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## Buying and Selling Real Estate Debt

### Introduction

As liquidity in the European banking sector begins to improve, buyers aiming to capitalize on declining or declined real estate values prevalent in the market are increasingly seeking out opportunities to buy real estate-backed loans at realistically priced discounts to par. Such buyers are also now beginning to target loans made to distressed owners of sound properties (core assets at opportunistic pricing are today's holy grail), although this is not a pre-requisite to finding realistically priced assets. This sentiment is beginning to put pressure on sellers, particularly in the UK where there is a perception that it is at the bottom of the cycle in terms of perceived value, to consider the assets they hold.

Real estate debt (more so at this stage of the cycle) is not without risk. Prior to buying such debt, a buyer must determine, through financial due diligence, whether or not: (i) the underlying borrower(s) and/or guarantor(s) of the debt have the financial capability to honour their respective debt obligations under the finance documents; and (ii) whether the value of the underlying real estate (and all other collateral) exceeds the amount paid by the buyer for the debt together with incidental costs. The answer to these questions will dictate the buyer's decision on whether or not to buy. A buyer will also need to analyze the underlying collateral for title issues, perhaps inspect the real estate and consider environmental issues (via desktop or otherwise) and other related matters, check the ranking of the security and whether such security has been validly created and properly perfected. While a buyer seeking to buy a single loan or a portfolio may think of itself as simply a buyer in the traditional, financial sense of the word, it is essentially a mortgage lender, real estate buyer, financial analyst, real estate operator and due diligence expert all wrapped into one. Accordingly, a successful buyer of real estate debt must possess expertise in all of the foregoing areas or be prepared to engage third parties who are experienced in such transactions.

Moreover, it is important to remember the goals of the parties as a backdrop to the financing transaction. The ultimate goal of the seller is either to reduce its exposure to the real estate sector or to sell the real estate debt at a profit. The buyer of a real estate loan will generally utilise variations of a "loan to own" or a "buy-fix-sell" model by seeking to make a profit by (i) receiving principal repayments on the total loan balance from the borrower in an amount exceeding the price paid for the loan, or (ii) enforce and sell or operate the underlying real estate in manner that renders income to the buyer that exceeds the price paid for the loan. At the outset, given current market conditions, both seller and buyer will need to determine if the loan to be purchased is to be treated as a distressed asset given the status of the deal or merely an asset trading at a heavy discount. This approach will have some impact on how the buyer, and the seller will approach the transaction and the terms of the sale documentation (for example the level and scope of asset level representations, more on which below). In the current market, it is possible for distressed assets (e.g. those subject to payment defaults) to be trading at prices notably higher than non-distressed assets, where for example the price is being driven down to low levels as a result of loan to value ratios rather than any actual payment defaults.

The keys to limiting the buyer's liability during the purchase process and enhancing the likelihood of an eventual profit to the buyer are thorough due diligence and careful documentation of the transaction. A buyer of real estate debt should analyze the transaction as though it were buying the underlying real estate or as if it were underwriting and originating the debt in the first place. Considerations and issues differ depending on the type of loan and the type of collateral securing the loan. Regardless of the type of debt purchase transaction anticipated, competent counsel with an in-depth knowledge of real estate loan purchase and sale transactions can be the difference between a successful transaction and an unsuccessful one. Moreover, in a European context, it's likely that the loan, security, obligors and the real estate will be subject to differing governing laws and therefore, buyers will need to seek advice from professional advisers in all applicable jurisdictions in order to be fully apprised of local issues, especially in the context of a work out or enforcement scenario.

### The Loan Sale Agreement

The loan sale agreement will contain all the terms on which the loan is sold by the seller and bought by the buyer, typically setting out the purchase price, the treatment of accrued but unpaid interest, and any other specifically negotiated deal points.

The contract should provide for the seller's agreement to unconditionally sell the loan and transfer all its rights under the finance documents, namely the loan agreement and all security documents. Such a transfer obviously includes with it all of the seller's rights to enforce the terms of the loan documents and exercise all remedies against the borrower, including without limitation the right to enforce the real estate security and assert claims against guarantors. The contract should contain provisions requiring the seller to provide copies of all loan documents, report on titles, legal opinions, asset management agreements and all other material documents included in the loan file, such as copies of insurance, the latest real estate valuation, financial statements of the borrower and rent roll. It is common for the agreement to provide the buyer with an appropriate due diligence period during which the buyer can adequately conduct all due diligence, the outcome of which will determine whether or not the buyer is bound to proceed with the purchase.

The loan sale agreement will usually contain a number of representations and warranties. The type and level of representations given will often be the subject of heavy negotiation, depending on whether or not they are 'seller representations' or 'asset level representations', the latter being the area of most discussion. Seller representations typically include representations by the seller that (i) it is validly existing under the laws of its jurisdiction of incorporation, (ii) it has due capacity, power and authority to enter into the loan sale agreement, and (iii) its obligations under the loan sale agreement are legal, valid and binding. A seller's starting position will typically be that it will not give any asset level representations, however, in the current market, and especially if the buyer is viewing the transaction as a distressed asset, it is becoming increasingly common (but still dependant on the bargaining power of the respective parties) for buyers to benefit from asset level representations from the seller. As an absolute minimum, the buyer will want the seller to represent and warrant that (i) it is the legal and beneficial owner of the loan, free and clear of all encumbrances, (ii) the loan has not been previously assigned, transferred or sub-participated, and (iii) the loan is not currently in default. If the buyer considers the asset to be a distressed asset then it may require the seller give more detailed representations, such as those published by the Loan Market Association in its distressed debt documentation. It will, of course, ultimately be a matter of negotiation on the exact nature and content of the representations given. Moreover, representations and warranties can be taken out of the equation entirely with the use of title insurance as a method of ensuring the liquidity of the asset.

Any buyer should, through its counsel or otherwise, make every effort to obtain as much information as possible on the loans and the documents governing the underlying loan *before* executing the contract. Further any seller should ensure that all loan files and information obtained in the underwriting and origination process (basically all material documents in its possession, in particular *original* land charges and other such security which will be needed in any subsequent enforcement situation) are collated and readily accessible to the buyer either through a virtual data room (which we are able to provide) or physically handed over to the buyer and its counsel. Thus, it is important to locate and put in order all documentation that will be required for the sale in a timely manner. The

more information the parties to a potential sale can gather at the outset of the process and prior to entering into the contract, the better able they will be to evaluate any resulting implications and incorporate them into any purchase price, as well as mitigating the risk of reaching an impasse (due to the necessity of a price adjustment mid-contract) after incurring due diligence expenses.

## Due Diligence Process

### Generally

The due diligence process is perhaps the most crucial undertaking in connection with buying or selling real estate debt. It is during this stage that the buyer can determine whether the price to be paid under the contract justifies the risks associated with the purchase. The only way the buyer can do this is by thoroughly analyzing each aspect of the purchase, including review of the loan documents (such review to consider, amongst other things, whether the security has been validly created and properly perfected), the real estate collateral for the loan, the financial condition and solvency of the borrower and any guarantors, the financial condition and solvency of the seller, and the legal opinions (each of which is dealt with in detail below). Often when we are advising on these transactions, we provide a detailed asset purchase check list for our clients setting out each stage of the due diligence process that needs to be completed to ensure that nothing is overlooked. If during this process an unacceptable risk is discovered (assuming the buyer's lawyers have appropriately drafted the contract), the contract may be terminated without continued liability prior to the expiration of any "free look" due diligence period. Haphazard due diligence, however, may place the buyer in a less desirable position with severely undervalued assets if, for instance, an unresolved title defect, development restrictions, or pre-existing environmental conditions exist on the real estate securing the loans.

### Review of Loan Documents

#### *(i) Loan Agreement*

The loan agreement governing the underlying loan, along with the related security, serves as a general guide of the lender's remedies in the event of a borrower's default. The terms of these documents determine the various rights and remedies of the buyer, as lender of the loan, and those of the underlying borrower. Other matters to be considered include the financial covenants such as the loan-to-value and debt service, other general covenants and income and expense

projections relating to the cash flow of the real estate. In the event of any existing borrower defaults, the buyer will want to consider whether the default is material, whether the lender (or loan seller) has formally called a default, and the likelihood that the borrower can cure such default. A buyer should ensure that the transfer provisions set out in the loan agreement (and any related intercreditor agreement) are complied with, namely ensuring that the restrictions on transfer are not breached and that the loan is in fact transferred pursuant to an appropriately drafted and correct form transfer certificate. This will require input from the buyer's legal counsel, as an incorrectly drafted transfer certificate raises numerous issues potentially nullifying the sale. Furthermore, there is a particular issue in Germany that the transfer provision and draft form transfer certificate in some loan agreements drafted under English law may fail to deal with the effect that if there is a novation of rights and claims, the accessory security (bank accounts, pledges and the like) cease to exist. The obligations of the Lenders under such transfer certificate however can be novated. The form of the transfer certificate set out in the underlying loan, which should substantially be followed, may need to be amended to deal with this, as at the time of origination, many lenders did not focus on this issue.

A further issue resulting from the current market conditions surround the increasing number of borrowers (or other companies within the sponsor group) looking to buy-back their own debt from lenders under pressure to trade out of a position. There are a number of reasons why a borrower group company may want to buy its own debt, most notably: (i) buying its own debt at a discount is effectively the same as repaying the debt at a discount; (ii) it may be able to sell the loan at a later date for a profit; and (iii) it gives the borrower (or its sponsor) a seat at the creditor's table, which may enable them to influence the creditors. In the context of real estate debt transactions, the buy-back of debt would usually occur at the subordinated or B loan level (i.e. the first loss position). Whilst the underlying loan agreement may not prohibit borrower group companies from owning the debt, a number of intercreditor agreements in the market (especially those put in place in the later stages of the European commercial mortgage-backed securitisation ("CMBS") boom) restrict subordinated lenders transferring the B loan to borrower group companies. In deals where a borrower group company has bought debt subject to these restrictions, the restriction must

first be waived. The waiver is usually subject to the subordinated lender rights being 'turned off' in their entirety (more on such rights below) and in some cases, there may also be a change to the waterfall of payments, removing the ability for the borrower group company to receive the interest coupon on the B loan, with such funds being redirected in prepayment of the senior loan (most typically held in the CMBS). During its analysis therefore, the buyer should also determine the existence of any intercreditor agreement and determine how they impact on the buyer's ability (or appetite) to purchase the loan.

If the buyer is buying a B loan or other subordinated interest in a whole loan, it will need to consider and negotiate, amongst other things, what cure rights, control rights, purchase rights and other subordinated lender rights it requires, as notwithstanding any prohibitions in the intercreditor agreement, consent to a transfer of the B loan to a borrower/sponsor affiliate is typically only granted on the basis that the typical B lender rights should be 'turned off' and should not be exercisable whilst the borrower or sponsor affiliate remains a B Lender. Accordingly, immediately following any such transfer, the new borrower affiliate buyer may not be able to exercise, have exercised on its behalf (other than by a servicer or a special servicer in accordance with the terms of the servicing agreement) or have accruing to it any cure, enforcement, consultation, approval, appointment and/or control rights (together the 'Rights') otherwise available to it under the terms of the underlying loan agreement, the intercreditor agreement and/or the servicing agreement.

Such transfers should provide that the Rights may be reinstated (a) for so long as the B lender, (i) does not control or manage (in each case directly or indirectly) the management or voting rights in the underlying borrower or an affiliate of the underlying borrower, (ii) is not controlled or managed (in each case directly or indirectly) by an underlying borrower or an affiliate of the underlying borrower, (iii) is not party to any arrangements with any other entity pursuant to which the underlying borrower or any of its affiliates would have any indirect control of whatsoever nature in relation to any of the Rights, and (iv) is not an underlying borrower or an affiliate of the underlying borrower, in each case being confirmed to the reasonable satisfaction of the facility agent; or (b) with respect to the whole or any part of the transferred B loans, following a subsequent transfer or assignment of such participation by the B lender. The transfer should further provide that each of the servicer and the

special servicer will be required to notify the B lender (or any of its designees) with respect to material actions (as determined by the servicer and/or special servicer acting reasonably) to be taken with respect to the whole loan provided that (a) neither the servicer or, as the case may be, the special servicer will be required to disclose any information to the B lender that, in the discretion of the servicer or the special servicer (acting reasonably), will compromise the position of the other lenders in the deal or reveal any strategy of the other lenders that could compromise the position of the other lenders with respect to the whole loan, (b) no such notification will be required where immediate action is required to be taken in accordance with the servicing standard; and, (c) for the avoidance of doubt, no such rights shall oblige the servicer and/or special servicer to take into account any advice, direction or representation made by the B lender in connection with such notification. Moreover, the B lender should agree that, prior to any subsequent assignment or transfer of whole or any part of any transferred B loan being effective (along with the ability to exercise all or any corresponding Rights) (i) the B lender either confirms or procures confirmation to a security agent that the subsequent assignee/B lender is a qualifying lender, and (ii) the conditions set out in both the underlying loan agreement and the intercreditor agreement must be otherwise complied with.

#### *(ii) Security*

The jurisdiction of the underlying real estate will dictate the appropriate form of security required and so appropriately appointed legal counsel will be needed to advise any buyer on the related security documents. Assuming the real estate is located in England Wales, the real estate should be secured by way of legal mortgage with the appropriate registrations made at the Land Registry (if registered land). The mortgage is the legal mechanism by which the buyer can obtain title to underlying real estate. This document plays a crucial role because it allows the buyer, directly or through any security trustee to take legal ownership of the real estate, appoint a receiver of the real estate or otherwise exercise its power of sale over the real estate. The mortgage should specifically entitle the lender (or its security trustee) to enforce the security following an event of default under the loan agreement. The buyer will want to ensure that the security it has is first ranking, and so it is important to ensure that the security was not only validly created, but also properly perfected

(through whatever registration, notice and other requirements are required in the relevant jurisdiction). The priority of the mortgage (and all other security) is of paramount importance, since a first ranking charge will entitle the buyer to enforce its security and apply all proceeds realised from any sale towards the discharge of the entirety of its debt, generally free and clear of any inferior security

#### *(iii) Real Estate Collateral*

With respect to any real estate collateral, the debt purchase should be treated as a traditional real estate purchase. The buyer should perform an onsite inspection of the mortgaged real estate and determine whether an updated survey is required. To limit the buyer's liability, an environmental site assessment of the real estate should be obtained, and the buyer should ensure that the current use of the real estate is in compliance with user, planning and other governmental restrictions on the real estate. Additionally, it is essential that the buyer obtain a new valuation of the real estate, so that it may get an accurate understanding of the current value of the land. The valuation will show the approximate market value of the real estate, but not necessarily what the buyer could expect to receive on an enforced sale. The buyer should also obtain any other third party reports during this stage. Finally, the buyer should analyze any income stream from the real estate, and ensure that the purchase price justifies the risk relating to such income stream in the event the buyer ultimately owns the real estate following enforcement of the mortgage. Analyzing the foregoing issues will mitigate any chance of the buyer being exposed to unknown, and potentially costly liabilities relating to the real estate.

#### *(iv) Financial Analysis of Borrower and Seller*

The financial solvency of the underlying borrower and any guarantors of the loan is important to the buyer for several reasons. Determining the solvency of the borrower allows the buyer to assess the likelihood that the borrower and/or guarantor can remedy any current or future default under the loan or other loan documents. The buyer should analyze the borrower's financial statements to determine if it is in compliance with any financial performance covenants and/or reporting requirements pursuant to the loan agreement (e.g., net worth requirements, debt-to-income ratios, etc.). Implicit in this analysis is a determination of the likelihood of whether the buyer will ultimately be

forced to enforce its security over the real estate. By determining the amount of equity the borrower has in the real estate (by comparing the latest valuation of the real estate against the outstanding loan balance), the buyer can determine the likelihood of default and subsequent enforcement risk, with the more equity held decreasing the possibility of a borrower's default, and vice versa.

#### *(v) Legal Opinions*

All underlying legal opinions provided in connection with the debt being purchased should be reviewed by buyer's counsel. Such legal opinions should be checked for the following to ensure that:

- They are addressed to the underlying finance and secured parties and any permitted successors and assigns, or at the very least, the security trustee for the benefit of the finance and secured parties from time to time;
- They are not subject to any unusual assumptions and qualifications;
- They provide a legal valid and binding opinion on the finance documents and provides a valid security interest opinion on the security created by the security documents;
- That, if the security perfection opinion is qualified by reference to other acts or documents to be carried out or delivered, that these other acts or documents are made a condition precedent to the acquisition of the loan;
- They opine on all applicable documents; and
- There are no other major issues identified in the opinion.

Further, local counsel should review all relevant foreign law opinions for the same issues as set out above.

## **Conclusion**

Real estate debt purchases have once again become the opportunity of choice for clients to profit from the uncertainties in the cyclical real estate market. Real estate and real estate debt may still be an effective protective hedge against inflation. For those buyers and sellers that are willing to utilise and accept a mixture of "value-add" asset management through to implementing

successful “buy-fix-sell” and/or “loan to own” strategies, understanding the process as a whole and appreciating the risks associated with owning the underlying real estate through the debt is the key to success. Moreover, those buyers who see the current distressed real estate market as an opportunity to expand their 'core' investment portfolio with good quality assets which are trading at good discounts to poor, will be well placed to profit from their investment. On the other hand, those that can't distinguish between good assets at a cheap price and bad assets at a cheap price will be less successful. Likewise those buyers that think creatively and attempt to work with sellers to share upside and approach these purchases in an intelligent manner will benefit. Buyers cannot take the view that they can buy core assets at opportunistic pricing and hope to be overrun with an array of assets, as this time around, many sellers who lost out during the last downturn cannot afford to do so again. Those buyers that realise this will benefit.

Finally, current conditions in the debt markets mean that, increasingly, parties to a proposed

debt purchase are having to explore more innovative ways of unlocking the transaction. At the buyer level, such solutions including deferred consideration, vendor guarantees, assumption/novation of the debt, vendor loans, mezzanine debt, subordinated debt, tranching debt, capital injections, or total return swaps may be explored. At the real estate level, dropping the property into limited partnerships, or introducing geared leases (split or otherwise) and use of sub-trust are all options. Similarly at the seller level, traditional profit share schemes, debt for equity swaps or new share issuances can all be explored.

Our lawyers at K&L Gates have extensive experience in the types of transactions and have geographically diverse, interdisciplinary teams focused specifically on Distressed Real Estate and a Real Estate Finance. We would be happy to provide assistance on the types of transactions discussed in this alert.

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