Borrowers beware: "Alternative lenders" are not what they seem

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We are all far too aware of the current state of financing all over the country, including new developments in New York City and the surrounding areas. Many projects have been put on hold, some indefinitely. With the stiffening debt market several new lenders have arrived, often offering deals that seem to be too good to be true. But, we cannot let the state of the economy and the overall lack of funding cloud our judgment when it comes to alternative lending sources. Some of these alternative lending sources are not exactly what they seem and in my experience many turn out to be fraudulent.

Recently, we have seen from several vantage points what we would consider to be lenders of a questionable nature. We have been fortunate enough that none of our clients have elected to take one of their loans, although we have seen others who have and the results have not been good.

The sequence of events is always the same. The borrower is approached by a "broker/lender" who claims to represent foreign funds. The broker presents a term sheet that is non-binding, and the borrower does not have to put down a good faith deposit.

The borrower signs the term sheet and shortly thereafter the broker produces a commitment letter which embodies the same terms but with a third party "lender." More often than not, the third party "lender" is a shell entity and has little or no assets.

The commitment letter typically contains an additional term that requires the borrower to put up five to ten percent of the loan in equity - either cash or a letter of credit. The equity will be held in escrow with a reputable financial institution pursuant to an escrow agreement, which allows the lender to pledge/borrow against the escrow (i.e., it enables the lender to seek financing with another lender - an escrow lender - using the escrow as collateral for the new loan).

The commitment letter is negotiated and eventually signed either simultaneously with or a few days before the escrow agreement and the borrower puts up the required equity.

This is where the problems begin. When the borrower puts up the escrow money, the lender, as permitted under the escrow agreement, takes out a short term loan with an escrow lender utilizing the escrowed money as collateral. The lender then uses the loan proceeds from this first loan to try and raise money to make the loan that is contemplated under the commitment letter from foreign investors.

Several things can happen at this point. The lender could raise the money for original loan and close it and then no one would be the wiser.

More often the lender has trouble raising the money for the loan. Consequently, to buy more time, the lender repetitively extends the date of its closing with the borrower under the commitment letter, and in turn it extends the escrow loan. This process can go on for months. Even if the lender decides not to close and refunds the escrow money, a large part of that money will go towards

paying off the escrow lender and the accrued interest.

If a borrower gets this far in this process, they begin to think of actions they can take against the lender. But because the lender is a shell organization and the escrow lender's interest is continuing to accrue under its loan, it places the borrower in a very difficult position.

In these slow development times, it is even more important that borrowers do their due diligence when looking at a new lender. Above all, beware of so-called "alternative lenders" especially those with "foreign sources."

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