Lending on Distressed Real Estate Notes: Business and Legal Issues

By Jan B. Brzeski and Michael J. Zerman

The great real estate buying opportunity that was expected to follow the recent financial crisis has yet to materialize.

While the residential real estate market has thawed somewhat with the help of ultra-low-interest mortgages provided by federal government agencies, the commercial market remains frozen. Income-property values are down about 40 percent from the peak, but transaction volume remains a fraction of what it was a few years ago. Given that most transactions from the boom years of the mid-2000s were financed with 70 percent to 80 percent debt, virtually all of these properties are now worth less than the loan amount. Accordingly, banks hold the key to when and how the commercial investment market becomes unfrozen.

Distressed Note Sales

One option that we are seeing more frequently — and that we expect will be active in 2011 — is the sale of nonperforming notes.

The bank benefits by replacing a questionable receivable with cash on its balance sheet, while the buyer pays less for the note than he or she would pay to buy the underlying property directly. However, the buyer may need to pay all cash, because banks are generally averse to taking a writedown on an asset and then extending new credit on that same asset.

For buyers seeking financing for distressed note acquisitions, an emerging trend is to use a bridge loan as part of the note acquisition. Not all bridge lenders are comfortable lending on a nonperforming note, but for those who are able to do it, the returns can be attractive relative to the risk.

Sample Economics of a Distressed Note Investment

For example, suppose a $10 million loan is sold for $7.5 million, while the underlying real estate is worth $9 million. A bridge lender might offer $4.5 million of financing, representing a 60 percent loan-to-cost (LTC) and a 50 percent loan-to-value (LTV) based on the value of the underlying property. Normally a bridge loan on good property at 50 percent LTV would yield in the single digits, but in return for taking a note as security rather than real property, the bridge lender would receive a double-digit yield. Usually the buyer of the distressed loan is expecting an unleveraged return in the 20-plus percent range, making double-digit financing costs acceptable to many buyers.

Selected Business Issues

When lending on a nonperforming note, the lender usually does not have access to the same quality of due diligence available when lending on real property.

For example, the actual income and expenses of the property may not be available. Therefore, the lender and/or the distressed note buyer may need to build current cash flow projections from the ground up.

Purchasing a note from the bank is like purchasing a bank-owned property, but the bank expects to close even faster in order to justify its decision to accept an even lower price.

Bridge lenders typically know that they will either be paid interest and principal, or else they will need to foreclose, with the potential for a bankruptcy by the borrower adding time to the

foreclosure process. Lenders whose security is a nonperforming note have one more layer of uncertainty in that the buyer of the nonperforming note could file for bankruptcy in addition to the owner of the real property. For this reason, among others, lenders whose security is a note rather than real property need to be conservative in the amount they will lend.

Selected Legal Issues

A bridge lender should not assume that the note buyer and the original lender have disclosed all the material issues that might affect the value of the collateral. A comprehensive list of due diligence issues is beyond the scope of this column, but a few real examples that the authors have encountered in recent years include: i) the legal description in the original deed of trust omitted a material portion of the collateral; ii) imposition of property tax liens exceeding $1 million that had priority over the lender's lien; iii) the secured property was conveyed (twice) to new owners without lender consent, despite due-on-sale restrictions; and iv) lawful street access to an office building was blocked by a stalled excavation project after loan origination.

Often, such issues are only discovered through a careful review of the loan files and certain updated reports, including a current title report and a Phase I environmental assessment. As a practical matter, there may not be enough time to complete such an extensive review, and few bridge lenders want to pay for it. Consequently, note buyers and bridge lenders should factor an appropriate price discount into the transaction to compensate for such risks.

The bridge lender should review a draft of the note buyer's purchase agreement before execution to insure that the note seller has made adequate representations, warranties and indemnities, which should be drafted to run in favor of the note buyer's successors and assigns, including the bridge lender.

Note financing is different from conventional real estate finance in several respects. The note buyer should execute a new promissory note and a security agreement in favor of the bridge lender; that grants the bridge lender a security interest in the note that is being acquired.

The California Commercial Code specifies a few different ways for the bridge lender to perfect its security interest, but the best method is for the bridge lender to obtain possession of the original note. Otherwise, the bridge lender could lose priority to a good-faith purchaser who buys the pledged note without knowledge of the bridge lender's security interest.

The Commercial Code provides that perfection of a security interest in a secured note also constitutes perfection of a security interest in the deed of trust securing such note. However, the bridge lender should also record a collateral assignment of the deed of trust, which gives constructive notice to third-party claimants. Additionally, if a collateral assignment is recorded, most title insurers will issue a CLTA 104.4 endorsement to the original lender's title insurance policy; that insures the bridge lender that the original deed of trust has not been modified or reconveyed and that the collateral assignment is effective. The 2006 ALTA Loan Policy gives a subsequent holder of the note insured status, and the bridge lender should obtain possession of the original lender's policy along with the original note and the other loan documents.

Whenever a loan is secured in whole or part by California real property, lenders must carefully consider the effects of California's One Action Rule and anti-deficiency rules, which provide, among other things, that a lender cannot sue the borrower directly on the note or take other legal actions against the borrower except as part of a judicial foreclosure action.

The penalties for violating the One Action Rule are severe: loss of the lender's lien on its real property collateral and, potentially, discharge of the debt. Therefore, if prior to the note sale, the original lender sued the borrower to collect on the note, then the collateral may be worthless.

Likewise, if after the note sale the note buyer sues the borrower on the note, then the bridge lender's collateral may be destroyed.

Finally, a bridge lender should anticipate that the note buyer may raise One Action Rule defenses if it defaults under the bridge loan. While the legal merits of such a defense are debatable, the risk can be mitigated through careful drafting of the bridge loan documents, including third-party guaranties with appropriate suretyship waivers.

Jan B. Brzeski *is the principal of Standard Capital LLC based in Los Angeles and is the manager of a mortgage fund focused on originating and investing in short-term real estate loans.*

Michael J. Zerman *is a partner at the law firm of Zuber & Taillieu, based in Los Angeles. His practice focuses on real estate transactions, including mortgage finance, purchase and sale, leasing and construction agreements.*