

Considerations When Purchasing Loans in Today's Market

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The author discusses loans (including partial interests) that may be available for purchase by real estate investors, why loans can be attractive investments and matters real estate investors should consider when deciding whether to purchase a loan.

For much of this decade, the commercial real estate market was on fire. Sales were brisk and prices rose dramatically. Market conditions, notably cheap debt and cap rate compression, rewarded all types of owners turned sellers—developers who took the construction risk and delivered a stabilized project, investors who improved underperforming assets by making capital improvements and signing new leases, and even passive investors who purchased buildings that were fully leased for extended periods. Many investors flipped properties after short hold periods for significant profits.

The robust market began to fizzle in 2007 and has stagnated in 2008. The lingering credit crisis and other economic uncertainties have caused a sharp decline in commercial property sales transactions. Some real estate investors who traditionally have made equity investments (owning properties directly or through joint ventures) are shifting their attention to buying real estate-related loans, particularly subordinate debt. This article discusses loans (including partial interests) that may be available for purchase, why loans can be attractive investments and matters to consider when deciding whether to purchase a loan.

Types of Loans

The capital structures of real estate projects range from relatively simple (with only a mortgage loan and

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owner equity) to extremely complex (with a mortgage loan and multiple levels of mezzanine debt, each divided into multiple tranches, and owner equity). Depending on the particular project, an investor may have the opportunity to purchase a mortgage loan, a mezzanine loan (made to the owner or owners of the property owner and secured by the ownership interests in the property owner), a B-note (a subordinate note from the property owner secured by the same lien as the senior A-note) or a participation interest (a participant acquires an interest in the loan from the existing lender and does not receive a note or otherwise have a contractual relationship with the borrower). A participation interest may grant the right to receive a pro rata portion of all payments on a *pari passu* basis or represent a particular tranche of the loan. Subordinate participation interests also are referred to as B-notes even though the holder does not receive a separate note.

Why Loans Can Be Attractive

Different investors have different objectives in purchasing loans, and an investor's motivation dictates which interest is most attractive. In short though, investors are seeking a greater risk-adjusted return, and perhaps a higher absolute rate of return, than they would achieve on an equity investment in a particular project—which likely is not for sale in any event.

Lenders sell both performing and troubled loans, often at a discount. Some selling lenders will finance the purchase, thus increasing the buyer's potential return. Some investors seek stable cash flow from the

scheduled payments during the loan term and a “bonus” payment (resulting from the discounted purchase price and any prepayment or exit fees) when the principal is fully repaid at maturity or an earlier refinancing. For them, performing loans whose borrowers have sufficient equity cushions can be desirable. Other investors have a loan-to-own mentality and the opportunity to acquire a loan that is in or possibly headed for default at a discount is attractive. These investors seem to be focusing primarily on mezzanine loans because of their higher interest rates and first-loss position in the capital stack. Even if the mezzanine loan buyer cannot realize its ultimate goal of acquiring the property owner through foreclosure, it would be entitled to receive interest payments (at a rate that may be higher than current returns to equity investors) and the full principal amount—of course, it also is possible that the mortgage loan is foreclosed after the property value declines to an amount less than the mortgage loan balance, thus wiping out the mezzanine lender’s entire investment! B-notes and junior participation interests also can be attractive to loan-to-own investors as holders of such interests typically have some decision-making powers concerning remedies and workouts.

Considerations in Buying Loans Generally

Investment Limitations

A threshold issue for any buyer is whether it can own loans or loan interests and, if so, which types. For example, if the potential buyer is a real estate fund, the subject loan must meet the investment objectives and parameters in the fund’s organizational agreement. Loan purchases can be problematic for tax exempt investors such as pension funds and for real estate investment trusts, and for funds whose investors include such entities. The ERISA and REIT rules are complex and a full overview is beyond the scope of this article. In short, however, tax exempt investors need to be concerned about how the purchase is financed because debt financing may result in unrelated business taxable income. REITs must meet certain asset, income and value tests. Because mezzanine loans are secured by equity interests in the property owner and not a lien on the property, they technically are not “real estate assets” under the Internal Revenue Code and thus can pose problems for the REIT tests. The IRS has issued a revenue procedure that provides that mezzanine loans nevertheless will be treated as real estate assets if certain requirements are met. Any potential buyer that is a REIT or has a REIT investor should carefully analyze whether the loan meets the stated requirements.

Due Diligence

Loan purchase transactions require extensive due diligence. To fully assess its rights and risks the buyer needs to underwrite and analyze the property, all bor-

rowers and guarantors, the borrower’s sponsor, the subject loan and any other loans and the related lenders. From a financial perspective, the buyer should analyze the payment terms (interest rate and maturity), any interest or other reserve balances, income and expense projections and debt service coverage and loan-to-value ratios, and whether the results of that analysis are consistent with its investment objective. Although such predictions are inherently uncertain, the buyer also should try to assess whether the borrower will seek bankruptcy protection and the probable outcome. If any loan has not been fully funded, the buyer should access the financial strength of the applicable lender or lenders and analyze the legal and business consequences of a lender default. The buyer’s physical and legal due diligence should include the investigations and analyses it would undertake if purchasing the property, recognizing that onsite inspections may be difficult depending on the seller’s rights under the loan documents. Additionally, the buyer should review:

- the subject loan documents to confirm that the basic terms are as represented and that they contain standard covenants, defaults and remedies;
- the seller’s loan file and due diligence reports;
- the legal opinions from the original loan closing to determine whether they raised any unusual enforceability or, in the case of a substantive non-consolidation opinion, structural issues and to confirm that they may be relied upon by successor lenders;
- the seller’s title or UCC insurance policy, as applicable; and
- if there is another loan, the applicable loan documents and any intercreditor, participation or other co-lending agreements.

Traditional equity investors may not be familiar with intercreditor agreements—as borrowers, they cared that the lenders reach an agreement, but not about the terms. The intercreditor agreement effectively amends the loan documents and needs to be analyzed carefully. These agreements are discussed below.

Loan Purchase Agreement

For the buyer, the key provisions in the loan purchase or equivalent agreement (in addition to the purchase price) are the seller’s representations and warranties and the buyer’s closing conditions. Sales frequently are largely on an as-is basis, and the buyer may receive only limited representations and warranties. The agreement might be signed concurrently with the closing, in which case closing conditions are unimportant. If there will be some period between signing and the closing, the buyer should consider whether any closing conditions are necessary. For example, the buyer may want the right to terminate the agreement if there is a material adverse change in the loan’s status or the borrower’s condition, such as a

material default or bankruptcy filing. Other closing conditions could include satisfactory estoppel certificates from the other lender, the borrower and possibly tenants. The seller likely will object to conditions outside of its control, particularly a "MAC out."

Special Considerations in Buying Mezzanine Loans

Mortgage Loan

Typically the mezzanine borrower's sole asset is its interest in the property owner and so a foreclosure of the mortgage loan will cause a complete loss to the mezzanine lender (unless it can recover from a guarantor). As such, the mezzanine loan buyer must understand the mortgage loan's terms to assess the default risk. Moreover, the buyer should consider whether it is financially capable of curing a mortgage loan default or purchasing the mortgage loan if necessary to protect its investment. Because the mezzanine lender's remedy is to acquire the property owner, the buyer also should review the mortgage loan documents to see if an equity transfer requires the payment of an "assumption" fee.

Intercreditor Agreement

The intercreditor agreement between the mortgage and mezzanine lenders typically grants the mezzanine lender certain rights and protections, but also imposes restrictions and conditions on the mezzanine lender's ability to enforce its loan documents. Some mezzanine loans offered for sale are held by the mortgage lender or an affiliate and so the mezzanine loan buyer can negotiate a new intercreditor agreement as part of the purchase (some suggestions are discussed below). If the loans are owned by different parties, then the mezzanine loan buyer will inherit the existing intercreditor agreement. The buyer should review the agreement for provisions that address its ability to own and foreclose on the mezzanine loan, the mortgage lender's ability to modify the mortgage loan documents and the mezzanine lender's rights upon a default under the mortgage loan. In particular:

- **Ownership of the Loan.** The agreement may provide that the mezzanine loan can be assigned only to certain types of transferees. If the mortgage loan was securitized, the agreement likely allows the mezzanine loan to be sold to a "qualified transferee" (the agreement will contain a lengthy definition that includes type-of-entity, financial and experience requirements), but will preclude sales to other entities unless the applicable ratings agencies confirm that the sale will not result in a credit downgrade of the mortgage loan securities.
- **Enforcement.** The agreement may impose a standstill or, more likely, limitations and conditions on the mezzanine lender's ability to

foreclose. If the mortgage loan was securitized, the agreement likely provides that (i) the foreclosure buyer must be a qualified transferee (which would include the mezzanine lender), (ii) any guaranties or indemnities provided by the original principals of the property owner must be replaced with similar agreements from a credit-worthy affiliate of the foreclosure buyer, (iii) the foreclosure buyer must provide the mortgage lender with an updated substantive non-consolidation opinion, and (iv) the foreclosure buyer, as the new owner of the property owner and mortgage borrower, must ensure that the property is managed by a qualified property manager. The agreement may provide for the waiver of any assumption fee otherwise payable under the mortgage loan documents. If both loans have a common guarantor, the agreement also may restrict the mezzanine lender's ability to pursue the guarantor.

- **Amendments to the Mortgage Loan.** The mezzanine loan buyer needs to be concerned about amendments to the mortgage loan that increase the risk of default and thus jeopardize the mezzanine loan collateral. The intercreditor agreement usually restricts the mortgage lender from, among other things, increasing the loan amount, interest rate and other payment terms, altering the maturity date and cross-defaulting the mortgage loan with other indebtedness.
- **Cure Rights.** Mezzanine lenders do not have the statutory notice and cure rights afforded to holders of junior mortgages. As such, the mezzanine loan buyer will want to ensure that the mortgage lender agreed to give the mezzanine lender notice of, and an adequate opportunity to cure, defaults under the mortgage loan.
- **Purchase Rights.** In some cases, the mezzanine lender may want or need to purchase the mortgage loan rather than cure the default. The agreement typically provides the mezzanine lender with a purchase right, but the mezzanine loan buyer should review the terms. In particular, the buyer should understand how long it has to exercise its purchase right and whether it will be obligated to pay default interest, a prepayment premium or other penalties resulting from the property owner's default.

If the selling lender also owns the mortgage loan, the mezzanine loan buyer may be able to negotiate better terms than those contained in a typical intercreditor agreement for securitized loans given the current market and the seller's desire to unload the loan. For example, the buyer could seek extended periods for curing mortgage loan defaults and purchasing the mortgage loan, the right to pursue immediate reimbursement for advances made to cure mortgage loan defaults and greater restrictions on amendments to the

mortgage loan. As to foreclosure matters, the buyer could seek greater flexibility in who will be considered a “qualified transferee” and an express financial or other objective standard for determining whether a proposed replacement guarantor or indemnitor for the mortgage loan is acceptable (many intercreditor agreements utilize a reasonableness standard). The buyer also might oppose any provision allowing the mortgage lender to vote any claims of the mezzanine lender in a bankruptcy involving the property owner, and instead agree not to vote for plans that would impair the mortgage lender.

Cash Management Agreement

The mezzanine loan buyer should confirm that adequate procedures exist, whether through the mortgage lender’s cash management agreement or otherwise, to ensure that property-level cash flow will not be disbursed to the property owner or the mezzanine borrower if the mezzanine loan is in default. Unlike the mortgage lender, the mezzanine lender, because it does not have a lien on the property, probably cannot have a receiver appointed to collect rents and administer the property.

Foreclosure Matters

Because the collateral for the mezzanine loan is personal property, any foreclosure will be conducted under the Uniform Commercial Code. The loan buyer should understand the foreclosure and notice provisions in the security agreement and the requirements under the UCC, which might dictate a longer enforcement process in a given situation. In particular, if the mortgage loan requires that a mezzanine foreclosure purchaser be a qualified transferee, the mezzanine loan buyer should assess the tension between this requirement, which limits the pool of potential purchasers, and the UCC’s requirement that foreclosure sales be commercially reasonable. The loan buyer also should consider potential federal and state securities law issues and understand the registration exemption guidelines set forth in various no action letters from the Securities and Exchange Commission. Finally, the loan buyer also should be aware that in a bankruptcy it may not be entitled to the special relief from automatic stay provisions afforded creditors of a single asset real estate debtor.

Property Owner’s Organization Structure

The mezzanine loan buyer should review the property owner’s organizational documents to determine whether the property owner issued certificated interests and opted in to Article 8 of the UCC, or whether its interests are uncertificated and governed by Article 9. Creditors generally prefer Article 8. The mezzanine loan buyer also should verify whether the property owner has an independent director and, if so, which actions require that director’s consent. The mortgage lender typically requires that the property owner’s organizational documents provide that the entity can-

not file bankruptcy without the independent director’s approval. As such, even if the mezzanine lender forecloses and acquires the property owner, it may not unilaterally put the property owner into bankruptcy to disrupt a mortgage foreclosure.

Other Liabilities

Because the mezzanine lender’s collateral is the equity interests in the property owner, the buyer should consider whether the property owner may have any significant liabilities other than the mortgage loan as such liabilities will remain with the property owner notwithstanding a change in its ownership. Due to lender requirements, the property owner’s organizational documents probably mandate that the property owner be a special purpose entity and not own any assets or engage in any business unrelated to the property. Nevertheless, even a SPE may be subject to future claims from parties such as contractors, tenants and leasing brokers. Additionally, if the property owner developed the property, the buyer needs to be concerned about construction defect claims.

Special Considerations in Buying Mortgage Loans

Intercreditor Agreement

If there is a mezzanine loan, the mortgage loan buyer also needs to analyze the intercreditor agreement, although its concerns are different, and generally more limited, than those of a mezzanine loan buyer. The mortgage loan buyer should confirm that the agreement imposes adequate restrictions on the ownership and foreclosure of the mezzanine loan so that it has some control over the identity of its borrower and any required guarantor, although a change of ownership of the property owner likely would be a default under the mortgage loan documents in any event. The buyer also should analyze the notice and cure rights afforded to the mezzanine lender and whether they will delay the mortgage lender’s ability to foreclose, any limitations on the mortgage lender’s ability to amend its loan documents, the terms upon which it must sell the mortgage loan to the mezzanine lender, whether the mezzanine lender’s right to payment is subordinated and whether the mezzanine lender is restricted from taking enforcement actions that could impair the property owner and any mortgage loan guarantors.

Foreclosure Laws

The mortgage loan buyer needs to understand the applicable state’s foreclosure rules and process and any related laws that may limit the buyer’s ability to recover upon a default. For example, in California, the buyer needs to understand the requirements and limitations imposed by the state’s one-action rule and anti-deficiency laws.

Special Considerations in Buying a B-Note or Participation Interest

Underlying Loan

Because the buyer of a B-note or participation interest will acquire a portion of a larger loan, it should analyze the considerations discussed above applicable to the underlying loan. Additionally, some loan documents restrict the originating lender's ability to sell participation interests. The buyer of a participation interest should review the loan documents to see if any such conditions exist and, if so, whether it satisfies the requirements.

Rights of Other Lender

Lenders holding B-notes and participation interests are similarly situated in that neither typically has the right to deal directly with the borrower. A single lien secures both the A- and B-notes (and frequently the B-note is a subordinate participation interest and not an actual note) and the holder of the A-note often controls enforcement actions. A participant has no direct relationship with the borrower and needs to rely on the lead lender and its selected servicer. The loan buyer must review, or negotiate, the intercreditor or participation agreement governing the relationship between the lenders. Key provisions include those regarding the ability of the A-note holder or special servicer

or the lead lender, as applicable, to amend the loan documents and grant waivers, forbearances and other concessions and the right to purchase the other lender's note or interest. Because B-notes and participation interests create quasi-partnerships between the subject lenders, the lenders' agreement should address how the property will be owned and administered if acquired through foreclosure.

Motivation of Other Lender

The buyer of a B-note or participation interest should assess how the other lender is likely to react in a default situation. Specifically, would it be more inclined to foreclose immediately or to pursue work-out? More broadly, are the two lenders on the same page or is there significant potential for disagreement, or contractual deadlock, over how to administer the loan?

Conclusion

Many traditional equity investors are considering buying loans. The buyer's analysis likely will start with the offered purchase price and estimated property value, but numerous other factors should be considered to determine whether a particular loan is a suitable investment.

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