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Options exist for buyers of distressed property

The flood of distressed commercial real estate transactions predicted to occur in 2009 did not come to pass.

Why? First, although many loans are underwater (i.e., the borrower owes more than the property is worth), the borrower is able to make required loan payments because of historically low interest rates that currently exist.

Second, the precarious capital status of banks and other lenders has resulted in federal regulators encouraging banks not to pursue foreclosure or other enforcement action. Instead, many lenders "extend and pretend" and defer the problem into the future.

Whether the expected wave of distressed real estate transactions will occur in 2010 remains to be seen. However, we can expect that when distressed transactions do occur, they will be different from distressed transactions we have seen in prior commercial real estate recessions for a number of reasons.

First, there are likely to be fewer bankruptcies in light of certain changes to the Bankruptcy Code that make cases more difficult to pursue, taking away negotiating leverage from distressed borrowers.

Second, many loans made in the last decade include "bad boy carve-out" provisions that provide for personal liability to the principals of the borrower if the borrower contests the lender's actions or files for bankruptcy. As a result, we can expect less legal wrangling and more cooperation between lenders and borrowers.

Finally, given the number of syndicated loans that have been made over the last decade, the nature of lenders has changed. Many decisions are now being made by "special servicers," who are third parties that administer the loan for the benefit of all the varied interest holders.

When most people think of buying distressed real estate, they think first of buying at a foreclosure sale on the courthouse steps. While this is a relatively common way to buy residential

real estate, for commercial real estate it is very unusual in Georgia.

Here, unlike in other states, the lender typically requires that the entire purchase price be paid in cash on the day of the foreclosure sale.

This "cash sale" requirement, when coupled with the buyer's limited ability to perform due diligence and to obtain title insurance, results in bids which are much less than fair market value. Consequently, in the vast majority of the cases, the foreclosing lender (or an affiliated entity) "credit bids" the amount of its loan and acquires the property.

Parties interested in acquiring distressed commercial real estate in Georgia should consider the following alternative structures:

■ "Short sale" purchased from owner. Borrowing a concept from the residential real estate market, a buyer may acquire distressed property directly from the owner for a purchase price less than the outstanding mortgage balance. This arrangement requires the consent of the lender, who may be willing to do so to avoid the time and risk of foreclosure as well as

the feared "taint" in the marketplace resulting from foreclosure.

■ Buy note and foreclose. Rather than allowing the existing lender to foreclose, a buyer may elect to purchase the note from the lender and acquire the distressed asset through foreclosure or by a deed in lieu of foreclosure from the borrower.

This alternative is not without risk. First, the borrower may well be uncooperative, limiting the buyer's ability to perform essential due diligence as to title and environmental matters, physical status of the property and status of third-party leases. Second, there is a risk of delay resulting from bankruptcy or defenses asserted by the borrower against any of the noteholder's collection activities. Still, early indications are that note sales are more common than in prior recessions.

■ Buy real property through a receivership.

A receiver is an independent party appointed by the court to take control of the property while the lender is pursuing its foreclosure and other remedies. While a receiver cannot transfer title to property, a purchase can be consummated through a receivership if the borrower is cooperative.

Early anecdotal evidence from elsewhere in the country is that purchasers are using this alternative for a number of reasons. First, the lender, particularly the "seller servicer" of a securitized mortgage, may desire not to foreclose and enter the chain of title from a risk exposure perspective. Second, the sale through a receivership will avoid the taint of foreclosure. Third, a borrower may be willing to cooperate and convey title through the receivership process in exchange for a release from any liability and to achieve certain tax advantages.

■ Buy foreclosed property from a foreclosing lender. The final alternative is for the buyer to purchase the "REO" (or real estate owned) property from the lender after it has foreclosed. In a way, this approach is simpler and has the advantage of buying the property after the defaulting borrower's interest has been terminated.

A typical REO transaction will be on an "as is, where is" basis, with the lender not representing much, if anything, as to the property. While the buyer will have an opportunity to perform due diligence, the lender may be unable to assist the buyer in this regard given the lender's lack of knowledge as to the property.

Each of these alternatives has relative advantages and disadvantages.

One of the key differences is the extent to which the buyer can perform due diligence as to title, environmental issues, tenant leases and physical condition of the property. Another difference among the various alternatives is the amount of risk assumed by the buyer.

The year 2010 promises to be an interesting and active one in the distressed commercial real estate markets. A buyer with sufficient liquidity will likely find attractive buying opportunities. Buyers should take care, however, to structure transactions in a manner consistent with their appetite for risk and reward.

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