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Real Estate Loan Acquisitions – A Guide for Purchasers

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Introduction

In light of significant deterioration in cash flows and asset values in many classes of real estate caused by the COVID-19 pandemic, many real estate lenders are finding some of their otherwise well-underwritten loans to be non-performing. The capital markets are generally not open for hospitality and retail properties and, with respect to other property types, debt financing is only available if there is relatively low leverage, significant debt service coverage and strong sponsorship.

Adding fuel to the fire, a number of debt funds, mortgage and other hybrid REITs need to raise liquidity in order to satisfy margin calls, meet covenants or pay basic operating expenses or other contractual obligations. At least some of these lenders are unable to meet margin calls and are requesting that their lenders forbear from making future margin calls until the market normalizes. However, even if liquidity is not an immediate issue, many of these lenders do not have the personnel bandwidth, financial wherewithal or desire to go through a workout process with their borrowers.

As a result, real estate loans have started to trade and it is expected that the velocity of these trades will only increase as the duration of the crisis lengthens. This will present opportunities for investors who are ready to play offense and strategically invest in re-priced loans. This article addresses a number of important underwriting considerations prospective purchasers of real estate loans need to pay attention to when evaluating these trades.

Due Diligence

There are many types and sources of real estate debt in today's market. Prospective purchasers should first consider the type of real estate debt being traded – for instance, mezzanine debt presents a different set of underwriting considerations than mortgage debt, and multi-lender scenarios present different considerations than single-lender situations, including those relating to control rights. CMBS bonds and B notes have their own unique characteristics relating to control rights, the nuances of which are critical to managing the ultimate resolution with the borrower. While analyzing the underlying loan documents and the underlying properties serving, directly or indirectly, as collateral for the loan, there are a number of unique challenges that require special attention.

- Short Due Diligence Period: The due diligence period is often compressed, particularly in situations where all due diligence must be completed prior to submission of a bid. However, even in non-bid situations, due diligence periods are brief, typically ranging from 10 to 14 days. In addition, the ability to close quickly will often be critical for a prospective purchaser to win a bid.
- No Access to Borrower and Property: Most real estate debt trades occur without the cooperation or participation of the borrower and, often, with restricted or limited access to the underlying properties.

Therefore, in most real estate debt acquisitions, the prospective purchaser's due diligence efforts will be limited to the quality and extent of information provided by the loan seller. Sellers should keep in mind that being transparent and providing complete and accurate information will lead to higher prices and significantly faster execution of the trade. Similarly, nothing can derail a deal faster than a material fact coming to light late in the sale process.

Expenses

The current uncertainty in the market has made pricing of real estate debt more difficult, as underlying assumptions relating to the impact of the COVID-19 crisis on asset value and tenants' prospects are rapidly changing and may not be correlated with other historical recessions. In prior downturns, real estate investors and lenders relied on the certainty of continued tenant occupancy and rent payments and, in the case of hotels, inherent demand drivers, even if capitalization rates expanded as a result of a shrinking economy, scarcity of financing options and/or a financial crisis. However, the stay-at-home orders issued throughout the country have shuttered almost every industry that utilizes real estate in their businesses. In that sense, the COVID-19 crisis is arguably much worse than the great financial crisis of 2008-2009 and poses a much different set of risk factors and solutions for real estate investors and lenders.

In determining their all-in basis, a critical step in the underwriting process, purchasers should keep in mind the following considerations:

- Tenant Leases: For real estate debt secured by retail, office or multi-family properties, special attention should be paid to the status of rental payments (including any rent forbearance arrangements), tenant bankruptcy risk, tenant improvement allowance obligations and the lease expiration date. Additionally, loans secured by retail properties should be further analyzed for any co-tenancy provisions, which may permit tenants to reduce their rent obligations or terminate their lease if certain key tenants, often anchors, leave the property.
    - Rental Payments: In the current environment, understanding of any rental payment delinquencies and any rent forbearance arrangements is critical in purchasers' underwriting process. The selling lender's cash management provisions can facilitate visibility into borrowers' bank accounts to verify data provided on rent rolls and other lease-related deliverables.
    - Tenant Creditworthiness: Solvency and bankruptcy risks of tenants needs to be evaluated. This concern is particularly acute in the retail sector, where large retailers have been downgraded or have already filed for bankruptcy protection. Other retailers are undoubtedly stressed as many states and cities are still subject to stay-at-home orders and, once staged openings occur, may be limited to curbside pick-up or be subject to capacity limitations.
    - Tenant Improvement Allowances: Prospective purchasers should also review the status of any tenant improvements allowances, focusing on the amount of tenant improvement allowance outstanding and on any defaults by the borrower resulting from failure to pay tenant improvement allowance when

due. To the extent the existing loan documents provide for a tenant improvement allowance reserve, reviewing that account should assist prospective purchasers in verifying any amounts outstanding.

    - Term: Expiration dates of all tenant leases should be confirmed and future vacancy rates and lease-up risks evaluated.

- Ground Lease: If the borrower's interest in the underlying property is a leasehold interest rather than a fee interest, the operative provisions of the ground lease should be scrutinized. Importantly, prospective purchasers should review the term of the ground lease (including any extension options), rental provisions (including any rent resets), permitted use provisions, continuous operation requirements, and – especially if a payment default exists – provisions relating to the ground lessor's remedies and lender cure rights. In addition, any information contained in a ground lessor estoppel should be reviewed.
- Management Agreement: Purchasers should verify whether the borrower is in payment-related defaults under any existing management agreement (and, for hotels, any franchise agreement), including for working capital, and if so, determine the potential remedies of the manager. To the extent a manager is a borrower affiliate, any provisions relating to the lender's termination rights should be confirmed.
- Sponsor: The track record of the sponsor, including breakdown of current portfolio, should be analyzed. The risk of a bankruptcy filing should be considered, particularly if because of the current market distress and the existence of other guarantees, the sponsor which provided the non-recourse carveout guarantees no longer has any material net worth.[1]
- Operator Concerns: Prospective purchasers should evaluate pending and threatened litigation against the operators as well as any regulatory investigations. This is especially important when evaluating loans secured by senior housing or gaming properties.
- Lien Priority:
    - Real Estate Taxes: A title report should be obtained to confirm that there are no delinquent real estate taxes, since a tax lien primes a prior perfected security interest. The risk of delinquent real estate taxes is minimized in scenarios where the existing loan documents provide for a real estate tax reserve held and directly applied by the lender to payments of real estate taxes.
    - Mechanics' Liens: When evaluating construction loans with remaining disbursement obligations, special attention should be paid to mechanics'

liens, which could result in loss of lien priority with respect to future advances.

- Other Liens: When evaluating mezzanine loans, prospective purchasers should further analyze a title report for any liens against the mortgaged property, as mezzanine collateral is structurally junior to those liens. In addition, liens which are subordinate to the mortgage lien may constitute defaults under the mortgage loan and may ultimately need to be satisfied or bonded by the mezzanine loan purchaser if the borrower fails to do so.

- Insurance: Prospective purchasers should verify that all required insurance policies are in full force and effect and all premiums have been paid. Ideally, the existing loan documents should provide for an insurance reserve (which is often combined with a real estate tax reserve) held and directly applied by the lender to payments of insurance premiums.

Foreclosure Considerations

As mentioned above, the uncertainty surrounding continued tenant occupancy and rent payments (or inherent demand drivers in the case of hotels), in addition to the havoc caused by margin calls to many REITs and debt funds and the material disruption in the CMBS market, have caused a severe liquidity crisis in the real estate finance markets. Therefore, even for a high-quality sponsor behind the real estate debt being traded, the ability to effectuate a full refinancing at maturity may be uncertain. Particularly in cases where the sponsor is faced with the prospect of having to put in substantial additional capital to effectuate a refinancing or in cases where the return on the "new money" needed to effectuate the refinancing is not sufficient, the risk of the sponsor defaulting on the real estate debt and walking away from the property substantially increases.

It is therefore critical that prospective real estate debt purchasers in current market conditions factor into their all-in basis determinations the following considerations relating to foreclosure:

- Receivership Costs: In instances where the borrower fails to maintain and adequately operate the property, prospective purchasers may incur costs relating to appointing a receiver pending foreclosure. While rates vary based on geographic location, the fee is often several hundred dollars per hour and, where property cash flow is insufficient or negative, has to come out of the purchaser's pocket.
- Transfer Taxes: While foreclosure procedures vary from state to state, in many states, purchasers of debt secured, directly or indirectly, by real estate will be responsible for payment of transfer taxes upon the completion of foreclosure.

Transfer taxes are often material and should be accounted for in the prospective purchaser's underwriting. For instance, in New York City, the current transfer tax rate in the event of a foreclosure of a mortgage loan would be approximately 3.275% of the aggregate debt amount. While in some cases, the payment of transfer taxes will be a recourse event under a non-recourse carveout guaranty, that still implicates credit and collectability risks.

- Carry Costs: Similarly, foreclosure timing varies from state to state. For example, in New York and Florida, where a judicial mortgage foreclosure must be pursued, purchasers should expect to incur carrying costs for the property during the foreclosure pendency (which can run for 9-12 months in the event of an uncontested foreclosure and for up to several years in the event of a contested foreclosure). Additionally, attention needs to be paid to foreclosure moratoriums that may exist in various jurisdictions.[2]

Additionally, if prospective purchasers are underwriting the real estate debt trade with a view of ownership rather than payoff at maturity (even if that is the result of the inability of the borrower to execute a full refinancing), additional factors should be built into the underwriting:

- New Debt: Despite the difficulties associated with assumptions in current market conditions, the amount and cost of any new debt should be built into the internal rate of return models.
- Lease-Up Costs: Given the uncertainty surrounding tenant occupancy and rent payments, costs relating to lease-up, including any tenant improvement allowances and leasing commissions, should be considered.
- Deferred Maintenance / Property Improvement Plans: Any deferred maintenance or PIP obligations (in the case of hotel properties) prospective purchasers may have to undertake should be scrutinized.

Special Considerations for Multi-Lender Situations

If the prospective purchaser is targeting a real estate debt that has been syndicated, control rights should be carefully analyzed. While the agent lender typically has wide latitude in decision-making relating to administering the loan (including the right to make protective advances), co-lenders' approval is typically needed for material issues affecting the loan and the collateral, such as decisions regarding loan acceleration following an event of default, maturity date extensions or changes to the interest rate.

Similarly, in a scenario where both senior and mezzanine real estate debt exists, the intercreditor agreement must be reviewed to determine decision-making rights of the senior and subordinate lenders.

Special Considerations for Mezzanine Loans

In underwriting real estate mezzanine debt, prospective purchasers should keep in mind two important underwriting considerations: first, before consummating a foreclosure, mezzanine lenders are typically required to cure any senior loan defaults – including the payment of any unpaid interest during the term of the loan and the entire outstanding amount at maturity – and second, mezzanine lenders are typically required to deliver to senior lenders replacement non-recourse guarantees and environmental indemnities, which likely will require the replacement guarantor to have substantial liquidity and net worth.

Tax Considerations of Foreclosure

In addition to transfer taxes, there are additional tax issues relating to foreclosure that prospective purchasers of real estate debt should keep in mind. Any debt purchased at a discount is subject to the "market discount" rules whereby the purchaser calculates how much of the discount "accrues" after the date of purchase under rules similar to the calculation of original issue discount (OID), and, on a sale or disposition of the note (including via foreclosure), the "accrued" market discount must be recognized as ordinary income. This can be a surprise, as foreclosing on a property usually does not trigger tax (much less ordinary income) to an acquirer. Thus, this potential extra cost imposed on a foreclosure should be taken into account in any planning around distressed real estate debt. For further discussion of this and other tax issues surrounding distressed real estate investing, please see our recent client alert here.

Conclusion

Buying real estate debt involves much more that calculating the implied yield from the trade. It requires careful underwriting that focuses on the following:

- True financial picture of the property (including tenants) and the sponsor.
- The prospective purchaser's appetite for a potentially contentious, time-consuming and expensive foreclosure process.

- Determination of the prospective purchaser's real all-in basis in the loan, assuming the underlying real estate debt is paid off at maturity or, more significantly, if the prospective purchaser is forced to foreclose.
- Prospects for being paid-off in full at maturity or, in the event of a foreclosure, the liabilities that will have to be assumed or satisfied as well as the type of new leverage (including the cost thereof) that will be available if the purchaser becomes the property owner.
- Types of tax liabilities potentially resulting from a loan foreclosure, including transfer tax liabilities.
- The prospective purchaser's ability to operate the underlying property serving, directly or indirectly, as collateral for the debt.

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Proskauer's cross-disciplinary, cross-jurisdictional Coronavirus Response Team is focused on supporting and addressing client concerns. Visit our Coronavirus Resource Center for guidance on risk management measures, practical steps businesses can take and resources to help manage ongoing operations.

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[1] For further details relating to the risks of possible bankruptcy filings, please see our recent article on this subject here.

[2] Recently, the New York County Supreme Court clarified that UCC foreclosures may proceed during the pendency of New York Governor's executive order which stayed all evictions and foreclosures for 90 days (see N.Y. Exec. Order No. 202.8 (March 20, 2020)), despite initially halting the UCC foreclosure in question from proceeding. *See* 1248 Associates Mezz II LLC v. 12E48 Mezz II LLC (Index No. 651812/2020).

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