Lending Law Update

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Real Estate Collateral and Land Use Implications – Who Cares?

Commercial mortgage lenders and those who require real estate collateral for credit facilities often overlook the land use implications of applicable laws that govern the utilization, development and taxation of the land and buildings that are the primary source of security for the loans. Lenders typically rely upon the due diligence provided by an appraiser when analyzing the zoning, a separate zoning analysis from a third party vendor or a certification from a governmental authority that has jurisdiction over the property. Most lenders expect a loan to be repaid and do not anticipate getting a property back on foreclosure or through a deed-in-lieu of foreclosure. Nevertheless, the return of real estate collateral should be analyzed thoroughly at the beginning of the underwriting process. Certain assumptions need to be made as to the continued use and occupancy of a property. Land use laws are fluid and can fundamentally impact the continued use and operation of a property, especially if there is a gap in its customary use. Zoning, land use, subdivision, variances, special exceptions, brownfield developments, taxing districts and enterprise zones can all have a substantial effect on what a lender might be able to do on a disposition of real estate that becomes owned or recovered in a troubled loan situation.

Who Cares?

The future marketability of a given property is not considered in order to determine whether it will have broad or limited sales appeal. For example, a custom or "build to suit" facility may not have multiple uses because of the limitations provided under its zoning classification or the land use regulations that govern it. During the last recession, numerous lenders were surprised, and distinctly disadvantaged, to learn (1) that their real estate collateral would be unable to be subdivided or developed because the subdivision plan process or land development approvals had sunsetted under existing legislation, or (2) that insufficient development work had been done on the property to warrant a completion of the project. In some instances, required variances were not received and special tax treatment was not available because the improvements were incomplete or missing.

A lender might also discover the nonconforming use of a property, which by virtue of being grandfathered in its pre-existing operation, no longer fits into the applicable zoning category. In the event of a fire or other casualty loss, a nonconforming property may, in fact, not be restored or rebuilt to the same or similar size specifications that existed prior to the casualty event. A special exception or variance that is not continually used or does not run with the land, may be unavailable for a new or substitute purchaser of the property. Moreover, in enterprise zones or special taxing districts, a property developer's or owner's failure to comply with certain covenants may require a lender to either refund certain tax benefits or require that abated amounts be paid back to the taxing authority before the property can be used.

Proper Due Diligence

Obtaining a zoning certification and determining whether a property has appurtenant land use approvals is paramount. Lenders should determine if a nonconforming property can be restored to its current size and location and whether its current use, under pre-existing zoning or land use, is operating on borrowed time. Engaging a land use attorney and an engineer who are familiar with the zoning laws of a specific location at the initial stages of a loan are critical components to making sure the real estate collateral has a broader range of uses and is marketable for other purposes. All too often, an appraiser's analysis of the property does not delve into specific attributes that make a property valuable to a broader array of potential purchasers. This analysis should be conducted before the loan closes and copies of all applicable licenses and land use approvals should be placed in the credit file so that upon asset recovery, a determination will already have been made whether the property, if returned to the lender, can be disposed of quickly and efficiently.

In conclusion, preparing a land use analysis is essential at the forefront of the transaction. By doing so, lenders alleviate the risk that the intended use and value of a property are significantly diminished or impaired by virtue of land use law implications.