Expediting the Sale of Distressed Notes Secured by Real Estate

By Kay K. Bains

Thorough review of documents and collateral is the critical first step.

In the current economic environment, some banks and financial institutions are deciding to sell commercial real estate notes. Over the last 18 months, from the first glimpse of the deteriorating real estate market to the present, my firm has closed hundreds of note sales.

In my experience, the sale of notes occurs in three distinct stages: preparing for the sale, negotiating the contract and closing the sale. This article provides an overview of the practical and legal steps involved. For convenience, I use the term "bank" when discussing the selling entity, but the steps and advice apply to any entity selling distressed commercial loans secured by real estate.

The sale of notes occurs in three distinct stages: preparing for the sale, negotiating the contract and closing the sale.

Preparing for a Sale

Once a particular loan has been selected to be sold, the first, and critically important, task is to assign a department with the responsibility for gathering all of the bank's files into one location. Typically, with distressed loans, files have been scattered among various departments. Depending on the geographic reach of the bank, different portions of the file could be located in different states. A complete inventory of the files should be performed, removing proprietary information and determining whether original documents have been located.

The availability of original loan documents is of significance in the marketability of the note, the purchase price and the liability of the selling bank to the buyer. The courts of some states require original notes be delivered into court in order to commence foreclosure proceedings. If the originals are not available, the courts will generally accept a lost note affidavit with a copy of the note, but that will extend the time for foreclosure. When a buyer learns the original note is not available, the buyer will likely demand a reduction of the purchase price to compensate for the extra time and expense that will be incurred in foreclosure. If, after a diligent search, the original note cannot be found, both potential buyers and bank's counsel should be informed.

During this preparatory stage, the bank will need to decide how to make copies of the loan files available to buyers. Depending on the volume of loans the bank intends to sell, copies are provided either in paper format, on disks or in secure data rooms accessed over the Internet. This is a labor-intensive process, and the bank should allow for sufficient personnel and time to accomplish the task.

A critical document to obtain before actively marketing a loan and before providing the buyer with access to the loan files is a confidentiality agreement signed by all potential reviewers of the loan documents. Parties signing the confidentiality agreements should include not only entity reviewers but also the individual principals of the

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reviewer. The potential buyer may be an entity with no assets, so an indemnification for breach of the confidentiality agreement would be of little value. The individual principals of the reviewing entity should be personally liable for the breach.

Another preparatory step is a review of the file to determine whether the loan is participated. Participants can be problematic in a note sale for less than par. The participant may not share the bank's view of the real estate market or this particular project and borrower. For financial reasons, the participant may not want to take a loss at this particular time. The participation agreement should be thoroughly reviewed to determine whether the bank must obtain the participant's consent to a sale. If the participant's consent is required, and the participant is not interested in selling its portion, will the participant consent to the sale of just the bank's portion? If only the bank's portion of the loan is to be sold, that scenario raises issues for a buyer, who may have no interest in having a participant attempting to control or to be involved in the liquidation of the collateral.

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Other determinations to be made during the preparatory process are whether letters of credit have been issued, if there are swap agreements and whether the loan to be sold is cross-collateralized or cross-defaulted with loans not being sold. If letters of credit or swap agreements are secured by the mortgage being sold, and if those letters of credit or swaps are not terminated, the bank will be exposed postclosing with no security. If the loan to be sold is cross-collateralized, the bank should take the necessary steps to "uncross" it before the closing.

In addition to conducting a thorough review of the loan documents, the bank should also be thoroughly familiar with the collateral. A current inspection of the collateral should be performed. Unfortunately, the buyer's due diligence often reveals that the property has not been maintained or has suffered unrepaired casualty. Such a discovery can lead the note purchaser to request a reduction in price. It is important to remember that anything the buyer discovers during its due diligence can result in a "retrade," or a demand for a reduction in the purchase price. Therefore, the bank must understand and be current on the condition of the collateral when it is negotiating the price.

Typically, if a loan is in distress, the bank does not want to incur additional costs. However, the bank should consider whether certain reports would be helpful in a sale. Lenders may consider ordering updated appraisals and updated environmental studies, since those would be needed should the lender decide to foreclose if the sale of the loan is not successful. The cost of those reports could be passed to a potential buyer in a negotiated sales contract.

During this preparation stage, the bank should determine if the legal description of the real estate collateral has changed since the initial loan was made. In land loans, for example, the legal description of the real estate collateral will initially be by metes and bounds. Subsequent to the loan closing, however, as part of the development process, the real property could be subdivided into lots, with a new plat recorded. The mortgage the bank is trying to sell may not have been amended to update the legal description, and the buyer must satisfy itself that the metes and bounds description and the replatted subdivision are the identical property. This change in legal description can become more confusing if lots have been sold. Often, a title report may reflect deeds to lots but no releases from the mortgage. The buyer is faced with the issue of whether those lots remain collateral or whether releases should have been filed. The bank preparing to sell a note secured by a subdivision should order a title update and research payment records to determine whether lots have been sold and whether releases should have been filed. Although the bank is advised not to make representations regarding what collateral secures the note, should a buyer determine during the due-diligence period that it will actually receive fewer lots than it based its bid on, the bank will be faced with either a terminated contract or a demand for a reduction in purchase price.

In addition to reflecting deeds and releases, an updated title report is critical in determining whether mechanics' liens have been filed and whether real estate and/or personal property taxes are current. Again, if the bank learns for the first time from a potential buyer that taxes are past due, the bank will be faced with a demand for a reduction in the purchase price.

Negotiating the Contract

The sales contract is the final agreement between bank and buyer. The bank should develop a form contract for consistent use in all its sales. The bank officers and bank lawyers should be clearly instructed as to what provisions are negotiable and under what circumstances and parameters those provisions can be negotiated.

Thorough preparatory work results in fewer surprises, fewer reductions in purchase price, fewer requests for extensions of due-diligence periods and fewer terminations of contracts.

The following provisions in a contract for the sale and purchase of a distressed loan are most likely to be negotiated and are the most important for the bank:

- Business terms
- Representations
- Disclaimer
- Existing litigation
- Look-back period

Business terms. Business terms include the purchase price, the amount of the earnest money, the length of the due-diligence period and the number of days after the due-diligence period within which the closing must occur. Due-diligence periods can be as short as a few days or as long as 60 days. The length of time is generally governed by the completeness and availability of the bank's files, whether the loan is the subject of contentious litigation and whether the collateral may have serious physical problems. The more preparatory work that the bank has performed and can share with the buyer, the shorter the due-diligence period. Once the due-diligence period has ended and the earnest money is "hard," the contract should call for a closing within a matter of days.

Representations. Perhaps the most significant legal issue in contract negotiations is the scope of the bank's representations. Frequently, buyers ask for more representations than my clients typically provide. Buyers ask for representations that they have been given the complete file, that the mortgage is a valid first lien, that the loan documents are valid and binding and that the bank has fully performed and is in full compliance with the loan documents and all applicable laws. The response to those requests is generally, "If you want more representations, pay more money." Typically, the bank should make as few representations as possible. The continuing liability of the bank to the buyer after closing relates solely to the representations made. Acceptable and appropriate representations include that the bank is an entity validly existing under the laws of the state of organization; that the officer executing the contract is authorized to do so; that the sale of the note does not require the consent of any other party (unless a participant is involved); and that the outstanding principal balance is a stated amount. Additional representations that could be given if applicable include a representation as to whether the loan is subject to litigation, whether the borrower or guarantors have made any written claims against the bank and whether the note is in default.

Representations that the bank should not agree to make would include that the bank has provided the buyer with copies of the entire file (undoubtedly, after closing, a stray file will appear); that the note is secured by a first lien on specific collateral (the buyer needs to rely on title insurance and its due diligence, not a bank representation); and that the condition of the collateral or the property is in compliance with zoning, environmental and other laws and regulations. Remember, the bank is selling paper only. It is not selling real estate. All representations should relate only to what the bank owns and is selling (that is, the loan). The bank should not make any representations regarding the collateral. In addition, buyers often request permission in the contract to access the collateral property for on-site inspections. Unless the bank has taken legal possession of the property, the bank has no right generally to provide anyone with access.

Disclaimer. The contract should include a disclaimer paragraph. Not only does the bank not make any representations regarding the collateral property, the bank discloses that there are no representations regarding the property, it makes no representations whether the note is secured, and it states that the buyer is performing its own due diligence and will make its own determinations.

Existing litigation. If there is existing litigation, the buyer and the bank will need to decide whether the buyer will be substituted as the plaintiff, whether the bank will continue to defend any cross-claims against the bank, whether any settlement by the buyer with borrower and guarantors must also include a release of the bank, and whether the buyer or seller will provide any indemnities to the other related to that existing litigation.

Look-back period. The contract should provide a drop-dead date, after which the buyer cannot look to the bank for any claims. This time frame should be as limited as possible, so the note, once sold, is truly off the books.

Financing the note sale. In some circumstances, the bank may be willing to extend a loan to its buyer as a purchase money loan for the acquisition of the note. The bank will have its typical loan documents executed by the buyer, incorporating the terms of the loan with the buyer. As collateral, the bank will receive an assignment of the note (the same one that it just assigned to the buyer) and an assignment of the mortgage and other loan documents as security, which assignment will be recorded immediately after the assignment of mortgage executed by the bank in favor of the buyer. It is important that the original sold note not be delivered to the buyer. It must be retained by the bank in order to protect and perfect its lien on and security interest in the note. The loan documents between the bank and the buyer should require that the buyer execute a mortgage, in the form attached to the recorded assignment of mortgage as security, immediately upon taking title at the foreclosure sale or by deed in lieu of foreclosure.

Closing the Sale

The closing of a note sale is straightforward. The bank prepares and executes the following closing documents:

- An assignment of recorded documents
- An allonge to the note, without recourse
- An omnibus assignment of all other loan documents
- A notice to the borrower, disclosing the sale of the note and the address of the buyer for note payments

The preferred procedure for closing is an exchange by e-mail of signed pdf closing documents and the wire transfer of funds. Upon receipt of the purchase price by wire, the bank's attorney will be authorized to disburse the funds to the bank and will be obligated to place in an overnight delivery package the original closing documents and the original documents of the loan being sold. Those original loan documents should not leave the possession of the bank or its counsel until the purchase price has been received and the funds are unconditionally and irrevocably payable to the bank.

More Preparation Equals Fewer Surprises

Once a decision has been made to sell a note, the focus and energy are on marketing, negotiating and closing. Thorough preparatory work results in fewer surprises, fewer reductions in purchase price, fewer requests for extensions of due-diligence periods and fewer terminations of contracts. If the goal is to sell quickly, be knowledgeable about the loan and the collateral property before entering contract negotiations.