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DISTRESSED DEBT

To buy or not to buy — that is the question.

William Meehan

Historically, purchasers of distressed debt have been sophisticated investors such as institutional lenders, banks or debt funds. In today's changing market, more and more non-traditional investors are considering purchasing distressed debt to take advantage of unprecedented discount rates being offered by sellers of these assets. Such investors, however, are sometimes confronted with the harsh economic consequences resulting from not completely understanding the assets being purchased and the rights, remedies and limitations associated therewith.

Know what you are buying: Sometimes the buyer of the distressed debt erroneously believes it can acquire fee title to the real property collateral directly from the seller/mortgage lender pre-foreclosure. Rather, by purchasing the note and mortgage documents, the buyer is purchasing a debt instrument secured by the real property for collateral, not the property itself. Although lenders routinely sell property acquired via foreclosure — known as real estate-owned property or REO property — buying the debt itself is a very different transaction, and there can be many obstacles to overcome to ultimately own the property.

Buyer Beware: Unlike an acquisition of real estate, the sale of the debt is almost always made without recourse, representation or warranty from the seller. That noted, it is important to insist on certain basic assurances in the loan-sale agreement, including that the seller owns the debt, that the debt is unencumbered and that the seller is able to transfer the debt. The buyer must also ensure it receives all of the documents, files and reports in the lender's possession or control regarding the loan.

Same Due Diligence: As a general rule, the buyer should perform substantially the same due diligence that it would otherwise conduct if it were buying the real property itself. That means, among other things, reviewing all of the documents delivered by the seller and obtaining an updated (i) appraisal (discussed further below), (ii) title report and survey, (iii) environmental reports, and (iv) bankruptcy, litigation and lien searches. The buyer also needs to understand what impound accounts, escrows, interest reserves, etc., are being held.

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Who's on the Hook? From the beginning, the buyer will need to determine if the loan is recourse, meaning the lender may seek to hold the borrower personally liable or pursue third-party obligors (e.g., guarantors), or is nonrecourse, meaning the sole source of repayment is the collateral. Even if the buyer does not intend to seek such recourse claims, whether or not the loan is recourse (even if only based on a so called "carve-out" guaranty) can materially affect the likelihood of cooperation by the borrower and such third-party obligors.

Know the Documents: An additional level of due diligence for a loan sale is a thorough analysis of the loan documents. Legal deficiencies in the loan documents can, at a minimum, make enforcement of remedies exponentially more expensive and, in a worse-case scenario, result in a total loss. Even some of the popular software products used to document commercial real estate loans have been known to contain defects, both in the boilerplate and the user options, that provide possible defenses.

Credit Files and Smoking Guns: A careful review of what most lenders call the "credit file" is crucial. The buyer needs to be certain that there are no notes or correspondence in the file that are materially inconsistent with the loan documents or its intentions. Key things to look for are notes, emails or other correspondence from the loan officer indicating that the lender will forbear from certain requirements or extend the date of payment or maturity or that the lender will agree to accept a discounted payoff of the loan. The buyer should assume that any offers made by the lender to forebear, accept a discount, etc., will be binding on the buyer.

Appraisals: The buyer must conduct an independent appraisal of the collateral or, at a minimum, obtain a "drive-by" or broker opinion of value. This is true now more than ever as lenders often retain old appraisals that do not adequately reflect the current market value of the property for their own internal reasons. Remember that an appraisal by its nature is a backward-looking assessment of value, so an appraisal that is a year or so old is based not on sales from 1 year ago, but rather on sales from about 18 months to 2 years ago, which bears almost no relation to today's value.

Who's In First? It is critical to confirm the priority of the mortgage. Even if the mortgage is a first priority lien, the mortgage is still generally subject to taxes, certain assessments and other charges. A thorough understanding of exactly what charges and liens are senior to the mortgage is imperative in evaluating whether to purchase the

debt and what price to pay. Unlike a seller of real estate who generally provides clean title to the purchaser (with adjustments at closing for taxes, charges, etc.), for debt sales the buyer simply acquires the seller's position.

What's In Second? On the other hand, what about junior debt? Although a foreclosure will generally wipe out junior liens, there may be subordination agreements that need to be reviewed as, among other things, junior lien holders and mezz lenders — that is, lenders who do not have a lien on real property, but rather a lien on the equity interests in the borrower or a mezzanine position — may cause trouble for the buyer, the borrower and the process, particularly if the goal of the buyer is to effectuate a deed in lieu of foreclosure.

Time is Money: A key part of the analysis in determining the purchase price is how long will the enforcement of remedies process take to complete. The buyer must understand the foreclosure process and the impact of any possible bankruptcy. It is not uncommon for the process, in the same state, to range from as short as a few months to a year or longer. It is also important to understand what steps have been already undertaken in connection with enforcement that could be leveraged to expedite the process or, potentially, cause additional delay.

Being a Lender: Lastly, being a mortgage lender is a very specialized business. Many real estate investors that buy distressed debt echo the same realization — being a lender is not easy. There are a variety of traps for the unwary in this heavily regulated industry, and a lender can suffer draconian consequences for failure to follow the letter of the law. Accordingly, without competent counsel and/or extensive experience, being a lender can present a number of unforeseen adverse consequences.

In sum, purchasing distressed debt can be a very lucrative investment and ultimately provide title to the underlying real estate at a substantial discount over the market price, provided the buyer conducts appropriate due diligence, prices the acquisition appropriately and understands the process.

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Reprinted From *Western Real Estate Business*, May 2010 © 2010 France Publications, Inc.
Atlanta, GA (404) 832-8262. www.WesternREBusiness.com