

Due Diligence in Acquiring Distressed Debt

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This article is about counseling clients in acquiring distressed commercial mortgage loans generally and in New Jersey in particular. Local requirements in other jurisdictions must be considered by practitioners because real estate laws and practices differ widely among jurisdictions.

There is no shortage of buyers anxious to buy distressed mortgages. The simple reason is the possibility of substantial profit if a loan can be purchased at a significant discount and there is a realistic possibility that the borrower or, if it forecloses, the lender, will be able to salvage the property. However, purchasers of distressed debt must take care to perform careful due diligence because the risks are great.

This article will describe the due diligence process for companies acquiring distressed commercial mortgage loans generally and in New Jersey in particular. Because real estate laws and practices differ widely among jurisdictions, practitioners must be aware of the requirements in other jurisdictions. Bankruptcy, special assets such as condominium properties and Uniform Commercial Code foreclosures are beyond the scope of this article.

Due Diligence

Lenders and purchasers come together through a variety of avenues, but common to

all is the need for the purchaser to conduct due diligence on the asset that the lender proposes to sell. Some lenders require due diligence to be completed before bids are received from prospective purchasers, others require due diligence to proceed under a letter of intent or similar stage of the process and still others will allow due diligence to be undertaken after a purchase agreement has been signed, which agreement will typically be contingent on the purchaser being satisfied with its due diligence. Common to almost all deals is the lender's insistence that due diligence be completed in a very short time period.

Due diligence for acquiring distressed mortgage debt is much like the due diligence a lender would conduct in deciding to make a loan in the first instance, except the loan file is or should be complete rather than being assembled as in the case of a original loan. Unlike your role in closing a loan, where you are assuring, to the greatest extent possible, that all issues are resolved before the loan can be closed, in this case you are

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issue-spotting. Additionally, due diligence proceeds in most deals without the cooperation or participation of the property owner; indeed, in many instances without the property owner's knowledge that the loan is being sold. The inability to interview the property owner, its tenants and in some cases access the property itself obviously constrains due diligence significantly. Moreover, due diligence in connection with acquiring distressed debt requires:

- Evaluating the performing status of the loan;
- The likelihood of being able to reach workout terms with the borrower;
- The status of pending litigation between the lender and borrower; and
- In general, envisioning a strategy that will enable the loan purchaser to recover its investment in acquiring the loan and realize a substantial profit.

If there is pending litigation, then, in addition to the areas noted below, litigators will need to review the litigation file. Aside from the litigation file, due diligence can be divided generally into several areas:

- The loan documents;
- The loan collateral;
- The borrower and guarantors; and
- The loan status.

Loan Documents

Obviously, the loan documents must be reviewed. Some of the material considerations include:

Complete Documents

First and foremost, determine if you have all the documents. Make sure they are complete, properly executed and, if applicable, acknowledged. It is not rare to find missing pages or portions of documents. Are originals available? Does the loan package include all the documents you would expect including the promissory note, mortgage, lease assignments, UCCs, guaranties, environmental indemnification agreement, adequate legal opinion and all loan amendments and modifications?

Quality of the Documents

Analyze the quality of the documents. Many, if not most, loan documents contain similar provisions but some are more comprehensive than others. You want to make sure your documents contain all customary terms. Your antenna should be up for unusual terms which may tell you about issues that were of particular concern to the lender when the loan was closed, which may appear in many ways including by way of escrow agreements or the like. What are the events of default, notice and cure periods? What are the due on sale and due on encumbrance provisions? Are the terms clear and unambiguous?

Business Terms

Pay particular attention to the business terms. Scrutinize the business terms of the loan, make sure there is no room for alternative interpretations of the terms. Are provisions for late charges and other charges clear and likely to be enforceable? Is the loan full or partial recourse, or non-recourse? Are there guaranties, full or partial, payment or completion? If the loan is non-recourse, are there carve outs? Are they typical? Is there personal recourse if the borrower files bank-

ruptcy? Can the loan can be prepaid and if so, under what circumstances?

Confirm Amount

Your client is buying debt and regardless of whether your client is paying a fixed price or paying a percentage of the outstanding indebtedness, you need to confirm that the amount the lender has stated to be the outstanding indebtedness is consistent with the loan documents. This is critical because you must assume that at some point the borrower will scrutinize and be prepared to challenge any calculation of its indebtedness with which it disagrees. Bear in mind that it will be a rare circumstance when you will be able to get a loan estoppel statement from the borrower before you close the loan acquisition, and certainly not if the loan is in litigation or on its way there. You also have to focus on escrows held by the lender and their accounting because the borrower can be expected to do so.

Funds to Be Loaned

Determine if funds remain to be loaned and, if so, how much and the conditions to further funding. If the loan is in default, it is very likely that the loan documents will not require the lender to continue funding although practical realities may impel the lender to do so in order for the real estate to have value or to maintain its value.

Loan Collateral

Nothing matters more than making sure, to the greatest extent possible, that the loan is property collateralized, the collateral is not impaired and the lender owns the loan. Issues regarding title, survey and lien priority are common to every deal. However, other issues relating to the physical assets vary

significantly depending on the nature of the asset, whether raw land, property under development, single or multi-tenanted, condominium, multi-family or other commercial.

Review Title Policy

Review the title insurance policy issued when the loan was made, and any endorsements or subsequent policies if the loan was modified. Make sure the mortgage was insured as a first priority lien (assuming your client is buying a first mortgage). Do not rely solely on title insurance; confirm for yourself that the mortgage and all modifications were properly recorded and that the mortgage constitutes a perfected lien.

Encumbered Property

Confirm that the encumbered real estate covers all the property that should be covered including appurtenant easements that may be critical for the proper operation and functioning of the property (for example, easements for parking on, or crossing, adjacent property) and look to see if all necessary and desirable title endorsements were issued. Also, if applicable, see if a construction loan policy was issued and has an expiration date.

Review the Survey

See if the survey is for the as-built project. Is the legal description in the mortgage and title policy the same as the legal description in the survey? Does the survey show material encroachments from or onto the encumbered property? Are there access issues? Has the property changed?

Is the Title Insurance Sufficient?

Check to make sure the amount of the title insurance policy is the same as the maximum loan amount.

Order Title Updates

Order title updates including property searches, tax searches and judgment searches on borrower and guarantors. Determine, as soon as possible, if the property has been transferred, if there are subordinate liens against the borrower or guarantors, and, of course, confirm that the lender hold the loan free and clear.

ALTA 10.1 Endorsement

You will probably request the title insurer to issue an ALTA 10.1 endorsement at closing of the loan transfer. This endorsement insures the validity of the loan assignment and the continued priority of the mortgage.

Assignment of Leases and Rents

Check to see if there is a separate assignment of leases and rents, and that it is properly recorded, if you are in a jurisdiction such as New Jersey where a separate assignment is necessary or preferable. Have UCCs been properly filed?

Review the Status of Development

Review the status of development, building and zoning permits and approvals as reflected by the loan file. The scope of this review may vary widely depending, for example, on whether or not the loan was closed on a fully developed and approved project, or one that was to be built. In any event, has zoning changed so that the project and its use no are no longer conforming?

Material Developments

Are there other material development related approvals or agreements, for example, a financial agreement with the municipality exempting the improvements from realty taxes and requiring payment in lieu of taxes? If so, you will want to know the status of the tax exemption, determine if all annual reports have been filed, if there is an audit underway by the municipality, if there are any issues with the municipality. If the project has been developed as a condominium, has it been registered with the Department of Community Affairs, have annual reports been filed, are any enforcement actions pending?

Is the Property Leased?

Is the property leased? Does the lender have current rent roll information, copies of leases? Does the information on the rent roll match the leases themselves? Are the leases subordinate? Has the lender entered into, or will it be obligated by the loan documents to enter into, non-disturbance agreements with some or all the tenants? Is there evidence of any tenant defaults? Are the tenants open for business?

Environmental Reports

Does the loan file include environmental reports? Were any issues uncovered by the reports? Is there evidence of ISRA compliance, if applicable? Is the property being used in a manner that could raise environmental concerns?

Insurance Policies

Does the file contain evidence that all required insurance policies and certificates have been issued, renewed and remain in full force and effect, for the benefit of the lender?

Is the coverage acceptable in scope and dollar amount? Is the insurer acceptable?

Financial Reporting Requirements

Have the borrower and, if applicable, guarantors, complied with financial reporting requirements under the loan documents? Are the financial reports in the loan file up to date and is the information in the reports acceptable?

Appraisal

Review with a critical eye the property appraisal that the lender received when the loan was made and any updates.

Material Information

The loan file should contain other material information regarding the property such as engineering and physical condition reports, material contracts and agreements.

Property Management

Is there a property manager? Is the management agreement subordinate to the mortgage or otherwise terminable on relatively short notice? Can you evaluate the manager and its capabilities?

The Borrower and Guarantors

Questions regarding the borrower and any guarantors really go to the likelihood of the loan being repaid, with or without entering into a workout agreement. The pricing of the loan sale undoubtedly will take into account the risk and hassle likely to be associated with collecting the loan, which will be significantly impacted by the availability of a deep pocket to pay the loan.

Reputation of Borrower

What is the reputation of the borrower and

any guarantors? Is there a competent management team in place?

Borrower's Personal Liability

Determine the nature and extent of personal liability for the loan. The borrower may have personal liability if the loan is recourse or even if it is non-recourse, to the extent of the carve outs, discussed below. However, most borrowers are single asset entities owning only the mortgaged premises, so the borrower's personal liability is not giving the lender much of anything beyond what the lender already has by virtue of its mortgage collateral.

Personal Guaranties

You may also have recourse under personal guaranties. Personal guaranties run the gamut from full recourse for the entire amount of the loan, partial recourse for a portion of the loan amount, recourse for completing construction in the case of a construction loan, recourse for environmental liabilities of the borrower and recourse for carve outs. You will scrutinize any personal guaranties to make sure they contain all the usual waivers of defenses and the like, and be particularly careful of partial guaranties to make sure the scope of liability is clear and unambiguous, which sometimes becomes an issue if not well drafted. For example, is a guaranty of 50% of the "loan" extinguished when half the loan is repaid, or does it remain outstanding for half of the unpaid balance until the loan is paid in full? As noted above, you will want to run judgment and lien searches, bankruptcy and litigation searches, credit and other investigations to determine the ability of a guarantor to repay the guaranteed obligations.

Carve Outs

Few loans are completely non-recourse. Most so-called non-recourse loans have carve outs, i.e., exceptions to the non-recourse terms listing events that will result in personal liability of the borrower which, in turn, may be guaranteed by one or more guarantors. The carve outs can be very important if the borrower's liability for breaching them is personally guaranteed, or in the unlikely event that the borrower has assets over and above the real estate collateral. Bankruptcy of the borrower is one of the most valuable carve outs if there is a deep pocket guarantor who most likely controls the borrower to a significant degree, because it reduces the likelihood of the borrower filing bankruptcy. Other carve outs similarly may be important, especially if and to the extent they impose liability for the full unpaid amount of the loan and not just for the actual losses resulting from breach of the carve outs.

Loan Status

The status of the loan, for example, whether it is in default or not, and the stage to which it has progressed and the route taken to get there, is a consideration as critical as any other.

Default

Is the loan in default? If so, how? Is the default material? What default notices are required by the loan documents? Have they been sent as required by the loan documents and do they conform with the requirements of the loan documents? Have notices been sent to guarantors? Has the lender elected to accelerate?

Other Loans?

Are there other mortgage loans on the

property? Are there intercreditor agreements? Mezzanine loans? Participants with the lender? What is the status of the foregoing?

Cross Collateralized Loan

Is the loan cross collateralized or cross defaulted with other loans? What is their status?

Pre-workout Agreement

Have the lender and borrower entered into a pre-workout agreement? Have there been workout discussions?

Lender Rights

Has the lender started exercising rights against the collateral? Does the lender collect or control rents?

Lender's Files

Review the lender's credit file, including internal memoranda. Review the loan administration history. Will loan officers be available as witnesses?

Borrower's Defenses to Repayment

Is there any evidence that the borrower might be able to assert defenses to repayment? Has the lender exercised undue control over the borrower's business or management? Has the lender agreed to forebear or conveyed a false sense of security to the borrower? The list of possible foreclosure defenses and lender liability claims is too long to enumerate here. It will be difficult at best to determine if any valid defenses or claims might exist based on a review of lender's files, but you will want to be on the lookout for any evidence in the way of letters or notes that might suggest a problem.

Summary

In summary, due diligence on a distressed mortgage asset is akin to a doctor doing a physical on a patient. You may not have time to examine everything, you will not be able to get all the information that would be available when a loan is originated, you need focus on what is important first and report on issues. This is a diagnostic exercise; you cannot cure defects at this stage, but you can evaluate

them. To the greatest extent possible, you need to understand the status of the loan, the collateral, the borrower and any guarantors. You will then be able to assist your client effectively in strategizing how the asset can be dealt with if and when it is acquired and, bottom line, if the asset is worth buying at the price the lender is demanding or can obtain.