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Techniques to Acquire Distressed Real Estate

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While the commercial foreclosure/workout market does not appear to be overheated, opportunities are surfacing with significantly more expected over the next two years. Buyers, investors and brokers armed with a variety of acquisition techniques will be positioned to step into some attractive deals during this temporary turbulence. Now is the time to get your game plan in order. The following is a listing of some devices that you might consider as you look for opportunities in this market.

1. Solicit Opportunities from Front Line Commercial Lending Relationship Managers.

Conventional wisdom of waiting to see the latest foreclosure filings is probably not where the hot opportunities are in today's market. Lenders realize that with little or no replacement money out there, if they foreclose, they just have to lend again on the same property to sell it—after taking a big shave. All they will have accomplished was to exchange one borrower for another, kept the same collateral, and took a beating in the process. Thus, lenders are likely, at least for awhile, to try and work things out with their borrowers. Although they must do so carefully, Lenders are looking for marriages between problem borrowers/property and money/talent/solution. If you fall into the money/talent/solution category, the deals are out there and waiting for you right now. You won't learn about these opportunities anywhere other than in a quiet luncheon conversation with the front line lending relationship manager. These deals may not be in workout, they are in relationship stress and the borrower's relationship manager wants nothing more than to fix it before it goes to workout.

2. Buy The Paper.

Lenders are beginning to sell their loans, some at steep discounts, rather than spend the time and money foreclosing and relending on the same collateral. The trick about paper is that when you acquire it, you are nothing more or less than the lender you bought it from. Institutional lenders rarely if ever give you much in the way of representations or warranties on the paper, so you are left to foreclose the paper and hope it is enforceable. Borrowers are as happy to defend against you as they are the selling lender, so you must be prepared for a long fight, particularly in Connecticut. The ideal scenario is to first cut a deal with the borrower for a friendly, uncontested, foreclosure. Maybe they get some upside piece if it all goes well. Maybe they get off their guaranty. Your goal is to have a cooperative borrower before you start the foreclosure. Then, you go in, negotiate your discounted purchase price, acquire the paper and foreclose. At the end of the day, you must view this as a regular purchase (i.e. regular property due diligence) coupled with a potentially lengthy court process and a contentious defense alleging lender liability. If you can fix the last piece, the first should move smoothly.

3. Buy the Tax Lien.

Not much need be said about this. You purchase the tax lien and ultimately foreclose it out. Owners have redemption rights, but you get a good return on your investment if they do redeem.

4. Be A Higher Return “B” or “Mez” Lender.

Many lenders are considering restructuring their existing non-conforming debt by converting it into two separately secured loans. The first is a fully conforming so-called “A” note typically collateralized in the usual manner—i.e. a first mortgage, etc. Assume, for example, the “A” piece is 60% of the existing troubled debt. Perhaps to make it all work, the lender forgives another 10% or 15% of the debt. That leaves a final piece which gets structured as so-called “B” debt. “B” debt can be a second mortgage, mezzanine secured by a pledge of ownership interests (i.e. member or stock interests) or even uncollateralized or severely limited collateralization. With an opportunity to have an attractive inter-creditor agreement with the first mortgage lender to provide you with some controls over the relationship, opportunities to step in and acquire ownership in time to cure future defaults while at the same time obtaining above market returns, picking up the “B” debt as a new lender can be attractive.

5. Join Up With The Borrower For The Fight.

If the Borrower believes it has defenses to the foreclosure, but lacks the staying power to fight, joint venture with the borrower (i.e. become a co-owner in the borrower entity), fund the defense and at some point enter into a workout with the lender presumably under some advantageous terms. If a change in ownership is a default, consider an option or purchase agreement and perhaps a pledge of the member interests to secure it. The idea with this strategy is to buy time to ultimately workout with a foreclosing lender and then you step into the real estate as a joint venture partner with a restructured more attractive debt.

6. Join Up With The Borrower As A Solution.

Recognizing that lenders are looking for solutions short of foreclosure, they are willing to modify debt with many going to an A/B structure. Underlying much of their foreclose/no foreclose analysis will be the viability of the borrower. If you can bring money, talent, tenants or other solutions to the table, the lender is likely to work with a reconstituted borrower. In that scenario, you might elect to joint venture with the borrower taking the lion's share for your “solution” or you may simply take the borrower out and give them something for their accommodation. If you elect to Joint Venture, then issues of control, management, additional capital calls, distribution waterfalls, preferred returns and partnership divorce will have to be worked through but all are manageable issues when avoiding foreclosure is the outcome.

7. Work with the Lender During the Pre-Foreclosure/Foreclosure Process.

There may be opportunities to obtain consulting fees when the lender is attempting to sort out the extent of its exposure and the viability of solutions. That consulting relationship may put you at the center of opportunity to acquire paper or foreclosed property. It may put you in direct contact with the borrower for a friendly foreclosure and sale to you, or a sale to you by the borrower with the consent of the lender and an assumption of a modified debt. Your consulting work puts you at the epicenter of where the opportunities exist right now. It may also color your advice, so there is a

tradeoff to consider.

8. Purchasing Out of Foreclosure.

Clearly the easiest and most old fashioned method is to show up at the foreclosure sale and bid with everyone else. In Connecticut, however, there are two methods of foreclosure. Old fashioned "sale" and "strict". Strict is a process whereby there is no sale. The court sets law dates and in reverse order, starting with the lien holder with the worst priority lien, each lien holder gets a shot at purchasing the property by paying off everyone ahead of it. If the property is slated for a strict foreclosure, you will have to join up with an existing lien holder to get your shot at "taking" everyone else out ahead of that lien holder. A purchase out of foreclosure is filled with traps for the unwary so you have to go in with good counsel. For example, if the tenants are named in the foreclosure, their leases are terminated and you may have no tenants or rents. The court controls the eviction date for the occupants, so there may be delays associated with that. You may have little or no opportunity to examine the property and do your due diligence. Bottom line --- better get a good price for the risk associated with the process.

9. Working Through Bankruptcy.

Bankruptcy is nothing more than a forum for the orderly rebuilding or liquidation of a problem property. If it is a liquidation, there will be a court ordered sale (or permission for the lender to continue its foreclosure). The concepts discussed above regarding doing your due diligence are just as important here. It is in the Chapter 11 workout portion of bankruptcy where all the concepts listed above become useful devices. When a borrower/property owner files for Chapter 11, it has to come up with a plan. That plan, like everything else, will likely need money, talent and solutions to make it work. There is ample opportunity to participate in that plan as a "B" lender, a "new money first mortgage" lender, a joint venture partner with new equity, a handsome guaranty to backstop existing debt, access to new tenants or an attractive lease modification.

10. Opportunity Resources.

Where are these opportunities found? Real Estate and Bankruptcy attorneys have their ears to the ground. Accountants often know about sinking ships before most others. Small talk at association meetings like homebuilders association, apartment owners association, BOMA can be revealing. Front line relationship managers at the different lending institutions are talking right now to your next opportunity. Commercial real estate brokers know who is in trouble. The commercial record reports on properties that are getting liened for failure to make payments. There are a variety of foreclosure reporting services available. In this market, at least now when there are no meaningful replacement lenders out there, the action is in the workout area. Distressed property owners are talking with their lenders right now, or are about to, and both parties are looking for solutions and each are likely willing to take a shave in exchange for a viable solution. Some incredible opportunities are going to open up in the next year so now is the time to get your game plan organized and start implementing it.

11. MacDermid, Reynolds & Glissman P.C.

MacDermid, Reynolds & Glissman P.C. is a commercial real estate law firm with a great deal of depth in this particular area. Our attorneys are increasingly being sought after to address distressed

real estate issues. Tenants seeking lease concessions, Landlords seeking lease enforcement and lenders and borrowers seeking loan modification, workouts and foreclosures are becoming more common once again. For further information, please refer to our website at www.mrglaw.com

This article is for general interest and education only and does not constitute legal advice. The reader is encouraged to seek legal counsel before utilizing any suggestions contained in this article.

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