancing payment by the borrower? Can it trigger a borrower default and a demand under loan guaranties?

• What legal remedies does the borrower have against the defaulting lender, whether pursuant to the loan documents or in a lender-liability context, to cover the borrower's actual or prospective losses from the loan default?

The first step, of course, is to review the loan documents to understand what express rights, remedies and obligations the loan documents provide on the subject. The following points in the loan documents, among others, are relevant to the analysis:[2]

Reciprocal Funding

As noted above, large loans which are funded by a syndicate of lenders typically provide for each lender to be liable to fund only its proportionate share of the loan. If one lender in the syndicate defaults, the loan documents typically provide that such default does not excuse performance by the other lenders, who continue to be liable for their several shares of the loan funding. But there are two potential pitfalls for the borrower here. First, the obligations of the non-defaulting lenders to fund their proportionate shares of a draw are conditioned on there being no default of the borrower under the loan documents. If a failure by one lender to fund a portion of a draw puts the borrower into a situation, for example, where contractors cannot be paid and liens are placed on the job, the borrower may find itself in default of the loan, and not entitled to draws from any lenders. Second, in loans where there is a senior loan and a mezzanine loan which are funding concurrently, the obligations of the senior lender and the mezzanine lender are generally contingent on the timely funding by the other. If one of the senior lenders defaults in funding, the condition to the mezzanine lender's obligation to fund is not satisfied. Because of the reciprocity provisions, the failure of the mezzanine lender to fund in turn relieves the remaining senior lenders of their obligations to fund. Thus, even though the senior loan documents may provide nominally for continued funding by the other senior lenders, practical application of these other provisions may preclude the borrower's entitlement to that funding.

An Additional Share

The documents in a syndicated loan typically provide a right for the non-defaulting lenders in the syndicate, in order of proportionate size of loan share, to fund the defaulting lender's proportionate share of the draw with a priority repayment as against the defaulting lender. If the loan is otherwise not in default, there may be a powerful incentive for another lender, particularly one with a large loan share which has been substantially funded, to step in and fund in order to prevent the loan from going into default, and risking the loss of the loan funds previously advanced. In this financial climate, however, many lenders are looking to reduce, not increase, their real estate exposure, and in particular their exposure to a single market or project, so may decline to fund an additional share.

Replacement Lender

In the event that none of the other lenders in the syndicate elects to fund the defaulting lender's share, the borrower may have negotiated for the right to seek a replacement lender to assume the unfunded obligations of the defaulting lender on the terms and conditions of the loan documents. This right, while undeniably useful, is also typically constrained with conditions that limit the borrower's flexibility to bring in a new lender. First, the consent of the loan administrative agent to the substitution will be required. If the administrative agent is the defaulting lender, the other lenders must replace the administrative agent pursuant to the loan documents before consent can be given to the replacement lender, thereby delaying and complicating the consent process. Second, the new lender must typically be an institutional lender, and may not be an affiliate of the borrower. Even in a situation of this gravity, the other lenders do not want the borrower to have a position in the lending syndicate, where the borrower's interests will be in conflict with those of the other lenders. If the loan documents do not restrict an affiliate of the mezzanine lender from buying a loan share, that may be a useful source for the borrower to seek additional funds, as the mezzanine lender has the most powerful motivation to protect its junior interest by advancing funds, and may find it useful to its overall deal position to hold a share of the senior loan. Third, the terms of the loan position held by the defaulting lender which is being assumed by the replacement lender may be less favorable than current market terms that would be demanded by a replacement lender. A replacement lender may seek a discount from the defaulting lender, or points or fees up front from the borrower to bring the loan to market terms, before the lender will assume the loan share.

Sub-Participants

If the defaulting lender has sold participations in its loan position, consideration should be given by the borrower to seeking loan funding directly from the participants. Participation arrangements are generally opaque to the borrower, with privity only between the participant and the primary lender, and not between the participant and the borrower, other than the granting to the participant of protections of certain of the loan document provisions. While the borrower may have no contractual right to demand funding directly from the participant, as a practical matter, the participants have the economic interest in the defaulting lender's share, and have already authorized the commitment of funds to the project, and an interest in protecting funds already advanced.

Borrower Funding

If no additional funding can be found for the loan piece, the borrower may, depending on how the loan balancing provisions in the documents are drafted, be obligated to fund the shortfall from the lender default as a balancing payment. "Balancing payments" are payments that are required to be made by a borrower to make up shortfalls in the event that the remaining funds available under the loan are insufficient to complete the project. This situation occurs when construction costs are over budget, and the borrower is obligated to fund budget overruns to bring the loan "in balance" before the lender will fund the remainder of the loan. A shortfall is also created, however, where a lender fails to fund its loan share. If the loan documents do not restrict the borrower's obligation to make balancing payments to an actual budget overrun, but more generally require balancing payments where the cost to complete exceeds the loan funds available, a borrower may find itself involuntarily obligated to fund a shortfall caused by the lender. In either instance, whether a voluntary funding or a balancing payment, the borrower will most likely be required to fund in the equity position, and not in a priority position. A borrower should, however, attempt to negotiate a short-term arrangement under which it will fund additional equity to cover the shortfall, with a right to withdraw the additional equity during construction if a replacement lender is subsequently put in place.

The risk to a borrower of lender failure is multiplied where a large construction loan is syndicated among many lenders, each of which is liable to fund only its proportionate share of the loan.

Completion Guaranty

If replacement funding is not available from the borrower or from other loan sources, the loan will go into default, and the loan guarantors may be called upon to honor completion and payment guaranties. A critical consideration of the risk that this poses to the guarantor is whether the completion guaranty is itself contingent on loan funding by the lenders. Just as described above with respect to the balancing payment obligation, it is important to analyze whether the completion guaranty covers cost overruns only, assuming the full funding of the loan, or whether it covers completion more broadly, including the obligation to fund all shortfalls whether or not resulting from a lender default. The guaranty analysis is tricky, even if the guaranty language provides for full funding of the loan: since loan funding is conditioned upon the guarantor not otherwise being in default under the loan, the guarantor may have to fund a lender shortfall in order to prevent further events of default, to satisfy the condition for the loan funding. Also important to analyze are the defenses to guaranty liability, and whether a guarantor is entitled, either expressly or by a carve-out from general waivers, to assert as a defense to liability the failure of a lender to fund. In addition to reviewing liability under a completion guaranty to the lender, a borrower should review whether it is potentially liable under completion guaranties given to partners or tenants, which might be triggered by the consequences of a lender default.

Other Issues

The insolvency or downgrade of a lender may also trigger other requirements that involve replacing the lender's functions vis-à-vis the loan, or third parties such as tenants. The loan documents may require replacement of an interest rate swap provided by the downgraded lender with a new swap counterparty meeting specified credit standards. A lease or construction contract may require that a letter of credit drawn by the borrower on the defaulting bank and given to the tenant or contract party be replaced with a new letter of credit from a replacement lender meeting specified credit standards.

Finally, of course, if a loan goes into default because of the lender's failure to fund, the borrower may seek to pursue legal remedies against the defaulting lender for the losses arising from the lender's default. If the other lenders have not only failed to step in to prevent the default, but by their actions in declaring a default have exacerbated the borrower's losses, aggrieved borrowers may likewise attempt to assert various lender-liability theories of breach of good faith and fair dealing against those lenders as well. Those legal issues will undoubtedly be litigated anew as the financial crisis grinds on.

1. See "Construction Loans: Avoiding the Pitfalls in Managing Distressed Loans," Jeffrey B. Steiner and Jason R. Goldstein, New York Law Journal Sept. 17, 2008,

2. Note that this analysis assumes that the defaulting lender is not in bankruptcy, and so the actions described are not subject to the automatic stay or to bankruptcy court approval.