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Lender Involved Condemnation Part 2: Lender Concerns in Condemnation

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This is the second installment in a series of articles related to lender-involved condemnations. The first installment provided a basic discussion of eminent domain and condemnation principles. This article focuses on lender concerns regarding eminent domain and condemnation actions. The third and final installment will develop a framework for managing lender risk and cost in these cases.

Due to the unique nature of real estate and the number of variables surrounding a particular loan, each condemnation (i.e., forced acquisition of property) requires a fact-sensitive analysis to determine the best approach to maximize security and minimize risk. It is important to analyze the financial metrics of the loan in the context of the taking while a litigation strategy is developed.

Underwriting Fundamentals Drive Risks

To begin, the holder of a secured interest (Lender) should revisit its initial documentation so it can determine whether sufficient collateral of an acceptable quality will exist after the taking. The Lender should also examine the likelihood that the borrower will enter default, either as a result of the taking or other circumstances. If the Lender determines that sufficient collateral of an acceptable quality exists after the taking, and that the borrower will likely continue to meet its obligations, then involvement in a condemnation action will result in unnecessary legal costs in order to protect the Lender's investment.

On the other hand, if the Lender finds that its collateral was substantially impaired by the condemnation or that the borrower is unlikely to continue to meet its obligations, then the Lender has a strong interest in any compensation available from the condemning authority. This strategy should reduce the risk that condemnation impairs the ability of the collateral to cover the outstanding balance on the loan. Most situations present an intermediate scenario that requires a cost-benefit analysis to determine how much cash the Lender should expend in order to protect its secured interest.

A Timely Response Reduces Risk

Efficient handling of a condemnation action by a Lender requires a rapid response by those with ready access to fundamental information concerning the loan and the borrower. In Georgia, a condemnee has only 30 days to contest the adequacy of the condemnor's deposit. Accordingly, as soon as the Lender is served, counsel for the Lender should file a responsive pleading to protect the Lender from risks related to a failure to respond. It is less risky to file an initial response and later dismiss than to risk missing the deadline, therein waiving its right to participate in a proceeding to contest value.

The Lender's underwriting department's analysis, concerning the Lender's tolerance for impairment to the collateral or if changes in the borrower's circumstance create a risk of default, must be performed within 30 to 60 days from the filing of the answer. Failure to promptly review the loan may result in unnecessary and unrecoverable costs related to discovery and litigation. When the underwriting review is complete, the Lender can decide whether it wants to seek additional compensation, seek a portion of the proceeds in the court registry or simply walk away. The maximum amount of recovery is limited by the fair market value of the property on the date of taking and the outstanding loan balance. Accordingly, the potential benefit from participation in the action can be quantified and compared to the expected expenses incurred by litigation. As part of its business decision, it is important for the Lender to discern the amount of legal and expert fees it will tolerate to recover additional compensation.

Appraisals and the Loan File are Likely Discoverable

If the Lender seeks additional compensation, the ultimate decision is typically made by a jury based on legally sufficient evidence. Lenders are at an advantage over property owners because they have more ready access to appraisals in the loan file and broker price opinions. However, appraisals for the purpose of demonstrating value of secured collateral can be more conservative than appraisals prepared for litigation. Accordingly, the Lender should consider the fact that appraisals created when the loan was originated may be discoverable. A condemnation proceeding may also require an appraisal that follows a certain format; these appraisals are often more costly than standard appraisals because they consider the value of the property before and after the taking. This is especially true when a taking changes the highest and best use of the property remaining after the condemnation. Condemnation cases also involve expenses for engineers, traffic circulation experts and other specialists. Careful consideration of these expenses, in light of the total fair market value at the time of taking, is important.

Working With Borrowers

Borrowers often contest the sufficiency of the compensation paid by the condemning authority and pursue claims for additional compensation. Many borrowers plan to use any proceeds to satisfy any outstanding debts related to the property, but some try to withdraw the funds without considering the obligations set forth in their deed of trust. Accordingly, it is important for the Lender to place the court on notice of its interest. It is also important to pay close attention to the pleadings filed by the borrower to avoid an unapproved withdrawal by a borrower.

If the borrower is seeking additional compensation and cooperating with the Lender, the interests of the Lender and the owner may be aligned. In that instance, the borrower directly bears the costs of litigation. Such a borrower will reduce the need for the Lender to pay costs directly. It will also eliminate the need for the Lender to attempt to seek reimbursement for costs to protect the collateral if such a course of action is allowed by the deed of trust. In all cases, the Lender should protect itself with an independent analysis of the risks and the potential rewards of participating in a condemnation case.

Conclusion

In order to conduct the analysis discussed above, it is beneficial for Lenders to create standard procedures for review of the loan underwriting, current fair market value, and the degree of impairment created by the taking. If designed appropriately, such standard procedures and criteria can aid the Lender by minimizing costs and maximizing the value received for collateral that is faced with a condemnation. The next and final installment provides considerations for preparing these standards and proposes a set of standards that can be implemented to achieve this goal.