Loan Purchase Transactions: An Innovative Approach to Acquiring Real Estate Assets in a Downturn Market

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The authors explain how acquisition of a mortgage loan can provide a company that is interested in the project with a clear path to achieve its objective.

As the ripple effect from the subprime meltdown continues to impact the nation's real estate market, undercapitalized projects that are midway through construction or redevelopment will likely begin to fail and go into "loan workout" or, even worse, foreclosure mode. Mortgage lenders that find themselves holding the non-performing loans on these projects will increasingly be inclined to consider selling their loans frequently at a discount or occasionally at par (particularly where the underlying real estate is extremely desirable or valuable). Their objective will be to rid those assets from their balance sheets in an expeditious manner that minimizes their losses and avoids protracted loan restructuring or foreclosure processes.

While this scenario is horrific for the developer that has gotten caught in the quagmire, it presents innovative opportunities for companies that are cash flush and in a position to purchase the non-performing loans at bargain prices. However, transactions of this type, where a developer or asset manager purchases a loan from a lender with the ultimate goal of gaining control of the underlying real estate asset through a foreclosure or deed in lieu of foreclosure transaction, are riddled with risks that must be properly managed to maximize the loan purchaser's return on its purchase investment.

Know the Property

The starting point for any analysis of the potential upside of a loan purchase transaction is to develop a complete understanding of the property, its value, its financing structure, and other key facts relevant to the failing project. Was the project financed solely with traditional mortgage debt? Mortgage debt that is secured by an indemnity deed of trust adds further complications that must be considered in structuring a loan purchase transaction. Has all or any portion of the mortgage loan been guarantied by individuals or entities affiliated with the borrowing entity, and in particular with guaranties that spring into full recourse obligations to repay the entire mortgage loan upon the filing of a bankruptcy petition? Does the mortgage financing provide the mortgage lender with any rights to share in

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the borrowing entity's equity interest in the project? If so, that could present a risk that a court would recharacterize the loan as equity, not debt, which could result in the subordination of the mortgage lender's position to the borrowing entity's other creditors. Was other financing also used to capitalize the project? The existence of mezzanine financing secured by the ownership interests in the borrowing entity inserts an additional lender into the mix, with its own competing needs and agenda into the transaction. If the mezzanine loan is also non-performing, has the mezzanine lender exercised any of its remedies, such as taking over control of the borrowing entity? Is there an intercreditor agreement between the mortgage and mezzanine lender that contains terms precluding the mezzanine lender from exercising its rights and remedies? Was any portion of the project financed with unsecured loans from lenders who stand to lose their entire investment and therefore have every incentive to throw obstacles into the mix that could severely adversely impact the loan purchase transaction?

Consideration should also be given to the status of construction of the project. Has all construction work completed? If not, there will likely be outstanding payments due to the contractor performing that work. Are there any mechanics' liens encumbering the project? In some states mechanics' liens can be wiped out in a foreclosure while in other states they can have priority over the mortgage lien encumbering the project. The loan purchaser must have clarity about the nature and scope of possible outstanding claims and whether they can give rise to future mechanics' liens on the project. If construction work is in process, how will the loan purchaser obtain an assignment of any existing permits required for that work? Finally, an understanding of the project's current fair market value is critical both because the value will impact the structure of a deal and because it will drive the likelihood that creditors will file an involuntary bankruptcy petition against the borrowing entity.

Once the loan purchaser has obtained the best possible understanding of the borrower entity's financial landscape, the loan purchaser should give thought to the most advantageous structure for the loan purchase. Three different structures are most commonly used for these types of loan purchase transactions:

- the direct mortgage loan purchase,
- the foreclosure bid purchase, and
- the consensual deed in lieu purchase.

Direct Purchase of Mortgage Loan

Under this structure, the loan purchaser acquires the mortgage loan from the mortgage lender in its current non-performing status and then forecloses on the lien securing the mortgage loan to obtain control of the asset. This approach will appeal to companies with a greater tolerance for risk because it will usually provide greater upside potential. On the one hand, the loan purchaser will likely be able to purchase the mortgage loan at a greater discount. On the other hand, this approach is the least desirable from a bankruptcy risk management standpoint because it puts the loan purchaser at full risk during the period after the loan purchase and before the completion of the foreclosure that equity holders or creditors will put the borrowing entity into a bankruptcy proceeding. Congress has amended the federal bankruptcy laws twice since the real estate downturn in the early 1990s to make it more difficult for single asset real estate entities to reorganize. Moreover, the Bankruptcy Code provides holders of first mortgage liens powerful rights to block reorganizations and provides credit bid rights where the borrowing entity, or bankruptcy trustee, seeks to sell the project during the bankruptcy case. However, given the costs of participating in the bankruptcy action (which are only recoverable if the value of the project exceeds the amount of the mortgage debt), associated delays in getting control of the asset due to the attenuated bankruptcy process and the lack of certainty of gaining control of the project, risk-adverse purchasers will usually want to avoid this structure.

Purchase of Foreclosure Bid

Using this approach, the loan purchaser acquires the right to take an assignment of the mortgage lender's foreclosure bid after the mortgage lender has virtually completed the foreclosure process and virtually all risks of bankruptcy by or on behalf of the borrowing entity have been eliminated. This structure requires the mortgage lender to agree to pursue the entire foreclosure process on behalf of the loan purchaser. Although the loan purchaser would bear all monetary costs associated with the foreclosure process, the mortgage lender may nonetheless find this approach undesirable, since the mortgage lender would face all the stigma associates with a public foreclosure.

Consensual Deed in Lieu of Foreclosure

In this case, the loan purchaser acquires the mortgage loan from the mortgage lender and concurrently enters into a consensual deed in lieu of foreclosure transaction with the borrowing entity. Obviously, the success of completing a loan purchase transaction using this structure requires the cooperation of the borrowing entity. Typically, the agreed upon deal terms with the borrowing entity are documented in a settlement agreement where, in consideration for releasing the borrowing entity and all guarantors from all liabilities associated with the mortgage loan, the borrowing entity conveys title to the property to an entity designated by the loan purchaser. To minimize the bankruptcy risks associated with this transaction structure, the loan purchaser should bifurcate the loan purchase from the property purchase, using one pur-

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chasing entity to hold the mortgage loan (keeping the lien securing the mortgage loan alive) and a separate purchasing entity to take title to the property. In this manner, if any unsecured creditors of the borrowing entity file a lien on the property after the closing on the purchase of the mortgage loan, the loan purchaser can protect itself by foreclosing on the lien securing the mortgage loan in order to wipe out those subordinate liens.

If the borrowing entity or other interested parties files a bankruptcy petition prior to the loan purchaser's closing on the loan purchase, then the loan purchaser can simply walk away from the transaction and avoid becoming embroiled in the bankruptcy mess.

The loan purchaser needs to be careful in structuring the deed in lieu transaction in order to minimize the risk that it can be attacked, after closing, as a fraudulent conveyance. Under both state and federal bankruptcy law, creditors can file suit to set aside, as a constructive fraudulent conveyance, a transfer made for less than fair consideration where the transferor was insolvent at the time of the transfer or was rendered insolvent by the transfer. Creditors can also file suit to set aside an intentionally fraudulent conveyance regardless whether the transferor is insolvent. A deed in lieu transaction is subject to attack both where the project's fair value exceeds the amount of the debt owed to the mortgage lender and where, as part of the transaction, parties other than the property owner receive consideration as part of the deed in lieu transaction. For example, payments made directly by the loan purchaser to the holder of the mezzanine debt in return for its cooperation would likely constitute a fraudulent conveyance which could put the entire deed in lieu transaction at risk of being set aside.

Conclusion

In each of these different loan purchase scenarios, the loan purchaser will usually seek to purchase the mortgage loan at a discount off of the outstanding balance of the loan. The willingness of the loan purchaser to take on the risks associated with each of these loan purchase structures must be juxtaposed and analyzed against the magnitude of the discount, if any, that the mortgage lender is willing to sell the loan for as well as the desirability of the property securing the mortgage loan.

Over the last several years the purchase and sale of distressed debt has developed into a booming industry. As a result, a company interested in purchasing a mortgage loan with the aim of gaining control of the underlying project may find unexpected competition from a distressed debt purchaser who has no interest at all in acquiring the underlying project. However, acquisition of the mortgage loan can provide a company that is interested in the project with a clear path to achieve its objective.

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