CRE Borrowers Limit Risk with Nonrecourse Bridge Loans

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For property owners, nonrecourse is the proper course for insuring against excessive commercial real estate losses.

BY JIM CONWAY

RISK: IT'S A SCARY WORD, ISN'T IT?
Prudent commercial real estate (CRE) owners quantify the potential economic losses associated with a multitude of risks and then do everything they can to insure against them. But now, in addition to the traditional operational and market risks, there is the growing worry of interest rate risk.

Interest Rate Risk

Bridge loans are often used by a borrower/sponsor to finance a "turnaround" opportunity in which a property is being acquired after a bank or a commercial mortgage-backed security (CMBS) special servicer has foreclosed.

The borrower/sponsor is convinced of the potential for significant value creation. Often, the price of the deal seems low for a property of reasonably good quality that just needs a fresh management and leasing approach, along with new capital to improve the property and its operating performance.

Bridge loans may carry a fixed or floating interest rate. With a fixed-rate loan, interest rate risk is primarily encountered when the loan matures and must be refinanced. If rates have risen significantly and property performance has stagnated or declined, the borrower/sponsor may be challenged to refinance and could need to inject additional equity capital.

Floating rates present additional exposure to risk because of their periodic adjustments. These adjustments typically have a fixed component (the spread) and a variable component (the index). For years, borrowers/sponsors have enjoyed extraordinarily low rates. But rates had been rising at the time of this writing (the yield on 10-year Treasury securities had increased by more than 1 percentage point over four months), and they were expected to go even higher with the tapering of quantitative easing (although the Fed had just announced QE tapering would be delayed).

When interest rates rise substantially, many borrowers/sponsors with floating-rate loans confront an increased risk of not being able to make payments. Additionally, higher rates may preclude borrowers/sponsors with both fixed- and floating-rate bridge loans from refinancing at maturity. They may not be able to meet minimum debt service coverage or maximum loan-to-value tests.

As interest rates rise, so do the capitalization rates used to value CRE. The devastating impact of greatly reduced property values resulting from dramatically higher cap rates can cause a borrower/sponsor to lose a property to foreclosure.

Nonrecourse versus Recourse Loan

Should a foreclosure occur in the case of a bridge loan secured only by a mortgage or deed of trust—in other words, a nonrecourse loan—the borrower/sponsor will only lose ownership. The equity investment made by the borrower/sponsor will be completely lost, but that loss will be finite and quantifiable.

By obtaining a nonrecourse bridge loan, the borrower/sponsor in essence bought an insurance policy: The lender agreed to limit the recovery of its investment to the funds from the sale of the property. The fancy legal wording for this arrangement simply says that the borrower/sponsor was "exculpated" from liability.

At loan closing, additional consideration was probably paid to the lender through some combination of fees and an interest rate higher than what would have been charged for a *recourse* loan. The borrower/sponsor paid this premium to limit its exposure to loss.

Contrast that nonrecourse loan scenario with the one that would play out in the case of a *recourse* bridge loan.

Typically, the borrower/sponsor is an entity comprised of a sponsor and one or more equity investors. The sponsor usually puts the deal together, including identifying the property, negotiating the acquisition, developing the business plan, attracting the equity investors, and negotiating the loan.

With a recourse bridge loan, the sponsor is also most often the party responsible for repayment of the entire debt. For collateral, the lender obtains a security interest in the property and a pledge of 100% of the sponsor's personal assets. The sponsor is *not* exculpated from any loss. In fact, the sponsor has given the *lender* an insurance policy against loss!

If the borrower/sponsor is unable to repay, the lender has multiple avenues to pursue. Depending on state law, the lender may do the following:

1. File a lawsuit against the borrower/sponsor that seeks to foreclose on the loan, take title to the property, and hold the sponsor personally liable for any loss the lender incurs upon sale of the property.
2. File a lawsuit solely against the sponsor, demanding payment in full of the debt,
   or
3. In the case of multiple sponsors that have signed personal guarantees that are joint and several, file suit against the individual sponsor/guarantor with the most assets. The joint and several guarantee allows the lender to pick and choose which of the sponsors/guarantors to pursue.

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Many lenders will go after just the "deep pockets" sponsor/guarantor, effectively making one entity personally liable for the entire debt. If the lender wins in court, the sponsor/guarantor will be hit with a judgment that it must pay in full out of his or her personal assets. The sponsor/guarantor will have to pay the lender's legal fees, too. Bye-bye to house, cars, boats, and college and retirement savings!

Prudent borrowers/sponsors often organize their CRE ownership entity as a limited liability company (LLC). They do this in order to limit their personal liability. It is unwise for a sponsor to go to the expense and trouble of establishing an LLC and then sign a personal guarantee in which the sponsor exposes himself, herself, or itself to unlimited liability.

The bottom line is this: Recourse—don't do it! ❖

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