Bank Notes Secured by Real Estate: Opportunities and Legal Risks for Investors and Lenders
Navigating Representations and Warranties, Lender Liability and Foreclosure Issues

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Today’s faculty features:

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Bank Notes Secured by Real Estate

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Dan is a partner at Raines Feldman LLP, with a practice focused primarily on transactional real estate matters, including asset and real property acquisitions and dispositions, finance, commercial leasing, formation and structuring of joint ventures, investment funds, syndications and other investment entities and private placements of debt and equity securities. Dan represents a wide range of clients, including real estate investment funds, developers and syndication groups, institutional landlords and asset managers, commercial lenders, receivers, hedge funds, private equity investment firms, entrepreneurs and high-net worth families and individuals.

Dan received his undergraduate degree from Cornell University, with a concentration in Industrial and Labor Relations. He received his Juris Doctorate from the University of Virginia School of Law. Prior to joining Raines Feldman LLP in 2007, Dan worked in the Los Angeles offices of Latham & Watkins and Allen Matkins.
Commercial Loan Defaults and Maturities

• 3rd Quarter 2010:
  – $46.8 billion in commercial loans were delinquent (8.32% of the total)
  – 4.36% of commercial real estate mortgage payments were late by at least 90 days

• Almost $1 Trillion in CRE loans will be coming due through 2012

• $300 billion in CRE loans coming due in 2012 alone.

• In 2011, 49% of the CRE loans maturing will be underwater, and in 2012, 63% will be underwater (Source: Foresight Analytics)
Lender Challenges

• Options for distressed loans:
  – Workout/modification
  – Short sale
  – Foreclosure (judicial or non-judicial)
  – Deed-in-Lieu of foreclosure
  – Receivership
  – Sell the loan (individually or bulk sale)
• Banks are not equipped to own and operate real estate
• Banks don’t want to incur additional costs and liabilities of owning real estate
• CMBS issues – special servicers
Loan Purchase Sources

• Banks and private lenders
• Mortgage Brokers
• Real estate owners and investors
• Hedge funds and private equity funds
• Attorneys
Note Purchase Overview

• Buying a loan vs. buying real property
• Comparison to REO or foreclosure purchase
• Reasons for purchase – investing in the loan vs. “loan to own”
• Who is the seller?
• Potential pricing advantages
  – Costs of enforcement
  – BK risk avoidance
  – Diminished collateral value
• Think like a lender
Note Purchase Documentation

• Term sheet or letter of intent
• Loan Purchase and Sale Agreement
• Allonge (or “endorsement”)
• Assignment of Deed of Trust or Mortgage
• Assignment of existing title policy (if applicable), or new lender’s title policy
• Assignment of other loan documents
• Closing statement
Loan Purchase and Sale Agreement

• Typically a lender form
• Clearly identify purchase price, earnest money deposit, diligence period and closing date
• “As is” purchase with limited reps & warranties
• Attach forms of closing documents as exhibits
• List all diligence materials to be provided in an exhibit
Note Purchase Diligence

• Diligence often begins at term sheet phase – lender may provide diligence files upon buyer signing a confidentiality and non-disclosure agreement
• Typically a very short diligence period, if any, is provided in the loan purchase agreement
• Request diligence materials as early as possible – and be specific as to items requested
• Order new title search as early as possible
• Order borrower UCC, judgment and bankruptcy searches as early as possible
• 3 main areas of diligence:
  – The loan
  – Condition of title
  – Condition of Property
Loan Documents

• Promissory Note – *make sure lender has the original executed note in its possession*
  – *UCC 9-309(4): security interest in a promissory note is perfected upon attachment*
  – *UCC 9-203(g): attachment of security interest in note is also attachment of a security interest in the mortgage*
  – “Follow the note” (i.e. in order to enforce the note, the party seeking to enforce must show present possession)
• Deed of Trust/Mortgage
• Guaranties (recourse or non-recourse; full or partial payment)
• Security Agreements
• Environmental Indemnity Agreement
• Assignments of rents and leases and other agreements
• UCC financing statements
• Closing statements
• Deposit account control agreements
• Pledge Agreements
• Intercreditor Agreements
Loan Diligence Considerations

- Review all loan documents from a litigation and bankruptcy perspective
- Loan payment terms
  - Interest rate
  - Amortization
  - Maturity
  - Pre-payment
- Defaults and lender remedies (and any limitations on remedies)
- Notice and cure periods
- Completeness and accuracy of loan documents
- Confirm the status of borrower’s default and lender’s enforcement
  - Has Notice of Default been given?
  - Are there monetary or non-monetary defaults (or both)?
  - Have all lender notices been properly given?
  - Has the foreclosure process commenced, and if so, is it judicial or non-judicial, or both?
  - Has a receiver been appointed?
- Accrued and unpaid interest and penalties
- Is the Note a “negotiable” instrument:
  - Signed by the borrower
  - Unconditional promise to pay
  - Payable on demand within a set time period
  - Payable to the bearer
- IMPORTANT: Make sure all loan documents are executed.
Loan Diligence Considerations (cont’d)

- Multiple lenders and intercreditor issues
- Unfulfilled lender funding commitments
- Enforcement of guaranties
- Tax and insurance escrows
- Cash management procedures
- Insurance requirements
- Borrower notice requirements
- Deficiency
- Confirm status of the note seller – is it the same as the original “lender” or some other party? Must insure proper chain of title and documentation (i.e. connect the dots to the current seller)
Borrower Rights and Remedies

• Defenses to lender actions
• Claims against the lender
  – Litigation re: wrongful acts or omissions
  – Breach of fiduciary duty
  – Covenant of good faith and fair dealing
• Borrower bankruptcy
• Redemption rights
• Doctrine of merger
• Jurisdictional considerations
Consent Issues

• Borrower consent rights
• Depository institutions – collateral accounts and lock-box accounts
• Intercreditor agreements
• Syndicated loan issues – participant consents
• Franchisor/manager consents
• Licensing and permits
Property Documents

• Existing survey
• Appraisal
• Certificates of occupancy
• Environmental reports
• Zoning reports
• Leases/SNDAs
• Tax bills
• Management agreements
• Service contracts
• Rent roll
• Insurance certificates
Property Diligence Considerations

• Tenant issues – vacancy, subordination, attornment, estoppels
• Environmental issues – successor liability
• Labor and employment issues
• Valuation of the underlying asset – obtain current appraisal or BPO (broker price opinion)
• Deferred maintenance and repairs
• Status of licenses and permits
• Access to the property for physical inspections
• Unpaid taxes
• Mechanics’ liens
• Unfinished construction
• Compliance with declarations/CC&Rs
• Easements/third party access rights
• Parties in possession – same as borrower?
Additional Diligence Materials

• Borrower’s organizational documents
• Seller/Lender’s organizational documents
• Borrower’s financial/operating statements
• Existing lender title insurance policies
• Borrower’s counsel legal opinion
• Operating permits and licenses
• All correspondence between lender and borrower – including default notices
• Anything in lender’s file
Title Diligence

• Obtain new title report and underlying documents
• Review all liens – junior and senior
• Lien priority considerations
• Assignment of existing lender’s policy
• Date down of existing policy or new lender’s policy (if necessary)
• Endorsements:
  – Assignment endorsement (ALTA 10)
  – Date down endorsement (ALTA 10.1)
  – Modification endorsement (ALTA 11-06)
• Mezzanine and junior loans
• Updated survey, if possible
Earnest Money Deposit

- Deposit of 5% to 10% of purchase price may be required
- Seller may require earnest money deposit to be “hard” concurrent with execution of purchase agreement:

  On or before the date which is two (2) business days following the Effective Date, Purchaser shall deliver to Escrow Agent an earnest money deposit of One Million and No/100 Dollars ($1,000,000) (together with any and all interest that may be earned thereon between the date of deposit and the date of Closing hereunder, the “Earnest Money”), which Earnest Money shall be non-refundable and shall only be refunded to Purchaser in the event that Seller fails or refuses to transfer the Mortgage Loan and the Loan Documents to Purchaser in accordance with the provisions of this Agreement or in the event that the conditions to Purchaser’s obligation to Close in accordance with Section 6.2 below are not satisfied, or if Purchaser terminates this Agreement pursuant to Sections 11 or 12 in the event of eminent domain proceedings or a casualty, respectively

- If deposit is non-refundable, ensure that all diligence has been conducted prior to execution of purchase agreement – there’s no going back
Seller Reps & Warranties

• “As is” purchase except for specific reps & warranties
• Lenders will typically provide as few reps & warranties as possible
• Critical reps & warranties:
  – Total outstanding indebtedness (including principal, interest, penalties and expenses)
  – Seller has provided all diligence materials (and they are true and accurate)
  – Seller has not previously released any “collateral”
  – Seller has received no notice of casualty or condemnation
  – Seller has received no claim or notice from borrower re: lender liability
Closing the Purchase

• Closing date will typically be scheduled very shortly after the contingency period is over
• Make sure original promissory note is delivered to the buyer (w/allonge)
• Recordation of assignment of deed of trust
  – if applicable based on jurisdiction
  – UCC perfection issues
• Settlement/closing statement
• Financing availability or all cash
Loan Purchase Risks

• Borrower loan repayment
• Costs of enforcing remedies
• Borrower bankruptcy
• Unenforceability of loan documents
• Limited diligence opportunities
• Uncooperative borrower
• Uncooperative seller
Note Seller Considerations

- Reps & Warranties
- Lender liability
- Diligence disclosures
- Indemnities and releases
Paul E. Comeaux

• Paul Comeaux is a partner in the Thompson & Knight real estate and banking group.
• Paul represents banks, national retailers, and hotel and restaurant chains, as well as private investors, in a wide variety of real estate acquisition, development, financing, and leasing transactions.
• Paul’s practice also includes loan workouts and restructuring, partnership structuring, off-balance sheet lease finance, and work with special servicers in the CMBS market.
• Paul has been listed in *The Best Lawyers in America®* by Woodward/White Inc. (Real Estate Law) from 2006 to the present.
• Paul lives in Dallas, Texas with his wife and two children.
After Closing

• Routine Actions
  – Send notices to borrower and guarantor
  – Put the original note in a safe place
  – Obtain copies of recorded documents and title insurance endorsement for file
  – Promptly address late payment and other non-performance issues

• What if the borrower defaults?
Following Borrower’s Default: Due Diligence

- Similar to diligence performed before purchasing the note
- Review loan documents
- Review communications with borrower/guarantors
  - Proper and timely notices given to borrower?
- Re-evaluate collateral
  - Condition of property (Property Condition Report)
  - Value of property (Appraisal)
  - Status of leases (Rent Roll)
  - Title issues (Title Report)
  - Delinquent taxes (Tax Certificates)
  - Environmental condition (Phase I)
- Record searches (litigation, bankruptcy, judgment liens, financing statements) on borrower, guarantors, and property manager
- Financial status of borrower and guarantors
  - Recourse or non-recourse loan?
  - If there is a “bad boy” carve out guaranty, has it been triggered?
Following Borrower’s Default: Consider Lender’s Options

• Do Nothing
• Accept Surrender of Collateral (Deed in Lieu)
• Accept a Discounted Payoff
• Restructure the Loan
• Exercise Remedies
Following Borrower’s Default: Consider Borrower’s Response

• Lender Liability Claims
  – No duty to negotiate a workout
  – Implied covenant of good faith and fair dealing
  – Typical claims: breach of contract fraud, duress, negligence, defamation
  – Strategies
    • Avoid vague statements, inconsistent proposals, partial disclosures
    • Avoid exercising control beyond that of a lender (mortgagee in possession risk)
    • Give proper notices, follow loan documents

• Borrower Filing For Bankruptcy
  – Expensive and lengthy process
  – Cannot prevent a borrower from filing bankruptcy
  – Automatic stay
  – Risk of “Cram down”
Lender’s Options: Accept Surrender of Collateral

- **Deed in lieu**
  - Borrower conveys the property to the lender in lieu of paying on the loan or suffering a foreclosure
  - No merger of title
- **Settlement Agreement**
  - Describe consideration
  - Include appropriate representations, warranties, and releases
- **Advantages of Deed in Lieu**
  - Quick and inexpensive
  - Consensual
  - No litigation
- **Disadvantages of Deed in Lieu**
  - Existing liens not extinguished
  - Fraudulent conveyance/ preferential transfer concerns
  - Transfer taxes
  - May need consent of minority investor/junior lienholders
- **Factors in Favor of Accepting**
  - Single asset borrower
  - Borrower has no equity in property
  - No junior liens
  - Clean title
  - Favorable state law
Lender’s Options: Accept Discounted Payoff

• Borrower finds another lender to refinance
• Fear that borrower will reap a windfall if market improves
• One solution: Retain a second mortgage to capture any upside
Lender’s Options: Restructure Loan (Workout)

• Pre-Negotiation Agreement
• Forbearance Agreement
• Workout/Restructure Agreement
Workout Documents: Pre-negotiation/Forbearance Agreement

• Timing: Execute before beginning substantive workout discussions
• Parties
  – Guarantor and principals
  – Anyone that has granted a security interest
• Important Terms
  – No obligation to modify terms of loan
  – No obligation to reach an agreement
  – Discussions entered into voluntarily by borrower
  – Right of any party to break off discussions at any time
  – Prevent admission of workout discussions in litigation by stating that discussions are being held in anticipation of settlement
  – Waiver of claims against lender
  – Borrower to pay fees and expenses of lender
• Forbearance
  – Lender agrees not to exercise remedies for certain period of time
  – May be intermediate document or part of pre-negotiation agreement
  – Try to get borrower to acknowledge existence of default (or at least facts surrounding default)
Workout Documents: Modification/Restructure Agreement

- Concessions to borrower:
  - Defer debt service payments
  - Lower the interest rate
  - Extend the term
  - Modify/waive financial covenants
  - Right to discounted payoff

- Strategies to improve lender’s position
  - Amortize principal
  - Institute a lockbox (hard or springing)
  - Escrow taxes and insurance
  - Reserves for capital improvements, tenant improvements, etc.
  - Change of management
  - Require additional equity or collateral
  - New or expanded guaranties
  - Condition concessions on performance milestones
  - Restructuring fee
  - Equity kicker
  - Deliver deed in lieu in escrow

- Fix problems in loan documents to protect lender
- Waiver of claims against lender
Lender’s Options: Exercise Remedies

• Preliminary Remedies
  – Injunctive Relief
  – Receivership
  – Constructive Trust for Rents
  – Bankruptcy

• Permanent Remedies
  – Non-Judicial Foreclosure
  – Judicial Foreclosure
  – Sue for Deficiency (Recourse Loans)
  – Sue Guarantors
Lender’s Remedies: Lawsuits

• Against guarantors
  – Full guaranty or “bad boy” carve out guaranty?
  – Adequate waivers and other guaranty issues
  – Discovery regarding guarantor’s assets
  – Tool to encourage settlement with borrower

• Against borrower for deficiency following foreclosure
  – Availability, procedure, and mechanics vary by state
  – Lender liability counterclaims
Lender’s Remedies:
Injunctive Relief/Constructive Trust

• Injunctive relief
  – Often the first step before applying for receiver or beginning foreclosure process
  – Preserve collateral and capture rent stream

• Constructive trust
  – A constructive trust should be imposed whenever legal title to property is held under circumstances that render it inequitable or unconscionable for the holder to retain and enjoy the beneficial interests of legal title at the expense of another
Lender’s Remedies: Receivership

• What is receivership?
  – A receiver is an officer of the court appointed to take possession of and preserve specified property that is the subject of pending litigation
  – The enforcement of a third party's liens or other rights to property held in receivership is merely suspended until their enforcement is approved by the court having custody of the property
  – Receiver may only act under the authority of the appointing court

• Right to Receiver
  – Receivers may be used only where authorized by statute or where appointment is in accordance with the rules of equity
  – The appointment of a receiver is discretionary with the Court
  – If the mortgagee or security agreement authorizes appointment of a receiver to collect rents, accounts receivable, etc., the court may appoint a receiver to enforce the provision under its equitable powers
Lender’s Remedies:
Receivership (part 2)

• Benefits
  – Can be fast and may be cost effective
  – Collect rents and revenues pending foreclosure
  – Preserve collateral pending foreclosure

• Potential Issues
  – Court (through the receiver) controls the property (not the debtor or secured creditor)
  – May not get the receiver you propose
  – Compensation of receiver
  – Risk of bankruptcy (the receiver is a "custodian“ under the Bankruptcy Code, and must turn over the receivership property to the bankruptcy trustee)
Lender’s Remedies: Bankruptcy

- If a borrower is diverting significant income from a property, a temporary injunction was not granted, and a motion for the appointment of a receiver is denied, an involuntary Chapter 11 might be the best option.
- Three unsecured creditors and $13,750 to file
- Beware of the “gap” period
- Single-asset real estate bankruptcy cases
- 2004 examination (deposition)
- Loan documents are rewritten if the plan of reorganization is confirmed
Lender’s Remedies: Foreclosure

• Judicial
  – Lawsuit/court supervised auction of property
  – Sale conducted by agent of the court
  – Procedure and mechanics vary by state

• Nonjudicial
  – Purchase of real property from a trustee at a public auction
  – No lawsuit/court involvement
  – Procedure and mechanics vary by state
Summary of Non-Judicial Foreclosure Process in Texas

• Demand letter – default, demand, and intention to accelerate
• Notice of acceleration
• Notice that property has been posted for foreclosure
• Appointment of substitute trustee
• Foreclosure Sale
  – First Tuesday of each month
  – Designated place at county courthouse
  – Trustee will conduct public auction, open bidding and “bid in” a portion of the debt
  – Third parties bid against the trustee
  – If third party wins, trustee will adjourn sale to collect purchase price (cashier’s check or wire transfer)
Summary of Non-Judicial Foreclosure Process in California

- Notice of Default (NOD) filed with county recorder
- Within 10 days of recording, copies of NOD are mailed to borrower
- Within 1 month, NOD is mailed to other parties as required by CA Civil Code §2924b(c)
- After 3 months, set Trustee Sale date
- At least 20 days prior to Trustee Sale, post Notice of Sale, mail Notice of Sale
- 14 days before Trustee Sale, record Notice of Trustee Sale
- 5 days before sale date, borrower’s right to reinstate the loan expires
- Sale Date: property is auctioned to the highest bidder on courthouse steps, or reverts to beneficiary
- Beneficiary can postpone Trustee Sale for up to 1 year
Additional California considerations

- One-action rule
- Anti-deficiency rules
- Enforcement of guaranties
- Suretyship waivers
Other Considerations

• Advantages of note purchases/sales
• Disadvantages of note purchases/sales
• Emerging trends