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Legal Update

US Commercial Real Estate Loan Purchase and Sale Considerations

Due to the negative market forces caused by COVID-19, we anticipate an increasing number of non-performing commercial real estate loans. Therefore, the secondary loan market in the United States is likely to become a pipeline of opportunity for well-prepared sellers and buyers alike. Lenders interested in selling one or more loans (the sellers) may find that this market presents opportunity to offload risk and better leverage balance sheets in an environment where scheduled or accelerated principal repayments, early discounted payoffs, and even current monthly payments may not be feasible for many borrowers. For those seeking to acquire loans in the secondary market (the buyers), this environment provides an avenue to invest in debt in amounts, at yields/asset cycles and with associated risks that may be more aligned with their investment strategies. Further, acquisition of distressed debt can also serve as a vehicle to acquire real estate.

Before commencing a commercial real estate loan purchase and sale transaction, each party should (1) identify its specific short- and long-term objectives; (2) consider the nature of the loan and underlying collateral and realistically evaluate its ability to administer the loan or, following foreclosure, the collateral; (3) identify the key opportunities, obstacles and risks in light of market realities; and (4) consider pricing factors.

This Legal Update provides a guide for commercial real estate loan purchase transactions and some practical considerations that parties should bear in mind during the course of such transactions. In addition to the considerations set forth below, the parties should engage professionals experienced with the type of debt under consideration, as it is critical at each stage that the parties consider and understand key distinctions relative to the kind and source of debt at issue and tailor the transaction accordingly. Some key distinctions in types of debt include:

- Nonperforming Loans vs. Performing Loans
- Senior Loans vs. Junior/Mezzanine Loans
- Loan Portfolios vs. Individual Loans
- Commercial Loans vs. Residential Loans
- Construction Loans vs. Permanent Loans
- Whole Loans vs. Partial Interests[1]

1. Term Sheet/Letter of Intent. The term sheet or letter of intent will establish the baseline terms for the loan purchase transaction. Loan purchase transactions can look like a property acquisition, with a purchase agreement pursuant to which a deposit is made and due diligence period occurs, or they can be structured as a "sign and close" transaction in which the loan purchase agreement is signed at the closing of the acquisition. In a "sign and close" scenario, the term sheet will effectively govern the transaction until closing, which may affect the level of detail the parties wish to include. Some of the key points to be covered in the term sheet include:

1.1 Price, Deposit and Other Financial Allocations. The term sheet should identify the purchase price (or at least the manner in which it will be calculated). Some considerations in pricing the loan include: whether the debt is fully secured, oversecured or undersecured given the current market value of the underlying collateral, the borrower's overall financial status (including the likelihood of a bankruptcy), the priority of the debt and other outstanding financing, and the direction in which the market/economy or the borrower's business is trending. In addition to the purchase price of the loan, the parties will need to consider the allocation of payments and advances from the time the purchase price is established through the closing date (and possibly beyond if a transfer of servicing occurs after the closing date). If the transaction is not a "sign and close," the buyer will likely be required to put up a deposit to serve as the seller's liquidated damages in the event of a buyer breach.

1.2 Scope and Priority of Purchase. Loans may be purchased individually or in groups or pools. If more than one loan is the subject of the transaction, the term sheet should specify whether, based on diligence or other specified events, the buyer may remove one or more loans from the transaction and continue with the acquisition of others. If there is active litigation in connection with the loan such as a foreclosure or a suit on a guaranty, the buyer will need the seller's interest in such litigation to be expressly assigned to the buyer and such assignment to be filed with the applicable court. For distressed loans, the buyer should verify whether there is any other lender or competing interest holder with a stake in the underlying asset, regardless of the seniority of the loan being purchased and/or the buyer's business plan for the loan. A junior or mezzanine lender may have a right to purchase a senior or mortgage loan or to approve material modifications of the debt which could forestall workout plans. A senior loan foreclosure process might be affected by a junior or mezzanine lender making a competing bid to protect its investment, and conversely could wipe out a junior lien and/or the value of any mezzanine collateral. Any other creditor of borrower or its major constituents could potentially create a bankruptcy situation that would be problematic for the buyer. Any of these outcomes may result in a buyer claim against the seller if the existence of other known interest holders was not been disclosed, based upon a breach of representation or warranty. Accordingly, it may behoove both the seller and the buyer to spell out how the parties contemplate handling the contractual rights/relationships of any third parties that may have competing interests in the proposed purchase.

1.3 Diligence. Diligence considerations are covered in more detail below, but should include loan documents and servicing files, as well as borrower and property diligence. As the diligence period is typically short or concurrent with document negotiation and, in either case, usually 30 days or less, prospective purchasers are wise to condition the commencement of the diligence period upon the seller's delivery of the complete loan/diligence file. Key diligence items which a buyer requires should be called out in the term sheet. The term sheet/LOI should specify the means by (and the timing within) which the seller will make diligence in its possession available, and as well as the scope of the buyer's rights to terminate the agreement (or to remove loans from the transaction) on the basis of diligence. Depending on the size, type and number of loans in the transaction, the basis for transaction termination/removal of loans may vary widely, from a buyer's sole discretion based on its opinion of diligence to the limited instances where there is a material defect in loan documents or a deficiency causing the seller's representations to be materially untrue. If the purchase agreement will have an escrow period, provisions regarding a deposit and diligence period should be included in the term sheet, although certain details regarding diligence objections and post-diligence period/pre-closing discoveries or events may not be negotiated until the purchase agreement is prepared. Other key provisions regarding diligence may be drawn from "Diligence" below for incorporation as well.

1.4 Servicing. The parties should specify in the term sheet whether the loan is being transferred on a servicing-released basis or whether the seller or the existing servicer will continue to service the loan. If the seller or an affiliate is servicing the loan pre-sale, the seller may wish to try and retain the servicing function for the ongoing revenue. Retaining the loan servicer in a loan purchase transaction simplifies the interface with the borrower, as the borrower will continue to deal with the same party on a day-to-day basis, and may result in fewer other logistical tasks (such as transferring accounts, etc.). However, engaging a servicer will come at a cost to the buyer, and the buyer should consider whether it is capable of servicing the loan, whether it has other servicing options it wishes to pursue, and whether it has confidence in the seller performing such role.

1.5 Confidentiality and Exclusivity. Loan document confidentiality requirements may create a corresponding need for the seller to include a confidentiality provision in the term sheet. The buyer should ensure that the scope of representatives and consultants with whom the buyer is permitted to share the diligence information covers with those whose expertise it will need to evaluate the loan, the borrower and the property, and should consider corresponding confidentiality commitments from such representatives and consultants. While the seller may be reluctant to provide, the buyer should push for the inclusion of an exclusivity provision—providing protection from potential dead deal costs in the event that the seller shops for, and signs with, an alternate loan purchaser.

1.6 Other Key Provisions. The term sheet should also address issues such as the anticipated closing date, termination rights and remedies, key representations, governing law, and allocation of transaction costs (legal fees, title updates, title endorsements, servicing release costs, and costs of obtaining tenant estoppels and/or the consent of any necessary counterparties, in each case as applicable). Many of these subjects are discussed in more detail below under "Diligence" and "Transaction Documents."

2. Diligence. The scope of due diligence in a loan purchase, subject to the "Other Considerations" set forth below in this section, should generally include a review of the loan documents, the servicing files (including borrower/lender correspondence) as well as the borrower, any guarantor and the underlying collateral. It is important that any buyer retain or otherwise deploy professionals with the right skills and experience applicable to type of loan (and asset) to assist in this review. The buyer will need a contractual seller commitment to cooperate with and/or facilitate the buyer's diligence efforts. The seller may want a contractual acknowledgement that the seller shall control communication with certain parties until the closing.

2.1 Loan Document Review. One of the most important tools in loan document review is a strong loan summary form which, among other matters, should provide a roadmap to the buyer's complete understanding of the material terms of the loan. In particular, the buyer should fully grasp each of the following upon completion of the loan summary form: (i) the payment terms under the loan (e.g., schedule of payments, how payments are made, the interest rate and accrual periods, default rate, late payment fees, the maturity date, any options to extend the maturity date and the requirements for any such extension), (ii) any other financial covenants with respect to the loan (e.g., balancing requirements, debt coverage ratios, requirements to submit financial statements, requirements to maintain a specified minimum net worth or net working capital amount); (iii) any impound or reserve requirements and/or any cash management regime (including whether the loan has a so-called "hard" or "soft" lockbox regime); (iv) any and all default provisions and remedies detailed in the loan documents; (v) exculpation and recourse provisions; (vi) guarantees or other credit support; and (vii) the standard borrower covenants (e.g., prohibitions against additional financing and/or transfers of interests in the property or the borrower/guarantor entities, covenants to maintain, repair, insure and pay taxes due with respect to the property, and covenants concerning borrower's entity status and other legal compliance with all legal obligations). It is critical in particular that loan documents are reviewed by a professional experienced in the applicable type of loan; otherwise, nuances which are material to the asset may be overlooked.

2.2 Property Review. An updated preliminary title or UCC report should be ordered in connection with the existing title or UCC insurance policy. In general, two endorsements should be also considered. It is common and inexpensive to get an endorsement substituting the buyer as the named insured on the policy. Standard form policy jackets for the existing mortgage and mezzanine policies insure whomever holds the debt secured by the insured lien, and, therefore, it is not technically necessary to change the insured's name by endorsement. However, this "named insured" endorsement has the effect of insuring the transfer of the loan itself. A so-called "date down" endorsement is also valuable but can be expensive, depending upon the jurisdiction. Because a purchaser of distressed real estate debt might eventually succeed to ownership of the collateral, the buyer should—in addition to assessing risks to which it may be exposed as lender (e.g., mechanic's/tax liens, environmental liability)—identify and assess those risks that a property owner could encounter (e.g., zoning/regulatory compliance, costs to complete construction, carrying costs, adjoining property issues and potential tort claims).

2.3 Borrower/Guarantor Review. The diligence examination should also include the borrower itself, along with any guarantors of the loan. While the organizational structure of the borrower/guarantor is important, the central concern of this inquiry should be on such party's financial capabilities—ascertaining whether the same is solvent and adequately capitalized to timely satisfy its obligations with respect to the loan. As most non-construction loans are non-recourse loans and SPE borrowers are prevalent, upon a loan default, the buyer's recourse (if any) in excess of collateral will likely be against the guarantor under the applicable guaranty (e.g., payment, completion and/or non-recourse carveout guaranty). The buyer should also consider the borrower/guarantor's reputation (including, relevant goodwill and/or history of performing or defaulting on loan obligations) and management and/or construction expertise with respect to the type of transaction/property at issue. Lien, UCC, judgment, bankruptcy and litigation searches are recommended.

2.4 Considerations for Special Loan Types. Thought should be given to whether the specific loan type at issue lends itself to special diligence needs or requirements. For example, if a loan secured by a hotel is being purchased, the buyer will need to determine whether the existing comfort letter from the hotel franchisor is transferable and/or whether it otherwise requires a new comfort letter from the hotel franchisor. If the property has a limited number of significant tenants, the buyer may wish to request tenant estoppels from such tenants. If the loan is part of a capital stack, estoppel certificates from other lenders in the stack or a lead lender may be prudent. If a foreclosure process or other legal action has begun, the buyer will want to assess whether the same has occurred in accordance with applicable law. The seller will need to evaluate its rights to request or require applicable desired confirmations or documentation from the current borrower under the loan documents and/or under any direct agreements between the seller and such counterparties.

2.5 Other Considerations Regarding Diligence Generally. Certain other deal specific factors may also affect a buyer's decision about the appropriate level of review to undertake, as well as the seller's position regarding how much diligence it is willing to facilitate. The farther "out of the money" the applicable loan is, the lower the tradeoff for effort spent on diligence; a purchaser of a mezzanine D note at a significant discount (a/k/a a "hope note") will not get the same value out of a careful and thorough diligence process as the purchaser of a first lien mortgage loan at par. In certain circumstances, the parties may consider a tradeoff between representations and a repurchase obligation from a creditworthy entity on one hand and certain aspects of diligence on the other hand. Additionally, the level of diligence undertaken for each loan, borrower and asset in connection with the purchase of a large number of small loans is likely to be less than that pursued for one (or a small number of) large loan(s). For example, in the purchase of a loan portfolio, the emphasis might be on key characteristics of the largest loans in the mix.

3. Transaction Documents. The primary transaction document is the loan purchase agreement ("LPA"). Additional documents (allonge, transfer and assumption, recordable assignments of recorded documents, UCC-3) will be required to fully effect the transfer at closing. If the transfer is on a servicing released basis and the existing servicer is a party other than the seller, written confirmation of the termination of such servicing agreement is advisable, and, if the buyer intends to engage a replacement servicer, the buyer will need a replacement servicing agreement. The parties will also need to agree on forms and delivery of notices to insurers (hazard and title), borrower, and other counterparties to the loan documents. This section will focus on the contents of the LPA and assumes that term sheet items discussed above will be carried over into the LPA.

3.1 Representations and Warranties. Representations and warranties are a key part of any LPA. The buyer and the seller should each expect to receive from the other customary corporate representations, including in regard to OFAC and ERISA. Most other representations will be from the seller regarding the loan, the borrower and the underlying asset. The buyer will be looking for as many solid confirmations as possible and the seller will try to limit representations to its own knowledge and its own actions, and eliminate matters which the buyer can confirm through its own diligence of the loan file.

a) Common seller representations and warranties include (subject to negotiation of the parties along the lines described above): (i) identification of all loan documents (including any modifications) and provision of true and correct copies thereof; (ii) specification of outstanding principal balance, unfunded loan amount (if any), and reserve amounts; (iii) whether any default on the part of lender has occurred and whether borrower's/guarantor's obligations are subject to any defenses, counterclaims or rights of offset; (iv) whether any claims, waivers or releases have occurred under the loan documents or any insurance policy with respect to the loan or underlying asset; (v) whether the seller is the owner of the loan, free of any encumbrances (alternative: whether the seller has transferred or encumbered its interest in the loan); (vi) whether diligence materials provided are true, correct and complete copies (a seller may wish to note that it is not making representations regarding the contents of third-party reports); and (vii) whether the seller has any knowledge of borrower or guarantor defaults.

b) Representations and warranties may survive the closing for some period of time, as short as one month and as long as 24 months for fundamental representations and warranties such as to ownership or authority to sell.

3.2 Covenants. An LPA which has an escrow period should include specification about whether and on what conditions the seller may take actions with respect to the loan prior to closing. The parties should discuss expectations as to modification of loan documents, exercise of remedies, and waivers or releases of terms, parties or collateral.

3.3 Indemnification. Generally, each of the buyer and the seller will indemnify one another for losses from circumstances or events caused by the indemnifying party during its respective period of loan ownership. Consideration may also be given to the buyer's unauthorized contact with counterparties during diligence and/or bad faith/willful misconduct of either party which does not occur during its period of ownership. Recovery may be capped in amount or limited to claims brought within a certain period of time.

3.4 Pre-Closing Defaults and Remedies. An LPA with an escrow period should grant each party the right to terminate the LPA in the event of the other party's pre-closing breach. If the seller breaches, the buyer will want the option to either terminate and recover its transaction costs or to pursue specific performance. If the buyer breaches, the seller will generally retain any deposit as liquidated damages and as its sole and exclusive remedy.

3.5 Repurchase Obligation. The seller may have an obligation to repurchase the loan in the event that breaches of representations and warranties are discovered post-closing. The seller may or may not have a cure right or obligation in lieu of or as a condition precedent to such repurchase obligation. If the seller is a special purpose entity or otherwise likely to be liquidated after the sale, a creditworthy entity with longevity will likely be required to backstop the repurchase obligation.

3.6 Closing Logistics. The LPA should also address closing logistics. Reserves and other accounts (or interests therein) may need to be transferred or credited. If a cash management system is in place, the seller may or may not be entitled to require borrower to relocate the applicable accounts to a bank of the buyer's choosing. The original loan file should also be delivered to the buyer.

4. Post-Closing. The buyer should ensure that it has professionals in place who are equipped to service and administer the loan post-closing, especially if the buyer has not engaged an experienced loan servicer. Construction loans will require a construction monitor-equipped to review construction progress and administer draw requests. Loans with cash management systems in place will require additional accounting and fund distribution functionality on the buyer's part. Loans secured by hospitality assets will require tracking of reserves, as well as monitoring of franchisor property improvement requirements. If foreclosure is the buyer's objective, the appropriate counsel should be prepared to coordinate with the applicable title company in such process.

In summary, prior to entering into a loan purchase transaction, buyers and sellers should:

- Begin with the end in mind; look at big picture short- and long-term objectives and whether they are realistically served by the proposed transaction;
- Staff the transaction properly, with professionals experienced in the specific type of loan and asset;
- Consider the appropriate (for buyers) and feasible (for sellers) amount of diligence for loan documents, collateral and borrower/guarantor based on the transaction, and whether "shortcuts" are available or appropriate;

- Tailor diligence and purchase terms to transaction, loan, and collateral type;
- Consider the post-closing creditworthiness of any party with post-closing obligations; and
- (Buyers) Have a post-closing operational plan.

If you wish to receive regular updates on the range of the complex issues confronting businesses in the face of the novel coronavirus, please subscribe to our COVID-19 "Special Interest" mailing list.

And for any legal questions related to this pandemic, please contact the authors of this Legal Update or Mayer Brown's COVID-19 Core Response Team at FW-SIG-COVID-19-Core-Response-Team@mayerbrown.com.

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Endnote

[1] Purchase and sale of partial or participation interests in loans are not generally covered in this Legal Update.