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Goodwin Procter's Mastroianni

By *Erika Morphy*

It is gospel among lenders engaging in negotiations with clients who are in a distressed situation or heading towards a workout to obtain a pre-negotiation letter before the talks can begin. Increasingly, though, the person on the other side of the table – the borrower – is realizing the benefits of having this protection in place as well. In fact, in this current market environment, the prevailing legal wisdom is that even those borrowers that are seeking refinancing or replacement financing should have such a document in hand.

"They set forth the ground rules for a free flow of communication between a lender and borrower in the context of a distressed or potentially distressed loan," Francis N. Mastroianni, an attorney with Goodwin Procter LLP, tells GlobeSt.com. "Essentially, they allow the parties to have open discussions and negotiations with respect to the loan without unknowingly waiving or compromising any rights that either party might have in the loan documents."

Conversations, or counter offers that were introduced in negotiations without the protection of a pre-negotiation letter can be used in legal proceedings, he warns.

GlobeSt.com: Isn't a lender more apt to insist on a pre-negotiation letter?

Mastroianni: Actually they are relatively common among sophisticated borrowers as well. They tend to benefit both parties and for that reason they serve as a useful tool. That being said, there are plenty of stories of work outs where the parties haven't entered into a pre-negotiation letter and that led to complications.

GlobeSt.com: What type of complications?

Mastroianni: For instance, a lender may fail to get the pre-negotiation letter executed by the entity or individual who has guaranteed the loan. It is always prudent to keep the guarantor formally in the loop.

GlobeSt.com: What are some of the basic clauses that should go into a pre-negotiation letter?

Mastroianni: One is that the negotiations were requested by borrower, are completely voluntary, and may be terminated by either party at any time, without recourse or obligation. Another provision might acknowledge any late payments on the part of the borrower that may be deemed a default or any other circumstances that necessitate a loan modification or workout.

GlobeSt.com: Is it in the best interests of a borrower to spell this out?

Mastroianni: While it is unlikely that a borrower would expressly acknowledge a default in a pre-negotiation letter, a lender might require a simple acknowledgement of the facts contributing to a possible loan modification, such as missed or late payments.

GlobeSt.com: Other provisions that you recommend?

Mastroianni: Of course there are the basics: All parties agree that any loan modification will not be binding until all terms are reduced to writing. Also, the loan documents must remain in full force and effect, unmodified except as provided in writing. The content and even mere existence of negotiations is inadmissible in court. All future claims relating to oral or written statements made during negotiations are to be waived and released. And finally, certain individuals in the negotiations are the authorized representatives of borrower and lender, respectively.

For lenders there are additional considerations. If the loan is guaranteed, the guarantor should execute or acknowledge the pre-negotiation letter. A lender will want to avoid guarantor's assertion of any suretyship defenses. Also, the underlying collateral securing the loan should remain unencumbered by any lien other than the mortgage. 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. Also, the borrower should pay all of lender's fees in connection with any modification or workout, or related negotiations. By negotiating this upfront, it avoids the issue arising at a more sensitive point in the negotiations, when any surprise could derail a resolution.

GlobeSt.com: What about specific protections for the borrower?

Mastroianni: 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.

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