

Purchase and Sale of Distressed Real Estate-Secured Loans

By Doug Van Gessel and Katharine Allen

Sheppard, Mullin, Richter & Hampton LLP

As the credit crisis continues and financial institutions seek to rid themselves of "toxic" real estate loans, most observers anticipate that, for the first time since the early 1990's, significant portfolios of distressed real estate loans will be purchased and sold once sellers and buyers can agree on a reasonable valuation for such portfolios. However, both the issues and the players involved in loan portfolio sales have changed significantly since the 1990's. This article discusses both the traditional issues involved in distressed loan portfolio sales and some new issues to consider for the next round of portfolio sales.

Types of Loans/Distressed vs. Nondistressed Loans

The first such consideration in selling or buying portfolios is the type of loan or loans proposed as part of the sale. In particular, a buyer will need to look at the overall "capital stack" of financing on the underlying property and the place the loan or loans being offered for sale hold in those respective capital stacks.

Foremost, it is imperative that prospective buyers understand the difference between a whole mortgage loan and a split mortgage loan. A whole mortgage loan is the simplest form of loan with respect to real property. It is evidenced by a single note and secured by a lien on the underlying property. By contrast, a split mortgage loan is evidenced by more than one promissory note or has otherwise been divided up into separate lender interests. Split mortgage loans most commonly involve A and B notes, whereby one or more lenders retain junior positions in the capital stack. Split mortgage loans contain additional risks above those present in whole mortgage loans. In particular, due to the multiplicity of lender interests under a split mortgage loan, there is a risk of default by the borrower under intercreditor agreements as well as the loan itself. It is also possible that other lender interests have exercisable right under such agreements at the time of the proposed sale.

In addition to whole loans and split loans, prospective buyers may also be offered opportunities to purchase mezzanine loans, construction loans or other more specialized forms of loans, which, among other aspects, may include participation interests in favor of the lender. While the exact differences between these types of loans is beyond the scope of this article, an understanding of those differences and the effects that they have on the risk of a particular loan are key prior to considering the purchase of a particular loan or set of loans.

Aside from knowing and understanding the type of loan or loans offered for sale, a prospective buyer needs to know the current status of each loan offered for sale prior to entering into negotiations. A loan that is already in default or teetering on the brink of default will give rise to an entirely different set of considerations than a non-distressed loan. This consideration is most clearly reflected in the general pricing for distressed loans, which typically sell for greater discounts than non-distressed loans. The discrepancy is due to the differences in the degree of risk associated with each category of loan.

Due Diligence Review

Its imperative for sellers of distressed real estate loans to realize that uncertainties and potential problems with the loans will be used by prospective buyers in order to drive down the purchase price for the assets. Given that

Prepared by:

Doug Van Gessel, Partner | 415.774.2989 | dvangessel@sheppardmullin.com

Katharine Allen, Associate | 415.774.2903 | kallen@sheppardmullin.com

Sheppard, Mullin, Richter & Hampton LLP

sheppardmullin.com | realestateandconstructionlawblog.com

the assets may already be troubled, any component of the portfolio that cannot be proved to be performing will be considered non-performing or otherwise in default or troubled by the bidders. Therefore, it's extremely important for sellers conducting a bid or other sale to prepare the most complete set of loan files, due diligence materials, title reports, surveys, environmental reports, UCC searches and any other related files for review possible.

In contemplating the purchase of a loan portfolio, a prospective buyer will want to conduct a broad scope of due diligence. Due diligence should include at minimum, a thorough review of all related loan documents, the overall structure of the capital stack, the collateral securing the loan obligation and the financial capacity of the borrower and seller.

Loan Documents

In commencing its due diligence, a prospective buyer will likely start with a thorough review of all documents evidencing or otherwise pertaining to the loan it contemplates purchasing. These loan documents might include an underlying loan agreement, a corresponding mortgage or deed of trust, a promissory note(s), related UCC financing statements, fixture filings, performance and/or repayment guarantees and any other applicable guarantees, and any analogous assignment of leases and rents or other documents evidencing collateral assignments. If the loan or loans being considered are split mortgage loans, the buyer will also need to review any resulting intercreditor agreements, participation agreements or other co-lender agreements. It is important that the loan documents are comprehensive and provide the lender with sufficient rights and remedies to adequately protect its underlying interest.

The first step for a prospective loan buyer in reviewing loan documents should be to analyze the key terms of the loan agreement. In particular, the buyer will need to understand the payment terms under the loan, including the schedule of payments, how payments are made, the interest rate, the maturity date, any options to extend the maturity date and the requirements for any such extension. The prospective buyer should also ascertain the current loan-to-value ratio with respect to the loan, as well as inquire into other aspects of the loan, such as the existence of impound accounts, balancing requirements, and debt coverage ratios. The loan documents should contain most, if not all, of the typical covenants, defaults provisions and remedies found in loan transactions. Standard borrower covenants might include financial covenants with respect to the borrower entity (including, without limitation, requirements to submit financial statements, maintain a specified minimum net worth or net working capital amount), covenants to maintain, repair, insure and pay taxes due with respect to the property, prohibitions against additional financing, covenants with respect to the borrower's entity status (i.e. single purpose entity covenants) and covenants to comply with all legal obligations. It may also be helpful for the buyer to prepare income and expense projections with respect to the loan or loans being purchased to ascertain whether the projections satisfy the buyer's investment objectives.

After understanding the basic terms of the loan, the buyer's inquiry should then take a more practical approach. The buyer should confirm that there are no defects in the enforceability of the underlying loan documents. Proper filing and recording of all necessary documents should be confirmed, as should the presence of all necessary signatures, notarizations, legal descriptions and pages to the loan documents. Another key inquiry will be whether the transfer of the loan will result in any loss of priority in relation to other lenders or creditors of the borrower.

If one or more of the loans offered for sale are distressed, the buyer should also inquire into the reason the loan has been classified as distressed. If the borrower is currently in default under the loan or is about to go into default, the buyer should consider the materiality of the default. A technical default of a nonmaterial provision of the loan is less of a concern than a default with respect to a material provision, such as a payment default. Technical defaults are less likely to impact the income flow generated from the loan and hence are less of a

concern to a prospective buyer. If the loan is currently in default, the buyer should also consider the likelihood that the borrower can and will cure the default. If the borrower is unable or unwilling to cure a material default under the loan, the holder of the lender's interest will likely be forced to either exercise its rights with respect to the underlying collateral securing the loan or otherwise agree to restructure the loan down the line.

Relation to other loans and lenders

Once a prospective buyer has an understanding of the loan documents, it will need to look at the loan in the broader context of the overall financing transaction. In particular, the buyer must consider where the loan being sold falls within the overall capital stack and the implications of such position on risk and remedies. This consideration is more relevant for split mortgage loans and properties with multiple forms of financing on them, such as a mortgage loan accompanied by a mezzanine loan.

If there are multiple lenders involved, a buyer should first review any related intercreditor agreements, participation agreements or similar agreement outlining the relationship between the lenders. The buyer should also review any correspondence between the various lenders relating to the overall financing transaction to the extent this information is made available. This is necessary in order to determine how the rights of the lender under the loan offered for sale are affected by the other loans in the capital stack. The considerations and risks associated with the purchase of the loan offered for sale will vary depending on the position of the loan in the capital stack.

Split Mortgage Loans

In the context of a split mortgage loan where there are junior and senior lender interests, it is imperative that a prospective buyer understand the relationship between those lenders and its impact on the lender interest under the loan offered for sale. In addition to understanding simple priority rules in the event of foreclosure, the buyer must also grasp the relationship between the lenders when the loan is current and performing. Thus, it is necessary to review any intercreditor agreements, participation agreements or other lending agreements in order to ascertain how the buyer's rights as lender under the loan will be affected by the rights of the other lenders. While review of these agreements is more important when purchasing senior debt, this step should not be overlooked in any transaction with multiple lenders.

Another possible scenario where the relationship between lenders must be taken into account is a situation both a mortgage lender and a mezzanine lender are involved. In the event the mortgage debt is offered for sale, potential buyers must review the rights of the mezzanine lender with respect to the debt purchased. In particular, the buyer should ascertain the extent of the notice and cure rights granted to the mezzanine lender with respect to any defaults under the mortgage loan, as well as any other potential limitations on the mortgage lender's right to foreclose following a default. Likewise, the buyer will also want to look at the rights it would have as the mortgage lender in the event there is a default under the mezzanine debt. In particular, the buyer will need to ascertain whether adequate restrictions have been placed on the mezzanine lender's ability to foreclose, or alternatively, to purchase the mortgage debt, and on the ownership and identity of the borrower entity. The buyer should also confirm that the rights of any mezzanine lender to receive payments are subordinate to those of the mortgage lender.

Mezzanine Loans

If mezzanine debt is offered for sale, the buyer's inquiry changes slightly. The buyer should first review whether there are any transfer restrictions imposed on the loan offered for sale. For instance, mezzanine lenders are often only allowed to transfer the lender's interest under the mezzanine loan to a "Qualified Transferee", which is

generally an institutional investor of sorts that meets certain financial requirements. Furthermore, intercreditor agreements will often require that any foreclosing entity under the mezzanine debt be a "Qualified Transferee".

Additional limitations may also be placed on a the buyer's ability to foreclose under a mezzanine loan. For instance, in order to foreclose, a mezzanine mortgagee is often required to meet the definition of a "Qualified Transferee", or alternatively, to obtain a "No Down-Grade Letter". Furthermore, because mezzanine debt is secured by equity interests in the borrower entity, foreclosures under mezzanine loans are generally governed by the UCC as opposed to real property statutes. Another important point to understand is that in the event the mezzanine lender forecloses, the underlying real property will still be subject to any mortgage loans then in place. As a result, a prospective buyer should evaluate any such mortgage loans.

A prospective buyer of mezzanine debt should first review any senior mortgage loan and all related intercreditor agreements for anything that would inhibit its ability to cure defaults under the mortgage loan, or alternatively, purchase the mortgage loan. A prospective buyer will need to pay close attention to the amount of any default interest specified in the mortgage loan documents, as well as any prepayment penalties or other fees imposed in the event the mezzanine lender desires to purchase the mortgage loan following a borrower default. A buyer of a mezzanine loan should also be aware of the rights of other lenders to modify related loans. In particular, a buyer will need to examine the ability of other lenders to increase principal amounts owed by advancing additional funds, adjust the interest rate or alter the maturity date of the loan. A prospective buyer will also need to examine any underlying cash management agreements or similar documents in order to assure that such agreements provide for the disbursement of sufficient cash flow. If the intercreditor agreement allows the mezzanine lender the right to purchase the senior debt upon a borrower default, how much advance notice is necessary, what is the purchase price and is the mezzanine lender required to pay any prepayment penalty, default interest or late fees associated with the senior debt?

Whole Mortgage Loans

In the context of a whole loan where there is no other debt financing with respect to the underlying collateral, the foregoing considerations are not relevant. However, in these contexts, a buyer should still consider other potential liens on the underlying collateral and how they affect the loan. For instance, if back taxes are owed on real property collateral and the buyer ends up having to foreclose on the real property, it would be responsible for those taxes regardless of the fact that they might have prior to the sale.

Borrower Entity and Guarantors

Once a prospective buyer has an understanding of the loan offered for sale and the relation of that loan to other loans, if any, applicable to the underlying collateral or transaction, the buyer should then examine the borrower entity itself, as well as any guarantors of the loan. The buyer should first conduct a cursory examination of the organizational structure of the borrower entity and guarantors. However, the primary focus of its inquiry should be the financial capabilities of the borrower and the guarantors. The buyer should examine financials for the borrower entity and the guarantors to ascertain whether both are solvent and adequately capitalized to meet their obligations with respect to the loan, The buyer should also confirm whether the current financial position of the borrower and any guarantors satisfies the financial covenants imposed under the loan documents. In addition, the buyer should ascertain the level of equity the borrower holds in the underlying property. If the loan to be purchased is mezzanine debt, the buyer should determine whether or not the borrower issued certificated interests and opted into UCC Article 8. Do the borrower's corporate documents provide for an independent director to vote on bankruptcy matters?

Prepared by:

Doug Van Gessel, Partner | 415.774.2989 | dvangessel@sheppardmullin.com

Katharine Allen, Associate | 415.774.2903 | kallen@sheppardmullin.com

Sheppard, Mullin, Richter & Hampton LLP

sheppardmullin.com | realestateandconstructionlawblog.com

A truly thorough buyer will also inquire as to the general reputation of the borrower entity and related guarantors. In particular, buyer should be wary of a borrower who has a history of frequently defaulting on its loan obligations or turning property over to its secured lenders in lieu of performing under the loan. It should also be wary of borrowers who lack management or construction expertise with the type of transaction or property upon which the loan is based. The buyer should also examine who the borrower's other creditors are and whether there is any pending or threatened litigation or other matters that could affect the borrower's solvency. Lastly, the buyer may also consider the overall relationship and history of dealings between the current lender and the borrower. An amicable history is obviously preferable to an adversarial one.

Collateral

Assuming that the prospective buyer is satisfied with its inquiries into the overall loan transaction itself, it should then examine the actual underlying collateral for the loan offered for sale. In most cases, this collateral will take the form of real property. However, additional collateral may include bank accounts, interests in income from real property or even personal property. If the loan offered for sale is a mezzanine loan, the collateral at issue will be equity interests in the borrower entity, thus making the inquiry conducted into the borrower entity more important.

Real Property Collateral

Where real property serves as collateral, the buyer of the loan would ideally perform an on-site inspection of the property to ascertain its condition. However, in many cases, this is not possible. Regardless, a review of title to the property is imperative. Reviewing title will alert the buyer to any recorded liens and defects in the property, as well as any other binding agreements or covenants of record affecting the property. The existing lender's title policy for the property is a good place to begin this inquiry, however, the buyer should be sure to obtain an updated report. The buyer may also wish to review a survey of the property, as well as any related zoning or environmental reports.

For properties under development, the buyer should have an understanding of how far the property is in the development process and the costs associated with completion. For properties already in operation, the buyer should review the income stream from the property and all related expenses. Retail or office properties will likely involve substantial leasing due diligence. Hotel, resort and other hospitality properties will necessitate thorough reviews of management and franchise agreements, and may even require manager and franchisor consent. It is also helpful to obtain an appraisal of the underlying real property. Buyers should be careful not to rely on the original property appraisal, especially with the substantial decline in property values over the last year.

In situations where multiple lenders are involved, prospective buyers should also evaluate overlaps in collateral. In particular, buyers should be aware of cross-collateralization and the effect it has on the lender's security interest under the loan offered for sale. Cross-collateralization is obviously more of a concern for junior mortgage lenders or mezzanine lenders whose interests in the collateral will be subordinate to any senior mortgage lender's interest.

Equity Interests

If the loan offered for sale is a mezzanine loan, the primary collateral securing the loan will be equity interests in the borrower entity. As a result, the buyer's investigation of the borrower entity is of utmost importance. It will not only need to understand the organizational structure of the borrower entity, but also the lender's role in the overall operation of the entity in the event the buyer has to foreclose on the equity interest.

Other Collateral

In many instances, a loan will be secured by other forms of collateral in addition to real property or equity interests. For instance, most commercial mortgage loans will include an assignment of leases and rents from the underlying property. As a result, a prospective buyer of this type of loan will need to inquire into the income stream from the property. An assignment of interests in personal property may also be present, in which case, the buyer should inquire into the condition of the personal property. If bank accounts are pledged as collateral, the buyer should determine who controls those accounts and any limitations placed on withdrawals or transfers from those accounts.

Seller

The last key component of a prospective loan buyer's due diligence is an investigation of the seller of the loan. It is important to understand who the seller is, since lender liability can be transferred to a buyer of a real estate loan. The buyer should consider the overall solvency of the seller. In the event that issues arise following the sale which are the responsibility of the seller as the prior holder of the lender interest, the buyer should be adequately assured that the seller will be able to fulfill its responsibilities. Examples of some potential issues that could arise after the sale include environmental problems with the property and incorrect prorations under the loan purchase agreement.

Buyers should also inquire into the seller's overall status. In particular, the buyer might perform searches for UCC and tax liens, as well as searches for any pending or threatened litigation. If the seller is an institutional lender, the buyer should determine whether any regulatory inquiries have been initiated against the seller in connection with the loan and also whether there have been any mortgage complaints filed against the seller.

The Loan Purchase Agreement

After completing its due diligence, the buyer should then focus on the terms of the loan purchase agreement. It can address any issues uncovered by its due diligence in the purchase agreement. Key aspects of a loan purchase agreement are typically the purchase price, the scope of the representations and warranties and the closing conditions.

Purchase Price

Typically, a purchase price will be given to each asset in the portfolio so that the aggregate purchase price can be adjusted as assets fall out of the portfolio. Those individual asset prices are sometimes listed as absolute dollars amounts, and sometimes as a percentage on the "par value" of the asset. Given the dynamic quality of most of the assets, it is important that those purchase prices adjust as principal or interest is paid under the loan.

Representations and Warranties

The primary focus of a prospective buyer's review of any proposed loan documents will likely be the representations and warranties provided under that agreement. Given the nature of most loan sales and the substantial discounts in the price received for these loans, the sale will almost inevitably be an "as-is" transaction with minimal representations and warranties.

However, although the seller's instinct will be to give as few representations as possible, it is important to understand that, as a general rule, the more representations given, the higher the price the seller is likely to receive for the assets, especially if the assets are sold in a bid scenario, as is common. Typical representations

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Doug Van Gessel, Partner | 415.774.2989 | dvangessel@sheppardmullin.com

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identify: (i) whether the borrower has asserted any claims or defenses that the buyer of the loan would be subject to upon acquiring the loan; (ii) the outstanding principal balance of the loan; (iii) the amount of disbursements made under the loan and whether the loan has been fully disbursed; (iv) the amount of any outstanding escrows, (v) whether any defaults exist under the loan; (vi) any liens affecting the loan; (vii) whether the loan is cross-defaulted with other loans; (viii) whether there are any other documents not shown to buyer which affect the loan; (ix) whether or not there are any defaults under any agreements with other lenders in the capital stack, or any known defaults under those other loans; (x) that all consents from other lenders in the capital stack, ground lessors, redevelopment agencies or other third parties have been received; and (xi) with respect to the real property collateral, whether the seller knows of any condemnation, litigation, law violation, hazardous materials or property defect issues.

A seller will typically try to limit its liability under such representations by: (i) a sunset provision such that liability for false representations expires within a period of months, (ii) capping its liability to a certain percentage of the purchase price, and (iii) providing that the buyer first look to the title company, issuer of an estoppel certificate or other liable third parties before pursuing the seller. Further, sellers often try to reduce liability by giving themselves the ability to buy back the offending asset at its purchase price, curing the defect or simply indemnifying the buyer for the resulting liability, all at the seller's option.

A buyer will be concerned about the ability of the seller to fulfill its obligations pursuant to those representations, especially if the seller is the REO unit of a bank or other special purpose entity. Therefore, it might request that a portion of the purchase price be held back for a period of time after the closing as a fund against which the buyer might make claims under the purchase agreement. The amount of the holdback would probably be tied to the seller's cap on its liability for misrepresentations under the purchase agreement.

Closing Conditions

As with most purchase agreements, the obligations of the parties to consummate the closing will be based on the other party not being in default and its representations continuing to be true. Given the potentially declining value of the assets between the date the agreement is signed and the date on which the closing occurs, the buyer will probably want to establish as a condition to purchasing a particular loan that the borrower (or relevant guarantors) have not gone bankrupt.

Since it is typical for sellers to market loan portfolios that contain both performing loans and deeply distressed loans, both seller and buyer will want to carefully monitor the effect of any loans dropping out of the portfolio sale prior to the closing in order to avoid "cherry picking". Both sides may wish to establish a threshold purchase price or amount of loans, or criteria for the identity of the loans to be transferred at the closing, with the relevant party having a right to terminate the agreement if that threshold is not met.

Conclusion

The foregoing overview is not an exhaustive list of all issues associated with the purchase and sale of portfolios of distressed real estate-secured loans. It is merely meant to provide a general overview of some of the more important components of such sales. The variety of problems facing the particular assets being transferred will require sellers and buyers to meet with their respective counsel to decide the best approach to transfer the assets.