

Presenting a live 90-minute webinar with interactive Q&A

Acquisitions of Distressed Commercial Mortgage and Mezzanine Debt

Key Issues for Mortgage vs. Mezzanine Debt, Due Diligence Strategies,
and Contract Considerations for Buyers and Sellers

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REO Properties: Legal Strategies for Lenders and Purchasers

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A Broader PerspectiveSM

Overview of Note and REO Sales

- Note Sales
 - Acquire Debt, Not the Underlying Asset
 - Seller is the Lender, Not the Borrower/Debtor
 - Subject to Defects in Documentation, Title, etc.
 - Must Complete Foreclosure Process Before Assuming Control of the Property
 - Know Your Enforcement Options
- REO Sales
 - Take Title to the Asset; Deal Directly with Owner
 - Must Wait for Remedies to be Completed
 - Uncertainty Pending Foreclosure

WHAT IS BEING SOLD, AND BY WHOM?

- ◆ Loan Portfolios vs. Individual Loans
- ◆ Bids vs. Negotiated Deals
- ◆ Commercial Loans vs. Residential Loans
- ◆ Construction Loans vs. Permanent Loans
- ◆ Whole Loans vs. A/B Notes or Participations
- ◆ Senior Loans vs. Junior/Mezzanine Loans
- ◆ Healthy Sellers vs. Failing Banks or FDIC

Note Sale Issues

- Abundant Product Still Available
 - Wave of Commercial Loans At Maturity or In Default
 - Banks More Likely to Sell than Special Servicers Who Tend to Foreclose
- Reasons for Lenders to Sell
 - Avoids time and expense of foreclosure
 - Avoids risk of being stuck with REO for lengthy period
 - Preferred Disposition Method for the FDIC
 - FDIC sales can come with protections, such as: (i) Loss share agreements, and/or (ii) Use of the FDIC “super powers”
 - Not preferred by FDIC once the note is sold to successor if there is a loss share agreement in place

Note Sale Issues (Part 2)

- Reasons for Investors to Purchase
 - Can Often Get Better Pricing on Note Sales
 - Can Provide Greater Options By Transferring Ownership of Entire Debt Package
- Obstacles
 - Purchaser must have the ability to deal with the foreclosure process
 - Purchaser Assumes Bankruptcy/Foreclosure Risk
 - Risk Sharing is Difficult to Negotiate – most sales are “as-is/where-is”

Due Diligence Issues

- Due Diligence Challenges
 - Note Sales Require Due Diligence on:
 - The Loan,
 - Bankruptcy risk,
 - Potential lender liability and/or defects in loan documentation or administration,
 - Condition of Title, and
 - Condition of the Property.
 - REO Sales Requires Standard Property Purchase and Sale Due Diligence:
 - Condition of Title, and
 - Condition of the Property.

Due Diligence – Note Sales

- Loan Issues
 - Must Understand Risk of:
 - Borrower Bankruptcy,
 - Lender Liability Claims,
 - Defects in Loan Enforcement
- Title Issues
 - Must Understand Effect of Foreclosure On Title
 - Eliminate Junior Liens
 - Effect on Development Rights?
- Property Due Diligence

REO Sale Issues

- Advantages Over Note Sales
 - Title is Cleaned Up for Purchaser
 - Bankruptcy Risk Eliminated
 - Can Be Structured in a Manner More Familiar to Purchasers
 - Requires No Special Expertise or Experience as Required for Note Sales
- Obstacles
 - Lenders Increasingly Reluctant to Take REO on Books
 - Glut of Residential REO on Lenders' Books
 - Lose the ability to clean up title (relation back theory of title)
 - Difficult to structure in “broken” construction loans or deals with subordinate debt
 - Long Delays for Buyers and Sellers
 - Borrower/Purchaser Concerns for the Lender

Due Diligence – REO Sales

- Focus On Property
 - Title Report
 - Which rights eliminated by foreclosure and which rights survive the sale
 - Market Research
 - Effect of Foreclosure on Market
 - Tenant Issues – Co-Tenancy Clauses, Rent Reductions, Etc.
 - Environmental Report
 - Effect of Judicial Foreclosure vs Non-Judicial Foreclosure on Redemption Rights
 - Redemption rights very limited in most states and most common in trust deed states

LOOK FOR HIDDEN VALUE

- ◆ Guaranties, letters of credit or other credit enhancements?
- ◆ CFD reimbursement claims, tax refunds or a tax increment financing scheme?
- ◆ Claims for fraudulent distributions to a creditworthy borrower affiliate?
- ◆ Upcoming extension, exit or other loan fees?
- ◆ Reserve accounts?

Use of Special Purpose Entities

- Often Used in Deed-in-Lieu Prior to or in REO Sales Following a Foreclosure
- Reasons for Forming SPE in Foreclosure
 - Isolate Troubled Asset from the Rest of the Loan Portfolio/Pool
- Who Controls the SPE
 - Agent or Lead Bank
 - Special Servicer
 - Sole member vs. Multiple Members
- Problems
 - Transfer of all Tranche/Syndication Interests into SPE
 - Partial Note Foreclosure Issues

Alternative Transaction Options

- Alternatives to Foreclosure
 - Deed in Lieu of Foreclosure
 - Title Subject to Competing Liens and Other Defects
 - DIL and then foreclosure strategy can be useful
- Consensual Foreclosure
 - Permits a Lender to “Clean Up” Title, And Can Speed Up the Process
- Consensual Bankruptcy
 - Risk Of Competing Creditor Interference
 - 363 Sale has Broader Effect on Creditor Claims

Common REO Issues- Regulatory Considerations

- Holding Period
 - Only Applies to Regulated Institutions
 - 5-Year Maximum – Regulatory Drive to Sell Within 12 months
- Appraisals
 - Valuation for Foreclosure/Bidding Strategy
 - Hold vs. Sale Considerations
- Property Inspection
 - Use, Repair and Maintenance Issues
- Environmental Audit
 - Foreclosure Review
 - Use, Repair and Maintenance Issues
 - Alternative Remedies – Personal Liability Under Indemnity

Survey and Title Considerations

- Use of Prior Survey
 - Update or Re-Certify Survey
 - Alternatives – Title Company Products (Plotted Easement Map, Etc.)
- Title Policy
 - Binder if Foreclosing Owner
 - New Title Policy for Purchaser
- Potential Problems
 - Easement, Setback and Parking Issues
 - Mechanics' Liens, CC&R Assessments

Survey and Title Considerations II: Emerging Title Issues

- **Creditor's Rights Issues**
 - Consideration for Upstream and Downstream Guarantors
 - Solvency Representations/Source of Equity
- **Broken Priority**
 - Financial Statements From Borrower/Guarantors
 - Signed Indemnity Agreement from Borrower/Guarantor
 - Construction loan agreement
 - Cost Break Down and Loan Budget
 - Cash Deposit/Letter of Credit

Land Use Considerations

- Entitlements
 - Unstarted Project – Beware of:
 - Moratoriums,
 - Changes in Developments Plans,
 - Expiring Development Agreements, and
 - Replacement Bonds
- Rent Control
 - Typically Survive Foreclosure

Successor Liability

- Leases
 - Review Liability Under SNDA:
 - Past Defaults,
 - Defaults During Ownership, and
 - Post-Assignment Liability.
- HOA/CC&R Defaults and Assessments
 - Typically Do Not Survive Foreclosure
- Profit Participation/Marketing Fees
 - Controlled by Agreements and Subordinations

Project Development Challenges

- **Stepping Into Former Project**
 - **Bonds need to be replaced**
 - **Broken Subdivisions**
 - **Gaining Control of the Declarant's Rights**
 - **Expired Entitlements and Development Agreement - Moratoriums**
 - **Fee Credit issues - Reimbursements?**

Project Development Challenges II

- **Cities Not Likely To Approve Large Projects**
 - **Fragmented Development**
- **Bond Security**
 - **Set-Asides May No Longer Work**
 - **Cash Deposit or Letter Of Credit**

Bankruptcy Sales

- Section 363(f) of the Bankruptcy Code provides that assets may be sold free and clear of the liens, claims, encumbrances and interests of third-parties, if one of five conditions is met:
 - Non-bankruptcy law permits a sale of the assets free and clear of the interest
 - The interest holder consents
 - The interest is a lien, and the price for the assets is greater than the aggregate value of all liens on such property
 - The interest is in *bona fide* dispute
 - The holder of the interest could be compelled to accept a money satisfaction in a legal or equitable proceeding

Advantages of Section 363 Bankruptcy Sales

- Can provide viable alternative to foreclosure or receiver's sale
- Can provide time and cost savings under certain scenarios, particularly if borrower has already commenced chapter 11 bankruptcy case
- Sales are free and clear of liens, encumbrances or interests
- Generally limits successor liability
- Bulk sales laws are inapplicable
- Purchaser may pick and choose specific assets to acquire, including contracts, leases, licenses and tangible assets
- Rejection of undesirable leases/contracts

Disadvantages of Section 363 Bankruptcy Sales

- Purchaser cannot expect to derive any significant protection by means of a debtor's representations, warranties and indemnification
- Uncertainty whether the sale can be free of certain types of claims, such as product liability and environmental claims

Flexibility

- Bankruptcy sale can be structured to offer maximum flexibility
 - Sale can be cash sale
 - Sale can provide for assumption of secured debt on reinstated or restructured basis
 - Absent consent of secure lender, reinstatement must comply with cure requirements of Bankruptcy Code
 - Any restructuring of secured debt must be either consensual or as part of “cram down”

Receiver Sales

- Lender obtains appointment of a receiver in state court receivership action.
- The powers of the receiver are set forth by statute and by the order appointing the receiver.
- C.C.P. Section 568.5 recognizes that receivers have the authority to seek an order selling real or personal property.
- Receivership orders can provide the receiver with the power and authority to market the property, engage brokers, etc.

Receiver Sales – Part II

- Borrower has opportunity to object to a proposed receiver sale. Uncertainty is created for the buyer if a receiver sale is approved by the court over the borrower's objection because the borrower could file an appeal.
- Title companies are reluctant to insure title after a contested receiver sale.
- The receiver would need lender approval to seek a sale with a discounted payoff.
- An “option agreement” can be used to enter into an agreement to sell the property on the condition that the foreclosure sale is completed.