Real Estate Loans in Trouble: Buying and Selling Distressed Debt
Strategies for Negotiating and Structuring Winning Deals

A Live 90-Minute Audio Conference with Interactive Q&A

Today's panel features:
George E. Covucci, Partner, Arnold & Porter, Washington, D.C.
Amy B. Rifkind, Counsel, Arnold & Porter, Washington, D.C.
Ren R. Hayhurst, Partner, Bryan Cave, Irvine, Calif.
Thomas O’Connor, Partner, Cooley Godward Kronish, New York

Tuesday, August 11, 2009
The conference begins at:
1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

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August 11, 2009

Strafford CLE Teleconference on Real Estate Loans in Trouble: Buying and Selling Distressed Debt

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Introduction

- Focus on Traditional Commercial Real Estate Loans
- Then & Now
- Continuum of Lender Options
- Key Topics
  - Dilemma of Real Estate Lenders
  - Strategies for Dealing with Distressed Real Estate
  - Loan Sales
  - Restructurings and Workouts
THE FOLLOWING PROGRAM CONTAINS THE LATEST DISTRESSED REAL ESTATE NEWS.

VIEWER DISCRETION ADVISED.
Dilemma of Real Estate Lenders

- Déjà vu all over again?
- The landscape of the late 80’s/early 90’s
- Tax law changes in 1981 and 1986
# Effects of Major Tax Legislation on Commercial Real Estate

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<tbody>
<tr>
<td>Allowable depreciation method</td>
<td>Straight-Line</td>
<td>175% Declining balance</td>
<td>Straight-line</td>
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<tr>
<td>Passive losses deductible?</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Max. ordinary income tax rate</td>
<td>70%</td>
<td>50%</td>
<td>38.5%</td>
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<td>Capital gains tax rate</td>
<td>28%</td>
<td>20%</td>
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Failed Banks (1988-1992)

Total: 776 (approximately)

Source: FDIC Historical Statistics on Banking
http://www.sba.muohio.edu/brunarkr/charters.pdf
Today

- Global recession hitting all sectors
- CMBS
- Toxic residential loans spread to commercial real estate arena and then to global market
How the Current Recession Compares with the Prior Real Estate Recession

Chart showing Dow Jones Industrial Average Monthly Close
Data source: MarketWatch.com
Residential Delinquencies % of Residential Loans

Q1 2009: 7.83% (and rising)

“Bad Bank Loans at Extreme Levels” – Jeffrey Bernstein (3/1/09)
http://seekingalpha.com/article/123380-bad-bank-loans-at-extreme-levels
CMBS Issues: 2006-2008

- 2006: 202.7 Billions
- 2007: 228.7 Billions
- 2008: 75 Billions
CMBS Delinquencies
585% Increase in 12 Months

1330 Avenue of Americas – New York Sells 3 times in 10 years

1101 Brickell Ave - Miami Sells 3 times in 8 years

The Watergate Hotel – Washington, D.C.
Sells 3 times in 11 years

Purchase Price: $39,000,000
August 1998

Loan: $69,815,000
August 2004

Purchase Price: $42,930,000
August 2004

Lender Forecloses:
$25M
No bidders other than Lender
July 2009
Commercial Real Estate World Turned Upside Down

2007 Acquisition

Assume:
- $5M NOI
- 5% cap rate
- 80% loan

Equity: $20M

Property Value: $100
Debt: $80

Millions
Commercial Real Estate World Turned Upside Down

2009 Value

Assume:
- NOI declines by 10% to $4.5M
- Cap rates increase by 200 basis points to 7%

Deficiency: $15.7M
Commercial real estate price declines accelerating

- Moody’s CPPI CRE price index was down 7.5% in May, after an 8.6% decline in April
- The index is now off 35% from its peak in October 2007
- The index is likely to reflect a much higher percentage of distressed sales going forward

Source: Moody's and REAL and Case Shiller

Richard Parkus (212) 250 6724 · 7/24/2009 · page 22

Deutsche Bank
Government Intervention

- Then
  - Federal Deposit Insurance Company (“FDIC”)
    - Receiver for 776 Savings & Loans
  - Financial Institutions Reform Recovery & Enforcement Act of 1989 (“FIRREA”)
    - Created Resolution Trust Corporation (“RTC”)
    - Approximately $400B sold
    - Teamed with Wall Street in developing CMBS industry
Failed Banks (1988-1992)

Total: 776 (approximately)

Source: FDIC Historical Statistics on Banking
http://www.sba.muohio.edu/brunarkr/charters.pdf
Government Intervention

- **Now**
  - FDIC & Banks
    - Direct Loan Sales
    - Direct Property Sales
    - Structured Loan Sales (80/20)
  - TALF
  - Public-Private Investment Program (PPIP)
    - Legacy Loan Program
    - Legacy Securities Program
      - 9 private fund managers with 12 weeks to raise $500M
      - Treasury matching private equity 1:1
      - Government non-recourse debt financing
Failed Banks – 2009 to Date

Total: 69

- January (6)
- February (10)
- March (5)
- April (8)
- May (7)
- June (9)
- July (24)

Bank Failures through July 31, 2009

Source: FDIC Failed Bank List
Total Number of Banks (2008)

FDIC: Historical Statistics on Banking – “Number of Branches, Institutions and Total Offices of FDIC-Insured Commercial Banks”
http://www2.fdic.gov/hsob/hsobRpt.asp
Less Regulatory Pressure to Classify Failing Real Estate Loans Resulting in Reactive Lenders and Borrowers

- No exit strategy such as RTC
- Funds with liquidity on sidelines
- No clear valuation methodology for problem assets
- Failures of banks may stabilize markets
Every Bank Failure Is Also a Beginning

Forty-two banks have failed since the beginning of 2008.
Chapter 11 Bankruptcies

- Federal law
- Chapter 11
- What is a bankruptcy?
  - Filing of a petition
- What legal effect?
  - Stay!!
  - Collateral
  - Continued control by debtor
  - Opportunity to restructure
  - Interim operations subject to cash collateral order
Plan of Reorganization in Bankruptcy

- Debtor exclusivity – 120 days
- Plan to manage and operate
- Classification of creditors
- Requirements for confirmation under § 1129
  - Secured creditors: PV or property
  - Unsecured creditors: liquidation value
- Cram Down
  - Acceptance by one impaired class
Real Estate Bankruptcies

- Then
  - Recourse debt
  - Large scale filings
  - Cram downs
  - § 1141 exemption
  - Threat by borrowers
  - Creative use of creditor classes
Chapter 11 Bankruptcies

- Now
  - ???
  - Less recourse debt, but...
    - Springing guaranties
    - Special purpose entities
    - Independent director
  - Pro creditor law changes
  - Limitations on § 1146(a)
Pre-Packaged Plan in Bankruptcy

- Negotiated before filing
- Benefits of bankruptcy court protections
- Section 1146(a)
  - Piccadilly Cafeterias
Creditor Rights in Bankruptcy

- Appointment of trustee
- Relief from automatic stay
  - Cause
  - Single asset real estate cases
  - Motion to dismiss
  - Terminate exclusivity
  - Valuation of claims
  - Adversarial proceedings
Lender Sale Options

- Lender objectives
- Loans to real estate
  - Sale of individual note vs. bundling notes into loan portfolio sale
  - “As Is” sales
- Motivations of buyers
- Limitation on information
- Loan sale process
Lender Sale Options (cont’d.)

- Options and values increase with cooperative borrower
  - Access to information
  - Other arrangements with borrower
  - Workout options
    - Note sale
    - Deed-in-lieu
      - Relative ease and speed vs. junior financing issues
    - Friendly foreclosure
      - Involvement of court vs. extinguishing subordinate liens
    - Pre-packaged plan in Chapter 11

- Alternatives to sales: Receivership
Borrower Strategies for Dealing with Distressed Real Estate

- Borrower objectives
- Unilateral remedies
  - Internal restructuring
  - Outside investors
  - Acquisition of note (at discount)
- Pitfalls and issues
  - Limitations in loan documents
  - Sources of funding
  - Appropriate returns
  - Property valuations
  - Income tax pitfalls
- Role of real estate consultant
Can Borrower/Lender Cooperation Create a Win-Win Situation for Restructuring

- Lender perspective
  - Relationships
  - Options
  - Time horizon
  - Litigation and other risks

- Lender due diligence
  - Preference issues
  - Default options
  - Potential remedies
  - Project documents
  - Property condition
Can Borrower/Lender Cooperation Create a Win-Win Situation (cont’d.)

- Process for restructuring
  - Pre-workout letter
  - Standstill agreement
  - Forbearance agreement

- Loan modification agreement
  - Extension of term
  - Reset interest rate
  - Restructure note
  - Guarantees
  - Additional collateral
  - Subordinated debt
Conclusion

- One size does not fit all situations
- Borrower and lender must realistically assess legal and business issues
- Buyer must realistically assess pricing and related issues
- Potential workout or restructuring will be measured against worst case scenario – bankruptcy/lender liability or suit and recovery under guaranty
- Lender has multiple options
- Outside factors (regulatory, accounting, or tax consequences) can result in irrational conduct by borrower and/or lender and make playing field confusing for a buyer
Conclusion (cont’d.)

- May we survive this global recession and not as quickly forget, as we have in the past, lessons learned regarding:
  - Careful underwriting and due diligence
  - Benefits of the transparency of financial products
  - Better oversight by ratings agencies
  - Limits on leverage
Real Estate Loans in Trouble: Buying and Selling Distressed Debt

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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
Overview of Pricing & Due Diligence Issues

• Overcoming the Bid and Ask Gap
  – Reasons for the Gap
  – Possible Solutions that Will Bridge the Gap – TARP? PPIP? FDIC Loss Sharing? What will work?

• Due Diligence Challenges
  – Note Sales Require Due Diligence on the Loan, Title and the Property
  – REO Sales Requires Standard Property Purchase Due Diligence
Overview of Alternative Strategies

• **Use of Deeds in Lieu of Foreclosure**
  – Allows Immediate Possession of Asset
  – Subject to Liens/Claims/Development Issues
  – Works Best When Combined with Note Sale and Subsequent Foreclosure

• **Option Transactions**
  – Provides Immediate Pricing and Allows Immediate Due Diligence
  – Contingent on Foreclosure Sale Results

• **Other Alternatives**
Note Sale Issues

• Abundant Product Available
  – Wave of Commercial Loans Maturity or In Default
    • Banks More Likely to Sell than Special Servicers
  – Numerous Potential Purchasers

• 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
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**
  – Pricing Very Uncertain – Lenders reluctant or unable to sell at too steep of a discount
  – Purchaser must have the ability to deal with the foreclosure process
  – Purchaser Assumes Bankruptcy/Foreclosure Risk
    • Risk Sharing is Difficult to Negotiate
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
  – Long Delays for Buyers and Sellers
Pricing Issues

• Where is the Bottom?
  – Pricing of deals difficult/impossible due to appraisal uncertainty and unpredictability of future market

• Capital and Reserve Requirements
  – Effects on Regulated Lenders

• The “Liquidity Problem”
  – Market Value(?) vs. Appraised and/or Book Value

• What Happens to the “Toxic Assets”?
  – Lessons From the RTC Experience
  – Lessons From the Current FDIC Experience
  – Use of “Bad Bank” Model
    • Who Will Invest and Own the Assets?
Pricing Issues (Part 2)

- **TARP?**
  - Focus on Management and Compensation Issues Have Shifted This to a Small Bank Program
  - No Longer Viewed as a Solution to the Sale of Distressed or Toxic Assets
    - Provides Additional Capital For Lenders in Trouble
- **ARRA?**
  - Not Designed to Address Distressed Loan Issues
- **TALF?**
  - Addresses Only CMBS Loans
  - Designed for AAA Product, Not Whole Loans or Distressed Assets
- **PPIP?**
  - Might Work Only If Price Point Can Be Found
- **Others?**
  - FDIC Loss Sharing – Not A Big Enough Program
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**
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**
Alternative Transaction Options

- **Alternatives to Foreclosure**
  - Deed in Lieu of Foreclosure
  - Title Subject to Competing Liens and Other Defects

- **Consensual Foreclosure**
  - Permits a Lender to “Clean Up” Title, And Can Speed Up the Process

- **Consensual Bankruptcy**
  - Risk Of Trustee Or Judicial Interference
Conclusion

• Understand the Advantages of Approaches and Use Them As Required to Negotiate the Best Price and to Address Timing Issues

• A Little Advance Warning to Third Parties Is Invaluable to Identify Problems Or Possible Claims

• Explore The Extent of Your Potential Remedies, and take Action To Factually and Legally Preserve All Rights and Remedies
BY THOMAS O’CONNOR

INCE THE ONSET of our current economic
downturn, many opportunity funds and other
investors have been actively seeking to
acquire distressed real estate properties and loans.
However, during the past year, there have not been
as many buying opportunities as would have been
expected, as many sellers have been reticent to
readjust their expectations to the new economy
and have held onto their properties and loans.
As the recession is now affecting commercial real
estate, this apparent standoff between sellers and
purchasers may be loosening, particularly in the
area of distressed debt.

Pressure on commercial real estate in 2008
was driven primarily by maturing loans that
could not be refinanced because of the lack of
liquidity in the credit markets. Lenders that
did not have to clean up their balance sheets
generally responded by negotiating extensions of
these loans in exchange for some concessions by
the borrowers, and continued to hold onto the
debt. However, many of the loans that matured
in 2008 were originated between 1998 and 2003,
before the dramatic drop in capitalization rates
and aggressive underwriting that followed between

Beginning in 2009, pressure on commercial real
estate is now coming from the collision between the
economic realities of the depressed market and the
exuberant pro-formas of the 2004–2007 vintage deals. The current surge of tenant
bankruptcies, lower rental rates, higher vacancy
rates and increasing capitalization rates were
not taken into account in the acquisitions and
financings of those halcyon days.

This reality is causing an increasing number of
defaults as these loans mature or interest reserves
that were on LIBOR (London InterBank Offered
Rate) life support run dry and the projected cash
flows are not achieved.\(^1\) As a consequence of
these rising defaults, many commercial lenders
will be faced with the option of having to either
take properties back or restructure debt, and may
instead choose to sell the debt at its then current
market price. Therefore, there are likely to be
more and more opportunities to acquire defaulted
commercial loans at discounted levels.

Acquiring a defaulted or “non-performing” loan
presents the purchaser with different issues and
challenges than the acquisition of a “performing”
loan.\(^2\) This article will discuss and analyze the issues
and challenges that are particular to acquiring non-
performing loans and provide recommendations and
insights for resolving them.

The first and perhaps most obvious distinction
between acquiring a non-performing loan and a
performing loan involves the pricing of that debt.

\textbf{Pricing}

A prudent purchaser in both cases will
re-underwrite the underlying property in order to
confirm whether it supports the debt level. However,
the purchase price for a performing loan is much more
closely tied into the actual outstanding balance of
the loan, because there is a reasonable expectation that
it will be repaid in full, and the anticipated return to
the purchaser is based upon the underlying interest
rate of the loan and the amount of the discount, if
any, off of the outstanding amount of the loan.

Thomas O’Connor is a partner in the New York office of Cooley Godward Kronish, head of the firm’s real estate
group and co-chair of the structured real estate investments group.
With respect to the acquisition of a non-performing loan, however, it can be argued that in calculating the purchase price, the amount of the loan is wholly irrelevant for two reasons. First, a non-performing loan is most likely in default because the underlying cash flow does not support the debt, and therefore whatever amount the holder of the debt had originally advanced to the borrower some time ago (and in a completely different economy) has little or no correlation to the value of the property and the amount of debt the property can service today.

Second, unlike a performing loan, there is little expectation that the debt will be repaid in full, and therefore the anticipated return to the purchaser of a non-performing loan is wholly linked to the value of the underlying property, not the debt amount.

For example, the purchaser of a non-performing loan will expect to recover its investment by either foreclosing upon the property and re-selling it, restructuring the loan with the borrower at new (and sustainable) loan terms, or accepting a discounted pay-off when and if the non-performing loan is refinanced. All three exits are driven solely by the then underlying value of the property and have nothing to do with then outstanding balance of the loan. Therefore, the fact that a non-performing loan is acquired at a 50 percent discount does not in and of itself reflect a good non-performing loan is acquired at a 50 percent discount when and if the non-performing loan is wholly linked to the value of the underlying property, not the debt amount.

These representations be made at contract and at closing, survive the closing for a reasonable period of time (anywhere from one year to the life of the loan) and be backed with adequate remedies. These seven fundamental representations are as follows:

1. the seller has the authority to complete the transaction;
2. the seller owns the loan free and clear;
3. the seller has delivered complete copies of the loan documents to the purchaser and the loan documents have not been amended, waived or released;
4. the seller has not taken any affirmative actions with respect to the loan that would give rise to any valid defenses to enforcement of it;
5. the correct amount of all reserves being held with respect to the loan;
6. the title policy insuring the loan (or the UCC policy in the case of a mezzanine loan) is in effect and enforceable (although this representation may not be needed if a policy endorsement to such effect is available at an acceptable cost); and
7. the outstanding balance of the loan.

Virtually all other matters regarding the loan, the borrower and the property that are covered in the full set of representations that a purchaser typically receives in the acquisition of a performing loan can be ascertained by the purchaser with its own due diligence or are not otherwise relevant with respect to the acquisition of a non-performing loan.

For example, in the sale of a fully performing loan, the seller customarily represents that “the loan is in full force and effect” and “there are no defaults and the borrower has no defenses to enforcement of the loan.” The effectiveness of the loan documents can be determined by the purchaser as long as it has a complete set of the loan documents (covered by representation (3) above), knows that the seller has not waived or released any provisions or done anything to impair enforcement of the loan (covered by representations (3) and (4) above) and knows that the lien is valid (covered by representation (6) above or a title policy endorsement).

The usual representation that there are no defaults is not meaningful because with respect to a non-performing loan, there are defaults. In addition it is not reasonable to expect that the seller is going to make a representation that the borrower has no defenses, because the borrower may very likely raise defenses if the remedies under the loan documents are exercised. It is also not reasonable to ask the seller to insure the outcome of any such proceedings and represent that the borrower will not prevail in any of its defenses, as the purchaser of a non-performing loan should be expected to take on the ordinary risk of litigation.

However, at a minimum, the seller should disclose whether it has affirmatively taken any actions that would cause any of the borrower’s defenses to be successful and impair such proceedings for the lender (as covered by the representations in (3) and (4) above) so that the purchaser can assess that risk.

**Seller Covenants**

A purchaser of a non-performing loan also needs to carefully address the conduct of the seller with respect to the loan between the signing of the contract and the closing. This is obviously more of an issue the longer the contract period will be.

With respect to the sale of a performing loan, the seller generally agrees to continue to service the loan in the ordinary course of business and also further agrees that it will not modify the loan or grant any consents under the loan without the approval of the purchaser. Although this is also the case with respect to the purchase of a non-performing loan, in that case there are additional specific activities of the seller that the purchaser needs to monitor and be involved with during the contract period.

A non-performing loan may be subject to foreclosure proceedings or other enforcement actions conducted by or on behalf of the seller. Accordingly, the contract needs to provide safeguards for the purchaser to protect the lender’s rights and positions in such proceedings. Bear in mind that the seller will most likely not be very motivated to incur any additional costs to continue such proceedings, and failure to do so could prejudice the purchaser’s ability to ultimately realize upon the collateral for the loan (for example, failing to answer any pleadings or motions by certain dates or failing to follow particular notice and/or advertising requirements).

Accordingly, a contract for a non-performing loan in which foreclosure proceedings or other litigation has commenced should require the seller to take all actions necessary to protect the seller’s rights as lender in such proceedings, and should further require that the seller consult with the purchaser regarding any further actions taken in such litigation, as the purchaser will be inheriting those claims. Such consultation might require the express approval of the purchaser of certain actions taken by the seller in any pending litigation (such as dismissing the action against any defendants, releasing any claims, etc.).
Subordinate Debt

The purchase of a non-performing or performing loan that is a mezzanine loan or other similar type of loan that is junior to other debt requires, in both cases, a thorough analysis of the intercreditor rights with respect to the relationship between the senior lender (or lenders) and the subordinate lender.

This analysis covers many issues and could easily require a separate article in and of itself. However, certain specific issues may be particularly problematic and more immediate in purchasing a junior non-performing loan that will be addressed here briefly.

For example, if a mezzanine loan is in default, the industry standard intercreditor agreement will generally provide that a default under a mezzanine loan does not “in and of itself” cause a default under the senior loan. This is a critical safeguard for the subordinate lender because it keeps the senior loan in place while the subordinate lender is trying to deal with the default or otherwise exercise its remedies against the collateral.

The purchaser of a non-performing loan must confirm that this safeguard is in place or it risks walking into an automatic senior loan default that could potentially wipe out the mezzanine loan it just acquired. Additionally, in some instances, a default under a mezzanine loan can trigger a “cash sweep” under the senior loan in which the senior lender can trap all cash flow from the property to pay the senior debt, property expenses and fund additional senior reserves with little or no cash being remitted to the subordinate lender. This cash sweep can potentially deprive the purchaser of a non-performing loan of any cash flow that might have otherwise been available to service at least some of the mezzanine debt.

More importantly, if the mezzanine loan is in default, it is reasonable to expect that the senior loan may also be in default or may be in imminent risk of going into default. The purchaser of the non-performing mezzanine debt must learn if a senior loan default has occurred or assess the risk of the senior loan going into default if such a default has not yet occurred. This is critical because most intercreditor agreements will provide that if the senior loan goes into default, unless the mezzanine lender either cures the default or purchases the senior loan at par, the senior lender will have the express right to foreclose its interest, which in turn will wipe out the mezzanine debt.

Moreover, if the senior loan subsequently goes into default, the holder of the mezzanine loan will be required to cure such default as soon as it forecloses upon or otherwise realizes upon its collateral (i.e., the equity interests in the senior borrower). Therefore, if it is determined that the senior loan is in default or is likely to go into default in the near future, then before proceeding with the acquisition of the junior non-performing loan, the purchaser must first determine if it is willing and able to cure the senior loan default, acquire the senior loan at par, or work out an acceptable restructuring with the senior lender.

The best method for the purchaser to determine the status of the senior loan is to require (or request) that the seller obtain an estoppel certificate from the senior lender. Intercreditor agreements typically require that each party deliver an estoppel certificate and therefore the seller should be able to obtain this without undue difficulty or cost.

Third-Party Rights

The purchaser of a non-performing loan needs to carefully review any third-party agreements related to the loan in order to assess whether the default under such loan might impact the purchaser’s rights and liabilities with third parties.

For example, if a non-performing loan is subject to a servicing agreement that is not terminable (which is often the case in a purchase of a mezzanine loan) or is only terminable upon payment of a costly termination fee, the default under the loan may have triggered the requirement that the loan be serviced by the “special servicer” instead of the “master servicer.” The servicing fees for the special servicer are typically much higher than the servicing fees for the master servicer and should be taken into account when pricing the transaction.

Conclusion

In summary, the potential return in the purchase of a non-performing loan can be significantly higher than the potential return in the acquisition of a performing loan. This is not unlike many other investments in which the return is a function of the risk.

However, by carefully understanding and analyzing the particular issues and problems that confront purchasers of non-performing loans, the risk-reward matrix of a particular transaction can be mitigated to reduce the risk side of the equation.

1. Many interest reserves established with loans originated between 2004 and 2007 have actually lasted longer than anticipated as the LIBOR based interest rates of these loans have been much lower than originally projected because LIBOR has been at historically low levels. However, even these extended interest reserves are now starting to be depleted while rents have failed to meet the levels needed to support the debt once the reserves were used up.

2. For purposes of this article, the term “performing” loan is meant to refer to a loan in which: (a) the debt is genuinely and adequately serviced by the actual cash flow of the underlying property (rather than by interest reserves or other external credit supports that ultimately expire); (b) the value of the property exceeds the loan amount by a traditional cushion; and (c) the loan is not expected to default at maturity or otherwise.

3. For purposes of this article, a “mezzanine loan” refers to a loan that is made to the direct or indirect equity owner of the property-owning borrower and which loan is secured by a pledge of such equity to the mezzanine lender. Additionally, a “mezzanine loan” as used herein also generically refers to other subordinate loans such as B notes and the like.

4. It is important to remember that although a default under the mezzanine loan is typically not cross-defaulted with the senior loan (such as in the case of a payment default), the event causing the default under the mezzanine loan can also independently be a default under the terms of the senior loan documents (such as a covenant default relating to the property because the borrower’s covenants are usually the same under both the senior and mezzanine loan documents).
I. Dilemma Of Real Estate Lenders

A. Déjà Vu All Over Again

1. Real Estate Landscape in Late ‘80s/Early ‘90s.
   a. A real estate meltdown and savings & loan (“S&L”) crisis, not global economic meltdown
   b. Direct relationship between Lenders and Borrowers with properties secured by first deeds of trust
   c. Small compared to today’s meltdown involving trillions of dollars in securitized debt worldwide with complicated tranches
   d. Cause: tax law changes and risky lending by S&Ls

2. Global Recession Today
   a. Causes
      i. The meltdown of CMBS market. In US alone, CMBS issues totaled $202.7B in 2006 and $228.7B in 2007, but only $75B in 2008
      ii. Increasingly lax underwriting in 2006 and 2007
      iii. Subprime debt
      iv. Bubble in real estate values
      v. Exacerbated by web of worldwide debt and new and difficult to understand “hedge products”
b. Consequences
   i. Frozen credit markets
   ii. Leveraged short-term first mortgage debt maturing
   iii. Mezz and mortgage loans upside down with loan amounts greater than value of underlying real estate
   iv. CMBS structure resulting in loss of personal relationships between borrowers and lenders and difficulties in modifying loans and addressing intervening events without “brinksmanship”

3. Government Intervention
   a. Role of Federal Deposit Insurance Company (“FDIC”). Failed S&Ls taken over by FDIC which was inundated with failed loans and real estate owned (REO) property held by the S&Ls
   b. Role of Resolution Trust Corporation (“RTC”)
      i. Established by Financial Institutions Reform Recovery and Enforcement Act of 1989 (“FIRREA”)
      ii. Sold approximately $400 billion of real estate and other assets of approximately 770 failed savings banks over a several year period
      iii. By 1995, RTC sold off commercial mortgage loans resulting in Wall Street issuing billions of dollars in commercial mortgage back securities (“CMBS”)

4. Government Intervention Today
   a. FDIC
      i. Receivership
      ii. Acts as a middleman orchestrating sales of failing banks, with acquirer taking ownership of REO and distressed real estate debt
   b. FDIC Sales Process
      i. Direct Loan Sales. Loan Portfolios/100% ownership
1. Loan portfolios are advertised by two companies, whose web sites are located at www.debtx.com and www.firstfinancialnet.com.

2. FDIC packages performing and non performing loans for sale in pools. Usually pools include assets of same type and general location.

3. Loans are sold through an auction with a sealed bid process.

ii. Individual Sales Of Property. Until recently, all the real estate the FDIC wanted to sell was found on their web site at www.fdic.gov/buying/owned/index.html. To acquire these properties, a buyer contacts the individual FDIC contact listed on that particular property’s listing on the website. CB Richard Ellis was awarded the contract to be the primary advisor to help sell portfolios of owned real estate for the FDIC in November, 2008. Available listings can be found at http://orelistings.cbre.com/. To be added to an interested parties list, potential buyers should email FDIC-ORE@cbre.com or contact Kim Celoni at (214) 979-6121

iii. Structured Loan Sales (80/20 Joint Ventures).

1. FDIC creates large loan portfolios which it contributes to an LLC. The LLC then enters into a participation agreement with the FDIC pursuant to which the FDCI receives 80% of loan payments streams. When a pre-determined threshold is achieved, the FDIC’s interest drops to 60%. In one transaction FDIC began with a 60% interest which will drop to 40% over time.

2. To become a qualified bidder, a potential buyer must execute a certificate of eligibility and confidentiality agreement on the FDIC’s form. On loan sales, the bidder must deliver a specified deposit prior to being able to bid on a particular package. The bidder will obtain access to online workrooms for due diligence, which will include an Invitation to Bid, Bid Instructions, Loan Sale Agreement, Loan Spreadsheets and related due diligence. The acquisition is “as is” and without recourse to the FDIC. Closing typically occurs no later than 20 business days after the award.
3. 20% owner is entitled to management fees equal to 50 basis points.

4. Process is run by one of two outside financial advisors, GlassRatner and Keefe, Bruyette & Woods.

c. Term Asset-Backed Securities Loan Facility (“TALF”)

1. Federal Reserve’s program run by the Federal Reserve Bank of New York to loan funds on a non-recourse basis to the holders of AAA-rated asset backed securities. Securities can be collateralized by many assets: car loans, student loans, credit card loans.

2. TALF was recently extended to cover CMBS including pre-2009 CMBS (“legacy”). In late July, the Fed accepted 35 top-rated CMBS bonds with notational amounts of approximately $23B.

3. Will TALF be extended through 2010?

d. Public-Private Investment Program (PPIP) (March, 2009)

i. Legacy Loan Program. FDIC’s half of PPIP was intended to relieve banks of troubles assets. Banks were to pool its own assets and sell to a private investor. FDIC will provide a guaranty not to exceed a 6 to 1 debt-to-equity ratio. The LLP pilot was supposed to launch in June but has been postponed.

ii. Legacy Securities Program. Managed by Treasury and Federal Reserve

1. 9 private fund managers were selected in early July, 2009 and given 12 weeks to raise $500M from private investors. Each fund manager must contribute $20M. Each fund is referred to a public-private investment fund (“PPIF”). There will be a three-year investment period and each PPIF will dissolve after eight years with the possibility of two one-year extensions.

2. Treasury will match the amount of equity financing one-to-one.
3. Treasury will also provide debt financing (as part of TALF) up to 100% of total equity in the PPIF with recourse limited to the PPIF and its assets. Other debt financing may also be obtained.

4. Eligible assets include CMBS that were issued before 2009 with ratings of AAA at the time of issuance.

5. Treasury has committed $30B to the program.

B. Less Regulatory Pressure To Classify Failing Real Estate Loans Resulting in Reactive Lenders and Borrowers

1. No exit strategy such as RTC

2. No clear valuation methodology for problem assets. Where is the bottom? Will real estate values revert to historic rates?

3. No liquidity in capital markets and liquidity on sidelines

4. Problems reach significantly beyond real estate markets

5. Failed banks may help stabilize the market

II. Bankruptcy

A. Chapter 11 Bankruptcies

1. Governed by Federal law. Federal law pre-empts all state law with respect to all matters pertaining to a bankruptcy proceeding

2. 11 USC Sec. 101 et. seq. Bankruptcy law is codified in the Federal Code

3. Bankruptcy is the filing either by a debtor (voluntary) or by three creditors (involuntary) of a petition seeking relief of the bankruptcy court in the relevant jurisdiction

4. Legal effect

   a. All legal proceedings against the creditor are automatically stayed

   b. Collateral previously given may revert back to the creditor (voidable preference)

   c. Debtor control. Debtor continues to operate the business in the ordinary course, subject to
d. Debtor and any creditor holding cash collateral agreeing on the use of that cash (e.g., rents)

e. Provides the debtor with an opportunity to restructure its affairs

f. Exclusivity period of 120 days for debtor to submit a plan of reorganization

B. Real Estate Bankruptcies Then

1. Many borrowers signed personally for real estate loans

2. Personal bankruptcy filings were more common to protect the guarantor against exercise by a number of lenders against a series of guarantees

3. Bankruptcy was used often as a treat by borrowers to obtain leverage in connection with a proposed restructuring of a real estate project

4. Cram downs were attempted to force secured creditor to restructure its debt, including creative mechanisms for classifying creditors

5. Sec. 1146(a) was liberally used to avoid transfer and recordation taxes in jurisdictions such as DC and MD under a pre-packaged plan

C. Real Estate Bankruptcies Now

1. ?????

2. There is less recourse debt, but

   a. Borrowers have signed “bad boy” carve outs which frequently include springing guarantees

   b. Special purpose entities have been used in most real estate transactions to make it more difficult to file or successfully prosecute a bankruptcy

   c. Independent directors have been added to the governance documents with the requirement that such directors must consent before the borrower can file a voluntary bankruptcy petition

   d. Congress changed substantially the bankruptcy laws to make it far more difficult for a borrower to obtain relief in a single purpose bankruptcy case

   e. The Supreme Court limited the use of Sec. 1146(a) in the case of State of Florida v. Piccadilly Cafeterias

D. Pre-Packaged Plan
1. Borrowers and Lenders may negotiate a restructuring arrangement before filing
2. Provides the agreed upon restructuring with the benefits and protections of a bankruptcy
3. Pressures recalcitrant creditors
4. Piccadilly Cafeterias may limit use to avoid transfer and recordation taxes

E. Creditors Rights
1. Can seek the appointment of an independent trustee to manage the affairs of the debtor
2. Can seek relief from the automatic stay
   a. Must have cause
   b. New laws provide favorable treatment in single asset bankruptcy cases
3. Can file a motion to dismiss
4. Can seek to terminate the 120 day exclusivity period of the debtor
5. An action can be brought to value claims
6. An adversarial proceeding -- a case within the bankruptcy case -- can be brought for any number of matters, including actions to set aside conduct of the debtor such as fraudulent conveyances and voidable preferences

III. Lender Sale Options

A. Lender Objectives
1. Preserve value of loan
2. Exit strategy
3. Limit risk

B. L(oans) to R(eal Estate). From packaging loan(s) to selling directly underlying real estate

C. Possible Sale of Note or Bundling Notes into Loan Portfolio Sale
1. Methodology
a. Traditional broker sales

b. Auction Process

c. Generally “as is” sales with representations and warranties limited to the following topics: ownership of loan, authority to sell, and perhaps: principal balance, accrued unpaid interest, whether there are any defaults, escrow balance, if any, and whether Borrower has made any written claims

i. Loan purchaser “inherits” all Borrower defenses, including lender liability claims

ii. Motivated lender may motivate purchaser with escrow to protect against Borrower claims and/or provide take back financing

d. Motivations of Buyers

i. Deep discounts

ii. Loan to own or loan to flip

e. Limitations on ability of both Lender and prospective purchasers to access all pertinent info on underlying real estate

f. Loan Sale Process

i. Lender offering and sale mechanics

ii. Nature of due diligence by potential Note Purchaser (see Attachment A)

iii. Possible conditions to closing

   1. Estoppels from Borrower
   2. No bankruptcy by Borrower or guarantor
   3. No lender liability claim
   4. No title issues re underlying real estate

2. Modification of Loan By Acquirer

a. Change interest rate or term

b. Reduce debt in return for equity interest
c. Cancellation of indebtedness issues to Borrower

D. Sale Options and Value Increases With Cooperative Borrower

1. Note sale still available
   a. Better access to property information
   b. Transitional management or on-going management by current Borrower depending on objectives of note purchaser and capability of Borrower
   c. Incentives to Borrower such as release of guaranty, modification of terms, fees for management

2. Deed in Lieu (either to Lender or Designated Buyer) should further increase value
   a. Pros: Additional knowledge and direct access to real estate should result in a higher value; quick because no notice or advertising required; generally cheaper than foreclosure; avoids potential negative publicity for parties and project; no fear of potential challenge to foreclosure sale; can address potential adverse tax consequences to Borrower on a consensual basis
   b. Cons: May not be available because of mezzanine debt, junior financing, construction liens or other liens that would remain in place; requires full cooperation of Borrower and costs of incentivizing that cooperation from Borrower
   c. Issues: Impact of intercreditor agreements; scope of representations, warranties and indemnification from Borrower and extent of recourse if breached; payment of title insurance (Lenders policy will not cover its new role as Owner); issue of allocation of costs such as transfer and recordation taxes, recording fees, survey and legal fees; resolution of guaranties, and other claims against Borrower
d. Documents: Settlement Agreement; Deed; possible Assignment to Third Party Buyer

3. Friendly Foreclosure Will Likely Result in Even Higher Value because results in extinguishing all subordinate liens

4. Pre-Packaged Plan in Chapter 11 Bankruptcy May Provide Even Greater Value
   a. Benefits of Sec. 363 Sale
b. Possible avoidance of transfer and recordation taxes under Section 1146(a)

5. Under Deed In Lieu, Friendly Foreclosure or Pre-Packaged Chapter 11, Concerns of Borrower Will Need to be Addressed
   a. Income tax consequences to ownership entity
   b. Allocation of financial costs, including obligation for transfer and recordation taxes
   c. Resolution of legal claims (if debt guaranteed, should there be a release or a partial payment on guaranty)

6. Limit on Potential Buyers
   a. Limited capital market
   b. Lender take back financing
   c. Spike in cap rates and substantial decrease in leverage
   d. Pool of buyers may increase as lender provides better access to real estate

E. An Alternative Approach: Receiverships
   1. Pros: Lender gains control of asset and prevents wasting; avoid double transfer and recordation taxes.
   2. Cons: Borrower remains in picture; ease of receivership depends on jurisdictional requirements

IV. Borrower Strategies For Dealing With Distressed Real Estate

A. Objectives of Borrower
   1. Maintain control of property
   2. Preserve “value”
   3. Limit liability, particularly under guarantees

B. Unilateral Remedies
   1. Internal Restructuring of Partnership to Fund Shortfalls
      a. Capital calls; member loans
b. Consider whether additional funding would be a prudent investment without loan restructuring

c. Is equity comfortable with ability of managing member to oversee the asset

2. Bringing in Outside Investors

a. New managing member

b. New equity

c. Structure of new equity investment as mezzanine debt

d. Control and management issues

e. May provide incentive for lender to restructure loan

f. Investment may be used to pay down loan at a discount

3. Seek to Acquire Note At Discount

a. Renegotiate waterfall of distributions

b. Restructure debt

c. Contribute debt for equity

d. CODI issues

C. Pitfalls and Issues

1. Is Internal Restructuring Permitted Under Loan Documents?

a. Bankruptcy Remote Entities

b. CMBS loans

2. Where is the Source of Funding?

a. Internal

b. External

3. What Returns are Appropriate?

4. What is Best Way to Structure the New Investment?

5. How is Property Valued?
6. Potential Income Tax Pitfalls
7. Restructuring of Ownership and Control Depending on Source of Funding
8. Potential Conflicts of Interest
9. Fiduciary Duty of Managing Member or General Partner
10. Will Lender Cooperate? (what concessions may lender provide)?

D. Role of Real Estate Consultant
   1. Provide a Reality Check
   2. Enhance Credibility with Lender
   3. Assist in Developing Pragmatic Options

V. Can Borrower/Lender Cooperation Create a Win Win Situation

A. Terminology
   1. Workout -- Lender is looking to terminate the relationship with Borrower. Lender goal is quicker recovery and higher realization on loan balance to lender
      a. Deed in lieu
      b. Friendly foreclosure
      c. Foreclosure
      d. Traditional pre-packaged bankruptcy
   2. Restructuring -- lender is looking to modify loan to keep relationship with the Borrower

B. Lender Perspective
   1. Relationship with Borrower
   2. Causes of Loan Distress
   3. Analysis of Sale Options and Other Options Cited Above
   4. Impact of Regulatory Pressures and/or Capital Requirements
   5. Role of Loan Officer versus Special Assets Personnel
6. Time Horizon for Ownership of Loan

7. Measure Against Backdrop of Litigation (risks, potential delay, expense)

C. Lender Due Diligence

1. Review Loan Documents and Identify Any Pitfalls (e.g., legal audit)

2. Consider Preference Issues Arising From New Actions to Protect Interest in Collateral

3. Analysis of Nature of Default (payment, covenant, waste) and Document Promptly all Defaults
   a. Are late payment fees and/or default interest enforceable
   b. Is there the need to prevent waste
   c. Was a subordinate lien improperly placed on the Project
   d. Did the Borrower pledge improperly its ownership interests
   e. Were the separateness covenants of the limited liability company violated

4. Analysis of Legal Remedies/Interim Steps
   a. Perfection of assignment of rents
   b. Ability to bring in a receiver
   c. Is there an expiring letter of credit. Note that draw on letter of credit in bankruptcy will not violate the automatic stay

5. Consider Issues Arising From Multiple Lenders

6. Impact of Project Documents
   a. Impact of foreclosure on anchor tenant
   b. Impact of foreclosure on hotel franchise or liquor license
   c. Claims of general contractor or subs in project under development/construction

7. Examination of Condition of Property

8. Update Appraisal. If ordered by Lender’s counsel may be subject to attorney-client privilege
9. Review of Financials For Property and For Any Guarantors

10. Review/Update Title Report and Environmental Reports.

11. Review Correspondence and Possible Claims of Borrower

12. Consider Regulatory and Tax or Accounting Implications of Different Remedies and Potential Restructurings

13. Potential Impact of Borrower’s Tax Situation on Remedies Available to Lender

14. Lender Should Demand all Relevant Information. Insist on full and timely information on all matters that potentially impact on its election of remedies, including a restructuring. Carrot of restructuring should result in a more cooperative Borrower, including any guarantor, to provide:
   a. Timely and current financial condition of Borrower
   b. Timely and current financial condition of guarantors
   c. Explanation of impact of other projects of guarantors on ability to restructure this project
   d. Steps taken by guarantor to work out or restructure projects with other lenders
   e. Explanation of any intrafamily transactions

15. Review Organization Documents of Borrower
   a. Who is authorized to speak for the Borrower?
   b. What consents to a restructuring are needed?

D. Process for Restructuring

1. Pre-Workout Letter
   a. Likely executed while lender is addressing its due diligence issues addressed above
   b. Neutral letter -- settlement discussions

2. Possible Standstill Agreement
   a. Consider if fear that other creditors are demanding additional collateral from guarantors
b. Abstain from litigation

c. Acknowledgment of default, loan has matured

d. Acknowledgement of amount due (principal, accrued interest, late fees, penalties, etc.).

e. Request waiver of claims by Borrower or identification of potential claims

f. All agreements must be reduced to writing before binding

g. Update of representations, warranties and covenants

h. Reaffirmation of guarantees

i. Right of lender to terminate forbearance and to exercise rights and remedies if information provided by Borrower is materially false in a material respect

E. Forbearance/Loan Modification Agreement. Each restructuring should be carefully considered to fit the facts and circumstances of the particular relationship and tailored to maximize the ability to preserve value and to achieve the lender’s exit goals (position for a sale through additional leasing; complete subdivision process and delivery of finished lots; allow time to identify joint venture partner for Borrower, etc.).

1. Extension of Term

2. Reset of Interest Rates: (floors and ceilings; flexibility of lender; prime based or LIBOR based lender)

3. Restructuring of Note (create A/B tranches; reduce principal on a dollar for dollar basis; discount in return for cash paydown)

4. Options With Respect to Fully or Partially Guaranteed Loan

5. Additional Collateral, Cross-Collateralization of other Borrower Projects or Additional Collateral from Affiliates of Borrower or Guarantors

6. Discounted or No Fee Relationship for Services Performed by Borrower/Developer/Operator and/or Affiliates

7. Consider Impact of Participants; Subordinate Debt

8. Consider Impact of Claims By Other Lenders Against Guarantors

9. Legal Terms Should Include:
a. Recitals setting forth key facts particularly if Lender wants to minimize risk of subsequent bankruptcy filing
b. Acknowledgment by Borrower of debt and confirmation of amount owed
c. Acknowledgment by guarantor of liability under guaranty
d. Waiver by Borrower and guarantor of all claims known and unknown
e. Documentation of agreed upon business terms
f. Bankruptcy proofing or further refinements to bankruptcy remote entity structure
g. Other remedies of lender if default (impact of monetary v. non-monetary defaults)
h. Protect against lender liability claims

VI. Conclusion

A. One size does not fit all situations
B. Borrower and Lender must carefully examine and realistically assess legal and business issues
C. Potential workout or restructuring will be measured against worst case scenario -- bankruptcy/lender liability or suit and recovery under guaranty
D. Value to Lender can increase with cooperative Borrower, but . . . .
E. Borrower will negotiate concessions
F. Outside factors (regulatory, accounting or tax consequences) can result in irrational conduct by Borrower, Lender and/or Buyers
G. May we survive this global recession and not as quickly forget as we have in the past the lessons learned regarding careful underwriting and due diligence, more transparency of financial products, better oversight by ratings agencies, and limits on leverage
Attachment A

LOAN PURCHASER DUE DILIGENCE CHECKLIST

1. Loan Agreement
2. Mortgage or deed of trust/UCC financing statements
3. Note
4. Other debt or relationships
   a. Mezzanine Loan
   b. Second deed of trust
   c. Intercreditor Agreement
   d. Participation Agreement
5. Guaranty and any related documents, including financials
6. Assignment of leases and rents
7. Key leases
8. Organizational documents of Borrower
9. Title
10. Survey
11. Appraisal
12. Correspondence with Borrower, including all default notices
13. Environmental reports
14. Zoning letter
15. Litigation search
16. Tax lien search
17. Site visit
18. Solvency of Lender as seller of note