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Opportunities Buying Distressed Mortgage Loans: The Paper Game

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Real Estate loan defaults are increasing and will probably continue to do so into 2024. Defaults are led by office property backed loans.[1] Office occupancy and tenant demand have been decreasing, and interest rates are relatively high, resulting in concern for repayment of some office property backed loans. New funds have been forming to deploy capital into distressed office strategies and massive commercial loan portfolios are trading hands for substantial discounts and, in some cases, seller financing.[2] Many office purchases involve drastic repositioning and change of use.[3]

This article is divided into three parts, the first analyzes the principles which make non-performing mortgage loans attractive to buyers, the second sets forth how key risks between the buyer and seller of a mortgage loan should be allocated as well as buyer due diligence concerns, and the third discusses receivership and foreclosure considerations. The commentary contained herein applies universally to the purchase of mortgage loans, generally, but also discusses the unique opportunities and allocations of risk factors associated with buying mortgage loans secured primarily by real estate improved and used as office space.

I. Incentivized Sellers and Inherent Discounts.

Lenders often seek to sell and monetize troubled loans as opposed to enforcing remedies and possibly litigating in a foreclosure lawsuit and/or bankruptcy. A loan sale can be an attractive alternative to exercising remedies against obligors and/or obtaining title to and selling real estate collateral, for at least the following reasons:

- Time, Expense, Risk, and Uncertainty of Litigation. Avoidance of time, expense, uncertainty and risk of litigation, including legal fees, receiver/management fees, and carrying costs such as real estate taxes, insurance, and utilities to name a few (which carrying costs are currently elevated and volatile in many markets due to inflation, government deficits, and other external forces). The time spent on litigation can be doubled or tripled when there is a real estate downturn as court dockets become backlogged, especially in judicial foreclosure states.

- Banks Loan not Own. Many lenders are banks or other institutions that are in the business of money. In particular, loaning money to yield fees and interest. Real estate lenders are generally not in the business of operating real estate, and do not want to manage or own real estate.

- External Public Relations. Banks prefer to be seen in the media as supporting businesses and borrowers, this allows them to loan more money and, in turn, make more money. It can be bad optics and public relations to squeeze an obligor to insolvency.

- Internal Optics. A quick exit saves the time and embarrassment of explaining the status of bad loans to the investment committee, board, and shareholders.

- Devaluation Risk. Since tenant demand for office space has been on a downward trajectory and is less predictable in the future as leases expire, the value of the office properties on the open market, when title is ultimately obtained by the lender, and collectability of guarantors (who often have net worth tied up in other similar office investments) for any deficiency, are both highly speculative.

- Skeletons in the Closet. Avoidance of unknown third-party obligations related to the property, deferred maintenance, and obligations that may run to an owner of a property in title.

- Immediate Liquidity. The loan is in default because something has gone wrong. This could range from a maturity default, to ongoing payment defaults, to covenant defaults. A loan sale can be the quickest exit to an otherwise illiquid, contentious, and stressful situation.

The above factors may combine to create an opportunity for a buyer to pay less for a loan than the current market value of the underlying real estate. Furthermore, even if loans are performing, lenders "are going to have to sell them at discounts partly because they were made when interest rates were a lot lower than today. An investor would want a discount to buy a loan paying a 6% interest rate if comparable debt issued today is paying 9%."[4]

Distressed loans will often be sold with a "discount to face", meaning that the purchase price of the loan is less than the original principal amount of the loan and/or a "discount to balance", meaning that the purchase price is less than the balance owed on the loan (or both). Since a commercial real estate loan is made against the value of a property at a given time, a buyer of a mortgage loan paying a discount to face for a senior secured real estate loan, is paying less than the appraised value of the property at the time the loan was originated (unless the property was originally underwritten at 100% or more loan-to-value). Typically, at least 25%-50% less, since a standard loan-to-value is about 50-75% of the collateral value at the time a loan is made.

II. Risk Allocation and Due Diligence.

With a motivated seller and favorable economics, buying a lender's interest in a non-performing commercial real estate loan may seem like easy money, simply exchanging money for a file of loan documents negotiated and signed long ago. Do not be deceived. Experienced dealers in paper know that hidden risks lurk below the surface of every distressed loan sale.

The selling lender will usually draft the loan purchase agreement to carefully place cost and risk on the buyer, such that the buyer "steps into the shoes" of the lender for liabilities and pre-closing actions of the lender. The starting point is often "As-Is/Where-is" with no representations, warranties, prorations, or conditions to closing, as well as a full release and indemnification of the selling institution. These forms are often drafted by sophisticated counsel for the selling institution and have been prepared to disclaim all liability and cost relating to any and every pre-closing or post-closing risk imaginable.

Aside from the loan file, the buyer acquires no physical assets, only the lender's right, title, and interest in the loan. Usually the buyer must exercise, or continue to pursue, remedies against the real estate collateral because the prospects of repayment from obligors or other non-collateral sources are dim.

Here are best practices for proper risk-allocation of key matters between the buyer and seller of a mortgage loan as well as buyer due diligence:[5]

- Loan Document List. Be clear on what you are buying. List all loan documents and all documents related to any prior transfers of the loan. Have the seller represent and warrant that the list is true, correct, and complete, in all material respects.[6] If the loan is part of a cross-default/cross-collateral loan structure, understanding the relationships with other loans, lenders, and third parties is critical.

- Loan Documents. Review the loan documents and all documentation related to any prior transfers of the loan carefully. Particularly the default and remedies provisions. Look for errors in the loan documents. For example, if an obligor's name is incorrect or the legal description of the property is wrong, these items are best addressed before the loan is purchased.

- Original Signatures/Affidavit. Require all original wet ink signed loan documents and all documentation related to prior transfers of the loan. If any key documents are not original, particularly the note and any guaranty, get a lost-document affidavit meeting the standards of legal admissibility in a civil lawsuit in the jurisdiction where the loan will be enforced and the property will be foreclosed, just in case any obligors or transferors challenge the electronic documents as being inaccurate representations of the originals.[7]

- Certified Loan Tape. The buyer will need to establish that a default has occurred (assuming a default has occurred). Therefore, the buyer should obtain a certified "loan tape" from the seller, which is a ledger showing the entire financial history of the loan. The more detail the buyer can obtain the better. Again, the best practice is to have certification in the form of an affidavit that meets the standards of legal admissibility in a civil lawsuit in the jurisdiction where the loan will be enforced and the property will be foreclosed, just in case any obligors challenge the loan balance.

- Loan File and Property Due Diligence. Beyond a review of the loan documents, the seller's loan file must be scrutinized. Due diligence such as survey, zoning, material correspondence, property condition, taxes, insurance, leases, service contracts, and environmental are very important and may come in helpful down the road. Consider whether the items in the loan file are sufficient because a buyer of a loan should do all the due diligence as if it were loaning on the collateral directly. The seller may want to keep certain things in the loan file confidential, such as their own internal correspondence, loan analysis, underwriting, and banker's notes (particularly regarding remedies), that is standard and acceptable from the buyer's point of view.

- Leases and Tenants. Review the leases. Recognize whether they are subordinate to the purchased mortgage. Be aware of tenant deposits, unpaid allowances, accrued or pre-paid rent (including common area and tax reimbursements), unfulfilled unusual landlord obligations, and tenant rights. All of these may bear on the buyer's eventual liability as landlord when the foreclosure or deed-in-lieu is completed. Obtain as many representations as possible concerning the status of the leases. The seller will likely resist any commitment to obtain certificates from obligors or estoppels from tenants in a distressed deal, but consider negotiating.

- Title. Get an assignment of the seller's rights to make a claim under the existing lender's title insurance policy, an assignment endorsement, and a date-down. Consider obtaining a current title commitment (which may be in "minutes of foreclosure" style, as discussed in Section III below).

- Default Letters. Review all default letters and confirm compliance with applicable law. Were they cured? How?

- Seller Indemnification. The seller may require the buyer to release and indemnify the seller for anything related to the loan or the collateral whether occurring before or after closing. Minimally, do not agree to release or indemnify the seller for its own pre-closing actions.

- Loan Reserves. Pay attention to loan reserves. The buyer must know when and how they were funded and depleted. If the seller has loan reserves, the buyer wants them turned over at closing. The obligation to (re)-fund reserves travels with the loan. Again, the best practice is to have certification in the form of an affidavit as to loan reserve status that meets the standards of legal admissibility in a civil lawsuit in the jurisdiction where the loan will be enforced and the property will be foreclosed, just in case any obligors challenge the status of reserves.

- Due Diligence on Obligors. Run UCC, tax, judgment, lien, and bankruptcy searches on obligors. A buyer should know if any competing creditors or claims are in the picture. Do as much research on the obligors as possible, as this will help handicap inclination to fight foreclosure and enforcement.[8]

- Servicing Release. Make sure the loan is being sold on a "servicing released" basis. Has the servicer been paid? Was the prior servicer reputable? Consider whether proof of termination is necessary.

- Lender Liability Concerns. Understand whether circumstances may exist for lender liability. These can include a myriad of potential claims such as breach of the duty of good faith and fair dealing, improper control over the borrower, interference with contracts and/or prospective business advantage, as well as conventional claims for breach of contract, misrepresentation/fraud and duress, negligence, conversion, defamation, environmental and other statutory liability. Also consider whether any obligors may have common law defenses to payment or performance or other equitable remedies.[9]

- Transfer Taxes. Are any transfer taxes owed on the transfer of the loan or property in the applicable jurisdiction? Are there applicable exemptions to transfer taxes for a lender taking title in a special purpose entity post-foreclosure, or as part of a deed-in-lieu of foreclosure?

- Lock Box. Pay attention to how funds are currently flowing from tenants. If there is a "lock box" arrangement in place, be sure to obtain all related information. This is particularly important in jurisdictions that allow lender collection of rent directly from tenants without taking possession of the property.

III. Foreclosure and Receivership Related Considerations.

The purchase of a distressed real estate loan will often involve enforcement of remedies against the real estate. In anticipation of the filing and/or continuance of a foreclosure consider the following:[10]

- Make sure the lis pendens (i.e., record notice of action pending), service/summons, court filings, publications of sale, and the certificate of sale and confirmation of sale, are bullet-proof and done in accordance with applicable law.

- If a receiver has not been appointed in the foreclosure, review whether a receiver is appropriate and have the information for the appointment of a receiver ready to file upon the acquisition of the loan. Alternatively, some jurisdictions allow mortgagee-in-possession ("MIP"), whereby the lender can take possession of the property directly. In such an MIP scenario, the lender is not usually entitled to fees but there may be a property manager involved that can assess fees. If the decision is made to pursue MIP, have the information for the appointment of a mortgagee-in-possession ready to file, if necessary, upon the acquisition of the loan.

- Prorate any receivership/management fees and property level costs, and true them up after closing with the seller. Include costs of carrying the property through the foreclosure which accrued prior to closing but have not been paid. Often overlooked, this single piece of advice has saved buyer-clients major dollars.

- Get a substitution of parties and counsel signed at the closing, so the buyer can substitute into any pending foreclosure case immediately.

- Talk to any receiver/manager about the property (ideally, with the seller's cooperation).

- Review all pleadings in the foreclosure case (with a particular eye on any affirmative defenses or counterclaims raised by any parties), the receiver's/MIP's appointment order, and the receiver's/MIP's reports. A receiver's/MIP's report will often have important property level information on financial performance, property conditions, and other matters such as a reference to a city issue, prospective building code violation, unpaid contractor, or broker, etc. that may not show up otherwise.

- Ask for a credit for any items identified as deficient or problematic in the receiver's/MIP's reports.

- If the loan has already gone to judgment or sale, get an assignment of the judgment and/or certificate of sale at the closing.

- Obtain a "minutes of foreclosure" style title commitment with respect to any pending or contemplated foreclosure case, to confirm that all necessary parties have been, or will be, named and served and the title company is not raising any exceptions or issues with respect to the property and the foreclosure case.

- Be aware if there any statutory cure rights, rights of redemption and/or rights of reinstatement in the applicable jurisdiction.

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Footnotes:

[1] The decline in office values is self-evident but to highlight the point, at least one S&P 500 Office RIET's Sub-Industry Index tracker has fallen approximately 43% since approximately February 2020. See: https://www.marketwatch.com/investing/index/sp500.40402040?countrycode=xx.

[2] See Peter Grant, "Wall Street is Ready to Scoop Up Commercial Real Estate on the Cheap", Wall Street Journal, August 15, 2023, https://www.wsj.com/articles/wall-street-is-ready-to-scoop-up-commercial-real-estateon-the-cheap-6edac64f?st=4yljvzzkusijauo&reflink ; Peter Grant, "Cash Pours Into Distressed Real-Estate Funds as Investors Aim to 'Play Offense'", Wall Street Journal, April 21, 2020, https://www.wsj.com/articles/cash-pours-into-distressed-real-estate-funds-as-investors-aim-to-play-offense-11587470400?st=lpgz5vcyklhlfsr&reflink; and Capital One, Third Quarter 2023 Results presentation, dated October 26, 2023. "The $888M Office Real Estate loan portfolio that was moved to LHFS in Q2'23 was sold in Q3'23, with seller financing provided. This financing had a balance of $363M at 9/30/23…"; https://investor.capitalone.com/static-files/d7f2aa72-5594-4c2c-bf7f-91a9621b5f82?trk=feed_main-feed-card_feed-article-content. In addition, one of the authors penned and circulated an article before the Covid-19 Pandemic explaining the opportunity for distressed real estate fund formation created by an epic run up in REIT values that may be of interest to the reader. See Chad Richman "Raise now, spend in a downturn: time to start a distressed real estate fund?", LinkedIn, published October, 24, 2016, www.linkedin.com/pulse/raise-now-spend-downturn-time-start-distressed-real-estate-richman.

[3] See Tracy Hadden, Egon Terplan, and DW Rowlands "Myths About Converting Offices into Housing and What Can Really Revitalize Downtowns", Brookings Institute Research, April 27, 2023, https://www.brookings.edu/articles/myths-about-converting-offices-into-housing-and-what-can-really-revitalize-downtowns/; and Konrad Putzier, "America's Downtowns are Empty. Fixing them will be Expensive.", Wall Street Journal, October 21, 2023; https://www.wsj.com/real-estate/commercial/wrecking-ball-targets-empty-downtown-offices-d0e3391.

[4] See Peter Grant, "Signature Loan Sale Likely to Lower Commercial-Property Values", Wall Street Journal, August 15, 2023, https://www.wsj.com/real-estate/commercial/signature-loan-sale-likely-to-lower-commercial-property-values-298edc31?st=y7vk2fmwotfnzn7&reflink.

[5] This is not an exhaustive listing of every essential term as all loans and situations are different.

[6] In Illinois, if a buyer obtains a seller representation that all loan documents are included in the sale, a buyer can feel reasonably comfortable. This is because Illinois has the Credit Agreements Act which states that "A debtor may not maintain an action on or in any way related to a credit agreement unless the credit agreement is in writing, expresses an agreement or commitment to lend money or extend credit or delay or forbear repayment of money, sets forth the relevant terms and conditions, and is signed by the creditor and the debtor." See 815 ILCS 160 et. seq. This includes amendments and modifications to credit agreements.

[7] Statutory and case law has leaned toward the enforcement of electronic loan documentation (especially in circumstances where loan documents expressly contemplate electronic versions) and sufficiency of computer-generated records but obligors can delay proceedings while the admissibility and enforceability of electronic documents is being litigated.

[8] The authors have had many borrowers roll over and offer a deed-in-lieu and substantial payment after an initial phone call but have also had many borrowers fight the foreclosure for years (and, one extreme situation where an obligor wound up in jail for filing billion-dollar fraudulent counter-liens against law firms, lenders, and even judges, different story, but the reader gets the point- not all borrowers are created equal).

[9] A full analysis of loan defenses and lender liability rules is beyond the scope of the article. Cases in which lenders overreached by duress or violated a duty of good faith are somewhat rare, but judges and juries tend to be sympathetic to loan obligors and fiduciary duties may be imputed on a lender, and expose the lender to liability, for acting in its own interest in exercising control over a borrower's affairs.

[10] In a non-judicial foreclosure jurisdiction (i.e., "power of sale" or "foreclosure by advertisement" jurisdiction) some of these would not be necessary considerations.

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