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COMMERCIAL LOANS

Acquisition of Commercial Mortgage and Mezzanine Loans


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Recent activity in the real estate markets has consisted in large part of the sale and acquisition of commercial mortgage and mezzanine loans. The pre-downturn prevalence of CMBS financings at high leverage levels has given the holders of commercial real estate loans significant control over the trading of commercial properties; a property that will not sell for more than the debt stack simply cannot be disposed of outside of bankruptcy absent some concession from one or more lenders. As a result, in recent years savvy real estate investors looking for access to properties began to acquire mortgage and mezzanine loans (and co-lender interests in those loans), initially at very attractive pricing that strongly enhanced projected returns. As the market in real estate debt has strengthened, the pricing advantages seem to have diminished to some extent.

Investors in the secondary market for real estate debt may have different goals. Some investors (though fewer as pricing has firmed up) acquire debt for the return, seeing recovering real estate values and any discount to par as creating favorable yield opportunities. Others are making these investments, occasionally at a premium to value, as a way to obtain control over the debt stack at the 'fulcrum point' (i.e., the most junior position in the debt stack that is that is at least partially "in the money"), since that position typically controls lender decisions under the applicable intercreditor arrangements and is also optimally situated to be the successful bidder in a foreclosure sale.

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These latter investors may also acquire positions junior to the fulcrum position in order to ensure control in the event the property appreciates in value. Once control over the debt stack is obtained, the investor can either transact with the borrower to obtain control over the property in a consensual restructuring or wait for the likely default and obtain the property through credit bidding in a foreclosure.

The Diligence Effort

As the secondary market for loans has become more competitive, the pace of these transactions has quickened. Many investors seek to preempt auctions or other competitive situations, resulting in closings that need to be consummated in a matter of days, not weeks. For lawyers working in this area, judgments have to be made as to what diligence can be done in this time frame, and what representations and warranties need to be obtained in order to compensate for diligence limitations.

It is a given that essential diligence will include review of the loan documents to understand the terms of the loan. Review of intercreditor agreements, pooling and servicing agreements (in the case of CMBS debt) and any relevant participation or co-lender agreements (i.e., agreements between lenders as participants or noteholders within a single tranche) is of similar importance. In the CMBS sector, the near-standardization of documentation, especially the intercreditor agreement, somewhat mitigates the diligence task, although the documents often deviate from the standard and must be reviewed with care.

A threshold diligence issue for intercreditor agreements is to determine whether or not a buyer is a "Qualified Transferee" under the agreement, as transfers by a lender to a non-Qualified Transferee typically require consent of all of the lenders. Qualified Transferee definitions can vary from transaction to transaction, and may require satisfaction of asset and net worth tests and require some level of experience in acquiring and owning commercial real estate loans or operating commercial properties. In addition, the intercreditor agreements usually prohibit sales of loans to affiliates of the borrower.[1] The intercreditor agreement also typically contains notice requirements, and sometimes can require notice of a transfer in advance of the effective date of the transfer, so these requirements need to be identified in the diligence process.

Another important feature in analyzing the intercreditor and co-lender agreements is to confirm that the control provisions are sufficiently clear. Documentation in these transactions is sometimes not a model of clarity, and inconsistencies in the various agreements can cause uncertainty among the lender group when the borrower goes into default and it comes time to exercise remedies or restructure the loans.

The diligence effort ideally also includes a review of the seller's complete loan file. Among the greatest risks to enforcement of the loan and the achievement of the client's objective (whether it is a 'loan-to-own' play or simply a return-driven investment) is the history between the lender and the borrower. That history can result in offset rights against the loan, defenses to enforcement, and even affirmative lender liability claims. Most buyers will focus on written communications between borrower and lender, given that it is practically all that will be available to investigate. A prudent buyer should want to review all written correspondence and other communications between borrower and lender (and among the various lenders in the stack) in order to assess the risk of offsets, defenses and lender liability claims. The loan file can also provide valuable information regarding issues with the collateral.

However, in practice, the seller of a loan is often not willing or able to produce the complete loan file for a various reasons, ranging from inadequate record-keeping, transition in responsibility for the loan, transition in the servicing of the loan, or simple unwillingness to expose its records. Moreover, given current means of communication in commercial transactions, much of the valuable information will be contained in e-mail exchanges, which a selling lender may be less willing to go through the trouble of producing and the volume of which can be overwhelming for a buyer to digest. Any limitation on diligence of the loan file should be addressed by strengthening the representations given by the seller.

All would agree that full property diligence is a necessity for a lender originating a mortgage or mezzanine loan. Logic would suggest that the scope of property diligence for the secondary market purchase of such a loan should be similar. However, in practice, full property diligence is less prevalent in secondary market transactions. Perhaps buyers of loans take some comfort in the detailed diligence performed when the loan is originated, coupled with the monitoring of the property that is typically performed by the party servicing the loan. In addition, given the pace of secondary market transactions, there is often insufficient time to order updated engineering or other third-party reports. The greater the interval between the loan origination and the secondary market transaction, the more important property level diligence becomes.

At a minimum, a visit to the property, review of the third party reports delivered to the originating lender and review of the borrower's and servicer's most recent reporting on the property is warranted. In addition, if practicable under the circumstances, a buyer should obtain a title update, though this is less of a concern if the loan being acquired is a mortgage loan that would likely have priority over intervening liens and encumbrances as opposed to a mezzanine loan that is structurally subordinate to any intervening matters.

Property level diligence is often complicated in the event that either party is reluctant to engage the borrower. For example, in a distress scenario where the relationship between borrower and lender has deteriorated, even to the point of litigation, a seller may resist cooperating with a buyer's efforts to diligence the property. On the buyer's side, if the buyer is looking to acquire a control position and does not want to tip off the borrower or other third parties to its strategy, the buyer may be willing to limit property diligence to what it can obtain from the seller. If available, the opportunity to discuss the loan and the collateral with the servicer can be invaluable.

It should also be noted that the scope of diligence will be influenced by the client's plan to finance the acquisition. If the buyer is paying cash for the acquisition or obtaining purchase money financing, the buyer can make its own call on the scope of diligence. However, if the buyer is using third-party financing for the acquisition, the buyer's lender will likely have more rigorous diligence requirements. The required scope of diligence will also be informed by the scope of representations obtained from the seller and the survival period of those representations.

Basic Representations

At its most basic level, a loan sale transaction is an 'as is,' 'where is' transaction; sellers, especially those who frequently trade in these assets, are typically reluctant to retain significant exposure for an extended period post-closing. That being said, certain basic representations and warranties are usually obtained. A buyer's ability to negotiate the legal documentation for the acquisition will depend in large part on whether the sale process is competitive, but even in a preemptive situation a buyer should be able to insist on some basic protections.

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The fundamental representations regarding the seller's ownership of the loan, the scope of the loan documents, the amounts outstanding under the loan, and the presence or absence of defaults under the loan are rarely at issue. On the other hand, sellers are usually successful in resisting making representations about the property, and buyers will usually accept the limited representation that the servicer's and borrower's reporting has been delivered to the buyer. A frequently negotiated representation relates to the loan file and communications between the borrower and lender (and also among the various lenders).

Sellers may be reluctant to make any broad 'loan file' representation and at a minimum will exclude oral communications. E-mail correspondence, which can form the basis of a defense to enforcement of the loan, is also resisted by sellers, as it is difficult to identify matters that should be disclosed as an exception to the representation. Most lenders will deliver (and stand behind) the paper file in the possession of the servicer, and may also be willing to represent that other than disclosed correspondence, there is no written correspondence that would have a material and adverse effect on the lender's position.

Other representations that should be considered by a buyer are those relating to the intercreditor agreement(s) and any senior indebtedness in the stack. Sellers will generally make representations on the scope of the intercreditor agreement and receipt of notices of certain actions under the intercreditor agreement. Sellers are usually more reluctant to make representations regarding senior debt positions, though sellers will sometimes make knowledge-based representations regarding the senior debt positions and some comfort can be obtained from review of the servicer reports.

In addition, some buyer concerns about the status of senior debt positions may be addressed through a representation regarding receipt of intercreditor notices (i.e., the seller would be entitled to notice of certain senior debt matters, such as defaults and enforcement actions, under the intercreditor agreement and would typically have the right to consent to significant changes in the senior loan documents).

Sellers generally will fight to limit the survival period of the representations and warranties. A survival period as long as six months is on the generous side, and 60 or 90 days is not uncommon. However, many sellers will agree to a longer survival period for fundamental representations, such as ownership of the loan and the amounts outstanding under the loan.

Most mortgage and mezzanine loan agreements require the borrower to deliver an estoppel to the lender on relatively short notice. Nevertheless, buyers often do not require an estoppel as a condition to closing. In part, this stems from some of the same factors that discourage contact with the borrower as discussed above, as well as timing limitations. From a buyer's standpoint, the estoppel risk can be ameliorated through obtaining representations and warranties relating to matters that would be covered by an estoppel and by requesting and obtaining a borrower estoppel shortly after acquiring the loan. The buyer is then in a position to confirm those representations and warranties and make a claim within the survival period for any issue raised by the estoppel.

1. While this prohibition may seem straightforward, in practice it can become tricky, if, for example, the buyer of the loan owns a preferred equity interest in the borrower.