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The Buyer's Guide to Distressed Real Estate and Loans: Important Legal and Business Considerations for Buyers of Distressed Real Estate and Loans

Article contributed by:
Charles D. Weiss, Esq. and Douglas M. Flaum, Esq. of McKenna Long & Aldridge LLP

Introduction

Due to the current state of the real estate market, the capital markets, and the overall economy, there are a significant number of distressed real estate projects (Distressed Real Estate) and non-performing or imminently non-performing loans secured directly or indirectly by real estate projects (Distressed Loans), which offer potentially attractive investment opportunities. The number of these opportunities appears to be rising rapidly as evidenced by a 48 percent increase (as measured by unpaid principal balance) in Fitch rated loans transferred to special servicing from the end of 2008 to March 31, 2009.[1] Since many current owners of Distressed Real Estate and Distressed Loans (together, Distressed Assets) do not have the financial means or other resources necessary to continue to own these assets in the current environment, they will be pressured to dispose of such assets on terms that are less than ideal for them. Specifically, foreclosures and take-backs have become increasingly prevalent methods of disposition for Distressed Real Estate, as shown by the 166 percent increase in real estate owned (REO) assets from the end of 2007 to the end of 2008 being held by 28 special servicers ranked by Fitch.[2] Not only is more Distressed Real Estate being acquired by loan holders, but special servicers appear to be increasingly eager to sell their REO assets, as indicated by significant decreases in average and median hold times for selling REO assets. As a result of all the blood in the water, significant pools of capital have been raised with the objective of purchasing Distressed Assets at substantial discounts.

This article reviews important legal and business considerations and due diligence matters that a potential buyer of a Distressed Asset (Buyer) should be aware of when evaluating potential acquisitions involving: (1) Distressed Real Estate being sold by a lender or receiver versus Distressed Real Estate being sold by an owner/operator; and (2) Distressed Loans directly secured by real estate (Mortgage Loans) versus Distressed Loans secured by the ownership interests in an entity in the ownership structure of the real estate (Mezzanine Loans). The scope of this article, however, does not include particular considerations for the acquisition of Distressed Assets in bankruptcy or involving hospitality, health care, or assisted living projects, given the unique considerations relevant to such projects.

Initial Considerations for Distressed Assets

A Buyer of a Distressed Asset must assess its abilities and determine its objectives very early in the process. Does the Buyer have the capability to operate the Distressed Real Estate or to service the Distressed Loan, or will it need to engage third parties to do so? How does the Buyer believe that it can maximize the value of the Distressed Asset? What resources is the Buyer prepared to invest post-acquisition and what is its time horizon? The answers to these and other strategic questions should help guide the Buyer in determining what type of asset to purchase and what strategies to employ, and therefore what considerations and due diligence are most critical for a successful acquisition.

Value and Effectiveness of Representations and Warranties

The Buyer should, of course, try to obtain from the seller as much information and time as is reasonably necessary in order to evaluate the purchase of a Distressed Asset. Undoubtedly, though, in many distress situations there will be significant limitations in the materials and the time that the seller is willing or able to provide, which the Buyer should counteract by obtaining representations and warranties to verify the information provided by the seller and to try to gain comfort that there are no material undisclosed problems regarding the asset. The Buyer should focus on obtaining representations and warranties as to those matters: (1) which are critical to avoiding a materially adverse economic impact, and (2) cannot reasonably be ascertained by other means, such as record searches, third party estoppels, or direct due diligence (all as further described below). Some examples of such critical representations and warranties will include: (1) in the context of a Distressed Loan, or Distressed Real Estate being acquired subject to a loan, the amounts of the outstanding indebtedness (including a breakdown as to principal, interest, fees, etc.) and reserve balances, and the non-existence of any undisclosed loan modifications or material borrower correspondence; and (2) in any Distressed Asset context, the non-existence of undisclosed lease modifications or default notices, notices of noncompliance with building codes, zoning ordinances or environmental regulations, or liability matters (including threatened litigation regarding personal injury or property damage relating to the property).

One very important concept for a Buyer to keep in mind is that representations and warranties are only as valuable as the strength of the party providing them and liable for their breach. If the entity that is providing, and is liable for, the representations is a special purpose entity owning no assets other than the Distressed Asset, then there would be nothing with which to compensate the Buyer if the Buyer later discovered that a representation was false, inaccurate, or incomplete. The same problem exists when the party is insolvent and has little or no resources with which to compensate the Buyer in the event of a breach. Specific wording is also central to the value of representations, as “knowledge” and “materiality” qualifiers can considerably dilute their practical effectiveness given problems of proof. Ultimately, the extent to which a Buyer should pursue and rely upon representations and warranties comes down to a balancing analysis: on one hand, representations and warranties can often be obtained quickly and cheaply without involvement of third parties, however, their utility may be seriously diminished if they are excessively qualified or given by a special purpose entity or an insolvent party; on the other hand, the use of record searches, direct due diligence and third party estoppels offers independence and greater reliability, but can be expensive, time-consuming, difficult to obtain, and may not address many latent problems Buyers must confront.

Buyer Considerations and Due Diligence for Distressed Real Estate

<u>General Considerations and Due Diligence for Distressed Real Estate</u>

A Buyer of Distressed Real Estate must, of course, assess the asset’s current value and the estimated cost and time required to improve the performance of the asset and to resolve any outstanding liability issues affecting the Buyer or the property after the Buyer takes ownership. The value of the Distressed Real Estate should be determined by some combination of third party appraisals, brokers’ opinions, and internal underwriting. For a Buyer to maximize its chances of success, it must determine the key conditions decreasing the project’s current performance or value in order to ascertain if there are actions that the Buyer can take to materially increase its performance. The Buyer should specifically seek to determine whether the asset is not performing chiefly due to mismanagement by the seller, inadequate capitalization for necessary repairs or renovations, ineffective marketing, suboptimal positioning, or general market weakness. To determine this, a Buyer should (as applicable): (1) review current and historical financial statements, and interview property managers, leasing agents, real estate brokers, and other individuals with operational knowledge of the Distressed Real Estate; (2) review any tenant leases, tenant estoppels, rent rolls, and documentation relating to applicable ground leases; (3) for planned unit developments, review all agreements relating to units under contract, relevant homeowners/condominium association documents, and association estoppels or financials to verify the status of association dues and any alleged non-performance; (4) review market reports for the area where the property is located reflecting the supply and demand for the subject property type, the local demographics, and the general financial condition of the area; and (5) conduct appropriate physical inspections of the property. The necessary performance turnaround costs should be evaluated in terms of required funding and timing to, as necessary, reposition, redevelop, rehabilitate, lease up or retenant the property, and replace on-site staff, property managers, leasing agents, and other service providers.

To identify outstanding issues that could cause the Buyer to incur liability after it takes ownership, the Buyer's due diligence should include appropriate record searches and third party reports. Such record searches and third party reports would typically include (as applicable, based on the property type): (1) a comprehensive title search and examination; (2) an as-built survey with appropriate surveyor's certification; (3) Uniform Commercial Code financing statement searches; (4) litigation, judgment, and bankruptcy searches; (5) a Phase I environmental site assessment (with subsequent Phase II evaluations performed as necessary); (6) a construction consultant's report; and (7) engineering and geophysical/soil stability reports. Assessing the asset's environmental compliance is extremely important given the onerous penalties to which owner/operators may be subjected under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980[3] and the Superfund Amendments and Reauthorization Act.[4] In addition, in the case of property not completely developed, appropriate inquiries must be made of all relevant government agencies to ascertain the status of and requirements to obtain all licenses, permits, and other entitlements necessary to develop and/or operate the property as intended. Understanding any problems and issues disclosed in these searches, inquiries, and reports is essential for a Buyer in order to avoid potentially devastating post-closing surprises. Armed with knowledge of such issues, however, a Buyer can seek an appropriate resolution by requiring the seller to rectify such issues, obtaining an appropriate reduction in price, factoring the anticipated resolution cost into the Buyer's business plan, or, if necessary, abandoning the purchase. If a Buyer is interested in acquiring property that is subject to significant liens or other encumbrances that are subordinate to an outstanding mortgage, the Buyer may want to consider, if possible, acquiring the Mortgage Loan (assuming the loan holder currently has, or within Buyer's time horizon will have, the right to foreclose) either in lieu of or in addition to acquiring the property (depending on the loan amount and perceived property value), as a means of extinguishing the subordinate encumbrances through foreclosure.

REO Sale vs. Sale of Distressed Real Estate by Owner/Operator

Whether the Distressed Real Estate is being sold by an owner/operator as opposed to a sale by a lender or receiver will greatly impact the information that is provided to the Buyer and the appropriate balance of direct and/or third party due diligence as compared to reliance on seller disclosures and representations and warranties. If the seller is a lender or receiver who has taken ownership or possession of the property from the owner/operator, then the lender or receiver will usually have limited knowledge of the property. Their information about the operations and performance of the property will typically be derived (1) from the limited (and possibly inaccurate) information provided to the lender during the loan term by the owner/operator, and (2) from the lender's or receiver's direct knowledge of operations during the limited period of time that it has operated the property. If, however, the Distressed Real Estate was conveyed to the lender pursuant to an agreement with the owner/operator, the lender may have obtained more complete information regarding the historical operations of the property and, possibly, representations and warranties from the owner/operator or its principals (which may or may not be reliable). The circumstances of the conveyance of the property to a lender or receiver can certainly alter the representations and information that it is willing and able to provide. In most cases, however, a Buyer will obtain very limited representations and warranties in an REO sale. The Buyer can potentially compensate for these limitations by requesting greater access to the project and a longer period of time to directly conduct due diligence and obtain third party analyses, and by obtaining complete disclosure of all documentation and other information that the lender or receiver has regarding the Distressed Real Estate.

If, on the other hand, the seller is the owner/operator of the Distressed Real Estate, then the seller should be able to provide more detailed and complete information covering a longer time period, as well as comprehensive representations and warranties about the property with a minimum of knowledge and materiality qualifiers, as a result of having substantial direct knowledge of the property. However, because the impetus for the sale by an owner/operator of Distressed Real Estate is often a loan default or imminent loan default or an urgent need to avoid further capital infusion to a non-cash flowing asset, there will likely be significant time pressure to consummate the sale, resulting in less opportunity for direct due diligence of the property by the Seller. Any such reduced opportunity to directly conduct due diligence and obtain third party analyses should be balanced by full and unqualified representations and warranties from the seller, which should be obtainable considering seller's presumptive knowledge of the property. Unfortunately, although Seller's representations and warranties may be more complete, they will in most cases involving Distressed Assets be worth far less than if a lender or receiver (who is typically indemnified by the lender) provides them, unless a party with significant assets would be liable for their breach. Accordingly, if possible, a Buyer should insist on the joinder by a solvent individual or multi-asset entity in the seller's ownership structure to the material representations and warranties in the purchase and sale agreement. Lastly, often times in the context of an owner/operator sale there will be one or more lenders involved that will need to approve either a discounted payoff or "short sale," or an assumption (and presumably, extension and/or modification) of its loan (often conditioned upon, among other things, contribution of new capital by the Buyer), so it is important to determine the position of each lender regarding the sale before too much time is wasted.

Buyer Considerations and Due Diligence for Distressed Loans

Of course, a Buyer of a Distressed Loan must always evaluate the real estate serving directly or indirectly as collateral for the loan as well as the loan itself. The key additional considerations, however, in buying a Distressed Loan are largely determined by the nature and priority of the collateral for the loan (i.e., mortgage (real estate) vs. mezzanine (pledged equity); senior vs. subordinate).

<u>General Considerations and Due Diligence for Distressed Loans</u>

For both Mortgage Loans and Mezzanine Loans, regardless of priority, it is critical for the Buyer to thoroughly review the applicable loan documents (including all modification agreements), servicing records, and underwriting file. The Buyer should: (1) review the required payment terms, including the timing and amounts of required payments and whether any party with assets other than the primary real estate collateral is liable for payments through a payment guaranty; (2) verify the purported collateral for the loan and that the collateral is properly granted to the loan holder; and (3) thoroughly review all remedy exercise provisions to ensure that they are complete, unambiguous, and adequate in scope, and that they are effective and enforceable under applicable state law to achieve their intended purposes. For instance, for properties in states providing for non-judicial foreclosure, the Buyer should ensure that all requirements necessary for a non-judicial foreclosure are complied with, since judicial foreclosures are typically far more expensive and lengthy. The Buyer should also research the public records to confirm that all necessary public recordings and filings have been properly and timely made to achieve perfection and the expected priority of the noteholder's security position. If there are any deposit or securities accounts containing funds or marketable securities intended to serve as additional collateral for the loan, the Buyer should ensure that a satisfactory control agreement from the deposit bank or a securities intermediary (as applicable) has been signed and adequately perfects the loan holder's security position in each such account. The Buyer should also review any "carveout" guaranties to ensure that there are sufficient behavior modification incentives to discourage the borrower from declaring bankruptcy or intentionally taking certain other actions that would harm the loan holder's position. It is important to verify that all material documents have been properly executed, witnessed, and notarized (as necessary under applicable law), and that the noteholder or its document custodian possesses signed original promissory notes, guaranties and other important, off-the-record loan documents (or satisfactory lost instrument affidavits in lieu thereof). A review of the borrower party organizational and authority documents and related legal opinions should be performed to ensure that the loan was properly authorized by the borrower parties. Since it is critical to evaluate the financial strength, background, credibility, and track record of the principals of any Distressed Loan borrower in order to determine the likelihood of their either negotiating and performing under a satisfactory loan restructuring or agreeing to a cooperative (or at least unopposed) take back of the collateral, or alternatively, the likelihood of their commencing adversarial litigation or declaring bankruptcy, it is advisable to conduct a thorough background inquiry using the Buyer's industry contacts, to perform an examination of financial records, tax returns, and on-line search engine results, and, in some cases, to conduct a complete background search through a private investigations firm.

The Buyer should also review all available correspondence between the noteholder and the borrower, and otherwise review the history of the loan, in order to assess any potential argument by the borrower that certain requirements were expressly or impliedly waived by lender or that the loan was modified by oral or informal written agreement or by course of dealing. Examples of acts giving rise to an argument that the loan was modified through the loan holder's course of dealing include its failure to exercise remedies in response to continuing, material defaults by borrower, including repeated acceptance of partial payments or deficient performance of non-monetary covenants (without appropriate written reservations of rights). Additionally, the loan correspondence and history should be reviewed to assess the likelihood of the borrower asserting any lender liability claim, which could arise from, among other things, a lender breaching the loan documents, acting in bad faith,[5] negligently administering a loan, not giving required notices before exercising remedies, meddling in the day-to-day management of the borrower and taking a commanding role in a borrower's business to its ultimate detriment, tortious interference with third parties, and aiding improper conduct by the borrower.[6] The consequences of lender liability can be severe, and can include punitive damages,[7] so it is especially important to be aware of these issues.

<u>Special Buyer Considerations and Due Diligence for Mezzanine Loans</u>

The acquisition of a Mezzanine Loan is more complex and risky than an acquisition of a Mortgage Loan because of the critical structural distinctions of buying equity in an entity one or more tiers above the real estate, as opposed to the actual real estate. The Buyer's primary concerns, aside from the obviously critical determination that the underlying project is worth more than the outstanding balance of any senior mortgage or mezzanine loans, are the relative collateral positions, rights and duties under applicable intercreditor agreements of all such other lenders and the potential liabilities which Buyer effectively assumes by acquiring ownership of equity interests rather than the real estate itself.

In order to assess the competing interests of senior lenders relative to the subject Mezzanine Loan, the Buyer should consider the size and performance of such senior loans, the value of the underlying property, and the identity and reputation of, and any helpful relationships with, such other lenders. If the value of the property is greater than the outstanding balance of such senior loans (as should, of course, always be the case, or else there would be no apparent reason to purchase the applicable Mezzanine Loan), then the senior lenders may have little incentive to modify or extend the terms of their loans instead of foreclosing. Of course, in some cases, even if a senior lender is over secured, it may not want to assume direct or indirect ownership of the real estate, and thus may be willing to modify and/or extend the loan. Accordingly, in order to achieve a successful outcome, the Buyer must ascertain its ability to either (1) perform under all senior loans in accordance with their stated terms for a sufficient period of time to achieve its economic objectives, (2) pay off or purchase such loans, or (3) negotiate satisfactory modification and/or extension terms with such lenders. In addition, the Buyer will want to review all intercreditor agreements to determine its rights and the rights of the other lenders to exercise their respective remedies against the applicable borrowers, cure defaults under the loans, modify the loans, and purchase the other loans. The Buyer should also review all senior loan documents to understand the collateral position and rights of the senior lenders with respect to their borrowers, and all correspondence between the applicable Mezzanine Lender and the senior lenders to understand the history of their dealings.

Additionally, if a Buyer takes ownership of the collateral for a Mezzanine Loan, then its equity interest in the real estate will be subject to all of the contractual and tort-based liabilities of the property owner. Consequently, the Buyer should seek to review whatever project level and entity level information may be available from the seller or other sources in order to become comfortable with the attendant risks. Unfortunately, in most cases, other than matters of public record and other general information obtainable through background searches on the borrower parties, the Buyer will only be able to obtain whatever information may have been disclosed to the seller/mezzanine lender by the borrower parties, which in many cases may be outdated and contain material inaccuracies and omissions and will undoubtedly be backed only by very limited and highly qualified representations and warranties from the mezzanine lender. As a result, a Buyer should consider whether part of its strategy should be to purchase (rather than pay off) the senior Mortgage Loan in order to have the ability, should significant hidden liabilities of the project owner come to light (subsequent to Buyer's acquisition of the Mezzanine Loan), to foreclose the Mortgage Loan and thereby acquire the real estate free and clear of such liabilities. As the efficacy of such a strategy is highly case specific, given the nature of the liabilities, applicable state law, the Mortgage Loan balances, project values, and fraudulent transfer considerations, it should be carefully evaluated with counsel.

One positive note worth mentioning with respect to acquiring Mezzanine Loans as compared to Mortgage Loans is that a Mezzanine Loan foreclosure is non-judicial and is governed by the Uniform Commercial Code, and can typically be accomplished in as little as three to four weeks (assuming the borrower does not file bankruptcy or otherwise seek to enjoin the sale). In contrast, Mortgage Loan foreclosures typically require from six weeks to four months in states that permit non-judicial foreclosure, and six months or longer in judicial foreclosure states (all assuming no borrower interference or bankruptcy).

Charlie Weiss is a senior partner, and Doug Flaum is an associate, in McKenna Long & Aldridge's Real Estate Finance Department, whose practices focus substantially on the representation of institutional and private equity lenders and equity investors and loan servicers in connection with distressed real estate transactions involving commercial and residential projects located throughout the United States. Mr. Weiss and Mr. Flaum can be reached at:

Charles D. Weiss | Partner | Tel: 404.527.8411 | Email: cweiss@mckennalong.com
Douglas M. Flaum | Associate | Tel: 404.527.8569 | Email: dflaum@mckennalong.com
McKenna Long & Aldridge LLP | 303 Peachtree Street | Suite 5300 Atlanta, GA 30308

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[5] *LaSalle Bank Nat'l Ass'n v. Paramount Properties*, 588 F. Supp. 2d 840 (N.D. Ill. 2008).
[6] *In re First Alliance Mortgage Co. v. Lehman Commercial Paper, Inc.*, 471 F.3d 977 (9th Cir. 2006).

[7] *1601 McCarthy Blvd., LLC v. GMAC Commercial Mortgage Co.*, Case No. CGC-03-425848 (Cal. Super. Ct. Jan. 26, 2005).