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Due Diligence in Acquiring Distressed Debt - Part One

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There is no shortage of buyers anxious to buy distressed mortgages. The simple reason is the possibility of substantial profit if a loan can be purchased at a significant discount and there is a realistic possibility that the borrower or, if it forecloses, the lender, will be able to salvage the property. This is the first of two articles about counseling clients in acquiring distressed commercial mortgage loans. Bankruptcy, special assets such as condominium properties and UCC foreclosures are beyond the scope of these articles.

Lenders and purchasers come together through a variety of avenues, but common to all is the need for the purchaser to conduct due diligence on the asset that the lender proposes to sell. Some lenders require due diligence to be completed before bids are received from prospective purchasers, others require due diligence to proceed under a letter of intent or similar stage of the process and still others will allow due diligence to be undertaken after a purchase agreement has been signed, which agreement will typically be contingent on the purchaser being satisfied with its due diligence.

Common to almost all deals is the lender's insistence that due diligence be completed in a very short time period.

Due diligence for acquiring distressed mortgage debt is much like the due diligence a lender would conduct in deciding to make a loan in the first instance, except the loan file is or should be complete rather than being assembled as in the case of a original loan. Unlike your role in closing a loan, where you assuring, to the greatest extent possible, that all issues are resolved before the loan can be closed, in this case you are issue-spotting.

Additionally, due diligence proceeds in most deals without the cooperation or participation of the property owner; indeed, in many instances without the property owner's knowledge that the loan is being sold. The inability to interview the property owner, its tenants and in some cases access the property itself obviously constrains due diligence significantly. Moreover, due diligence in connection with acquiring distressed debt requires evaluating the performing status of the loan, the likelihood of being able to reach workout terms with the borrower, the status of pending litigation between the lender and borrower and, in general, envisioning a strategy that will enable the loan purchaser to recover its investment in acquiring the loan and realize a substantial profit.

If there is pending litigation, then, in addition to the areas noted below, litigators will need to review the litigation file. Aside from the litigation file, due diligence can be divided generally into several areas:

- **The loan documents**
- **The loan collateral**
- **The borrower and guarantors and**
- **The loan status**

In this article we discuss due diligence related to the first two items, the loan documents and the loan collateral.

A. Loan Documents

Obviously, the loan documents must be reviewed. Some of the material considerations include:

1. First and foremost, determine if you have all the documents. Make sure they are complete, properly executed and, if applicable, acknowledged. It is not rare to find missing pages or portions of documents. Are originals available? Does the loan package include all the documents you would expect including the promissory note, mortgage, lease assignments, UCCs, guaranties, environmental indemnification agreement, adequate legal opinion and all loan amendments and modifications?

2. Analyze the quality of the documents. Many, if not most, loan documents contain similar provisions but some are more comprehensive than others. You want to make sure your documents contain all customary terms. Your antenna should be up for unusual terms which may tell you about issues that were of particular concern to the lender when the loan was closed, which may appear in many ways including by way of escrow agreements or the like. What are the events of default, notice and cure periods? What are the due on sale and due on encumbrance provisions? Are the terms clear and unambiguous?

3. Pay particular attention to the business terms. Scrutinize the business terms of the loan, make sure there is no room for alternative interpretations of the terms. Are provisions for late charges and other charges clear and likely to be enforceable? Is the loan full or partial recourse, or non-recourse? Are there guaranties, full or partial, payment or completion? If the loan is non-recourse, are there carve outs? Are they typical? Is there personal recourse if the borrower files bankruptcy? Can the loan can be prepaid and if so, under what circumstances?

4. You are buying debt and regardless of whether your client is paying a fixed price or paying a percentage of the outstanding indebtedness, you need to confirm that the amount the lender has stated to be the outstanding indebtedness is consistent with the loan documents. This is critical because you can be fairly certain that at some point the borrower will scrutinize and be prepared to challenge any calculation of its indebtedness with which it disagrees. Bear in mind that it will be a rare circumstance when you will be able to get a loan estoppel statement from the borrower before you close the loan acquisition, and certainly not if the loan is in litigation or on its way there. You also have to focus on escrows held by the lender and their accounting because the borrower can be expected to do so.

5. Determine if funds remain to be loaned and, if so, how much and the conditions to further funding. If the loan is in default, it is very likely that the loan documents will not require the lender to continue funding although practical realities may impel the lender to do so in order for the real estate to have value or to maintain its value.

B. Loan Collateral

Nothing matters more than making sure, to the greatest extent possible, that the loan is properly collateralized, the collateral is not impaired and the lender owns the loan.

Issues regarding title, survey and lien priority are common to every deal. However, other issues relating to the physical assets vary significantly depending on the nature of the asset, whether raw land, property under development, single or multi-tenanted, condominium, multi-family or other commercial.

1. Review the title insurance policy issued when the loan was made, and any endorsements or subsequent policies if the loan was modified. Make sure the mortgage was insured as a first priority lien (assuming your client is buying a first mortgage). Do not rely solely on title insurance; confirm for yourself that the mortgage and all modifications were properly recorded and that the mortgage constitutes a perfected lien.

2. Confirm that the encumbered real estate covers all the property that should be covered including appurtenant easements that may be critical for the proper operation and functioning of the property (for example, easements for parking on, or crossing, adjacent property) and look to see if all necessary and desirable title endorsements were issued. Also, if applicable, see if a construction loan policy was issued and has an expiration date.

3. Review the survey. See if the survey is for the as-built project. Is the legal description in the mortgage and title

policy the same as the legal description in the survey? Does the survey show material encroachments from or onto the encumbered property? Are there access issues? Has the property changed?

4. Check to make sure the amount of the title insurance policy is the same as the maximum loan amount.

5. Order title updates including property searches, tax searches and judgment searches on borrower and guarantors. Determine, as soon as possible, if the property has been transferred, if there are subordinate liens against the borrower or guarantors, and, of course, confirm that the lender hold the loan free and clear.

6. You will probably request the title insurer to issue an ALTA 10.1 endorsement at closing of the loan transfer. This endorsement insures the validity of the loan assignment and the continued priority of the mortgage.

7. Check to see if there a separate assignment of leases and rents, and that it is properly recorded. Have UCCs been properly filed?

8. Review the status of development, building and zoning permits and approvals as reflected by the loan file. The scope of this review may vary widely depending, for example, on whether or not the loan was closed on a fully developed and approved project, or one that was to be built. In any event, has zoning changed so that the project and its use no are no longer conforming?

9. Are there other material development related approvals or agreements, for example, a financial agreement with the municipality exempting the improvements from realty taxes and requiring payment in lieu of taxes? If so, you will want to know the status of the tax exemption, determine if all annual reports have been filed, if there is an audit underway by the municipality, if there are any issues with the municipality. If the project has been developed as a condominium, has it been registered with the Department of Community Affairs, have annual reports been filed, are any enforcement actions pending?

10. Is the property leased? Does the lender have current rent roll information, copies of leases? Does the information on the rent roll match the leases themselves? Are the leases subordinate? Has the lender entered into, or will it be obligated by the loan documents, to enter into non-disturbance agreements with some or all the tenants? Is there evidence of any tenant defaults? Are the tenants open for business?

11. Does the loan file include environmental reports? Were any issues uncovered by the reports? Is there evidence of ISRA compliance, if applicable? Is the property being used in a manner that could raise environmental concerns?

12. Does the file contain evidence that all required insurance policies and certificates have been issued, renewed and remain in full force and effect, for the benefit of the lender? Is the coverage acceptable in scope and dollar amount? Is the insurer acceptable?

13. Have the borrower and, if applicable, guarantors, complied with financial reporting requirements under the loan documents? Are the financial reports in the loan file up to date and is the information in the reports acceptable?

14. Review with a critical eye the property appraisal that the lender received when the loan was made and any updates.

15. The loan file should contain other material information regarding the property such as engineering and physical condition reports, material contracts and agreements.

16. Is there a property manager? Is the management agreement subordinate to the mortgage or otherwise terminable on relatively short notice? Can you evaluate the manager and its capabilities?

In our next article we will discuss due diligence regarding the borrower and any loan guarantors, and the loan status.

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