

DISTRESSED DEBT – ACQUISITIONS AND STRATEGIES

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A. Overview of Today's Distressed Debt Transactions.

In today's world, more than ever before, investors, lenders and their respective clients, consultants and business associates, all seem to now exist in a world revolving around the secondary market, which has grown to extraordinary levels over the past two years, especially the past few months, as a consequence of the depressed real estate marketplace here in South Florida, throughout the country and around the world. Rather than engaging in the vibrant conversation of acquiring new parcels of land and/or new income-producing projects, most often today the conversation focuses on distress, distress, and even more distress. Aspects of a real estate malaise include failed securitized loans, failed public and private financial institutions, evaporating credit for many transactions, credit tenants closing their doors, and major real estate companies slipping into default, if not insolvency.

B. Types of Transactions to be Considered.

Generally speaking, acquisitions of distressed-debt transactions fall within one of two categories:

1. Single asset purchases; and
2. Portfolio sales.

The essential tools needed in order to evaluate a single asset purchase can most often be applied to portfolio sales as well, though the necessary underwriting criteria may be more difficult to apply when dealing with multiple transactions within a portfolio simultaneously. There are some essential considerations which must be considered by anyone acquiring such assets, which include:

1. What is the intent of the Buyer: to negotiate terms with the borrower and attempt a loan workout, or
2. Continue with the foreclosure process, and ultimately obtain title to and possession of the underlying real estate asset?

C. Factors in Properly Evaluating Such Asset Acquisitions.

1. Extent of capital structure of buyer (including any participants, partners, or lenders of same).

2. Level of risk undertaken versus reward achieved, or expected to be achieved.
3. Demand of due diligence requirements.
4. Are all assets local, out of state, or spread throughout the country or elsewhere?
5. Are underlying assets in great condition, partially constructed, or in some level of disrepair?
6. Status of existing leases, maintenance obligations, debt service, including those in favor of bondholders, options to purchase held by tenants or others?
7. Any litigation pending, including damage or destruction where insurers have not, as yet, made full payments?
8. Is current outstanding loan on a recourse or non-recourse basis?
9. Are recent appraisals available and, if so, are they reliable?
10. Are any demographic studies available? If so, are the absorptions of “for sale” or “for rent” parcels acceptable?
11. Has anyone reviewed existing loan documentation?
 - a. Has title and survey analysis been performed? Has anyone updated title to a relatively recent point in time?
 - b. Has loan matured and/or does borrower have any options to extend, rights of purchase, etc.?
 - c. Is the selling party the original lender, assignee of lender, or perhaps, has some other relationship with the initial loan transaction?
12. Evaluation of Entitlements.

D. Toxic Assets.

Should you consider portfolio acquisitions?

1. Is the sale of a portfolio of non-performing mortgage loans and REO properties worth pursuing, especially in light of time and cost involved?
2. How reliable are the financial materials describing the loans, assets, asset pools, or overall portfolio?

3. Has any independent analysis been performed with respect to same?
4. Has any offering memorandum been provided?

E. Evaluating Distressed Debt.

1. Distressed Debt.
 - (a) Non-Performing Loans
 - (b) Packages of Non-Performing Loans
 - (c) Performing Loans where the current holder is looking to sell for a variety of reasons:
 - (i) Underlying real estate is an asset class in which the current holder has to reduce exposure.
 - (ii) Credit risk profile of the borrower or the loan has materially changed and the likelihood of the loan becoming non-performing has increased.
 - (iii) Due to regulatory requirements, current holder has to reduce its loan portfolio to meet requirements of the FDIC.
2. Acquiring Community Development District Bonds (“CDD’s”).
 - (a) Hundreds of districts have been created throughout the United States, including many throughout the state of Florida.
 - (b) Asset values directly correlate to status of real estate projects, and the extent of infrastructure already installed and to be installed. Has annual maintenance costs been evaluated?
 - (c) Key component in any such acquisition is the stature of the master developer or, in some cases, the lack thereof due to default, insolvency or such similar result.
3. Underlying Dynamic – Real Estate Play.
 - (a) Usually the purchasers of distressed debt evaluate its merits based on intrinsic asset value of underlying real estate.
 - (b) By acquiring distressed debt at a discount as compared to the outstanding balance of the debt and foreclosing the mortgage, debt purchasers are able to acquire various types of commercial real estate assets, often for deeply discounted prices.

- (c) Having acquired the real estate at a deep discount, especially for “value added” type properties, and then renovating, re-tenanting and waiting for the market to recover, may result in significant gains and/or appreciation of asset values.
- (d) Keep in mind the risk, time and expense of foreclosing the debt acquired in order to get to the ultimate goal: control of the underlying real estate.

4. What is Being Purchased and How – Loan Documents.

A. Promissory Note:

- ▶ The promise to pay the amount of the loan, plus interest at a stipulated interest rate.
- ▶ The Promissory Note is transferred by endorsement or an allonge, which is a separate document, endorsing the Note.
- ▶ The Promissory Note is a negotiable instrument so it is vital to have the original of the Note as part of the package of loan documents being acquired.

B. Mortgage:

- ▶ Document that grants a lien against the real property which serves as security for the Promissory Note.
- ▶ Mortgages are transferred by “Assignments,” which are recorded in the public records, providing “record notice” of the ownership of the debt.
- ▶ Business terms and conditions, such as payment of taxes, insurance requirements, financial requirements, casualty and condemnation, default and remedies.

C. Loan Agreement:

- ▶ Not always used.
- ▶ Sets out more detailed business terms, conditions, representations, and warranties for the loan.

D. Guaranties:

- ▶ The principals of the borrower may have recourse liability under personal guaranties (“PG’s”) of the loan.
- ▶ All PG’s need to be separately assigned as part of the sale of the loan as PG’s provide a lot of leverage to get the borrower to cooperate in later resolution of the problems with the loan.

▶ The principals of the borrower may have recourse liability under PG's.

▶ Need to determine enforceability and extent of liability of existing guaranties, including payment and performance, completion, or such similar documents.

E. Recourse Carve Out Guaranties:

▶ While not as strong a leverage tool as a full recourse guaranty, where there may be arguments that the borrower breached a relevant loan covenant, creating a recourse guaranty creates some leverage with the borrower. (**Note:** Non-recourse Carve Out Guaranties may also be important, though not as helpful as full recourse guaranties, depending upon the extent of carve out coverages, the status of the loan's performance, and status of pending default(s) of borrower.

F. Assignment of Leases and Rents:

▶ An additional security document that grants the lender the right to receive rents from tenant at the mortgage property after an event of default has occurred.

▶ Effectiveness is governed by Florida Statutes §697.07 which requires obtaining a court order directing payment of the rents to the lender.

▶ Transferred as part of the Assignment of Mortgage.

G. UCC-1's:

▶ Must determine if UCC-1's are still enforceable, meaning that they have been renewed beyond the usual five (5) year expiry for same.

H. Entity Documents of Maker of Assigned Note.

▶ Important to determine with certainty that the Note previously signed was and is enforceable pursuant to the terms of same and also evaluate if such entity is currently in good standing.

I. Updated Title Commitment.

▶ As previously discussed, title work and survey documents, including updated title information, is important to confirm that the loan being acquired is/is not a first mortgage lien on the property, as well as the relative priority of any other subordinate matters. In most instances, it is worthy to consider obtaining an assignment/endorsement to the existing title policy in order to further protect the assignee.

J. Reserve Fund Agreements, such as Tax and Insurance Reserves, Cap Ex Reserves and TI and Commission Reserves:

- ▶ The underlying loan transaction may have required the borrower to fund and make monthly contributions into any variety of reserve funds held by the lender.
- ▶ The terms of the reserve fund agreements may provide that, after any event of default, funds held in the reserve funds may be used by the lender to pay down the debt.
- ▶ As part of due diligence, it is important to assess the status of the reserve funds agreements and the funds being held to make sure that the rights under these agreements are transferred and the funds accounted for in the closing of the sale of the loan.

K. Miscellaneous Loan Documents of Importance:

- ▶ Certificate(s) of Insurance;
- ▶ Good Standing Certificate(s) of maker, and confirm good standing of lender-entity, which is assignor of loan;
- ▶ Certified copies of authorizing resolutions for the assignor-entity;
- ▶ Appraisal of the mortgaged property;
- ▶ Environmental reports from original loan transaction.
- ▶ Loan File:
 - (a) All correspondence between lender and borrower is important to have as part of the package of documents being purchased as there may be correspondence that, arguably, modifies the terms and conditions of the loan, to which a purchaser would be subject in a loan purchase.
 - (b) Collection register: it is important to have a full history of payments of the loan, specifically if any default interest or late charges have been assessed and collected. One of the standard defenses to any enforcement by the lender is usury, so it is important to have the history of payments from the borrower.

F. Due Diligence.

1. Legal Due Diligence.

- (a) Review all of the Loan Documents for legal sufficiency – can the Loan Document be foreclosed?
- (b) Review loan file and correspondence between existing lender and borrower: did the existing lender do anything that could give rise to a defense to the foreclosure?
- (c) Evaluate potential bankruptcy ramifications – hopefully the borrower is a Single Purpose Entity where any bankruptcy filing can be challenged or dismissed without too much difficulty.
- (d) Obtain and review a foreclosure title insurance commitment to assess what other parties need to be joined in a foreclosure, such as subordinate mortgagees, lien holders, judgment holders and similar claimants and creditors.
- (e) Review any inter-creditor agreement with subordinate mortgage holder or mezzanine debt lender to assess what rights, if any, a subordinate creditor may have before a foreclosure can be filed and what defenses, if any, the subordinate creditor may be able to interpose, such as failure to give notice of default under senior debt being acquired.
- (f) Zoning & Land Use review: consider obtaining a PZR report to assess zoning & land use status of property to make sure that there are no significant zoning violations or open permit issues that would add expense or delay to intended use of property, once acquired.

2. Business Due Diligence

- (a) Review financial status of loan by reviewing loan file, payment history, status of reserve accounts and payment delinquency information.
- (b) Analyze loan terms and conditions and assess ramifications of loan being paid off.
- (c) Review financial status of borrower based on most recent set of financial statements (to the extent available).
- (d) Review capital structure of underlying transaction to identify potential subordinate debt holders, such as second mortgagees or mezz debt.

3. Real Estate Due Diligence.

- (a) Generally, a loan purchaser will not have access to the real property to conduct hands on due diligence.
- (b) Review what is available from existing loan file.
- (c) Discuss with existing lender having the environmental report updated and then getting a reliance letter from environmental inspection company.
- (d) Use due diligence as an opportunity to re-assess whether value in underlying real estate supports following through on the transaction.

G. Loan Purchase and Sale Agreement.

1. Financial Terms.

- (a) Set forth purchase price for loan with specificity.
- (b) Set forth any deposits with specificity.
- (c) Include a recitation that the loan documents are being purchased for a negotiated purchase price which is less than the outstanding balance (both principal, interest and default interest) under the loan.
- (d) Credits against purchase price for any reserve accounts under the loan.

2. Assets Being Purchased.

- (a) Describe each of the loan documents being purchased with specificity.
- (b) Be sure to include as much in the way of loan files, correspondence and similar documents, in addition to the loan documents, being purchased.
- (c) Include covenant to cooperate where seller agrees that it will cooperate with reasonable requests of buyer to provide copies of all related loan materials.

3. Due Diligence Period or Concurrent Closing.

- (a) Sometimes, loan purchase transactions are structured like a real estate transaction (an executory contract) where the P&S Agreement is signed, a deposit put up and the purchaser has a due diligence period to review the due diligence materials associated with the asset being purchased.
- (b) Other times, the loan purchase transaction is structured like a corporate deal with the P&S Agreement being executed concurrently with closing.

4. Closing Procedures.

- A. It is extremely important that originals of as many of the loan documents as possible are delivered at closing. It is vital that originals of the following are obtained at closing:
 - (i) ALL promissory notes, including amended, restated or consolidated notes, prior notes which have been amended, restated or consolidated into newer notes.
 - (ii) All personal guaranties from guarantors.
- B. Closing is evidenced by:
 - (i) delivery of all of the relevant loan documents, especially originals of all notes and guaranties.
 - (ii) delivery of an allonge or endorsement of the promissory note.
 - (iii) delivery of an assignment of the other loan documents.
 - (iv) payment of the purchase price.
 - (v) exchange of a closing statement, detailing the transfer of funds.

5. Reps and Warranties.

- A. Sellers are reluctant to give a lot in the way of reps and warranties.
- B. The most important reps and warranties to get from sellers are:
 - (i) Seller owns the loan.
 - (ii) Seller has not previously sold, transferred, assigned, pledged, hypothecated, mortgaged or granted a security interest in, or permitted any lien or judgment to attach to the loan documents being transferred.
 - (iii) No impediment to seller selling the loan.
- C. Other reps and warranties may include authority of seller to undertake transaction, status of any foreclosure litigation pending, no litigation against seller that would prevent transaction, and similar authority type reps.
- D. Very difficult to get any reps and warranties with respect to underlying real estate.

H. Pricing and Financing Consideration.

1. Risk Factors for Pricing.
 - (a) As a real estate play, acquiring and working out distressed debt is time consuming and labor intensive.
 - (b) Purchasers should expect and price into deal both delays from borrowers and from the court system.
 - (c) There is a distinct possibility that the borrower may pay off the loan before a foreclosure can be completed.
 - (d) There is also the distinct possibility that the borrower will put up a vigorous fight to the foreclosure, including dilatory bankruptcy filings, creating delays and increasing costs of litigation.
 - (e) As a purchaser analyzes the price it is willing to pay, take into account the potential for delay and increased costs.
 - (f) Expect that it will take longer and cost more than initially estimated to get control of the underlying real estate.
2. Structuring Funds and JV's to Acquire Distressed Debt.
 - (a) As the loan is in default, keep in mind that there will be little or more likely no cash flow from the asset being purchased.
 - (b) As the promoter/active member of any JV or fund structure (as opposed to the equity investor), factor in that you will be incurring costs, using resources such as asset managers, financial analysts, executive personnel to conduct due diligence and then deal with the troubled asset. This is all very labor intensive.
 - (c) Equity investors are going to want a preferred return of some sort.
 - (d) Consider including a variety of fees in deal structure to compensate for time spent acquiring, working out and dealing with foreclosure or possible bankruptcy, to be paid ahead of any preferred returns to investors.

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