



CLIENT GUIDE

DISTRESSED COMMERCIAL REAL ESTATE LOANS
INCLUDING, ACQUISITION, WORKOUTS AND
ENFORCEMENT

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BUYING A DISTRESSED REAL ESTATE LOAN

When you buy a loan, you are essentially buying a pile of paper called the loan file. If the originating lender did things right, the loan documents in that file give you certain rights, including the right to collect the payments due under the loan and the right to foreclose if the borrower goes into default.

There are several key elements that real estate investors should be aware of when buying distressed debt, especially if your sole strategy is to get to the property. First, in addition to underwriting the collateral property, you must understand the loan documents and the existing lender-borrower relationship before you commit to purchasing the loan. Second, you are going to be a lender before you own the property and you need to act like one, or risk lender liability claims.

In this guide, we review the life cycle of a distressed debt acquisition. We break down buying real estate secured debt into two sequential parts. First, negotiating the loan acquisition and second, working out the loan or foreclosing to own the property.

PART ONE: NEGOTIATING THE LOAN ACQUISITION

The Loan Sale Agreement

The Buyer's ability to successfully negotiate the loan sale agreement ("Sale Agreement") depends on several factors, including whether the acquisition will be accomplished through a negotiated transaction or a competitive bid transaction. Buyers will typically have better luck negotiating

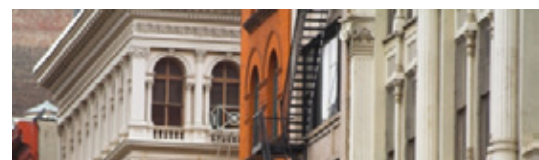
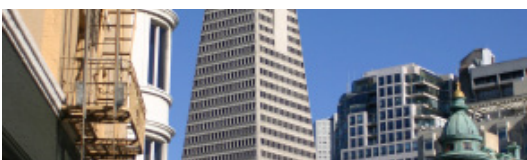
the Sale Agreement for a single asset balance sheet loan in a negotiated sale than for a pool of loans sold by a competitive bid process (as one example).

More often than not, the Sale Agreement is drafted by Seller's counsel as an "as-is" sale, with very limited representations and warranties from the Seller. In negotiating the Sale Agreement, we recommend counsel be as aggressive as possible within reason. The motivations for selling a loan vary from bank to bank and you do not know what you are going to get until you ask. Bear in mind however, achieving Buyer-favored provisions are only as good as the Seller's financial strength and may be subject to caps and time limitations. The Buyer should be prepared to negotiate important provisions in the Sale Agreement, including the following:

What is a Buyer Purchasing? The Sale Agreement should provide that you are purchasing all of Seller's right, title, and interest in the loan, the loan documents, and the loan file including, without limitation (and this is important) the servicing rights to the loan, any pending enforcement actions (foreclosures and receiver orders), and claims filed by Seller in any pending bankruptcy case or insolvency proceeding. You should also receive the rights to any escrow deposits that you might be obligated for post closing.

Representations and Warranties. There are several representations and warranties that are important to the Buyer. At a minimum, Seller should represent:

- Seller has the authority to sell the loan. Participation interests and complex intercreditor agreements were common through the mid 2000s. Therefore you want Seller to represent that it has the ability or has all the consents to sell the loan.



- Seller has delivered to Buyer all of the documents and materials (including correspondence) relating to the loan and collateral in the lender's possession.
- The accurate current principal balance of the loan and the balances of all escrow funds of any kind held by Seller as of the closing date. After the closing date, the Buyer will likely be responsible to the borrower for funds originally held by the Seller prior to the sale.
- The loan is neither cross collateralized nor cross defaulted with any other loan that is not the subject of the Sale Agreement. Borrowers sometimes have extensive relationships with their lending partners and the real property collateral maybe pledged to multiple loans with the same lender.

Deposit. The deposit and due diligence provisions should allow for Buyer to have complete discretion whether to proceed with the transaction, and if Buyer does not proceed for any reason (or no reason at all), Buyer should get its deposit back without qualification. Sometimes the deposit language is more complex allowing Buyer to terminate only for specific reasons, or requiring Seller's approval for a return of Buyer's deposit on termination.

Allocation of Risk. The Sale Agreement should provide that Seller is responsible for the loan before closing, and Buyer is responsible for the loan only after closing. If the Sale Agreement is not clear on this issue, Buyer may acquire unanticipated liabilities.

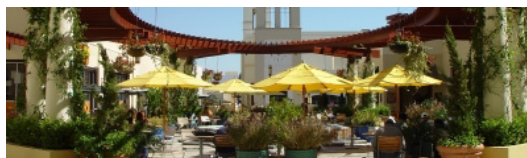
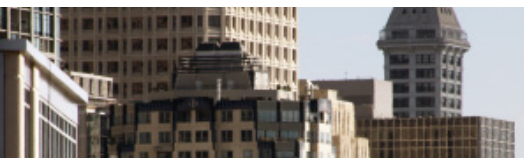
Seller's Default. The Sale Agreement should address what happens if the Seller defaults and it should make clear what

the Buyer's remedies are. For instance, can the Buyer terminate immediately and get its deposit back, or is the Buyer required to allow Seller an extended period of time to cure its default? Buyer should seek an indemnity from a financially strong Seller for Seller's acts prior to closing and in the event of Seller's default under the Sale Agreement. If the Seller's default is discovered after closing, the Sale Agreement can provide for the repurchase of the loan after the expiration of an acceptable cure period.

Understanding Risks - Executing Due Diligence

Sellers typically do not provide a complete due diligence package at the outset of the transaction and therefore the Buyer must be proactive. We advise that during the letter of intent stage, Buyer and its counsel should *develop a document and due diligence request list* specific to the loan and asset type. That request list should be sent to Seller prior to the commencement of the due diligence period. Pre-acquisition due diligence is essential on distressed loan assets because more often than not, in addition to the default, many issues relating the lending relationship will affect the value of the transaction to Buyer.

At the outset, Buyer should learn key elements about the lending relationship between Seller and its borrower. The guaranty, updated title report, lender-borrower correspondence and intercreditor or participation agreements are important documents to fully understand. You also want to understand whether the distress relative to the loan is due a failure of the property to perform, a problem with the borrower as operator, or simply an inability to refinance a maturity default.



Problems range from the misspelling of the borrower's name on a UCC filing to title being vested in the wrong borrower entity, unpaid taxes, mechanics liens and defective guaranty agreements (guaranties that do not include the requisite real property waivers essential to maintaining a separate claim against the guarantor).

Before the end of the due diligence period, Buyer's counsel should provide a concise *due diligence report* highlighting the material issues, common defects and deficiencies to assist a Buyer to determine strategy, adjust pricing or walk away from the deal.

Several important legal issues to examine during the due diligence period include:

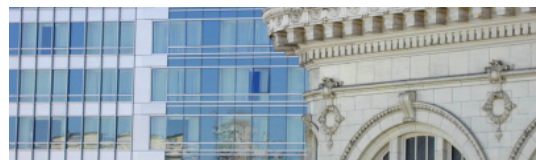
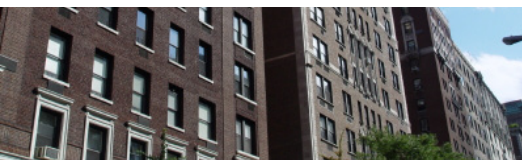
The Loan Documents. The Buyer should never assume the basic loan documents are in good shape. At the simplest level, you want to ensure that the *original* note, deed of trust and assignment of rents exist, along with an assignable lender's title policy. Despite the acceptance of fax signatures today, it is still important to receive the original wet-ink promissory note. When a loan has traded hands several times, the original note may be hard to find. And without the original note, you may have trouble foreclosing on the collateral.

The deed of trust and assignment of rents are not always properly executed or recorded. Documents get lost, especially with loans that have been sold before. Also, if the acquisition involves a mezzanine loan, the mezz lender only has a security interest in the company (the borrower), which means the Buyer will also acquire liabilities that relate to the borrower/company.

Loan Agreement. Loan Agreements are typically lender favored documents. However, Buyers need to watch out for certain provisions imposing post closing obligations on the Buyer. The loan agreement may contain complex provisions such as rebalancing payments, additional improvements funding obligations (construction draws) and non-recourse carve-outs for guarantors. The loan agreement may also contain provisions regarding escrowed funds that are considered the borrower's money. All of those amounts may be significant in total, and the Buyer will be responsible for them post-closing unless otherwise agreed in the Sale Agreement.

Guaranty. The guaranty agreement may be full-recourse, non-recourse with carve-outs or, in some cases in California, worthless. A well-drafted guaranty is an important tool for a lender to maintain bargaining position throughout the work-out process. A lender's right to sue on a guaranty for a deficiency as part of a separate action is enhanced if the guaranty agreement contains specific waivers under California law. All of these issues affect whether the guaranty agreement will be helpful in pressuring the borrower to a friendly foreclosure.

Title Report. The status of title will materially affect your foreclosure strategy and perhaps your decision whether to buy the loan in the first place. With distressed assets it is not uncommon to find mechanics' liens that relate back to a date prior to the recorded deed of trust, junior liens (that perhaps violated the original senior loan), judgment liens and taxes encumbering title. There can also be CC&Rs affecting a variety of properties – not just residential condos. Title may also show whether there are cross collateralization issues. You should also obtain a copy of the as-built survey, which will show whether the survey matches title and references all of the easements.



Learn About the Borrower. Read the correspondence file between the Seller and the borrower. Has Seller provided proper notice to borrower of all defaults? You want to know what the Seller has told the borrower about the default and how the borrower has reacted. This may tell you whether there is a pending lender liability claim or if borrower has valid defenses, offsets or counterclaims. The increase in use of email has resulted in the documentation of negligent loan management practices. The Seller may also have entered into forbearance agreements, which “extend and pretend,” creating a reasonable expectation by the borrower of more of the same. Finally, you also want to get a flavor for how psychologically invested the borrower is in the property to determine whether or not he is going to toss you the keys or fight, regardless of the logic to do so.

Forbearance Agreements & Enforcement Action Filings.

If the loan is in default, the Buyer will need to know what actions the Seller has taken to enforce the loan. Such items may include Seller’s notices to the borrower, copies of the recorded notice of default, pre-negotiation and forbearance agreements, cooperation agreements and any litigation filings including (by way of example) a court order appointing a receiver.

Inter-creditor & Other Agreements. The loan file may include participation or inter-creditor agreements that affect your rights as lender when there is a default. You may not be able to proceed directly to a foreclosure sale without first complying with specific provisions in these agreements. In some instances you may not be purchasing the lead lender position, thus having little or no control over a workout or loan enforcement. Separately, in the case of hospitality loans on flagged properties, look for a tri-party agreement with the

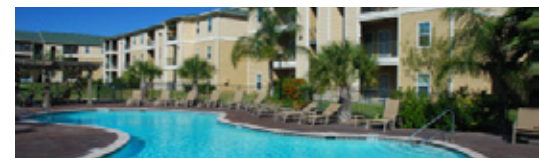
franchisor and get an understanding of its notice provisions or outstanding property improvement requirements. There may be cross easements and tenant in common agreements in the file requiring notice and cure rights.

Construction Loans. For construction loans, Buyers should confirm that lender’s title policy contains relevant endorsements including coverage for optional advances. A review of construction and liability insurance is a must and an understanding of the stage of completion and the cost to complete remaining improvements. Buyer should find out if any additional advances are required or whether advances have been made by the Seller post default.

Payment or Maturity Default. Buyer should establish whether the borrower is in payment default or maturity default. In California, if the loan has not matured, a borrower can reinstate a defaulted loan by bringing the loan current (including default interest and fees), thereby stopping the foreclosure process.

A few other items that should be reviewed include:

- Borrower’s entity documentation. Is the borrower a single purpose entity (SPE), and what borrower parties are required to sign on board for a friendly foreclosure?
- Third party agreements and reports including environmental, property inspection reports and CC&Rs. Does the Phase 1 require additional study?
- Public records search, including relevant UCC searches, federal and state tax liens, bankruptcy,



criminal and money judgments against the borrower or guarantors.

PART TWO: POST CLOSING STRATEGIES; PROPERTY ACQUISITION, WORKOUTS AND ENFORCEMENT

After you acquire the loan, you are the lender. And as a lender holding a distressed loan, your strategy may include working out the loan to a performing asset (and possibly re-selling the loan to a bank), or taking back the property.

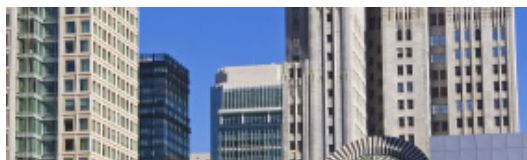
Lender Liability. Once you own the loan you have to watch your step. Before you begin the process of engaging with the borrower Buyer should consider entering into a pre-negotiation agreement (discussed below). To avoid lender liability, Buyer should not make promises to the borrower that you are willing to do a workout if you are not, and do not give the borrower advice or exercise any measure of control over the borrower or the collateral. Distressed borrowers may be quick to sue a lender, and therefore it is critical to confirm that all notices (including default and acceleration) required under the loan documents have been sent to the borrower and relevant parties. Oftentimes lenders selling distressed loans have not provided proper notices of default to the borrower or to junior lenders under the loan documents. Buyer should have in place sound servicing practices consistent with that of a true money lender; you are not the property owner yet.

The Pre-Negotiation Agreement. In a defaulted loan, the lender should seek a pre-negotiation agreement with the borrower *before* conversation (of any nature) takes place. The purpose of the agreement is to establish ground rules for

discussions between the borrower and the lender. The agreement will provide that any discussions with the borrower are neither a waiver of the lender's rights nor a modification of the loan documents. Even if you want to move directly to a foreclosure, a pre-negotiation letter can help preview issues the borrower may raise while obtaining important waivers. You can get an idea of how cooperative the borrower will be. It is also an agreement that can be used to correct existing defects in the loan documents among other things. Regardless of your exit strategy, before you communicate with the borrower, a pre-negotiation agreement is strongly advised to solve some of the aforementioned issues and to permit orderly termination of discussions if they are not productive.

Deed in Lieu of Foreclosure and Non-Judicial Foreclosure.

Deed-in-lieu agreements are similar to purchase agreements and typically contain representations and warranties, as well as other important covenants from the borrower benefitting Buyer, the "purchasing" lender. Some defaulted loan assets are good candidates for a deed in lieu of foreclosure and others require immediate foreclosure action. If the asset involves no material lien issues, a sophisticated borrower who wants to exit the asset quickly, or there are complexities to the transition of the property, then a deed-in-lieu of foreclosure may be the best and fastest route to the property. Hotels are prime examples because of the complexity of the transition to a new owner and manager. You may also want to enter into a cooperation agreement in connection with a deed in lieu or forbearance agreement whereby the borrower/developer on an unfinished condo development agrees to sell the units and keep you sealed off from construction defect liability. Note, the title policy that is issued upon recording of the grant deed in a deed-in-lieu situation may contain exclusions from coverage relating to "borrower's remorse" and



resulting bankruptcy. Always request and review all endorsements to the title policy prior to closing. Finally, the parties to a deed-in-lieu transaction should be aware that the transaction otherwise looks like a sale of real property and might involve transfer taxes and escrow costs.

Alternatively, when there are junior lien issues or an uncooperative borrower, in many western states it is advisable to focus on a non-judicial foreclosure (trustee sale). In California, the trustee sale will take at least four months to complete after filing and recording the Notice of Default. Any defect in the process can delay the sale and subject the lender to wrongful foreclosure claims. Buyer, on the advice of its counsel, should seek the assistance of default services at title companies or reputable third-party foreclosure service companies to ensure compliance with statutory procedures. Challenges to non-judicial foreclosure sales result primarily from (i) claims based on the lack of a material default justifying a foreclosure, and (ii) a defect in the foreclosure process.

Receiverships and Judicial Foreclosure. Your strategy may include seeking a court ordered receiver, judicial foreclosure in certain circumstances, and anticipating and responding to borrower bankruptcy filings. In certain western states, there may be no reason to bring a judicial foreclosure unless you are seeking enforcement of an assignment of rents provision, recourse against the borrower, or to resolve particular lien issues that require litigation. Bear in mind that judicial foreclosure is required in many states, including New Jersey, Ohio and Florida.

After the acquisition of a loan asset, Buyers often enforce an assignment of rents by seeking the appointment of a receiver for apartments, unfinished condos, hotels or office buildings.

Appointment of a receiver provides certain benefits and legal protections to lenders because the receiver is an agent of the court and not of the lender. Receivers can not only collect rents and manage properties, but they can sell assets if permitted in the court order.

COMMON BANKRUPTCY ISSUES

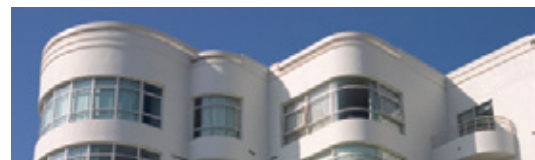
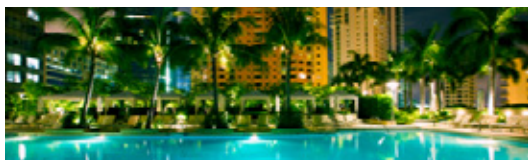
Effect of Borrower's Bankruptcy on Enforcement of Debt

Distressed debt acquisitions often involve distressed borrowers. Distressed borrowers may resort to filing for bankruptcy. Several key facts will affect a lender's ability to obtain relief from the automatic stay to enforce its rights under the loan documents.

Clients often ask lawyers to draft clauses in forbearance or pre-negotiation agreements to procure the the borrower's agreement not to file bankruptcy. However, agreements made in advance to waive the automatic stay under the Bankruptcy Code are generally deemed invalid as a restraint against filing bankruptcy, which is in violation of public policy. The Buyer should factor into its underwriting analysis the cost of protracted bankruptcy litigation.

The Automatic Stay

When a debtor files for bankruptcy protection, an automatic stay under the Bankruptcy Code immediately stops any action by the lender to collect the debt or enforce the lender's rights to foreclose on the real property. The purpose of the stay is to give the debtor time to liquidate or reorganize for the benefit of all its creditors. The stay blocks litigation, lien enforcement, and other lender self-help remedies.



However, a lender may seek a court order allowing relief from the stay to proceed against specific property in certain circumstances. Lenders should plan on no less than 60 to 120 days to get relief from the automatic stay. The actual period of time may be much longer in instances where there is equity in the property or the debtor can prove the lender is adequately protected.

Can the Lender Get Relief from the Automatic Stay?

After the debtor files for bankruptcy and the automatic stay is in effect, the Bankruptcy Code provides four possible grounds for obtaining relief from the automatic stay.

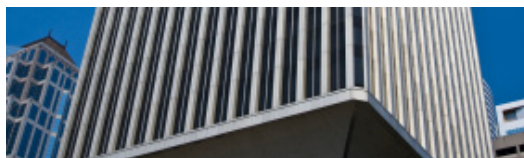
Lack of Adequate Protection. Lender can establish lack of adequate protection of its interest in the property by showing erosion in the value of the collateral resulting from declining market values, unpaid real property taxes, waste, deferred maintenance, or failure to maintain adequate insurance. Defenses developed by debtors include the ability to make periodic cash payments or bringing in new cash investment to the extent of the decrease in value of the property.

Debtor Holds Insufficient Equity and the Property Is Not Necessary to an Effective Reorganization. Lender bears the burden of establishing whether the debtor has equity in the property. If the debtor has no equity in the property and has little or no chance of successfully reorganizing, there is no reason to delay a lender's enforcement of its rights, even if the lender's interest in the property is adequately protected for the moment. On the other hand, if there is significant equity in the property, maintaining the stay gives the debtor an opportunity to maximize the value of the property for its unsecured lenders and interest holders, either through orderly liquidation or retention of the property under a confirmed plan. If

the property is necessary for reorganization (that is, there is significant cash flow that will support the asset and provide additional cash to assist the debtor's reorganization effort), then a lender needs to be concerned about a "cram-down," – that is, the approval of a plan without the lender's consent, particularly if the asset value is less than the total lien. The fact that the property's market value is less than the total lien does not mean that relief from stay is automatic. Current and future projections of cash flow are equally important from the debtor's and the court's perspective.

Single Asset Real Estate Cases. As part of the 2005 amendments to the Bankruptcy Code, Congress made it harder for a single asset real estate borrower to use bankruptcy to protect itself from a foreclosing creditor. In theory, it should not be difficult to assess the business of a single asset real estate venture and propose a plan. As a result, a lender may obtain relief from the automatic stay more quickly than if the debtor has multiple assets. In a single asset real estate case, the debtor must take one of two actions within 90 days after the petition date: (i) file a plan of reorganization that the court believes has a reasonable possibility of being confirmed within a reasonable time; or (ii) make monthly payments to the secured creditor in an amount equal to interest at the non-default contract rate on the portion of the claim secured by the real property. The 90-day period can be extended by the bankruptcy court, otherwise this deadline effectively fast-tracks a single asset real estate case.

A Scheme to Delay and Defraud Creditors. The bankruptcy filing may be part of a scheme to delay and defraud the lender, involving a transfer of the real estate without lender or court consent, multiple bankruptcy filings affecting the property, or simply the debtor's bad faith. Sometimes debtors become serial bankruptcy filers to prevent foreclosure. When there is



only a short period between the dismissal of a prior bankruptcy case and the filing of a new petition, some courts have required debtors to show there has been a change in circumstances justifying the new case.

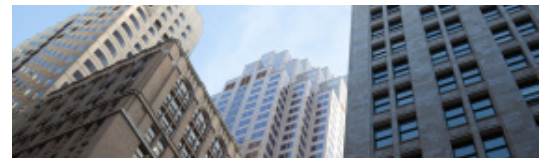
Settling the Automatic Stay Litigation

As with any litigation, there is the possibility of settling with the debtor during the automatic stay. The lender can negotiate a stipulation with the debtor or trustee modifying the automatic stay, which might include “drop dead” dates or periodic protection payment agreements. Any such stipulation is, of course, subject to approval by the bankruptcy court after notice to other creditors and the US Trustee’s office. With “drop-dead” date agreements, a lender and debtor can execute an agreement allowing the lender the freedom to foreclose if the debt is not paid in full or reinstated by a stipulated date certain — the *drop dead date*.

A lender and the debtor can also agree on a schedule of periodic adequate protection payments or use of cash collateral through a stipulated order terminating the stay, whereby the lender agrees to restrain from enforcing the loan documents conditioned on receipt of the agreed payments and the debtor’s use of cash proceeds according to a specified budget. Cash collateral agreements can be very useful in protecting lender’s interest in proceeds from a business or property.

Note - This guide considers distressed debt transactions as a generic matter. Each troubled commercial real estate loan will have its own unique issues based on the loan documents, the lender-borrower relationship and the state law involved. As such, the foregoing information is only a brief overview of the many complex issues in the acquisition of distressed real estate loan assets.

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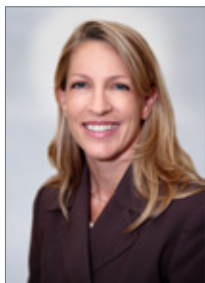
REAL ESTATE GROUP - ATTORNEY PROFILES



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CCG REAL ESTATE PRACTICE

Corporate Counsel Group attorneys provide expertise throughout the entire spectrum of real estate transactions, including acquisitions and dispositions of assets and debt, financings, joint ventures, loan workouts and recovery, leasing, development, and construction. Our team has experience with a variety of property types including, office, hotel, multi-family, mixed use and retail, industrial and condominiums.

We assist clients in all phases of the acquisition of real estate secured loans, whether for a pool of loans or a single loan transaction. Our goal is to help loan buyers develop their strategy with each loan asset in order to realize on their investment.

We welcome the opportunity to discuss your next transaction.

ABOUT CORPORATE COUNSEL GROUP LLP

Corporate Counsel Group LLP was founded in 2002 to address the need for cost-effective, first-class legal solutions in today's marketplace. At CCG, we focus exclusively on real estate and corporate transactions and we pride ourselves on an approach that is responsive, efficient and strategic. In short, we are a seasoned team of entrepreneurial-minded attorneys who understand what it takes to get deals done and move business forward. We have attorneys located in San Francisco, Los Angeles and Orange County.

For more details about our Real Estate Group, representative transactions and team members, visit our web page at www.corpcounselgroup.com

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