



presents

Distressed Commercial Real Estate Debt: New Opportunities and Legal Risks Strategies for Buying and Selling Loans Facing Default

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

George E. Covucci, Partner, **Arnold & Porter**, Washington, D.C.

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Thursday, March 11, 2010

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Non-Performing Commercial Loans for Sale

Mind the pitfalls if acquiring them.

BY THOMAS O'CONNOR

SINCE 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 2004 and 2007.

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.

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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.

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.

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 deal for a purchaser, whereas a 50 percent discount off of the outstanding balance of a performing loan that is expected to pay off in full is certainly more meaningful.

Representations

Even though the discount from the loan amount of a non-performing loan is not meaningful to a purchaser of non-performing debt, it is certainly meaningful to the seller of that debt for the simple fact that it determines how much money the seller is going to lose in that transaction. Accordingly, and as might be expected, sellers of non-performing debt may most likely view these dispositions as “fire sales” or “as is” transactions in which the seller retains little or no liability after the closing.

The seller’s primary motive in the loan sale is to “cut its losses.” Therefore, unlike in a performing loan sale where it is more reasonable for the purchaser to expect all of the customary representations regarding the loan, the borrower and the underlying property (which representations can be quite lengthy), the purchaser of non-performing debt may have to settle for minimum representations as a tradeoff for the loss being incurred by the seller.

If a purchaser of a non-performing loan is being pressed to accept the bare minimum with respect to the seller’s representations in order to get the deal done (or is looking to bid aggressively for a

non-performing loan and is trying to entice the seller with an offer that is as close to an “as-is” transaction as possible), then such a purchaser should bear in mind that there are still seven basic representations that are necessary to insure that the purchaser receives, in essence, what it is bargaining for.

These representations should 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 loan³ 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.⁴ 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 restructure 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).