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Distressed Real Estate Loan Acquisitions: Due Diligence Strategies and Contract Considerations

Best Practices For Buyers and Sellers of Commercial Mortgage and Mezzanine Loans

TUESDAY, AUGUST 30, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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"An Insider's Guide to the Purchase of B Notes, Mezzanine Loans and Other Distressed Debt"

STRAFFORD WEBINAR

AUGUST 30, 2011

PREPARED BY BRUCE E. PRIGOFF, ESQ.

B NOTES

1. Multiple notes or participation interests
2. A Note and B Note collateral – undivided interest in mortgage and other security
3. Interest Rate; B Note vs. A Note
 - a. Senior/subordinate yield differential based on payment priorities
 - b. Pari-passu notes (often for future funding obligations)
 - c. Residual interest rate notes
4. Payment priorities
 - a. Dual waterfall structures
 - i. Alteration of payment priorities upon Triggering Event
 - ii. Pro rata payments vs. ordered priorities – impact of cash shortfalls
 - iii. Impact of servicing fees and costs, including workout fees, special servicing fee, liquidation fees and master servicing fees
 - iv. Multiplier effect of fees based on whole loan
 - v. Dual accounting – Borrower loan payments vs. payments to Noteholders
 - vi. Agreements with Borrower regarding weighted average interest rate on note split subject to divergent rate upon event of default, non-pro rata application of prepayments
 - vii. Treatment of certain liquidation payments
 - b. Default waterfall triggering events, cure rights of B Noteholder and limitations on cure rights
 - c. Impact of workout on waterfall and avoidance of elevating lower priority payment claims
 - d. Voluntary prepayment provisions
 - i. In absence of agreement with Borrower

- ii. Borrower rights with respect to priority of application of prepayments
- 5. Loan servicing
 - a. Unified loan servicing and administration
 - b. Roles of master servicer, special servicer, B Noteholder, controlling certificateholder, operating advisors, in securitized transactions
 - c. “Accepted Servicing Practices” as servicing standard for A/B loans
 - d. Seller/servicer in non-securitized transactions – dealing with conflicts of interest
 - e. Pooling and servicing agreements and co-lender\participation agreements
 - f. Approval rights of B Noteholders and/or controlling certificateholders, as operating advisor, subject to servicer “trump” (except for imminent default determination)
 - g. Limitations on servicer advancing, including contractual and practical considerations and impact on asset management decisions
 - h. Servicing transfer events – imminent defaults, other defaults, B Noteholder blocking rights through cure or consent rights
 - i. Control appraisal period – appraisal events and formula; threshold collateral
 - i. Potential for control over modification approval rights by out-of-the-money junior notes
 - ii. Formula variation in context of future advances
 - iii. As-is appraisal value vs. as stabilized value for value-added properties
 - j. B Noteholder or controlling holder removal and replacement of special servicer – reasons for removal, mechanics and potential for cost savings
 - k. REMIC rule limitations on seller financing of foreclosed real property (or property acquired by deed-in-lieu)
- 6. B Noteholder right to purchase A Note at par

- a. Triggering events
 - i. Event of default
 - ii. Servicing transfer event
 - iii. Control appraisal event
 - b. Option termination events
 - c. REO sales
 - d. Purchase price
 - e. Inclusion or exclusion of liquidation fees
7. Fair value option on loan sale by servicer
- a. Absence of par bid, including non-exercise of B Noteholder par purchase right
 - b. Fair value options in favor of B Noteholder and servicer
 - c. B Noteholder opt out right and related pooling and servicing agreement errors, modification
8. Risks and impediments to achievement of B Noteholder strategic objectives
- a. Risks absent purchase option exercise:
 - i. Inability to proceed unilaterally to acquire title (unlike a mezzanine lender), even after foreclosure or deed-in-lieu
 - ii. Incomplete right to control servicing decisions, consultation rights and risk of servicer trump on enumerated major decisions
 - iii. Risk of modification, extension upon servicer trump, despite B Noteholder objections
 - iv. Risk of modification without trigger of purchase right upon servicing transfer for imminent default
 - v. Costly structure of loan servicing impacting cash flows
 - vi. Risk of full payment subordination

- vii. Risk of control appraisal event
 - b. Risk of borrower bankruptcy, extension of low contract interest rates for extended period
 - c. Risk of being paid off at par on refinancing or par purchase by a mezzanine lender
 - 9. Core strategies for B Note buyers
 - a. Loan-to-own
 - i. Exercise par purchase right as soon as the opportunity arises; and foreclose on default
 - ii. Buy a “half-in-the-money” position that has “thickness”
 - iii. Block any modification or stretch out of the loan through major decision approval rights (to the extent feasible) prior to A Note purchase; deny requests for modification or extension post A Note purchase
 - iv. Buy a loan for which a control appraisal event has not occurred and is not likely to occur, unless the occurrence gives rise to a par purchase option
 - v. Block transfer to special servicing based on imminent default unless transfer triggers par purchase right
 - b. Buy at a substantial discount and seek to extend the loan term until market values recover
 - i. Exercise cure rights and threshold collateral rights to postpone/avoid control appraisal event, onset of special servicing fees and waterfall trigger event
 - ii. Leave senior debt in place, extend maturity, avoid foreclosure - encourage workout and borrower commitment of capital for future property expenses
 - iii. In a depressed market, generally subordinate debt holders side with the borrower to bargain for more time for the markets to recover and values to rise, so oppose foreclosure, deed-in-lieu, short sale,

appointment of receiver with power to sell the Property subject to the debt; evolving law; legal challenges

10. Alternative strategies for B Noteholder
 - a. Unlike mezzanine loans, B Noteholder unable to separately foreclose its collateral, cure non-monetary defaults requiring possession of the collateral, and assume the senior loan, so creativity is required
 - b. Convert B Note to equity – avoid REMIC foreclosure restrictions – cancel B Note in exchange for equity stake through loan assumption transaction with existing borrower – may be required to pay assumption fee
 - i. Issues of control of new borrower, recourse carveout guaranties upon assumption or subsequent change of control, economics of venture
 - ii. Combine with workout, extension and/or partial paydown of A Note
 - c. Sell B Note to Borrower or affiliate or third party (see mortgage borrower related party restrictions below)
11. Special issues involving borrower or borrower affiliate as B Note purchaser
 - a. Objective is to deleverage and take advantage of market discounts on subordinate out-of-the-money B Notes (and mezzanine loans)
 - b. Major obstacle – many pooling and servicing agreements, co-lender agreements, participation agreements, intercreditor agreements, mortgage loan documents and/or mezzanine loan documents contain a prohibition against a Borrower or Borrower affiliate (“mortgage borrower related party”) and, in some cases, a subordinate lender, from acquiring an interest in the mortgage loan or any interest therein, or a note more than one tier senior to the potential purchaser’s position
 - i. Who is the restriction intended to benefit?
 - ii. Avoidance of “squeeze play” involving intentional default and foreclosure controlled by junior interest
 - iii. Avoidance of conflicts of interest
 - iv. Avoidance of debtor control of servicing decisions

- v. B Note holders are commonly barred from selling interests in the B Note to mortgage borrower related parties
 - vi. Alternative to outright prohibition – loss of control rights, intercreditor rights
 - vii. Potential modification of prohibitions, assuming the parties are willing
 - viii. Structuring around restrictions
 - (A) Affiliate and control definitions
 - (B) Independently managed affiliates
 - (C) Joint ventures with third parties and other structures to address outright transfer prohibitions of any ownership interest in acquired debt
 - c. Consider tax implications of debt purchase by affiliate of borrower – can result in cancellation of indebtedness income
12. Qualified Transferee requirements
- a. Pre-approved qualified transferees
 - b. Eligibility requirements
 - c. Use of subsidiaries
 - d. Permitted fund managers
 - e. Rating agency approval of otherwise non-qualifying purchasers
 - f. Credit requirements applicable to future funding obligations
 - i. Backup guaranties
 - ii. Letters of credit

MEZZANINE LOANS

13. Structural Subordination
 - a. Upper tier mezzanine borrower as compared to property owner
 - b. Bankruptcy remote SPE as mortgage borrower and mezzanine borrower
 - c. The vanishing second mortgage
 - d. Equity pledges utilized
14. Equity Pledge Features
 - a. Collateral weakness/collateral risks
 - b. Difference as compared to real estate mortgage
 - i. No mortgage lien priority
 - ii. Upon foreclosure mezzanine lender takes subject to all liabilities and obligations of the property owner absent contractual subordination or termination rights
 - c. Voting rights
 - d. Article 8 vs. Article 9 perfection
 - i. Opt in to Article 9, with irrevocable proxy
 - ii. Use of certificated securities
15. Title insurance
 - a. UCC "Eagle 9" policy
 - b. Owners title policy with mezzanine loan endorsement
16. Recourse carveouts that are unique to mezzanine loans, as distinguished from first mortgage loans
 - a. Expansion of full recourse on bankruptcy or reorganization to cover mezzanine borrower and any intervening entities, as well as mortgage borrower and guarantor

- b. Expansion of due-on-sale or due-on-encumbrance provisions to include specifically deeds-in-lieu and consensual foreclosure or sale agreements
 - c. Increased exposure of carveout guarantors to recourse damage claims for violation of SPE provisions due to structural subordination
 - d. Given the lack of real estate mortgage lien priority upon foreclosure, some mezzanine lenders provide for recourse to cover mechanics liens, unapproved contracts and agreements, claims/liabilities, borrower indemnity obligations, judgments and tenant breach claims (No SNDA)
 - e. Senior loan modification entered into that was not approved by mezzanine lender
 - f. Purchase of senior loan by mortgage borrower related party
 - g. Real estate transfer taxes upon foreclosure
17. Special provisions relating to mortgage loan
- a. Automatic assignment to mezzanine lender of any interest acquired by mortgage borrower related party in mortgage loan and covenant to release mortgage lien and not enforce
 - b. Inclusion of provisions in favor of mezzanine lender in property owner's operating agreement
 - c. Special grant of cure rights and powers of attorney in favor of mezzanine lender upon alleged default under mortgage loan
 - d. Cross default to mortgage loan event of default, or perhaps alleged event of default
 - e. Prohibition against modification of mortgage loan documents
18. UCC foreclosure
- a. Requirements of commercial reasonability and waivers thereof
 - b. Public vs. private sale
 - c. Impact of qualified transferee restrictions

- d. Borrower demands for provision of replacement guarantor upon acquisition of title by mezzanine lender, and mezzanine lender reluctance to provide same, or narrowing of carveout liabilities assumed
 - i. Special considerations regarding principal guaranties and environmental liabilities
 - ii. Distinctions between requirement by mortgage lender for replacement vs. intercreditor removal or release language
 - iii. Potential for party other than mezzanine lender to acquire title and not be bound by replacement guaranty provisions
 - iv. Risk of full recourse liability to existing guarantor for non-complying mezzanine loan foreclosure
 - v. Risk to existing borrower of recourse liability for bad acts directed by mezzanine lender through use of pre-foreclosure voting control
 - (A) Borrower waivers of claims in pledge agreements
 - (B) Mezzanine lender disclaimer of fiduciary liability
 - vi. Mezzanine lender steps into mortgage borrower's shoes – need for subordination of sponsor subrogation and reimbursement rights for letters of credit and interest rate hedging obligations entered into for the benefit of mortgage borrower
- e. Impact of transfer taxes

INTERCREDITOR AGREEMENTS

IN THE CONTEXT OF LOAN ACQUISITIONS

19. What is being sold?
 - a. Senior mortgage loan
 - b. B Note or junior participation
 - c. Senior mezzanine loan or junior mezzanine loan
20. What is the debt stack?
 - a. Senior mortgage loan/A Note/senior participation
 - b. B and C Notes or junior participation
 - c. Senior and junior mezzanine loans
 - d. Borrower
 - e. Sponsor
 - f. Preferred Equity Investor
21. Which positions are in the money and by how much?
 - a. Fulcrum concept
 - b. Is the loan being sold partially in the money and partially out of the money, and, if partially out of the money, by how much?
 - c. What event most likely going to precipitate creditor and borrower interactions where rights and remedies matter - current default, anticipated default, imminent default, maturity defaults and other incurable defaults, monetary vs. non-monetary defaults
22. Which Lenders in the debt stack have cure rights and how do they work in sequence?
 - a. Concurrent or supplemental cure periods, sequential cure periods
 - b. Limited senior lender standstill

- c. Events terminating cure periods
 - i. Bankruptcy
 - ii. Impairment of use, value or operation of collateral
 - d. Foreclosure requirements in context of curing non-monetary defaults
 - i. Time periods allowed, contrasted with time to conduct commercially reasonable sale
 - ii. Waiver of defaults not susceptible of cure
23. Which lenders have purchase options and how do they work in sequence?
- a. Triggering events
 - b. Purchase options in inverse order of seniority
 - c. Obligation of junior lender to purchase intervening tiers when purchasing higher tier under option
24. What are the events that terminate purchase options
- a. Two party intercreditor agreements – foreclosure/deed-in-lieu, payment in full
 - b. Multiple party intercreditor agreements surviving foreclosure of one position
25. Open market note sales
- a. Buying up and down the capital stack
 - b. Controlling the fulcrum
 - c. Acquiring decision-making control
 - d. Qualified transferees
 - e. Mortgage borrower related party restrictions
 - f. Junior creditor restrictions – squeeze play
 - g. Loan funding obligations – credit requirements

26. Intercreditor payment priorities
 - a. Subordination provisions
 - b. Carveouts from subordination provisions
 - c. Exercising cure rights to avoid subordination
 - d. Turnover provisions
 - e. Cash management structures
 - f. Conflicts between cash management waterfall provisions and intercreditor provisions regarding payments
 - g. Treatment of foreclosure proceeds

27. Prepayment Provisions and Discounted Payoffs
 - a. Terms of the loan documents (mortgage/mezzanine/B Note)
 - i. Do they allow for non-pro rata payment?
 - ii. Do they require pro rata payment?
 - b. Terms of the intercreditor agreement
 - i. Does the intercreditor agreement require absolute priority of payments in order of seniority?
 - ii. Has a senior event of default occurred or a senior event of default occurred that has not been timely cured by the mezzanine lender that affects order of priority?
 - iii. What is the source of payments and what does the intercreditor agreement permit in terms of payments by Sponsors?
 - c. Is the creditor willing to forgive a portion of the debt?
 - d. Is the borrower or an affiliate or white knight friend of borrower seeking to purchase the debt or pay it off at a discount?
 - e. What is the impact of restrictions on loan document modifications in terms of effectuating a discounted payoff?

- f. Can the creditor convert all or any portion of its loan to an equity portion in exchange for debt forgiveness, without the consent of the other lenders under an intercreditor agreement?
- 28. Consent of other lenders to loan modifications
 - a. Intercreditor provisions
 - b. Provisions in loan documents, including workout restrictions as to senior loan contained in junior loan, above and beyond intercreditor limitations on modification
 - c. Inter-dependent extension conditions
- 29. Restricted permission to foreclose upon mezzanine equity collateral and separate collateral
 - a. Qualified foreclosure purchaser and UCC issues
 - i. Qualified transferee
 - ii. Hard lockbox
 - iii. SPE compliance and non-con opinions
 - iv. Carveout recourse obligations for stepping into shoes of borrower; requirement of creditworthy replacement guarantor
 - (A) Limiting to liabilities for future events (facts, events, circumstances first occurring . . .)?
 - (B) “Removal” of existing guarantor language vs. if the senior loan documents expressly provided for “release” of the guarantor; reluctance of senior lender to agree to such release
 - (C) Defenses of existing guarantor
 - v. Replacement qualified property manager
 - b. Requirement to cure senior loan default?
 - c. Injunctive relief
- 30. Treatment of bankruptcy issues

- a. Treatment of mezzanine lender claims in mortgage borrower bankruptcy
 - b. Restriction against mezzanine lender filing petition for mortgage borrower bankruptcy (subject to termination provisions of intercreditor agreement)
 - c. Provision of mezzanine lender recourse carveout for filing bankruptcy in capacity as owner of mortgage borrower post mezzanine loan foreclosure under replacement guaranty
 - d. SPE structure and borrower sponsor recourse carveouts for bankruptcy filing adversely impacting ability of mezzanine lender to protect its collateral
 - e. Termination of mezzanine lender cure rights on bankruptcy of mortgage borrower
 - f. Lack of mezzanine lender creditor claim in mortgage borrower bankruptcy
31. Tranche warfare
- a. Stuyvesant case (Bank of America, N.A. v. PSW NYC LLC, No. 651293/10, 2010 WL 4243437 (N.Y. Sup. Ct. September 16, 2010))
 - b. Borrower defensive strategies
 - i. Deleverage
 - ii. White knight
 - iii. Alliances with junior lenders
 - iv. Bankruptcy
 - c. Loan-to-own strategies – finding a clear path to ownership of the asset
 - d. Controlling the mortgage loan – exercise of the purchase right
 - e. Financing the purchase of a defaulted first mortgage loan

LOAN PURCHASE AND SALE AGREEMENTS

32. Opportunities for negotiation of purchase and sale agreement terms
 - a. Privately negotiated transaction
 - b. Purchases in bid structure
 - c. FDIC transactions
 - d. Bias of purchase agreement terms in favor of seller
 - e. Cost/risk/exclusivity considerations in investing time and money on due diligence and contract review and negotiation
33. Negotiating purchase agreement
 - a. Bid information cut-off date
 - i. Allow a short period for buyer information rollup and bid preparation following bid information cut-off date
 - ii. Treatment of post bid information cut-off date matters disclosed to or learned by buyer either pre-closing or post-closing
 - iii. Identification and segregation of disclosures furnished before and after the bid information cut-off date
 - b. Bid price
 - i. Pricing effective date
 - ii. Allocation of bid price among loans
 - iii. Allocation of pre-closing loan payments and accrued unpaid interest with distinctions between performing and non-performing loans
 - iv. Closing delays and provision of yield to seller beyond scheduled closing date based on purchase price
 - c. Close on all or selective loans?
 - i. Seller right to carve out loans

- ii. Buyer right to eliminate loans prior to expiration of contingency period
- d. Seller files disclosure; excluded lender documents
- e. Buyer deposit; escrow arrangements; contingency period; liquidated damages; basis for deposit retention; buyer cure rights
- f. Seller breach and buyer remedies; exclusivity/break-up fee
- g. Seller's representations and warranties
 - i. Types of representations and warranties
 - (A) Corporate representations
 - (B) Seller ownership right to sell and absence of transfer restrictions or assurance of receipt of consents
 - (C) Full disclosure representations
 - (D) Litigation/claims
 - (E) Future funding obligations
 - (F) Loan documents and any modifications
 - (G) Defaults
 - (H) Outstanding principal balance, accrued interest and interest rate
 - (I) Seller usury representation (or buyer due diligence regarding same), seller licenses
 - ii. Drafting representations from buyer's standpoint
 - (A) Buyer avoidance of seller quitclaim language
 - (B) Buyer avoidance of seller materiality qualifiers
 - (C) Seller knowledge qualifications
 - (D) Impact of seller's use of loan servicer upon representations and disclosures

- (E) Tying full disclosure representation and other asset-based representations to bid information cut-off date
 - (F) Limiting exceptions qualifying seller representations to scheduled items (pursuant to schedules furnished to buyer prior to the bid Information Cut-Off Date) versus charging Buyer with the contents of the disclosure files
- iii. Defective mortgage loans; breaches; breach claim deadlines and consequences of failure to timely file breach claim
 - (A) Survival of corporate representations vs. asset-based representations
 - (B) Waiver of borrower claims where buyer “knew” of breach prior to closing
- iv. Alternative remedies for seller breach
 - (A) Indemnification
 - (B) Cure within a specified period of time
 - (C) Repurchase, including repurchase price formula
 - (D) Bar of breach remedies upon buyer post-closing loan modification
- h. Seller covenants regarding delivering executed assignment documentation and original mortgage loan documents, in advance of closing to permit buyer inspection
- i. Assumed liabilities; excluded liabilities (lender liability issues); cross indemnities and releases, allocation of legal proceedings responsibilities
- j. Undisbursed loan funds
- k. Interim loan servicing responsibilities
- l. Original notes: lost-note affidavit vs. seller indemnity
- m. Buyer avoidance of seller’s corporate approval as condition of sale
- n. Title endorsements (104.13 or equivalent), vs. title report; loan sale condition?



- o. Addressing risk of seller insolvency/fraudulent conveyance risk; seller creditworthiness
- p. Notices to counterparties
- q. Mechanics of transfer of reserves and cash collateral accounts
- r. Confidentiality
 - i. Contact with borrower/guarantors or other lenders
 - ii. Estoppels
 - iii. File destruction in absence of closing