



**Martin V. Lavin**



## **Loan recourse: Panacea, or *panic and I'll see ya?***

### **Seeking help**

Recently, as the manufactured housing industry has seen new home shipments drop to levels unknown since 1960, the industry has turned to any device which may again start a shipments growth. Since changing the entire industry model to allow for more profitable and survivable lending is extremely difficult—especially for chattel loans—industry participants have sought easier methods to open the lending spigot wider.

Coming to the forefront once again has been the willingness of individuals and/or companies who need more accommodative lending to take on some degree of loan “recourse.” Recourse is the process whereby you make promises to the lenders, that if the lender alters what would be its normal loan underwriting to a more accommodative one, the one selling the product or another party will take on greater legal and financial responsibility for the loan should it go bad. As we’ll explore in this article, this can take on many degrees of recourse risk.

In all loans the entity originating the loan makes certain representations. These include the fact that: the loan details are all materially true; all elements of the loan origination are legal; and, there was no negligence or fraud in the loan origination. Within broad guidelines,

those are the guarantees the loan originator normally makes to the lenders at loan closing time, and these representations are in effect usually for the full duration of the loan’s existence.

### **Recourse losses**

Notice that if no violation exists of the above loan conditions, in the event of default, repossession of the collateral and loss by the lender, the loan originator has no financial responsibility to the lender and the lender can seek no recourse to the loan originator for any losses. The lender must look to the borrower(s) for any losses they may have suffered. The reality of the financial capability of most of our borrowers and the substantial home value depreciation most of our homes suffer, means the losses at default, repossession, and resale can hit the lender’s solar plexus like a Mike Tyson punch. Loan recoveries in the 20 percent to 50 percent of loan amount are common, and when they approach 50 percent, most lenders feel satisfied.

It is this substantial loss of loan value at repossession that makes manufactured housing lending so problematic, and to stay at the 50 percent loss range requires numerous experienced personnel with finely tuned instincts to keep losses even at that level. If you didn’t before, you now know the problem: it’s not the repossessions of themselves which are the problem; it’s the severity of loss upon repossession and resale which dog industry lenders. Note that this condition is especially prevalent in many land lease communities, with chattel-financed homes. It

is easy to demonstrate that most of the home shipments losses—since the last industry top of 1998, to below 100,000 homes in 2007—have come from this category of homes. Lenders now use extreme caution with these types of loans.

In order to spur more accommodative chattel loan underwriting by lenders, there has recently been a whole new interest in taking on loan recourse by originators. This recourse can take many forms: from the originator taking on the responsibility for certain actions, say, like keeping track of the status of the borrower in the home; to helping repossess the home at default; to refurbishing the home for resale, reselling it, and finally, in a full recourse scenario, making good lender losses that may occur for virtually any reason. Lenders, being what they are, love full recourse. Since lenders and recourse parties are both hesitant to take any losses, this sets up the basis for what commonly happens in recourse, particularly full recourse. When losses mount and recourse payments stop, the gloves come off and the fight begins.

## Risks and rewards

Lenders who loan on manufactured housing commonly believe their underwriting fully comprehends the risks of lending on their product. This is a balancing act, weighted between risk/reward. The truth is that until the early 2000s the full risk/reward of lending in manufactured housing was not well understood, and lessons are being learned even today. Most 1990s industry lending participants, almost all of which had flawed underwriting, are now long gone, leaving with huge loan losses. The few remaining survivors had taken on less risk, but none lend today as they did in 1998. All learned many lessons and put stricter underwriting in place to survive. That strict un-

derwriting contracted the industry. It continues to this day with the real estate subprime problem leading to further recent tightening.

Now, as loan originators once again seek to create more accommodative loan underwriting, what are the rewards of recourse protection for the lender, and what are the risks for the originator? We are hardly without guidance in trying to analyze the goods and bads of recourse. The trailer/mobile home/manufactured home industry has a rich history of recourse which we can review, starting in the 1950s and continuing to this day.

The lender must evaluate the assistance recourse will give their loan performance based upon the level and strength of recourse extended by the originator. As an example, any lender would be pleased to have a “park agreement” with a land lease community owner, which assures the lender that the LLC owner will keep an eye on the borrower in the home, repossess it upon default, refurbish the home at cost, resell the home after refurb, and abate the monthly rent the lender is paying the LLC to keep the home there for some period of time after default. Recourse at that level can and has worked when both parties were prepared to handle the matter with integrity, and by the full terms of the agreement.

## Breakdown

Where it can break down is when, through its actions, one of the parties fails to uphold the full tenor of the agreement or made a mistake originally when evaluating the benefit recourse would bring. Commonly, the recourse party will stop doing the things they promised the lender they would do and/or the lender fails to live up to the terms of the agreement, at which point the lack of compliance often leads to a

disagreement, a demand of recourse losses, and a lawsuit. Is this a rare event? Unfortunately it is not. Recourse programs commonly wind up in court. So, who’s to blame? Most instances with which I am familiar found plenty of blame to go around, with few innocents.

Does this mean recourse cannot work over time? My opinion is that if it did work, with absolute certainty, the industry would be using it far more effectively than it does now and it would be a far larger industry than it is now. Who is pushing the recourse? Interestingly, it is the loan originators who seek it to loosen underwriting, and it has usually been that way.

So far, we’ve spoken of relatively limited recourse. How about full recourse? Well, there are people who work with dynamite and others who are airline pilots. Both of these endeavors require diligence and concentration not inherent in everyone’s makeup. Full recourse is like that; it can lead to problems... big problems.

## Deep pockets?

When you accept full loan recourse, without any stop-loss measures, every dip in your borrowers’ lives such as divorce, death, transfer, inability to resell their home, job loss, and other traumas, becomes yours. The losses attendant to them will also be yours. And the losses attendant to these types of activities can be substantial. If loan losses are known to put a lender out of business, what makes you think you have more money than they have?

Aside from the borrowers, you have another worry with full recourse; your lender. Lenders, being what they are, often resort to sending out demand notices to the recourse party for rapid payment, often without fully complying with the con-

tractual terms of the recourse. Lenders don't like going to the internal loan committee to explain why that "trailer" loan goes unpaid, and will go to great lengths to avoid that.

As an example, often the lender will start the loan program by giving the recourse party prompt notice of borrower events and is prepared to finance the buyer of the repossession on terms and conditions which accommodate the resale without loss. However, as time goes by, lenders are known to tighten their lending on repo resales. That may not be too big a problem for a home originally financed as a resale when sold to the defaulting borrower, but it is a big problem if the home sold was originally new and now the lender underwriting requires financing the repo like a resale, which the home now is. The recourse party will be assured of a loss—often a big one—and the fact the lender is uncooperative in financing the repo resale will cause heartburn. "Rare occurrence," you may say. I'm afraid it's not.

Worse, since repos tend to come in bunches, often driven by the economy, the lender might well refuse to finance any repos in the future, as the loan committee there senses troubles ahead. Never happens? Hardly; it is so common that you can almost set the 3-5 year clock and watch it happen.

I remind those who think recourse is a panacea that it is a device used to try to repair an otherwise fractured financing model. Better than recourse would be to install within the industry those measures for which lenders have been clamoring to make loaning on manufactured housing more rational, hence easier, less risky and more profitable.

That remains a dream.

## The answer?

If recourse was the answer to

our lending constraints, we'd have no problems, but the industry has endured great problems in spite of extensive loan recourse. Whether it was the "Great Meltdown of 1974-75," the "S&L Crises of 1989-93," or the "Greensec Collapse of 1998-2004," the one thing in common with the majority of the defaulted loans during those eras is that most had some level of recourse. Yet, the losses borne by lenders were catastrophic and failed to save most lenders or loan investors. The only thing that saves lenders is smart underwriting and intelligent servicing, and recourse surely didn't save accommodative lending nor stem losses. Experience shows recourse without fully funded reserves will not save the lender because after a certain point the recourse parties will not pay. Additionally, on the other side, because of the false security of recourse, the lender commonly fails to do everything they should do to assure loan quality and recoveries. "Nah, let's just send out a recourse demand so we won't take a loss," said Mr. Friendly Lender.

Does this mean no recourse should be extended and used? Hardly. I think a limited recourse that assists the lender in those areas where they are weak—like anything done to and with the home on site—can be a real benefit for both parties. The lender will like the protection a committed recourse party provides, and the loan originator will benefit from greater trust in the deal by the lender, leading to better lending. However, if there is one theme upon which you can depend on manufactured housing lending, "nothing is forever."

A recourse program can work but frame it carefully; keep good open dialogue between the parties, and by all means put intelligent stop-loss measures in place to limit your exposure. How would you like to

be responsible for a large unfunded recourse liability, for many years after the lending program ends, your repos not being financed, and dealing with an antagonistic lender? I've been there, and I didn't like it; neither will you. ☀

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