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Acquiring Distressed Debt: Anatomy of A Mortgage Acquisition Transaction

The bottom line is getting a deal closed quickly

By Russell Bershad

By all accounts, banks and other lenders are holding enormous amounts — several trillion dollars — of commercial mortgages that are nonperforming, under-performing or approaching maturity with dim prospects for refinancing. Although lenders have not yet flooded the market with sales of distressed debt, there are many reasons to believe that the gates will open wider in the not-distant future. This article provides an overview of a distressed commercial mortgage loan acquisition transaction.

The acquisition of a distressed commercial mortgage loan generally begins when bank workout officers make known that they are interested in selling a loan or portfolio of loans. Buyers who are interested in proceeding will be required to sign a confidentiality agreement and will be allowed to conduct a review of the loan files and, possibly, contact lender's counsel if the matter is in foreclosure, in order to understand the status of the foreclosure proceeding.

A lender may choose to sell to a selected buyer or may proceed by auction after soliciting bids from buyers who have had an opportunity to complete the loan file reviews. There is no set mechanism for bidding to proceed, although most lenders set a deadline for bids to be received. Some lenders may allow a second round of bidding.

The successful buyer or bidder typically will be required to enter into a letter of intent to acquire the loan or loans. The letter of intent usually, but not always, is nonbinding on the buyer and may require an initial deposit to be posted, which usually (but not always) is refundable. Savvy buyers will seek to have the letter of intent be binding on the lender, at least in part. In particular, a buyer will want the lender to refrain from marketing or selling the loan to other parties so long as the transaction with the successful buyer is proceeding.

The letter of intent will require the buyer to enter into a loan purchase agreement within a very short period. A week or two is not atypical. The letter of intent often allows and requires the buyer to proceed with due diligence immediately.

Unless a deposit was paid on signing a letter of intent, it will be required on signing the loan purchase agreement. Most lenders will agree to allow the deposit to be held in escrow by a third party, such as the lender's counsel or a title company. The deposit will be refundable if the buyer elects not to proceed as a result of its due diligence investigations.

The due diligence period will be short, just a matter of days or a week or two at the outside. Once due diligence is completed, the buyer will not have grounds to terminate the loan purchase agreement, other than due to the lender's default. Except in those instances where the lender will agree to allow the buyer to assume the mortgage loan, which will be the exception, there will be no financing contingency for the buyer.

The loan purchase agreement will require the buyer to close the loan acquisition very quickly after completing due diligence, possibly in a just a few days and usually within a week or two.

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Loan Purchase Agreement

There is no standard loan purchase agreement, although most cover similar ground. In a number of respects, the loan purchase agreement will be similar to a real estate purchase agreement, especially if the loan is not in foreclosure.However, because it involves purchase of debt, not real estate, there are unique considerations in a loan purchase agreement. Preliminarily, the seller has to be prevented from taking any action, including entering into any settlement agreement with borrower, that would adversely affect the loan or the amount of the debt.

In addition, the parties have to account for funds of the borrower that are being held by the seller, including tax, insurance and repair escrows, as well as for interim loan payments, including regular monthly payments by the borrower and payments resulting from unit or lot sales, in the case of a condominium or other residential development that is in the process of being sold. Although unlikely, it is possible that the seller will receive insurance proceeds or a condemnation award prior to closing. All payments received by the seller will reduce the debt, and the purchaser will want a credit against the purchase price for at least a portion of the amounts received by the seller.

Sellers will resist all but the most innocuous of representations and warranties about seller's due authorization and execution of documents and the like. There is little chance a seller will represent anything about the mortgaged real estate. However, it is fair to ask a loan seller to represent or identify with particularity (which representations will have to survive closing for a limited period, to be of much value): the amount due on the loan; that seller owns the loan, free and clear, and has not sold or conveyed any interest in it; that there is no litigation pending regarding the loan or the real estate, or, alternately, the status of any pending litigation; that no offsets, counterclaims or defenses to payment of the loan have been asserted by the borrower; all the material loan documents; the loan title insurance policy and certifying that it is in effect for its full amount; that the seller is not insolvent or in bankruptcy; and, importantly, that the seller has not entered into, and will not enter into, any settlement agreement, forbearance agreement, release agreement or similar agreement with the borrower or any guarantor pending closing.

The agreement also should contain provisions addressing default by seller, including any material misrepresentations. Termination or specific performance would be the typical remedies available to the purchaser for a default by seller. Damages will be resisted strenuously.

Other provisions will be required if the loan is in foreclosure or other litigation is pending with the borrower, which will depend on the particulars of the litigation, but in any case the parties will need to provide for purchaser's counsel to take over the litigation with substitution of counsel and delivery of litigation files. Purchaser will seek representations from seller regarding the status of the litigation, and seller will seek indemnification from purchaser, which, if acceptable, must be carefully crafted.

Due Diligence

Due diligence varies greatly depending on the nature of the underlying real estate asset and whether or not foreclosure or other proceedings are pending with the borrower. To the greatest extent possible given the limits on due diligence in acquiring a loan, the purchaser wants to review and understand: the status of the loan; the loan documents for completeness, defects and perfection; the financial and legal status of the borrower (and guarantors), its development and management skills, integrity and reputation, and any litigation among the owners of the borrowing entity or with third parties; the environmental status of the property; status of title to the asset and title insurance; any liens; legal proceedings regarding the asset; development and use permits; regulatory filings; tax abatement agreements, if applicable; the rent roll or status of condominium or unit sales and pending contracts; and any other relevant information regarding the property.

If litigation is pending between lender and borrower, a comprehensive review of pleadings, motion practice and discovery must be undertaken by the litigators. If the loan is being foreclosed, it will be important to know that a title insurer will be prepared to insure title following completion of foreclosure upon issuance of a sheriff's deed. The lender should allow counsel for the purchaser to discuss the litigation status with the lender's counsel.

In most cases, the possibility of a bankruptcy filing by the borrower must be considered and the affect of such a filing should be reviewed by bankruptcy counsel, with an eye toward determining to the extent possible whether or not, and how quickly, the loan purchaser will be able to get relief and proceed with a foreclosure sale.

Due diligence will be impeded if the lender proposes a confidentiality agreement that is so broad that it bars contact with governmental agencies. It is important to try to carve out limited exceptions from a confidentiality agreement to allow inquiries to be made of governmental agencies regarding the status of approvals, required regulatory filings and legal and regulatory compliance.

Effective loan purchase due diligence requires a broad range of expertise in real estate lending, title, real estate development, condominium law, tax abatements and environmental law, in addition to analyzing foreclosure, other litigation and bankruptcy issues. Each matter is different in the specifics, but most loan acquisition will require similar skill sets being focused in a short period of time to determine if material deficiencies exist that might derail the loan purchase.

In summary, the role of counsel representing a client acquiring a distressed commercial mortgage or portfolio of loans requires an intense, relatively short burst of efforts, probably beginning with a confidentiality agreement, followed by a letter of intent, due diligence, negotiation and execution of a loan purchase agreement and closing. More than anything, counsel has to be able to bring to the deal legal expertise in a variety of practice areas while recognizing that clients are looking for common-sense, practical assistance. The bottom line is getting a deal closed quickly and effectively while understanding the asset and risks as much as possible. ■