

Buying Distressed Debt – An Overview

We continue to receive frequent inquiries from those interested in buying distressed debt. This article provides an overview of the loan sale process and addresses some of the issues that potential buyers should consider – especially if their business plan is to buy the debt as a means to acquiring the underlying real estate assets at a discounted price.

In a typical loan sale, the buyer pays the purchase price to the seller, usually by a wire transfer on the date set for closing, and the seller assigns and delivers to the buyer the promissory note and other documents evidencing and securing the loan. The note is transferred by endorsement and delivery to the buyer. Endorsement often is accomplished by attaching a separate writing, known as an allonge. There also may be a general assignment of the other loan and security documents, although in some instances an assignment is not given because those documents, by their terms, inure to the benefit of the successors and assigns of the original, named lender, i.e., the party who is the current holder of the note. For mortgage loans, there often is a separate assignment of the mortgage, in a form suitable for recording. After closing, the buyer may additionally choose to file an amendment to the UCC financing statement to change the name of the secured party.

In addition to transferring the loan and security documents, the seller typically transfers to the buyer any escrow accounts currently being held by the seller. This can be done through a credit against the purchase price, or if the accounts are held by a custodian for the benefit of the lender, by an amendment of the custodial agreement. Following the closing the buyer typically notifies the borrower that it has become the owner of the loan, although that may not be necessary if the loan is being administered by a servicer and the buyer elects to retain the same servicer after the sale.

The rights transferred by the seller are all of the seller's rights under the loan documents, including all of the seller's interest in any security for the loan. Buyers should, however, be aware that the transfer is without recourse and except for limited representations concerning ownership of the loan and the right to transfer it, the seller typically does not make representations or warranties concerning the loan or any of the security. Therefore, as discussed below, the buyer's due diligence is a critical element of the loan sale.

The rights transferred also include the right to receive the payments, if any, due from the borrower under the loan and, importantly, if the strategy is to gain control of the underlying real estate, the right to enforce the loan documents against the borrower and realize on any security for the loan. In addition to transferring all rights of the seller under the loan documents, the transfer of the loan documents also transfers to the buyer any obligation of the lender that has not been performed at the time of transfer. Therefore, the extent of the lender's unperformed obligations, if any, should be part of the buyer's due diligence.

The primary motivation of the selling lender usually is a desire to raise cash. The sale of a loan has the effect of monetizing the borrower's obligation to repay the loan and the value of the underlying security without the lender having to go through the time, expense and uncertainty of a mortgage foreclosure or other enforcement proceeding, and without the lender having to take title to the collateral and incur the potential liabilities of ownership and the market risk associated with selling it.

Buyers are motivated to purchase distressed loans because the purchase of a loan at a discounted value can provide an attractive cash on cash return if the borrower is capable of some performance, and if there is potential to resell the loan at a higher price if the credit worthiness of the borrower or performance of the underlying project improves. If the buyer's business plan is to gain control of the underlying real estate asset, an additional motivation is the potential ability to acquire title to the real estate through enforcement of the loan documents if the borrower defaults. Additionally, if there are competing interests in the project, the ability to step into the selling lender's priority position may make it more advantageous to buy the loan rather than to buy the property from the owner/borrower.

As discussed above, the buyer's due diligence is critical in the loan purchase context because of the nonrecourse nature of loan sales, potentially adverse conditions affecting the loan, or underlying security if the loan is nonperforming. Typically, the buyer will have an opportunity to perform some level of due diligence with respect to the loan. In portfolio sales, this often occurs after the buyer has signed a confidentiality agreement. The buyer will then be given a copy of the seller's loan file, which should at least include the loan documents, but may include other material information, such as correspondence with the borrower, and information concerning the underlying security.

The buyer should review the loan documents carefully, in order to understand the extent of the lender's rights and the lender's future obligations (if any), such as an obligation to pay future draws under a construction loan or land acquisition loan. The buyer also should review any correspondence and notes in the loan file, to confirm that the seller or a predecessor of the seller has not taken any actions that might constitute a waiver of the lender's rights under the loan documents or a modification of the loan, and also to ascertain the existence of any facts which might constitute defenses of the borrower to the enforcement of the loan documents. The buyer also should confirm that the selling lender or its predecessor has taken its security interests in the collateral effectively and that its security interests have been properly perfected, e.g., the mortgage has been properly recorded and the financing statements have been filed in the proper offices.

If there is secondary or other financing, the buyer should review the available loan documents for that financing and, in particular, any intercreditor agreements, to confirm the extent of the selling lender's rights to enforce its loan documents without the need for any third party consent. The buyer also should consider any consents that may be required for the transfer of the loan, such as from a lead bank or other participating bank or, in some cases, the borrower. The buyer also should consider the solvency of the borrower and the likelihood that the borrower will file for bankruptcy, the timing and cost of enforcing the loan documents against the borrower and the security, whether redemption rights have been waived and the effect of a foreclosure on the underlying project, including the project leases and any key agreements.

If the buyer's strategy is to obtain control of the underlying real estate by purchasing the loan, the buyer should attempt to perform the same level of due diligence with respect to the underlying real estate as it would if it were purchasing the real estate from the owner/borrower. This may be difficult, however, because the due diligence periods offered in loan sales typically are shorter than those in real estate transactions, and the information available in the selling lender's file will most likely date from the time of the loan closing, and therefore will not be current. As a result, some due diligence information typically reviewed by real estate purchasers, such as current operating statements and a current rent roll, may not be available. The buyer, however, should obtain significant information from third parties and/or public records, including a current title insurance commitment, ordinances and recorded documents related to entitlements, environmental information, and information on the general market position and condition of the property. In some instances, the selling lender may have the right, under its loan documents, to require the borrower to furnish current information about the property and its operations. The buyer may also have an opportunity to ask that the seller make such a demand on the borrower. In our experience, however, this is not typically done.

For buyers who understand the risks associated with purchasing distressed loans, and for those who have the knowledge to underwrite the borrower's credit and evaluate the underlying security, buying distressed debt offers the potential for attractive returns. For example, we recently saw a transaction in which the buyer's cash on cash return was approximately 12%, and the loan was secured by entitled land with a potential market value equal to about four times the price paid by the buyer for the loan. The buyer, however, was a sophisticated party with a deep knowledge of the relevant market area. This is consistent with what we are hearing from our clients and friends: that for a loan buyer to be successful in this arena, the economics of the transaction should leave room for unexpected events and buyers should focus on market areas and projects that they understand.

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