



# REAL ESTATE LAW & INDUSTRY



## REPORT

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### DISTRESSED ASSETS

## Important Issues in Purchasing and Resolving Distressed Real Estate Debt

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**G**iven the current economic environment, it is no surprise that “distressed debt” has become the favorite catch phrase and a frequent topic of discussion among real estate professionals. For some, this may evoke a sense of déjà vu with respect to the Reso-

lution Trust Corporation transactions and general real estate climate of the early and mid 1990s. However, for many, this is an element of the real estate cycle to which there has been little or no prior exposure. This article explores some of the important issues involved in underwriting, acquiring, working out, enforcing remedies, and liquidating distressed real estate debt.

### Part I: “So You Want to Buy Distressed Debt. . .”

**Things to Consider Before Making a Deal.** As with any transaction, the first step in the acquisition process is to evaluate the asset and identify risks so that an investment decision can be made.

**What Is Being Sold, and by Whom.** There are myriad kinds and sources of distressed real estate debt in today’s market. It is important to understand the applicable distinctions so that underwriting can be tailored appropriately.

*Loan Portfolios vs. Individual Loans; Bids vs. Negotiated Deals*

Loan portfolios must be approached differently than single loan transactions. For example, it may not be practical to engage in a detailed analysis of governing documents, correspondence history, property condition, and status of title when evaluating several hundred loans. Rather, the focus may be on key characteristics of the largest loans in the pool. However, similar review constraints can arise in any situation in which the prospective purchaser does not have the protections of an exclusivity arrangement (*i.e.*, dead deal costs are a con-

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cern) or the time or resources to conduct extensive due diligence investigations (e.g., in a bid situation in which all diligence must be completed prior to submission of the bid, or when the economics of the deal depend upon the closing occurring prior to a fiscal, reporting or other significant deadline). Also, certain large portfolio transactions (and Federal Deposit Insurance Corporation (FDIC) bid situations, in particular) may impose upon potential purchasers forms of agreements to which few comments will be considered (and in some circumstances submitting comments may disqualify a bid). Accordingly, in large loan portfolio transactions (and bid situations, in particular) there may be an emphasis on buying at a steeper discount to account for the increased likelihood of undiscoverable or unknown risks and inability to extensively negotiate.

#### *Commercial Loans vs. Residential Loans*

Besides typically being larger in size, commercial real estate loans are likely to entail more complex documentation and loan structures. In addition, commercial properties by definition involve the operation of certain businesses (whether by one or more tenants or the property owner), which will usually necessitate a much more thorough diligence process. However, residential loans are not without their complications, as consumer protection laws and similar regulatory constraints are likely applicable and their potential impact must be considered during underwriting.

#### *Construction Loans vs. Permanent Loans*

Generally, it is easier to underwrite the acquisition of permanent loans because typically there are no additional disbursement obligations. Depending on the funding conditions applicable to additional construction loan disbursements, though, remaining disbursement obligations may not be of much concern to the prospective purchaser of a loan secured by a troubled project. Moreover, the potential risk associated with additional disbursements may be outweighed by the additional recourse options typically inherent to construction loans. However, partially completed or otherwise troubled construction projects do raise numerous other issues, including costs to complete, repositioning challenges, and potential mechanic's lien issues.

#### *Whole Loans vs. A/B Notes, Participations, and MBS/CDO Interests*

The significant distinctions between whole loans and partial interests relate to control, pricing, and allocation of risk. When acquiring a whole loan, typically the loan purchaser acquires complete servicing authority, the economics are as evidenced by the note, and the purchaser is entitled to all loan receipts (and accordingly assumes all risk of loss with respect to recovery or realization upon the collateral). In other situations, such as acquiring only one of multiple notes or a participation interest, the interest rate may differ from the note (with the "blended" rate of all interest holders equal to the rate under the note<sup>1</sup>), and payments in respect of the

<sup>1</sup> For example, the holder of a \$10,000,000 promissory note that provides for an interest rate of 7.50 percent may agree to sell a 25 percent participation interest in such note at a discount (i.e., for less than \$2,500,000) if the participant agrees to accept a "below-coupon" pay rate on its participation interest (i.e., an interest rate on its \$2,500,000 portion of the principal that is less than the 7.50 percent rate payable thereon under the note); the participant might also agree to such a reduced rate if the holder of the note agrees to subordinate its interest

loan must be allocated among the interest holders (e.g., *pari passu* allocations, senior/subordinate structures, "LIFO" arrangements, etc.). Also, the purchaser may not be able to effectuate a workout or foreclosure without the consent of third parties (e.g., other interest holders, servicers or rating agencies), may have only limited consent rights rather than the ability to take independent actions, or may be constrained by regulatory schemes (e.g., REMIC rules<sup>2</sup>).

#### *Senior Loans vs. Junior/Mezzanine Loans*

A tiered loan structure (whether comprised of multiple liens on the same collateral and/or mortgage and mezzanine loans) raises additional issues.

The purchaser of a senior loan that ultimately desires to acquire the property (by deed-in-lieu or foreclosure) or enter into a workout should be aware that there is another party with a stake in the property that might have competing interests. For example, a junior lender might frustrate workout plans if it has a right to purchase the senior loan or if a material modification of the debt requires its consent (contractually or pursuant to state law). A junior lender might also affect the foreclosure process by exercising a reinstatement right or making a competing bid, or by filing (or being forced into) bankruptcy.

The purchaser of a junior loan should realize that its interest can generally be wiped out by foreclosure of the senior lien<sup>3</sup>, and that repayment of the senior debt may thus be necessary to preserve its investment. Furthermore, if the junior loan is a mezzanine loan, the foreclosure scheme applicable to personal property should be evaluated (in particular, the ambiguous "commercial reasonableness" requirement applicable to UCC foreclosures<sup>4</sup>), as should the possibility that the lender might acquire ownership of a borrower with significant outstanding obligations.

#### *Contractual Constraints: Intercreditor, Participation, and Pooling and Servicing Agreements*

Intercreditor (and Co-Lender) Agreements typically provide the parties (i.e., senior and junior lienholder, multiple noteholders, or mortgage and mezzanine lender) with mutual assurances in respect of their rights and risks inherent to these structures.<sup>5</sup> For example,

in certain note payments to that of the participant, or if the participant is in a "last in first out" (i.e., LIFO) position with respect to principal advances or repayment of principal. Because the weighted average of the parties' respective interests (i.e., the "blended" rate) must equal the note rate of 7.50 percent, if, for example, the parties agree that the participant will receive an interest rate of 6.00 percent on its \$2,500,000 share of the principal, then the holder of the note will have increased its effective rate of interest on its remaining \$7,500,000 share of the principal to 8.00 percent (i.e., [7.5 percent - (6.00 percent x 0.25)] / 0.75).

<sup>2</sup> REMIC is the common abbreviation for "real estate mortgage investment conduit," and describes the elective pass-through tax status on which the special purpose vehicles that hold securitized mortgages (and the investors that hold interests therein) depend for tax efficiency. See 26 U.S.C. §§ 860A-G; 26 C.F.R. §§ 1.860A-G.

<sup>3</sup> See, e.g., Cal. Code Civ. Proc. § 701.630.

<sup>4</sup> See, e.g., Cal. Com. Code § 9610(b).

<sup>5</sup> See, e.g., the "CMSA" form of Intercreditor Agreement (commonly used by mortgage and mezzanine lenders when the mortgage loan is to be securitized because of the rating agencies' familiarity with and credit-neutral view of the same), available at <http://www.cmsaglobal.org/WorkArea/showcontent.aspx?id=10064>.

the junior/mezzanine lender may have a right to cure defaults under the senior/mortgage loan and to purchase the senior/mortgage loan in the event the holder thereof is entitled to exercise remedies, in exchange for an express subordination by the junior/mezzanine lender and restrictions upon the junior/mezzanine lender's ability to exercise remedies and affect the management of the underlying real property. Also, the parties typically agree not to make certain modifications to their respective loans without the consent of the other party. Consequently, any loan workout will likely require the consent and cooperation of each party that holds an interest in each loan relating to the property.

Participation Agreements govern the rights of the parties that hold undivided interests in the underlying loan or note, and describe the economic terms of their arrangement (e.g., *pari passu*, senior/subordinate, "LIFO," etc.). The originating lender often retains general servicing authority for administration of the loan, subject to consent rights in favor of each interest holder for certain fundamental decisions (e.g., modifying the interest rate, payment terms or maturity date, waiving defaults, releasing collateral, or consenting to a transfer of title or change in control).

Pooling and Servicing Agreements are typically utilized in the context of securitized loans, to provide for the servicing of such loans on behalf of the trust that owns them (and ultimately on behalf of the certificate holders that own beneficial interests in the trust). In addition to establishing the obligations of the "master servicer" (e.g., collect payments on the loans and remit payments to the certificate holders in the established order of priority), these agreements also determine when loan servicing is to be transferred to the "special servicer" (who is often related to, or otherwise represents the interests of, the "first loss" interest holders in the securitization) and describe such servicer's authority to resolve distressed loan issues.

#### *Healthy/Capitalized Sellers vs. Failing Banks and the FDIC*

The identity, reputation, and creditworthiness of a transactional counterparty are important considerations. Such characteristics can be helpful in evaluating a party's familiarity with and access to relevant information, usefulness of any remedies against such party, ability to close on a timely basis, propensity for extensive negotiations, and litigiousness. With respect to distressed debt, this is primarily relevant to (i) the scope and utility of the loan seller's representations and warranties (i.e., to the extent the loan seller is willing to provide assurances, can they be trusted as accurate and thus as a supplement or perhaps replacement for due diligence?); (ii) the availability of meaningful remedies against the loan seller in the event of a breach (i.e., are there likely to be resources available to satisfy a judgment for damages if the loan seller fails to close or an assurance turns out to be inaccurate, or to fulfill an obligation to repurchase the loan?); and (iii) the extent to which insolvency and related risks will need to be evaluated.

In situations in which the FDIC is the loan seller, purchasers should be aware of the protections potentially afforded them (as successors-in-interest to the FDIC) by the common law "D'Oench Duhme Doctrine" and the related statutory provisions in the Federal Deposit Insurance Act. Together, this scheme underlies a public policy designed to protect diligent creditors, innocent

depositors, and the taxpayers (who ultimately fund FDIC losses) from bearing the losses that would result if claims and defenses based on agreements that are not properly documented and authorized could be enforced against a failed institution.<sup>6</sup> In this particular context, the protections serve to both maximize liquidation value and expedite the liquidation process, by prohibiting borrowers from asserting defenses or making affirmative claims pursuant to agreements (or alleged agreements) that have not been properly documented.

**Investigating and Underwriting the Deal** In many ways, the acquisition of distressed real estate debt is underwritten similar to a loan origination. However, some aspects of property acquisition diligence are often applicable, and an appreciation of the risks and issues unique to acquiring, working out, and liquidating distressed debt is essential.

#### *Due Diligence on Property Operations, Loan Documents, Borrower Parties, and Loan History*

Diligence will of course focus on the underlying property, from which the value of the debt is ultimately derived, and the documentation and terms of the loan. The governing loan documents will need to be carefully reviewed to determine (among other things) the financial terms of the loan, the parties' ongoing obligations, and the lender's remedies upon default. And in a distressed loan situation, it is particularly important to evaluate the extent to which the lender may have recourse against a financially viable person or entity. Given the prevalence of SPE (i.e., "special purpose entity" or single asset entity) borrowers, this recourse will most often be against a guarantor under payment, completion and/or non-recourse carve-out (e.g., "bad boy") guaranties. Other characteristics of the borrower parties should also be considered. What is their level of experience—are they capable of salvaging the project if given the chance? What is their reputation—are they known for being particularly litigious?

It is also important to understand the loan history, which may affect the approach to diligence, documentation, and strategy for resolution, and by which a purchasing lender will likely be bound. Is the loan "distressed" because the lender is in trouble, rather than by reason of the borrower's failure to perform? For example, if a construction lender has failed or refused to disburse funds, the borrower might have a lender liability claim. Has the loan been non-performing since origination, and if so and the loan is a residential loan might there be potential liability for predatory lending?<sup>7</sup> Have

<sup>6</sup> The federal common law "D'Oench Duhme Doctrine" is derived from *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942), and the related statutory provisions are at 12 U.S.C. §§ 1821(d)(9)(A), 1823(e). See also Federal Deposit Insurance Corporation: Statement of Policy Regarding Federal Common Law and Statutory Provisions Protecting FDIC, as Receiver or Corporate Liquidator, Against Unrecorded Agreements or Arrangements of a Depository Institution Prior to Receivership, available at <http://www.fdic.gov/regulations/laws/rules/5000-4300.html>; Jason Kellogg, Comment, *D'Oench Lives, But For How Long?: The Eleventh Circuit Breathes Life Into an Ailing Banking Doctrine*, 30 Fla. St. U. L. Rev. 167 (2002), available at <http://www.law.fsu.edu/Journals/lawreview/downloads/295/kellogg.pdf>.

<sup>7</sup> General information regarding predatory lending is available from the Mortgage Bankers Association's website. See, e.g., <http://www.mortgagebankers.org/IndustryResources/>

defaults been waived, either expressly or by course of conduct; or were promises made or assurances given to the borrower regarding forbearance or future funding, formally or informally? While it is likely that the loan documents will provide that actions of this nature must be in writing and appropriately executed on behalf of the lender, it is nonetheless important to assess whether the loan purchaser may be inheriting a potential argument on these issues. (However, to the extent the FDIC is involved in the transaction, the D'Oench Duhme Doctrine may be applicable in these regards.) Depending on the circumstances, it may be possible to obtain an estoppel from the borrower regarding the terms and status of the loan.

#### *Known and Unknown Risks*

In addition to the typical risks to which a lender is exposed (e.g., the borrower's failure to pay, environmental liability, mechanic's liens and tax liens), the purchaser of distressed debt should typically also evaluate the risks that a property owner would scrutinize. This is because the purchaser might eventually succeed to ownership of the property and have to market the property for resale. For example, such diligence might address zoning and other regulatory compliance, costs to complete construction, property "carrying costs," disputes with neighbors, and potential tort claims. Similarly, because of the likelihood of a workout or foreclosure, it is particularly important to ascertain whether the property (or borrower) is subject to any liens other than the subject mortgage, which other interests might present complications (e.g., in respect of maintaining priority following a loan modification, or in connection with the bankruptcy of a junior lienholder).

Legal requirements, uncertainties and associated risks of owning distressed debt should also be considered. For example, in California, it seems clear that a usury-exempt loan will retain such characteristic following transfers of the loan (regardless of whether the transferee is an exempt lender).<sup>8</sup> However, it is not clear whether a usury-exempt loan may lose the benefit of such exemption if, in connection with a workout, a non-exempt transferee subsequently modifies the loan to provide for a higher, usurious interest rate.<sup>9</sup>

Similarly, in certain circumstances the acquisition of an interest in a loan might necessitate appropriate licensing. For example, in California, a finance lender's license is generally required for those engaged in the

business of making consumer or commercial loans.<sup>10</sup> There are exemptions for (among other things) banks and mortgage loans arranged by a licensed real estate broker, and for those who make no more than one commercial loan in any 12-month period.<sup>11</sup> However, given the strong policy considerations underlying the California Finance Lenders Law, it is not clear whether licensing would be required in connection with the modification of multiple loans, or the acquisition of a pool of construction loans that contemplate additional advances by the lender.<sup>12</sup>

#### *Potential Pitfalls: Communications with the Borrower and Uncooperative Third Parties*

Some parties will only approach a distressed loan to acquire the debt. Others may consider such an acquisition in connection with or as a possible alternative to an equity investment in or the acquisition of the property. In any event, there should not be any communication with the borrower regarding a transaction unless and until the borrower has executed a Pre-Negotiation Letter and the existing lender has provided its written consent (which many loan sellers will refuse to do). Occasionally, a potential loan purchaser might also hold an ownership interest in the borrower (e.g., a capital partner might have the opportunity to salvage a struggling investment by buying the debt at a significant discount). In such case, the prospective purchaser should require that the Pre-Negotiation Letter be executed by the borrower and all of its owners (and any guarantors or other parties obligated under the loan documents), and contain (i) a waiver of any conflicts presented by such party's acquisition of the debt, and (ii) each such party's agreement that such affiliation shall not restrict the purchaser's right to exercise remedies under the loan in the same manner as a third party lender (or limit the purchaser's, or if applicable any affiliate's, rights or remedies under the documents governing the relationship among the borrower's owners). Without a Pre-Negotiation Letter, there are a host of claims to which a potential purchaser or investor may be exposed, such as fraud (if information is delivered under false pretenses, like the promise of an equity deal with the borrower), promissory estoppel (if an alternative opportunity is ignored), and tortious interference.

There are several other parties from whom assurances, concessions, or approvals may be necessary or desired (e.g., tenants, other lenders or interest holders, ground lessors, governmental agencies, service providers, servicers, and rating agencies). And often there is little or no incentive for such parties to cooperate with a potential loan purchaser. It is important to underwrite the possibility (or likelihood) that such parties will be uncooperative, and to anticipate resistance to conditioning the loan acquisition on cooperation from such parties.

#### *Workout/Modification and Foreclosure/Deed-In-Lieu Concerns*

<sup>10</sup> See Cal. Fin. Code §§ 22000 et seq.

<sup>11</sup> See Cal. Fin. Code §§ 22050, 22057.

<sup>12</sup> See, e.g., *Brack v. Omni Loan Company, Ltd.*, 164 Cal.App.4th 1312 (2008) (finding that the provisions of the California Finance Lenders Law are fundamental and unwaivable, and accordingly invalidating a choice of law provision under which Nevada law was to govern a loan made in California by a Nevada corporation to a nonresident member of the military stationed at Camp Pendleton).

ResourceCenters/PredatoryLendingWebLinks.htm; <http://www.mortgagebankers.org/IndustryResources/ResourceCenters/PredatoryLending>.

<sup>8</sup> See California Constitution, Article XV, § 1. See also, e.g., *Strike v. Trans-West Discount Corp.*, 92 Cal.App.3rd 735 (1979).

<sup>9</sup> See, e.g., *Ghirardo v. Antonioli*, 8 Cal.4th 791 (1994) (holding that a modification by the initial lender's successor in interest retained its original "time price" [i.e., credit sale, or seller financing] exemption, on the theory that the lender could have foreclosed and then sold the property back to the borrower subject to seller financing and thereby achieved the benefit of the initial exemption). But see, *Ghirardo* ("[I]n response to the unmistakable legislative intent of the people, courts must be vigilant to pierce the veil of any transaction that in effect results in a loan or forbearance at an interest rate exceeding the legal maximum. I would apply the principle even when a forbearance extends a loan that was originally exempt from the usury law, and even if the parties did not set out to violate the usury law.") (Mosk, J., dissenting).

Many aspects of the workout/modification and foreclosure/deed-in-lieu processes should be taken into account during underwriting; Part III below addresses some of these issues.

## **PART II: “So You Still Want to Buy Distressed Debt. . .”**

**Things to Consider in Documenting—and Closing—the Deal.** Like any transaction, once the decision has been made to proceed with the investment, the logistics of the deal and risk allocations must be negotiated and memorialized.

**Important Deliverables.** In distressed real estate debt transactions, it is particularly important to obtain all relevant underlying documents and properly document the agreements of the transactional parties and of third parties.

### *Assignments, Original Loan Documents and the Loan File*

A loan purchase is typically governed by a Loan Purchase Agreement, which will include concepts similar to those in an agreement for the purchase of real property, but with revisions to account for the fact that a loan (and not real property) is being sold and that the selling lender does not own the property and likely cannot provide access to the property absent the cooperation of the borrower. The following instruments typically effectuate the purchase: (i) Endorsement (or Allonge) to Promissory Note; (ii) Assignment of Recorded Instruments (e.g., the Deed of Trust/Mortgage and the Assignment of Leases and Rents); (iii) General Assignment (with respect to all of the loan seller’s right, title and interest in the loan and related documents); (iv) UCC-3s (with respect to the personal property filings); and (v) Notices to relevant parties (e.g., borrower parties, tenants, servicers, rating agencies, cash management banks, and other lenders). Ideally, the loan seller can deliver the original loan documents, as well as all correspondence and all non-proprietary materials relating to the loan. In any event, all right, title and interest to the same should be assigned to the loan purchaser pursuant to the General Assignment noted above.

Of particular importance is delivery of the original promissory note (endorsed to the loan purchaser). Assuming that the note is a negotiable instrument (e.g., is it payable “to order?”),<sup>13</sup> as a “holder in due course” (similar to a bona fide purchaser), a party that acquires an original negotiable instrument without knowledge of “personal” defenses to the collection of the debt (e.g., lack of consideration or delivery, or “fraud in the inducement”; as opposed to incapacity, duress, discharge, or “fraud in the factum”) or other claims of ownership of the note takes free from such defenses and claims.<sup>14</sup> In the event the original note has been lost or destroyed, an affidavit to such effect and indemnity in these regards from a creditworthy entity may suffice in its stead. However, if the closing of the loan acquisition is not conditioned upon delivery of the origi-

nal note, then the purchaser should negotiate an acceptable form of lost note affidavit and indemnity prior to entering into the purchase agreement.

### *Lender’s Title Policy and Date-Down/Assignment Endorsement*

The originating lender’s title policy should inure to the benefit of the loan purchaser. Nonetheless, for assurances regarding modifications to the loan, or the lack thereof, and the current status of title (keeping in mind that junior encumbrances can be problematic), it is recommended that a loan purchaser receive (and institutions and other sophisticated parties typically require) coverage from a reputable title insurance company to such effect. Such title coverage may also ensure that the beneficial interest under the deed of trust or mortgage has been assigned to the loan purchaser, and that priority of the encumbrance (as modified, if applicable) is as expected.<sup>15</sup>

### *Estoppels and Consents*

As noted above, third parties are likely to be relevant to distressed debt acquisitions. Estoppels and consents can be an effective way to confirm and supplement underwriting and diligence assumptions. Indeed, delivery of particularly significant estoppels and receipt of required consents may be closing conditions, though typically loan sellers will resist conditioning the closing on receipt of estoppels.

**Representations and Warranties and Related Remedies.** Although representations and warranties are often a vital component of a distressed loan acquisition, they are only as good as the party backing them up and the remedies available in the event of a breach.

### *Assurances Regarding the Loan and the Property*

Typically, the loan seller should represent and warrant, among other things, that (i) it owns the loan free and clear, (ii) the loan was enforceable at closing and it has not taken any actions that would render the loan unenforceable, (iii) the loan is evidenced and secured by certain scheduled documents and such documents have not been amended, (iv) the loan file is true and complete and contains all material information relating to the loan, (v) the outstanding loan balance and the components thereof are as scheduled, (vi) if applicable, the loan has been fully funded, and (vii) the loan is current and no party is in default, except as may be specifically identified. The loan seller may also be asked to represent and warrant that the loan file does not include any waivers in respect of the loan documents. Of course, to the extent any of the foregoing are untrue, appropriate qualifications should be described in detail.

However, most loan sellers will resist making many representations or warranties regarding the property. A compromise position can often be reached with representations and warranties that, to the loan seller’s knowledge, the loan file contains all material information relating to the property within the loan seller’s possession, and there are no problematic conditions affecting the property except as disclosed in the loan file. Loan purchasers may wish to clarify that material infor-

<sup>13</sup> See, e.g., Cal. Com. Code §§ 1201(b)(21)(A) (defining “holder” with respect to negotiable instruments), 3104 (defining “negotiable instrument”).

<sup>14</sup> See, e.g., Cal. Com. Code § 3302 (defining “holder in due course”, in part with reference to §§ 3305-6, which describe certain defenses and claims, knowledge of which will preclude holder in due course status).

<sup>15</sup> See, e.g., ALTA Loan Policy of Title Insurance (6/17/06) and ALTA 10.1-06 Endorsement, available at <http://www.alta.org/forms>; cf. ALTA 10-06 Endorsement. See also CLTA 104.13 Endorsement, available at <http://ul.firstam.com/default.aspx>; cf. CLTA 104, 104.1, 104.8, 104.10 and 104.12 Endorsements.

mation includes notices regarding litigation, environmental or regulatory violations, condemnation, or casualty.

Depending on the nature of the sale, the loan seller may be unwilling or unable to provide most or all of these representations and warranties (e.g., when purchasing from the FDIC as receiver for a failed bank).

#### *Assurances and Concerns Relating to the Loan Seller's Solvency*

In contrast to a real property sale, there is no readily available insurance coverage to protect against the risk of a loan sale being affected by the post-closing insolvency or failure of the loan seller. The loan seller might represent and warrant that it is receiving fair consideration for the loan and is solvent, and that the loan sale will not render it insolvent; however, absent a guaranty along these lines from a creditworthy affiliate (which loan sellers are likely to strongly oppose), there does not seem to be much practical value to such assurances. Also, if the loan seller has requested that a deposit be released to it prior to closing, such deposit might be at risk if the loan seller becomes insolvent or fails while the loan purchase agreement is executory (i.e., after execution and prior to the closing). Loan purchasers should consult with bankruptcy counsel regarding these risks prior to entering into a binding purchase agreement.

#### *Damages vs. Put-Back Right as Remedy for Loan Seller's Breach of Representations and Warranties*

Loan sellers are often interested in making a clean break from their troubled loans, and want to avoid the possibility of future liability (or a fight over alleged liability) for damages arising from breach of a representation or warranty. Accordingly, in addition to limiting the scope and survival of their representations and warranties, some loan sellers may seek to limit the remedies for a breach thereof to a right to "put" the loan back to the loan seller under certain circumstances (such circumstances are often a heavily negotiated point). The FDIC may even go one step further, by not actually making representations and warranties but rather simply conditioning the exercise of the put right upon certain assumptions (with respect to matters typically represented and warranted) being untrue.

The repurchase price (i.e., its relation to the initial purchase price) can also be a contentious issue. For example, should it be reduced by payments received by the purchaser while it holds the loan (and by all payments or only principal payments)? And should it be increased by additional advances made, to reimburse the buyer's diligence costs or to account for the buyer's cost of funds during such period?

In any case, it is important to understand the position of the party that is making the representations and warranties and, similarly, to evaluate its (and any other responsible parties') creditworthiness. In some situations, a guaranty, holdback or escrow may be appropriate to ensure that the responsible parties can satisfy their liabilities in these regards, though in practice sellers seldom agree to such an arrangement.

### **PART III: "So You Have Purchased Distressed Debt. . . Now What?"**

**Things to Consider as the Holder of Distressed Debt.** There is often pressure to complete distressed loan acquisitions quickly, and to then dive right into the workout and foreclosure processes. Indeed, an investor's

ability to realize its desired return will likely depend upon the prompt repositioning or disposition of the asset(s). Success in this regard, especially for loan pool acquisitions, is enhanced by a framework for efficient, regular interaction among principals, asset managers, counsel, and other service providers (e.g., title agents, brokers and consultants), with established reporting requirements and centralized electronic data management.

**Issues Related to Working Out the Loan.** In some cases, a non-performing loan may be acquired with the intent to immediately foreclose; often, though, it is in the mutual interest of the borrower and the lender to attempt to achieve a workout of the loan.

#### *Pre-Negotiation Letters as a Condition to Discussing a Workout*

As discussed above, Pre-Negotiation Letters are important for establishing a framework for discussions that minimizes exposure to lender liability claims and misunderstandings between the parties. The Pre-Negotiation Letter should acknowledge that the lender is not under any obligation to agree to a forbearance or modification, that the borrower will not forego other opportunities during the workout negotiations, and that only a definitive written agreement (as opposed to discussions) will bind the parties; depending on the circumstances, it may also be appropriate to ratify the status quo (e.g., that the borrower is in default). Most borrowers will recognize the importance and utility of a Pre-Negotiation Letter and quickly agree to reasonably requested terms, so that the parties can move on to addressing the substance of the workout.

#### *Provisional Remedies (Receivership, Injunction, and Attachment)*

To avoid the liability and other issues that can arise from being a "mortgagee-in-possession", a receivership is often sought following a loan default to preserve the value of the property if the borrower is (intentionally or negligently) failing to maintain and adequately operate the property and/or to properly use any rents or proceeds from the property (e.g., to pay taxes or make payments on the loan).<sup>16</sup> Of course, receivers do not work for free, and borrowers may resist attempts to divest their control of the property and cash. An injunction complements the receivership process, by enjoining the borrower from diverting rents (and causing or permitting damage to the collateral) pending implementation of the receivership and, thereafter, from interfering with the receivership. A writ of attachment against the borrower's non-collateral assets may be available if the value of the collateral has declined since the loan was originated.<sup>17</sup> However, an attachment can have adverse consequences under California's "one action rule", and thus in states like California any attachment must be

<sup>16</sup> See, e.g., *Johns v. Moore*, 168 Cal.App.2d 709 (1959) (acknowledging that a mortgagee-in-possession is a fiduciary of the borrower and junior lienors and must manage the property as would any prudent owner or trustee, and finding that a mortgagee-in-possession could be held liable for failure to use reasonable diligence, or for fraud, gross negligence or willful default). See, e.g., Cal. Code Civ. Proc. §§ 564(b), 568 (authorizing, for the benefit of a secured lender, the court appointment of a receiver with power to take possession of the property, receive rents and collect debts).

<sup>17</sup> See, e.g., Cal. Code Civ. Proc. § 483.010.

evaluated in that context (see “Anti-Deficiency/One Action Rule Risks” below).

*Forbearance Agreements (and Evaluating Leverage in a Default Situation)*

Lenders may be willing to agree to forbear from exercising remedies for a period of time to allow distressed borrowers an opportunity to refinance, restructure or otherwise salvage their projects and return to good standing, or to facilitate coordination of a loan modification, discounted payoff, deed-in-lieu or friendly foreclosure. In contrast to the Pre-Negotiation Letter, the Forbearance Agreement represents an opportunity to demand representations and warranties, a release and similar concessions from the borrower and each guarantor (e.g., confirmations that the loan documents are valid and in full force and effect, of accrued and unpaid interest, including default interest, and of the absence of defenses or claims for offsets). It is also common for such agreements to restate many of the protective concepts contained in the Pre-Negotiation Letter.

In determining how to proceed in a forbearance situation, there are also factors beyond the borrower’s breach that should be considered in evaluating the lender’s leverage. For example, while a delay in proceeding with foreclosure might seem to favor the borrower, such a delay might actually exert pressure on the borrower by reason of ongoing property level expenses. Similarly, the lender’s declaration of an event of default might trigger a cross-default provision applicable to a guarantor, and using such circumstance for leverage may be more productive than declaring an event of default.

*Loan Modifications, Date-Down/Modification Endorsement, and Maintaining Priority*

The lender may agree to temporary reductions or deferrals of payment obligations, or to more significant modifications to the loan terms (e.g., an extension of the maturity date or revised amortization schedule). Such concessions may be conditioned upon the borrower’s agreement to pay modification or other fees to the lender, provide additional collateral for the loan, or otherwise enhance the value of the debt to the lender. These modifications are typically effectuated by a comprehensive modification agreement and by ancillary amendment documents (for example, to provide notice that the loan documents of record have been amended by the modification agreement, without disclosing the sensitive economic terms of the arrangement).

However, given the likelihood that a troubled borrower may incur additional debt and grant junior liens in efforts to stay afloat, or may have failed to pay certain parties who have the ability to place liens on the property (e.g., tax authorities or materialmen), it is important to recognize that material modifications may not enjoy the same priority as the initial obligation.<sup>18</sup> In

<sup>18</sup> See, e.g., Restatement (Third) of Property (Mortgages) § 7.3(b) (“If a senior mortgage or the obligation it secures is modified by the parties, the mortgage as modified retains priority as against junior interests in the real estate, except to the extent that the modification is materially prejudicial to the holders of such interests and is not within the scope of a reservation of right to modify”); *Lennar Northeast Partners v. Buice*, 49 Cal.App.4th 1576 (1996) (holding that a senior loan modification providing for additional advances prejudiced the junior lender’s security, and that equity warranted subordinating such additional advances to the lien of the junior lender). But see, *Friery v. Sutter Buttes Savings Bank*, 61 Cal.App.4th

this regard, the lender should request (and institutions and other sophisticated parties typically require) coverage from a reputable title insurance company to the effect that the priority of the security instrument remains as expected, though such coverage may require consent from each junior lienholder. Such coverage is provided by the CLTA 110.5 title endorsement<sup>19</sup>, which also ensures that the property continues to be secured by the debt (as amended) and that no new encumbrances affect title. In any event, consideration should be given to seeking each junior lienholder’s consent to significant modifications.

*Discounted Payoffs (DPOs)*

If a distressed loan has been purchased at a significant discount, the new holder of the loan may be willing to accept a discounted payoff of the loan by the borrower. Understandably, borrowers are often committed to retaining ownership of their properties, and a discounted payoff provides the opportunity for borrowers (who may owe more than their properties are worth) to maintain ownership and, if applicable, continue development of their properties. For the lender, a discounted payoff eliminates the time, expense and associated uncertainties of attempting to workout the debt and/or foreclosing and disposing of the asset as a real estate owned (REO) property.

*Tax Consequences of Loan Modifications and DPOs*

Lenders should be aware that a “significant modification” of a debt instrument (e.g., changes in yield, changes in timing/amount of payments, changes in the obligor if the debt is recourse, and changes in security, guarantees or other credit enhancements) will be treated as a taxable exchange of the initial instrument for a new one. In such event, the lender will recognize gain or loss equal to the difference between the “issue price” (i.e., deemed principal amount) of the new debt and its adjusted basis in the initial debt. A similar analysis applies in the event the lender agrees to accept a discounted payoff of the loan. The potential exposure to taxable gain is particularly significant if the loan was purchased at a discount (because such discount likely equates to a low basis in the initial debt for the loan purchaser).

However, in order to reach a mutually acceptable workout, it is also important to understand the borrower’s potential tax exposure by reason of the sale or exchange treatment that might arise from a modification, or the cancellation of indebtedness income that would be triggered by a discounted payoff of the loan. Furthermore, each partner or member of a pass-through entity

869 (1998) (rejecting the junior lender’s request for reversal of priority as a remedy for the senior lender’s agreement to a workout that advanced the senior loan’s maturity date by nearly five years; narrowly construing *Gluskin v. Atlantic Savings & Loan Assn.*, 32 Cal.App.3d 307 (1973) in finding that, generally, senior lenders do not have a duty to protect the security or interests of junior lenders; and acknowledging *Middlebrook-Anderson Co. v. Southwest Savings & Loan Assn.*, 18 Cal.App.3d 1023 (1971) and *Gluskin* in support of the concept that total reversal of priority or equivalent monetary relief may be an appropriate remedy for harm of this sort to a seller who has subordinated its seller financing to the purchaser’s construction loan). See also *Handy v. Gordon*, 65 Cal.2d 578 (1967) (describing the requisite degrees of definitiveness and specificity for enforceable subordination agreements).

<sup>19</sup> See, e.g., CLTA 110.5 Endorsement; cf. ALTA 11-06 Endorsement and CLTA 110.4, 110.10 and 110.11 Endorsements.

may have different exposure to this tax liability, thereby creating a potential source of tension among the beneficial owners of a borrower.

Tax professionals should be consulted in connection with any potentially significant modification to or discounted payoff of a loan for a complete analysis of these issues.

*Potential Complications: Third Parties and Binding All Parties*

A workout may require the consent or cooperation of third parties, who may or may not have common interests. For example, a tenant might welcome a change in ownership (and management), but each party's relative leverage will depend on the circumstances (e.g., is the tenant's interest subordinate, has it agreed to attorn, and is its current rent above or below market?). In contrast, the various parties in the capital stack may have adverse interests, with the "first loss" party likely to favor a workout and the most secured party likely to push for immediate foreclosure and repayment of its loan (or interest). Also, to ensure that all relevant parties are bound by any modifications to the terms of the loan, and that any guarantors are not released by reason of such modifications, it is important for all obligors to execute all modification documents and for all guarantors to execute an affirmation of the guaranteed obligations (as so modified).<sup>20</sup>

**Issues Related to Foreclosures, Deeds-In-Lieu, and REO and Loan Sales.** It is important to understand the various liquidation strategies and remedies applicable to distressed real estate debt, and how to avoid the associated risks.

*Real Property Foreclosure Process and Issues, and Credit Bid Issues*

Local counsel should be consulted regarding applicable foreclosure procedures and timing, since the foreclosure process is different in each state. There are two methods of foreclosure in California, which may be pursued concurrently<sup>21</sup>, though only one process may ultimately be consummated: judicial (i.e., a court-ordered sheriff's sale further to court-issued decree of foreclosure) and non-judicial (i.e., a trustee's sale further to the power of sale in the deed of trust). In relation to the non-judicial foreclosure process (which can be completed in approximately 120 days for non-residential properties), the judicial process can be lengthy, costly and adversarial.<sup>22</sup> But judicial foreclosure may preserve the right to a deficiency judgment against the borrower (which, even if the borrower is an SPE, can be important if there may be claims against the borrower or its owners for fraudulent distributions) and minimize the risk of process-related lender liability claims.<sup>23</sup> If non-judicial foreclosure is pursued, it is imperative that the process prescribed by statute (e.g., regarding filings, notice parties and time periods) is adhered to, and a Trustee's Sale Guaranty from a reputable title insur-

ance company can provide valuable assurances with respect to such process.

Generally, it is rare for third parties to bid at commercial property foreclosures; however, guarantors and junior lienholders may participate in an effort to protect their interests. The absence of third parties may be a result of opportunists preferring to purchase REO property from banks, which provides an opportunity for diligence. It is also likely a function of the practical difficulties of financing such a purchase (e.g., in California, the requirement that the purchase be quickly consummated by delivery of cash, a cashier's check or, in the context of non-judicial foreclosures, a "cash equivalent"<sup>24</sup>), and the related difficulties in obtaining an adequate owner's policy of title insurance effective as of such a purchase. In comparison, the foreclosing lender is able to credit bid in an amount equal to all or a portion of the secured obligation.

For those lenders that find themselves in a credit bid situation, the following considerations are relevant: (i) in determining whether to outbid a third party, a lender should take into account the present value of the above-described known and unknown risks and costs associated with being the highest bidder and acquiring the property; (ii) before placing a full credit bid in satisfaction of the full indebtedness, the lender should consider whether doing so might preclude pursuit of other security (such other security might include rents held by a receiver, insurance and condemnation proceeds, personal property and guaranties); (iii) in calculating an appropriate bid amount, the lender should consult tax counsel regarding the potential tax consequences of being the successful bidder at such amount (see "Tax Consequences of Foreclosures and Deeds-In-Lieu" below); and (iv) if the successful credit bid is significantly less than the fair market value of the property, then the foreclosure sale may be at risk of being set aside as a fraudulent transfer. Other factors to consider include (i) redemption rights that may be triggered by the bid amount (see "Reinstatement Rights" and "Redemption Rights" below), (ii) claims against the borrower that might be waived with a full credit bid (e.g., for waste, fraud or fraudulent transfers to the owners of the borrower), and (iii) any cross-collateralization of the underlying debt.

*Mezzanine Loan Foreclosure Issues*

Mezzanine/UCC foreclosure is complicated and (as with any debt) care should be taken and counsel consulted before taking any remedial actions following an event of default.<sup>25</sup> The following are among the issues that should be considered: (i) whether the collateral is a "general intangible" or a "security" for purposes of the UCC (i.e., has the issuer opted to treat interests therein as "investment property" under Article 8 of the UCC?), and if the latter whether the interests have been certificated<sup>26</sup>; (ii) whether there are applicable intercreditor or other contractual restrictions (e.g., can the interests only be transferred to a "qualified transferee", and is

<sup>20</sup> See, e.g., Cal. Civ. Code § 2819 (providing that a surety is exonerated if the lender alters the original obligation or impairs its rights against the borrower).

<sup>21</sup> See, e.g., *McDonald v. Smoke Creek Live Stock Co.*, 209 Cal. 231 (1930); *Flack v. Boland*, 11 Cal.2d 103 (1938).

<sup>22</sup> See Cal. Civ. Code § 2924 (regarding the non-judicial foreclosure process).

<sup>23</sup> See Cal. Code Civ. Proc. §§ 580b, 580d (prohibiting deficiency judgments in certain circumstances).

<sup>24</sup> See, e.g., Cal. Code Civ. Proc. § 701.590; Cal. Civ. Code § 2924h.

<sup>25</sup> See, e.g., Cal. Com. Code §§ 9601 et seq.

<sup>26</sup> See, e.g., Cal. Com. Code §§ 8102(a)(15), 9102(a)(42), 9102(a)(49) (defining "security", "general intangible" and "investment property", respectively); Cal. Com. Code §§ 9301 et seq. (regarding perfection and priority of certain security interests).

rating agency approval required?); (iii) whether all right, title and interest in the collateral has been pledged and advance consent to the transferee's admission as a member or partner has been provided (e.g., will enforcement only result in a charging order on the borrower's economic interest?)<sup>27</sup>; (iv) the requirement that all aspects of a UCC foreclosure be commercially reasonable<sup>28</sup>; (v) the potential application of federal or state securities laws in the event the interests being marketed constitute unregistered securities for purposes of such laws; and (vi) liabilities of the mortgage borrower for which the mezzanine lender may become responsible or subject to upon its acquisition of ownership of the mortgage borrower.

#### *Deeds-In-Lieu: Fraudulent Conveyance and Title Coverage Issues*

Any transfer of property is subject to attack (by the transferor's creditors or bankruptcy estate) as a fraudulent transfer if made for less than fair consideration, or if the transferor is insolvent at the time of the transfer or becomes insolvent as a result of the transfer, on the theory that such a transfer disadvantages the transferor's creditors. Both the Uniform Fraudulent Transfer Act (as adopted in most states) and federal bankruptcy laws provide a basis for such a claim, and deed-in-lieu transactions are particularly vulnerable in this regard because the underlying concept is that the borrower cannot repay the debt (which suggests that the borrower is insolvent).<sup>29</sup> One way to address the risk of a conveyance being attacked as a fraudulent transfer is to obtain creditors' rights title coverage by way of endorsement to the new owner's policy issued to the transferee, if available in the applicable jurisdiction.<sup>30</sup> However, title companies may not be willing to insure this risk in the context of a deed-in-lieu conveyance to the lender. Such coverage will be particularly difficult to secure if the borrower is not an SPE (and is thus likely to have other significant creditors) and the property is not significantly underwater, though in many cases the lender may be able to secure a title company's commitment (by way of a binder) to provide such coverage to a bona fide purchaser that subsequently acquires the property from the lender. In any event, prior to accepting a deed-in-lieu, lenders should generally (for their own benefit, and to increase the chance of obtaining creditors' rights title coverage) obtain a third party appraisal of the property, and an estoppel from the borrower confirming the appraised amount of the

property and that the deed-in-lieu is intended to be a true conveyance of the property and not a disguised mortgage. Bankruptcy counsel should be consulted in deed-in-lieu transactions to address these issues.

In addition, unlike a traditional sale, in a deed-in-lieu situation there typically are no sale proceeds to backstop the typical affidavit and indemnity given by the seller to the title company with respect to potential intervening liens and interests (which document allows the purchaser to receive an owner's policy without related exceptions, e.g., for mechanic's liens and tenants' rights). Accordingly, if the deed-in-lieu agreement does not obligate a creditworthy affiliate of the borrower to provide such indemnity, the borrower may have unexpected leverage if the lender later requests delivery of the same, or title may have to be taken subject to such exceptions.

#### *Income Tax Consequences of Foreclosures and Deeds-In-Lieu*

For lenders, tax issues are relevant to credit bids during foreclosure because, generally, (a) a credit bid for less than the fair market value of the property may result in taxable gain to the lender, (b) a credit bid for more than the lender's basis in the loan (i.e., more than the principal amount of the debt if the lender was the originator, or more than what the lender paid if the lender acquired the loan) may result in taxable gain to the lender, and (c) a credit bid for less than the lender's basis in the loan may result in a taxable loss to the lender if, as and when the loan becomes uncollectible (e.g., because the loan is non-recourse and there is no additional collateral or recourse). With respect to deed-in-lieu transactions, there is no presumption as to the value of the property acquired by the lender, and thus the lender should consider whether an agreement with the borrower and/or an appraisal might help to establish such a value. If the property value is greater than the lender's basis in the debt then the deed-in-lieu transaction will trigger gain for the lender, and if the property value is less than such basis then such transaction will trigger a loss for the lender.

For borrowers, there should not be a distinction for tax purposes between a foreclosure and a deed-in-lieu. In each case, the borrower is treated as having transferred its property in satisfaction of the loan. The borrower will recognize gain or loss based on the difference between its adjusted basis in the property and the value of the property (which, if the loan is non-recourse for tax purposes, is presumed to equal the amount due under the loan). Also, where the debt is recourse for tax purposes, the borrower will have cancellation of indebtedness income to the extent that the fair market value of the property is less than the amount due under the loan (note that recent legislation has changed the rules for a taxpayer's recognition of cancellation of indebtedness income).

Tax professionals should be consulted prior to completing a foreclosure or deed-in-lieu transaction for a complete analysis of these issues.

#### *Property Tax Reassessment on Change of Ownership*

In some jurisdictions, the property value for purposes of real property taxes will be reassessed upon a change of ownership in connection with a deed-in-lieu or foreclosure. In California, for example, such a change in ownership and reassessment could result in a significant increase in real property taxes if the borrower had a low assessed value (e.g., if the property had been

<sup>27</sup> See, e.g., Cal. Corp. Code §§ 15674(a), 17303(a) (providing, respectively, that an assignee of a limited partnership interest or a limited liability company interest will not be admitted as a limited partner or member unless a majority in interest of the other partners or members approve such admission); cf. 6 Del. C. §§ 17-704(a)(2), 18-18-704(a)(1) (requiring, respectively, that all other partners or member approve such admission). See also Cal. Corp. Code §§ 15672(a), 17301(a); 6 Del. C. §§ 17-702(a), 18-702(a)-(b) (limiting the rights of an assignee that has not been admitted to the assigned economic interest, such as sharing in profits and losses, without any right to participate in management or exercise other rights or powers).

<sup>28</sup> See, e.g., Cal. Com. Code § 9610(b).

<sup>29</sup> See National Conference of Commissioners on Uniform State Laws: Uniform Fraudulent Transfer Act (1984), available at <http://www.law.upenn.edu/bll/archives/ulc/fnact99/1980s/ufta84.htm>; Cal. Civ. Code § 3439; 11 U.S.C. § 548.

<sup>30</sup> See ALTA 21-06 Endorsement and CLTA 131 Endorsement.

owned by the borrower for several decades). Moreover, such reassessed value may not be based upon the foreclosure bid for the property (or the discounted loan purchase price), but rather is likely to be determined by an appraisal of the property to assess its “full cash value” (which appraisal may presume, for example, stabilized occupancy with fair market rents and capitalization, regardless of the actual state of the property).<sup>31</sup> Accordingly, potential loan purchasers should not assume that following foreclosure or deed-in-lieu they will inherit the borrower’s assessed value, or that the new assessed value will equate to the purchase price for the loan, and may wish to verify underwriting assumptions in respect of property taxes with tax professionals.

#### *Actions Against Guarantors*

Most real estate borrowers are SPEs with no assets other than the property, and many permanent (as opposed to construction) real estate loans are non-recourse (either contractually or pursuant to applicable law). In such situations, the lender may need to rely on a guaranty from a creditworthy person or entity to discourage and protect itself against “bad boy” acts by the borrower or its principals (e.g., fraud, waste, prohibited transfers, etc.), and in order to recover funds in addition to foreclosing on the property. For loans with a payment guaranty, the lender may be able to significantly improve its recovery by suing and collecting from the guarantor.

There are two important considerations in respect of completion guaranties for construction loans: (a) a completion guaranty is not likely to be specifically enforceable<sup>32</sup>, and thus measure of damage issues (e.g., cost to complete vs. increased value upon completion, carrying costs, and the effect of undisbursed loan proceeds) are relevant to understanding the potential value of the guaranty and the lender’s leverage in working out a project secured by such a guaranty; and (b) the guaranty may provide a right to cure by completing the project, and may obligate the lender to make disbursements to the guarantor in such event.

#### *REO Sales*

For many distressed loan purchasers, foreclosing or accepting a deed-in-lieu is only one step in the process of realizing on their investment. Most lenders will want to sell most or all REO properties. These sales will typically be on an “as is, where is” basis, and often at some discount of the perceived market price of the property. Seller financing may also be provided, especially for properties that are difficult to underwrite or otherwise fail to attract or qualify for new third party financing.

#### *Loan Sales*

There may be certain loans that attract the interest of parties who desire to acquire the underlying properties (e.g., development sites), or the interest of other investors. Typically, such loan re-sales are on an “as is, where is” basis, relate to loans that were a part of a loan pool, and are made to purchasers who are not in a position to purchase an entire loan pool.

**Additional Borrower Issues and Risks: Bankruptcy, Defenses and Cure Rights, and General Concerns.** Despite typically being the party in distress, there are many options available to borrowers; distressed loan purchasers must be aware of how borrowers can gain leverage, and

of ancillary concerns that may be just as important as the economics.

#### *Bankruptcy Risks*

There are two significant concerns to address in the context of a borrower bankruptcy: the automatic stay of foreclosure, and post-transfer claims of a fraudulent transfer. Generally, the automatic stay of foreclosure is not likely to significantly delay the foreclosure process in “single asset real estate cases” (i.e., if the borrower’s only asset is the property); in other instances, foreclosure will be stayed pending resolution of the bankruptcy proceedings.<sup>33</sup> As a mitigating factor, however, the borrower’s bankruptcy may trigger full recourse to a creditworthy guarantor (this has been a common concept in non-recourse carve-out guaranties). Be wary, however, of the opportunity presented to borrowers by way of a recent case holding that a junior lienholder’s bankruptcy will stay a senior lienholder’s foreclosure, even if the junior lienholder is an affiliate of the borrower: borrowers may seek to acquire junior liens through affiliates as a way to buy time without triggering recourse under a guaranty.<sup>34</sup> In any event, it is prudent to consult bankruptcy (and possibly litigation) counsel to evaluate these issues.

#### *Reinstatement Rights*

Local counsel should always be consulted regarding reinstatement, redemption and other borrower cure rights, and other state specific foreclosure procedures, remedies and rights. In California, at any time prior to entry of a decree of foreclosure (in the event of judicial foreclosure), or until five business days prior to the established date of sale (in the event of non-judicial foreclosure), the borrower or any party with a junior encumbrance may reinstate the loan to good standing (in respect of any monetary default) by payment of all delinquent amounts (i.e., excluding accelerated amounts) together with the lender’s reasonable costs of enforcement.<sup>35</sup>

#### *Redemption Rights*

In California, in the event a deficiency judgment is not prohibited and has not been waived following a judicial foreclosure, (a) there is a three-month right of redemption applicable if the foreclosure proceeds satisfied the foreclosed obligation, and (b) there is a one-year right of redemption applicable if the foreclosure proceeds did not satisfy the foreclosed obligation.<sup>36</sup> There is no right of redemption following a non-judicial foreclosure in California. During the redemption period, the borrower may have the ability to retain possession of the property.

#### *Anti-Deficiency/“One Action Rule” Risks*

Loan purchasers should consult local counsel regarding applicable anti-deficiency laws. In California, for example, lenders may not pursue a deficiency against a

<sup>33</sup> See 11 U.S.C. §§ 101(51B) (defining “single asset real estate”), 362 (providing for the automatic stay, with subsection (d)(3) governing removal of the same in single asset real estate cases).

<sup>34</sup> See, e.g., *In re Three Strokes Ltd. Partnership*, 2008 Westlaw 5102112 (Bankr. N.D. Tex. 2008) (holding that a senior lienholder’s foreclosure is barred by the automatic stay in favor of a junior lienholder further to its bankruptcy petition, notwithstanding that such junior lienholder was affiliated with the borrower/property owner and that its lien was deeply subordinate pursuant to an express subordination agreement).

<sup>35</sup> See Cal. Civ. Code § 2924c.

<sup>36</sup> See Cal. Code Civ. Proc. §§ 726(e), 729.030.

<sup>31</sup> See Cal. Rev. & Tax. Code §§ 75.10(a), 110.

<sup>32</sup> See, e.g., Cal. Civ. Code §§ 3390-92.

borrower following foreclosure of a seller-financed loan or residential purchase money loan, or following non-judicial foreclosure.<sup>37</sup> Such restrictions are complemented by California's "one action rule", which can be invoked by borrowers both as an affirmative defense to an action by a creditor and as a sanction following an action by a creditor. There are essentially three aspects to the rule in California (all of which are derived from Section 726 of the California Code of Civil Procedure): (a) the "one action" concept provides that a creditor is entitled to only one action on mortgage debt, such that omitting a component of the collateral from a judicial foreclosure action can act as a release of such omitted collateral<sup>38</sup>; (b) the "one form of action" concept provides that foreclosure is the sole remedy for enforcement of an obligation secured by real property, such that obtaining judgment on a secured note can act as a release of the collateral<sup>39</sup>, and (c) the "security first" concept provides that every deed of trust includes an implied obligation to exhaust collateral before proceeding against other borrower assets, such that obtaining a writ of attachment against other assets (or a bank unilaterally applying funds in an unrelated deposit account

<sup>37</sup> See Cal. Code Civ. Proc. §§ 580b, 580d.

<sup>38</sup> See, e.g., *Walker v. Community Bank*, 10 Cal.3d 729 (1974) (holding that judicial foreclosure against some but not all collateral acts as a release of the collateral not included in such foreclosure action); cf. *Freedland v. Greco*, 45 Cal.2d 462 (1955) (holding that non-judicial foreclosure of some but not all collateral does not restrict subsequent judicial or non-judicial foreclosure of the remaining collateral). See also *Federal Deposit Insurance Corp. v. Dintino*, 167 Cal.App.4th 333 (2008) (finding that accidental reconveyance of the collateral precludes suit on the note but not a claim for unjust enrichment).

<sup>39</sup> See, e.g., *Salter v. Ulrich*, 22 Cal.2d 263 (1943); *O'Neill v. General Security Corp.*, 4 Cal.App.4th 587 (1992).

towards a mortgage debt) can act as a release of the collateral<sup>40</sup>. The application of any "one action rule" is likely to be very fact-specific, and it is thus important to carefully evaluate any prejudgment actions in this context (e.g., in California, certain prejudgment attachments, and petitions for appointment of an receiver, are expressly excluded from the scope of the rule<sup>41</sup>).

#### *Considerations Related to Publicity and Up-Tier Obligations*

Crafting a mutually acceptable workout requires an understanding of the borrower's situation. Consider the following: (i) agreeing to a deed-in-lieu, or filing a bankruptcy (even if just a SPE), may be a stigma with reputational ramifications beyond the subject project, and thus problematic for the borrower group; and (ii) such actions might be problematic for the borrower's affiliates under up-tier credit facilities or organizational documents.

#### **Conclusion.**

For borrowers and lenders, familiarity with loan workouts, foreclosures, and related issues fosters efficiency and permits navigation of the various potential liabilities. For the potential distressed debt investor, ex-ante consideration of such matters is a fundamental element of underwriting (and crafting and implementing exit strategies with respect to) investments in distressed real estate loans. Ultimately, however, this new (yet, in many ways, old) market landscape is a land of opportunity for those who understand the rules and options.

<sup>40</sup> See, e.g., *Security Pacific Nat'l Bank v. Wozab*, 51 Cal.3d 991 (1990) (regarding creditor's setoff of debtor's unencumbered deposit account with creditor); *Shin v. Superior Court*, 26 Cal.App.4th 542 (1994) (regarding pre-judgment attachment of unencumbered assets in Korea pursuant to a Korean court order).

<sup>41</sup> See, e.g., Cal. Code Civ. Proc. §§ 483.012, 564(d).

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