Investments:

Non-Recourse Loans

Last month, I wrote about interest-only loans for investment properties. For this month's column, I will discuss non-recourse loans, and how they can benefit you as a real estate investor.

What are Non-Recourse Loans?

You probably have had at least one non-recourse loan in the past without realizing it. In California, by law, all loans on personal residences are non-recourse.

If a loan is non-recourse, this means that the lender has no recourse if the borrower defaults on the mortgage other than taking his property by foreclosure. In most cases; loans on investment properties have recourse: If you borrow $800,000 to buy an 8-unit property for $1.2 million; default on the loan, and the bank sells your foreclosed property for $700,000, they can (and will) come after you for that $100,000 shortfall. If that had been a non-recourse loan, by comparison, the bank would lose $100,000. The lender, by agreement, has no recourse against you other than taking your property. A non-recourse lender is making a loan to the property, rather than to the investor personally.

What Non-Recourse Loans Can Do for You

A non-recourse loan can lower your personal risk substantially: if something goes wrong with a property, the bank can only take that property away from you. A lender foreclosing on a property with a non-recourse loan can not try to take your home, other investment properties, or investment portfolio to satisfy that debt. An investor buying property with a non-recourse loan is, therefore, taking less risk than one using fully recourse financing.

Note that non-recourse loans do feature what are sometimes called "bad-boy carve outs." These carve outs contain limited situations where the lender can come after you. For example: if you dump toxic waste on the lot the bank can then seek recourse damages. These carve outs can be fairly far-fetched, but there are attorneys who are paid to think of every possibility. A borrower who avoids committing fraud or intentionally damaging the property can avoid running afoul of these special carve outs.

But I Won't Lose My Properties to Foreclosure. Why Should I Worry About Non-Recourse Loans?

As I told an investor today: "Nobody ever plans on giving up a property through foreclosure, but it happens every day." I do understand where the askers of this question are coming from, though. If I was evaluating a property that I thought might get foreclosed on, I wouldn't buy it in the first place.

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Christopher Miller is a Managing Director with Specialized Wealth Management in Tustin, California and specializes in tax-advantaged investments including 1031 replacement properties. Chris' real estate experience includes work in commercial appraisal, in institutional acquisitions for a national real estate syndicator, and as an advisor helping clients through over two hundred 1031 exchanges. Chris has been featured as an expert in several industry publications, and on television, and earned an MBA emphasizing Real Estate Finance from the University of Southern California. Call him toll-free at (877) 313 – 1868.

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In addition to limiting risk, non-recourse loans can give other valuable financial benefits to borrowers by allowing them better (and sometimes cheaper) access to credit. For example: A potential borrower with a $1 million home and a $2 million 8 unit property has a $500,000 loan on his home and a $1,000,000 loan (both with "Lender #1") on his 8 units. If this borrower wants a $500,000 loan to buy 4 more units for $1 million; potential lenders will be concerned with his existing 8 units. If he gets into trouble with that property, and it is foreclosed on: will that lender come after the house and 4 units? (The very ones that Lender #2 is considering a loan on.) If the $1 million loan on the 8 units was non-recourse; this could make the loan less concerning to a potential new lender: If the investor gets into trouble with that asset, it won't necessarily affect his other assets (the assets he could use to help make payments to Lender #2.) Lenders, after all, are most concerned with getting their money back.

Syndicated real estate offerings, in which many individuals buy an investment property, often feature non-recourse loans that are described as "off balance-sheet loans." If the investor above had $1 million of equity with a corresponding $1 million of debt in a syndicated deal; that $1 million would go in the assets column of his balance sheet when applying for that $500,000 loan. The $1 million of debt wouldn't be listed, as the investor isn't personally named as a borrower. His balance sheet, and suitability as a borrower, looks much more favorable to lender #2. While applying for a loan – trying to convince a bank to lend you money – healthy financials certainly never hurt.

Interest only loans are a powerful tool used by larger investors to keep their balance sheets healthy, allow easier access to credit, and manage risk. For smaller investors, it may be something worth learning more about.

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