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Lessons Learned about Real Estate Lending in this Last Recession

Article By
[Nancy Leary Haggerty](#)
[Michael Best & Friedrich LLP](#)
[Client Alert](#)

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We all know real estate, and especially real estate lending, was heavily affected by the recession. Now that banks are starting to lend again, what can we learn from those bad years to set us on a better course for the future?

1. Real estate lending in the last cycle. We learned problem loans arose principally on loans with high loan to value ratios, or based on projections that were too optimistic, or in geographic markets where the lender did not have good market knowledge, and especially where the bank became more of a joint venturer with the developer. Smaller community banks especially felt more pressure to help home grown companies expand.

2. Problems exposed in the recession and recovery.

- Appraisal methodology. Through the hard lessons of foreclosure and bankruptcy we learned more acutely about appraisal methodology, and the weaknesses of this methodology in troubled times became transparent. We learned that, although appraisers are not supposed to take “forced sales” into account in calculating fair market value, when the market is thin, “forced sales” may be the only comparables.
- Exercise of developer’s rights. We also learned a developer’s decisions can have a drastic impact on a lenders’ ability to recover collateral, and on holding costs during workout or foreclosure. This was especially clear in cases where a condominium developer suddenly expanded the condominium into future phases, even when units were not selling, thus creating many separate tax key numbers with separate real estate tax bills, separate condominium association assessments, and no means of reversing that decision except with unanimous or near-unanimous consent of all condo unit owners and their lenders.
- Interstate Land Sale Act. Condo unit buyers attempting to cancel contracts to purchase condos whose value had fallen, started using the long-dormant Interstate Land Sale Act as a weapon, with increased liability to developers.
- Priority of municipality’s rights under development agreements. The Baylake Bank case in Wisconsin highlighted the ability to challenge the priority of charges and obligations contained in municipal development agreements.
- Drastic impacts to condominium and homeowners’ associations’ budgets. Failure of even a small percentage of condo unit owners or homeowners to pay their assessments resulted in grave difficulties in that association’s ability to function.
- Foreclosing on less than all needed assets of a project. Lenders foreclosing on projects discovered they lacked the ability to make needed changes in the project to facilitate its resale and needed to negotiate with their delinquent borrowers to secure Declarant rights reserved in condo declarations, permits issued only in the borrower’s name, and necessary easements.

3. Reaction to market risks. In response to these risks exposed in the recession, parties in the real estate market took action.

- Title insurance changes. In reaction to the sudden increase in title claims, title companies not only increased their fees substantially, but also reversed their practice of deleting the “creditor’s rights” exception in their policies.
- Secondary mortgage market changes. In response to liability claims, Fannie Mae, Freddie Mac, the Department of Veterans Affairs and others modified their requirements for purchase of loans from primary lenders, which changed requirements for condominium declarations and strongly encouraged phasing of projects.
- Lending changes. Lenders are now under more scrutiny and stiffer governmental oversight on all real estate loans.

Those of us who are involved in the commercial real estate world hope we are starting on a new cycle of expansion. However the “hangover” of this recession will require us to change our documents and practices for success in this new period.