

Purchasing Loans?

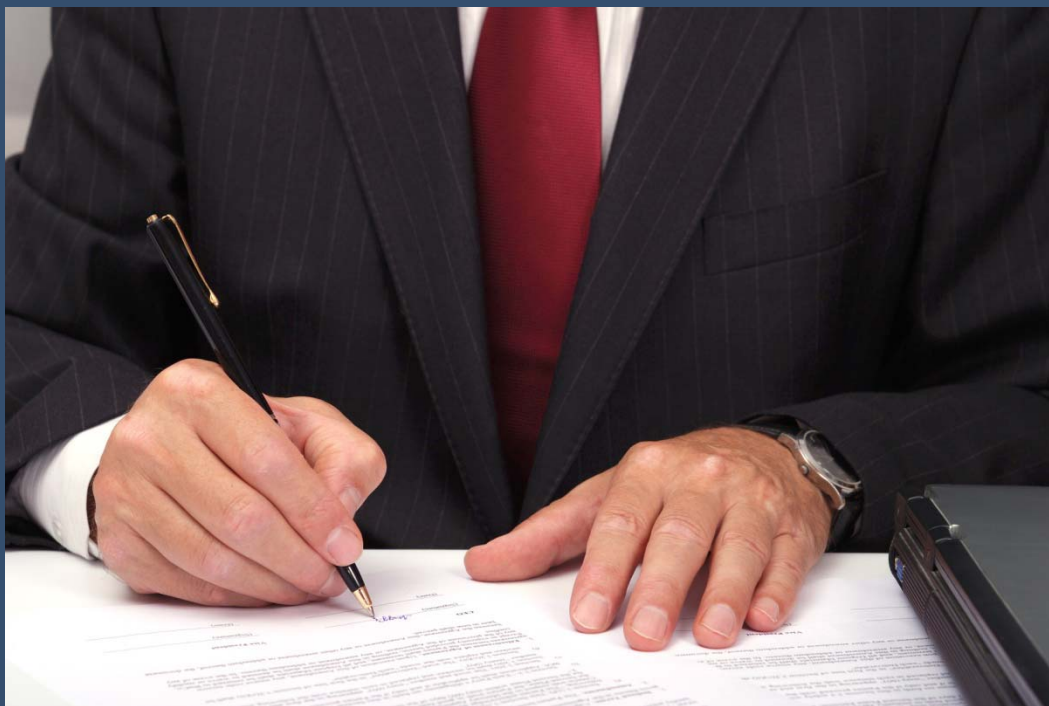
Ten Warning Signs for Investors

By Bridgette G. Kimichik

Today's market conditions are offering many investment opportunities, including buying loans that are in default or are secured by collateral types that are losing value, such as shopping centers, single tenant properties, office buildings, and hotels. Buying a troubled loan at a severe discount may allow the purchaser to structure a modification that will allow the borrower to recover and pay the loan back at a profitable rate of return to the purchaser, or allow the purchaser to foreclose and recover on the collateral at a profit after the market turns around. Whatever the motivation, your investment could result in delayed recovery and loss of investment. Identifying the warning signs through proper diligence, will help you better evaluate the potential risks of your investment and allow you to properly address any concerns in your loan purchase agreement (PSA).

Consider the following warning signs:

- 1) **Loan File Availability?** Request immediate access to the loan files and preferably electronically, so your counsel can study them at the same time. Identifying the nature of what you are purchasing along with potential loan, document and perfection issues; will give you the opportunity to address these issues in the PSA being negotiated and adjust your pricing accordingly. Incomplete or missing files signal a problem.
- 2) **Where Are the Original Loan Documents?** If the loan documents are with a servicer or a custodian, retrieving the originals in time for closing may be a process and require special approvals. In certain cases, banks have pledged their loans to the Federal Home Loan Bank or the Federal Reserve to allow for improved liquidity.



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3) Do You Know What You are Buying? Are the loans whole loans, mortgage loans, unsecured loans, personal property only loans, mezz loans, or participated loans? Identifying the nature of the loans helps determine what loan documents should be in the loan files and what collateral should be transferred with the loan documents, such as escrows, reserves, operating accounts, letters of credit, certificates of title, and life insurance policies. In addition, you will want to identify any future funding and third party obligations. Seller descriptions and information should be complete.

4) Are there Document Deficiencies? Gaining access to the loan files early in the transaction is important to confirm any representations and warranties made by the seller in the PSA, if any, with respect to whether or not the loan files are complete and whether or not the seller is properly perfected as lender with respect to the collateral. Missing or improperly filed mortgages and assignments of rents, missing or incomplete security and pledge agreements, and expired UCC financing statements, are serious warning signs that the lender may not have a valid lien on the intended collateral. Representations and warranties in the PSA are not popular and the seller will try to avoid them by making the transaction "as-is, where is, with all faults and without any representations and warranties". Insist on at least the two noted - that the loan files are complete and that the lender has an enforceable lien on the intended collateral, to give you comfort with respect to your investment.

5) Is Remedial Action Impaired? Study the loan files and any other information provided by seller with great diligence to determine what remedies are available if the borrower defaults under the loan. Document deficiencies (missing legal description on recorded mortgage or lapsed financing statement) may impair your ability to pursue an important remedy, such as foreclosure. Also, determine if the loan is in default, and if yes, what remedial action, if any, has the seller taken that could impair continued remedial action or risk lender liability claims? Was the borrower failure a proper default under the loan documents entitling the lender to default the borrower and/or accelerate the loan? Was the proper notice and opportunity to cure given? Did the lender take any action to waive its right to pursue remedial action? Is a bankruptcy filing likely?

6) What is Lien Status of Collateral? Watch for any lien releases and subordination agreements. The loans you are buying may not be secured by a first lien or the liens may have been released partially or in full. Also check for any title searches, commitments and policies to confirm lien position.

7) Is the Borrower Troubled? - Searching the county records where the collateral property is located and the secretary of state records where the borrower is organized, will provide valuable information with respect to the overall health of the borrower and its property, by identifying any non permitted encumbrances, such as mechanics liens, tax liens, and creditor liens and judgments.

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If the principal or guarantor of the borrower is subject to IRS liens, the borrower and the property are also likely compromised.

8) Is Your Loan Participated? If any of the loans are participated to third parties, confirm that the seller is the lead lender and has the authority to sell its interest in the loans without any consent of the other participants. In some cases, there may be participant consent requirements, transfer restrictions (i.e. buyer must be a qualified transferee satisfying certain financial net worth or ratings), and/or first options to buy the seller's lead position in the loan if a sale is contemplated. Your PSA should specifically require that any participated loans and their terms be identified. The seller's loan inventory may not show the loan as a participation.

9) Are There Third Party Obligations? Depending upon the nature of the collateral, an assignment of the loan may require the underlying ground lessor's consent, the manager's consent (typical for a hotel property), the franchisor's consent (typical for franchised properties, such as hotels, convenience stores, gas stations and fast food restaurants) or as previously discussed, the consent of a participant. Check any estoppel certificates, ground lessor consents, subordination agreements or third party agreements for any consent requirements or third party rights. Failure to obtain the required consents may void your purchase transaction. If you are seeking remedies with respect to a hotel, you may not have the right to terminate the management agreement.

10) Are Loans Cross Defaulted or Cross Collateralized? Your PSA should contain a seller representation and indemnity that the loans to be purchased are not cross defaulted or cross collateralized with any other loans to the same borrower or related borrower party. Incorporate

uncross provisions in your transfer documents, just in case. You would not want a third party to have any rights against your borrower's collateral.

Conducting proper diligence with respect to your investment is critical. If your closing is on a short fuse and you will not have time to complete your due diligence process, include a provision in the PSA which allows the buyer, for a short time period, to reject any loans that do not satisfy PSA requirements, reps and warranties, with either a credit to the purchase price or a redemption against the purchase price from a post closing escrow.

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- 2) Where Are the Original Loan Documents?
- 3) Do You Know What You are Buying?
- 4) Are there Document Deficiencies?
- 5) Is Remedial Action Impaired?
- 6) What is Lien Status of Collateral?
- 7) Is the Borrower Troubled?
- 8) Is Your Loan Participated?
- 9) Are There Third Party Obligations?
- 10) Are Loans Cross Defaulted or Cross Collateralized?

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