THE RISKS OF DEBT PURCHASE TRANSACTIONS

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The commercial real estate (CRE) industry is facing a looming wall of $2 trillion in debt maturities, with an estimated $929 billion coming due this year.[1] These staggering numbers are particularly troubling since refinancing opportunities for these CRE loans are limited or unavailable because of continuing high interest rates, declining CRE property values, and the absence of meaningful transactional activity on the part of CRE lenders. With this dismal backdrop, it is not surprising that in the next three years, $670 billion of the maturing debt will likely be comprised of "potentially troubled" loans largely in the office and multifamily sectors (but with some lesser impact on retail and industrial assets).

These market conditions are not just gloomy but also alarming, as the distressed state of the CRE industry poses continued risks to the banking system.[2] However, these conditions may present unprecedented opportunities for more risk-tolerant investors to purchase debt secured by distressed CRE assets at potentially significant discounts. However, buying CRE-secured debt is very different than acquiring real estate itself, with unique risks and requirements which can have a potentially material and adverse impact on investment returns.

Here are some guidelines that can help you understand these differences and better manage the associated risks for your clients.

ASSUMING LENDER LIABILITY

The first thing to keep in mind is that when investors purchase debt, they become lenders. That means they must conduct themselves as lenders and assume risks of lender liability. Borrowers can make claims of lender liability on a number of bases (including breach of contract, negligence, fraud, and breach of fiduciary duty). One of the more common claims of lender liability arises based on the implied covenant of good faith and fair dealing that applies to every party to the loan documents.

This implied covenant requires a lender to exercise its discretion under the loan documents reasonably (and not arbitrarily). To avoid liability, a lender's actions must be based on well-documented and commercially reasonable grounds. A lender must also act in good faith and not take opportunistic advantage of a borrower in a way that could not have been contemplated at the time the agreement was made.

Investors should not buy a loan *solely* with the intention of foreclosing on the real estate serving as its collateral unless they are willing to take the risk of a lender liability claim. They must conduct themselves accordingly and with a view toward avoiding lender liability. In exercising foreclosure remedies, beware of states that have a statutory right of redemption.

Establish the amount of a foreclosure bid bearing in mind this statutory provision that is favorable to borrowers and junior creditors.

EVALUATE HOW THINGS CAN GO RIGHT (AND WRONG)

Here are some examples of the possible outcomes of a debt purchase transaction, ranging from the best case scenario to one involving a catastrophic loss:

Outcome 1 – Things Go According to Plan

After purchasing the debt, the investor services it in a customary manner (as a lender) until it is repaid at maturity or sooner, refinanced by the borrower (i.e., the borrower performs its obligations and fully repays or refinances the debt), or the investor sells the performing or non-performing debt to someone else either at or above the total purchase price. Alternatively, if the debt is in default or if the borrower subsequently defaults under the debt: (i) the investor exercises available remedies under the loan documents; (ii) no bankruptcy petition or other borrower actions are filed; (iii) no claims by other secured or unsecured lenders or third parties are initiated; and (iv) the client obtains title to the CRE (or achieves any other remedies pursued) within the anticipated time frame and for the projected costs.

Outcome 2 – Things Do Not Go According to Plan

Following a borrower default, the investor exercises remedies and either:

- Does not obtain title to the CRE securing the purchased debt but does receive some of the targeted investment returns. This can occur where competitive bidder outbids the investor at the foreclosure sale; or
- The borrower files a voluntary bankruptcy petition (or a creditor of the borrower files an involuntary bankruptcy petition) and the plan of reorganization is confirmed by the bankruptcy court. If the borrower is able to implement the plan, it will likely refinance the debt at some later point, preventing the investor from foreclosing and ending up with title to the CRE. In this scenario, at the time of the refinance, the investor would be reimbursed for the full amount of the outstanding principal and interest on the loan and any enforcement costs, receiving a return of (and possibly some return on) the investment.

Outcome 3 – An Impaired Return on Investment

The purchaser buys the debt, exercises remedies under the loan documents, and obtains title to the CRE collateralizing the debt, but the process takes longer and/or costs more than anticipated.

This can occur when: (i) there is an overpayment for the debt based on an inflated valuation of the CRE asset securing the debt; (ii) bankruptcy petitions are filed by the borrower or one of its creditors; or (iii) unanticipated claims are initiated by secured or unsecured creditors or other third parties that are not extinguished by a foreclosure sale resulting in unanticipated delays and litigation and transaction costs.

Outcome 4 – Catastrophic Loss

This can happen when the selling lender does not own the loan and the purchaser does not get good title to the debt or when the loan documents governing the loan are defective and unenforceable, precluding the exercise of any remedies in the face of a borrower default.

BEFORE PURCHASING DEBT, DO YOUR HOMEWORK

Gather all pertinent facts about the debt, the selling lender, loan servicers (and any other interested parties, in particular if the debt has been securitized), junior secured and unsecured creditors, ground lessors, third-party claimants, the borrower, any guarantors, and the property. Then, follow this due diligence checklist:

- Conduct comprehensive due diligence on the debt, including the loan documents governing

the debt, focusing, in particular, on whether the debt has been securitized. This should include a legal evaluation of the seller's title to the debt, the enforceability of the loan documentation, and the specific remedies available under the loan documents.

- Conduct customary due diligence on the CRE securing the debt to get a clear understanding of its fair market value and the impact a foreclosure sale will have on any major occupancy leases.
- Review the loan file to determine whether the borrower has asserted claims against the lender or any facts that could form the basis of a borrower's claim.
- Obtain a clear understanding of the laws of the jurisdiction governing the loan documents and occupancy leases and how they might impact efforts to exercise remedies.
- Based on the specific facts and circumstances surrounding the debt, evaluate the likelihood of whether the borrower would contest the exercise of remedies and whether a bankruptcy petition might be filed by or against the borrower.
- Map out the path to follow in exercising any remedies under the loan documents in light of applicable law and local custom and practice (i.e., would you exercise the assignment of leases and rents, seek a receivership, proceed immediately to a foreclosure, or pursue a deed in lieu?) and develop a timeline for the pursuit of these remedies.
- Carefully determine the purchase price for the debt, based on the lower of the estimated value of the property securing the loan and the maximum amount to achieve the minimum acceptable yield, assuming the borrower fully performs and pays off the loan at its scheduled maturity, and factoring in discounts for the risks presented by the specific facts surrounding the loan.
- Carefully document the acquisition of the debt, both in terms of obtaining a complete set of loan documents governing the debt and in requiring proper documents to transfer the debt.
- Obtain an assignment of the selling lender's mortgagee title insurance policy and purchase an updating endorsement to that title policy changing the name of the insured to the debt purchaser and adding the recorded assignment/transfer of deed of trust or mortgage as part of the description of the "insured mortgage."

GENERAL DOS AND DON'TS

- When possible, only acquire distressed debt, since this might present a reduced likelihood of a challenge to the investor's election to an exercise of remedies.
- Only buy first lien real estate secured debt that has an associated mortgagee title insurance policy and that would constitute "Single Asset Real Estate" under the Bankruptcy Code, reducing the likelihood of any bankruptcy filings by the borrower or its creditors.
- Since a debtor will have a better chance of successfully reorganizing under the bankruptcy laws where its property's value exceeds the debt, endeavor to buy debt whose principal amount materially exceeds the value of the real estate securing the debt.
- Where possible, acquire debt where the investor is the sole secured creditor and there are few other unsecured or mezzanine lenders.
- Avoid Buying Debt: (i) where the facts and circumstances may allow a court to reform the debt into equity, either through equitable subordination, debt recharacterization, or otherwise; (ii) where the full principal amount of the loan has not previously been advanced by the selling lender; (iii) that involves an identifiable and contentious course of conduct between the selling lender and the borrower; (iv) where due diligence reveals that the borrower may have any basis to assert lender liability claims; or (v) where the facts and circumstances indicate the likelihood of third-party claims. That includes a lender participation

feature or where the lender (or its affiliate) holds an equity position with the borrower (or insists on buying and controlling all lender "equity" positions in addition to the debt).

CONCLUSION

The issues and risks associated with CRE secured debt purchase transactions can be managed to achieve an investor's targeted investment returns. However, the facts and circumstances for each debt acquisition vary considerably and must be carefully analyzed on a case-by-case basis.

Notes

1 Erik Sherman, Globe Street, Just How Big is the Wall of Maturities? (Apr. 3, 2024), available at https://www.globest.com/2024/04/03/just-how-big-is-the-wall-of-maturities.

2 Erik Sherman, Globe Street, A Significant Share of Banks Are Overexposed to CRE (Feb. 27, 2024), available at https://www.globest.com/2024/02/27/a-significant-share-of-banks-have-excess-cre-loan-exposure/.