COXCASTLENICHOLSON

REAL ESTATE FINANCE, RESTRUCTURING & WORKOUTS

WINTER 2009 NEWSLETTER

THE INS AND OUTS OF LOAN ADMINISTRATION AND DISPOSITION

by Bruce E. Prigoff and Trevor M. Codington

Notwithstanding that bank balance sheets are bulging with troubled real estate loans, lenders have been reluctant to sell these loans at heavily-discounted prices. However, the banks' strategy of holding these troubled assets has not been successful given the continued decline in real estate prices. As market conditions further deteriorate, lenders may finally consider selling at least some of their non-performing loans as a means of mitigating this risk. Also, sales of problem loans can reduce a lender's loan servicing costs and limit the losses incurred by the seller in connection therewith.

When a decision is made to sell a loan, as a first step, the seller should consult with market advisors to obtain an estimate of the price the loan is likely to obtain from a third party purchaser. The seller should then provide the borrower with a one-time opportunity to purchase its loan at a discounted payoff by a specified date, and accept any offer that meets or exceeds the expected sale price. After "harvesting the low-hanging fruit" through this discounted payoff process, we recommend that sellers implement the procedures set forth below in order to maximize the potential recovery from a loan sale. Further, a well-run sale that minimizes surprises on either side creates greater certainty that closings will occur in an efficient and timely manner.

Due Diligence Process. To give order to the loan sale process, and to provide the bidder with a finite time to formulate its bid, sellers should be prepared to make disclosures and to establish a hard due diligence cutoff date after which no further information relating to the loan will be provided to bidders. Creating and maintaining orderly files for the loan in advance of bringing it to market is essential to this process as the information in these files can both maximize value and minimizing losses. Sellers must assure that adequate information regarding the loan has been assembled, and that the files and documentation pertaining thereto are well organized and have been thoroughly reviewed. This process includes compiling all documents pertaining to the loan (including junior/mezzanine loans, participations/syndications and modifications, amendments, etc.), the property and the borrower/sponsor, and verifying that the title policy is in the file and that insurance policies are current. It is also vitally important that the lender obtain current information regarding the property and the borrower/sponsor. The lender may also wish to review the loan documents to determine what information the borrower is required to provide. Even if the extra effort required to obtain such current information does not result in a higher price, this information base is fundamental to decision-making regarding the administration of the loan if it is not sold.

Purchase Agreement. The form of the seller's purchase agreement should be furnished to prospective bidders at the commencement of the due diligence review period. While the seller should aim for an "as is, where as" sale of the loan, at a minimum, the seller's representations and warranties therein with respect to each loan must be subject to all information disclosed to the bidders prior to the due diligence cutoff date and should only survive for a prescribed period of time after the closing (e.g., six months to one year post-closing). In addition, the seller's potential liability with respect to a sold loan can be further reduced by establishing a damage threshold that must be exceeded before the buyer can bring a claim for damages against the seller with respect to a breached representation, and, even then, the seller should have the ability to satisfy such claim by curing such breach, indemnifying the buyer with respect thereto or repurchasing the applicable loan.

Bidding Process. Bids should be scheduled for submission within seven to ten days after the due diligence cutoff date, and should include the bidder's comments to the purchase agreement. Structuring the bidding process in this manner allows the seller to balance the risk that a sale may not occur (because the parties are unable to agree on the terms and conditions of the purchase agreement) and the price being offered. Also, a seller may want to negotiate the purchase agreement with one or more of the top bidders, not only to assure that the purchase agreement is final before selecting the winning bid, but also because the time period before the bid is selected is when the seller has maximum leverage.

If properly implemented by a seller, the procedures set forth in this article can have a positive impact upon the financial results of a loan sale, because a seller that invests the time and money that is necessary to prepare a loan file prior to an attempt to sell the loan, will be able to both maximize the value of the loan and minimize the losses associated therewith.

Newsletter Continues on Back Page

COURT OF APPEAL PROVIDES FURTHER PRECEDENT THAT ANTIDEFICIENCY STATUTE DOES NOT APPLY TO GUARANTORS by Owen Gross

The Fourth District Court of Appeal recently held that guarantors are not entitled to the "fair value" protections of CCP §580a under existing case law and that individual guarantors who were the (a) sole members of a limited liability company that was the trustee, (b) settlors, and (c) secondary beneficiaries of a trust were "true" guarantors of the indebtedness of such trust.

In *Talbott v. Hustwit*, a lender made a loan to a trust that was secured by real property. Repayment of the loan was guaranteed by the settlors (and secondary beneficiaries) of the trust. A limited liability company owned by the guarantors was the trustee of the trust. When the loan went into default, the lender acquired the real property pursuant to a partial credit bid at a nonjudicial foreclosure sale. Thereafter, the lender sought recovery from the guarantors for the unpaid balance of the loan.

The guarantors argued that they were not liable for the unpaid balance of the loan because the fair market value of the real property on the date of the foreclosure sale exceeded the outstanding balance of the loan, such that the lender had been made whole by the acquisition of the real property at the foreclosure sale and any recovery against the guarantors would violate a general state policy against secured creditors obtaining excess recoveries. Furthermore, under such circumstances, the "fair value" protections of CCP §580a would prevent the lender from recovering the deficiency between the amount of the winning bid at the foreclosure sale and the outstanding balance of the loan. However, the Court of Appeal, in affirming the judgment against the guarantors entered by the lower court, noted that 60 years of case law has uniformly held that CCP §580a has no application to an action against guarantors and that the general state policy was not significant enough to justify abandoning Supreme Court precedent.

While consistent with existing case law, this opinion does have a certain amount of additional significance in that it is the first published opinion of a Court of Appeal with this holding after the Supreme Court ordered a contrary holding in *Bank of Southern California v. Dombrow* depublished in 1995.

The guarantors also argued that they were not "true" guarantors as there was an insignificant degree of separation of interest between the individual guarantors and the trust borrower such that the trust borrower was a "mere instrumentality" of the individual guarantors and the individual guarantors were, "in reality," the "primary obligor" (and, therefore, were entitled to the "fair value" protections of CCP §580a). An earlier Court of Appeal opinion had reached this conclusion with respect to individual guarantors who were also the trustors, trustees and primary beneficiaries of a trust borrower. In *Talbott*, however, the Court of Appeal determined that the use of a limited liability company as the trustee of the trust borrower sufficiently limited the liability of the individual guarantors for the obligations of the trust borrower (i.e., that the individual guarantors would not have been personally liable for the loan made to the trust borrower absent the guaranty), but otherwise made it clear that the determination of a party's status as a true guarantor or a primary obligor is primarily factual in nature to be determined on a case-by-case basis.

The decision also included a concurring opinion that focused on the disconnect between courts' refusal to afford guarantors the protections of CCP §580a and the goal of Civil Code Section 2809 to protect guarantors from incurring obligations "more burdensome" than those of a principal debtor, but review of the case was denied by the Supreme Court.

ABOUT THE REAL ESTATE FINANCE, RESTRUCTURING & WORKOUTS TEAM

The Real Estate Finance, Restructuring and Workouts Practice Group of Cox, Castle & Nicholson LLP is proud to represent a variety of traditional and nontraditional lenders, including banks, insurance companies, pension funds, finance companies, mortgage bankers, private investment funds, and other entities, as well as developers and other borrowers, in the financing of real property, businesses, receivables, and other assets. Our finance capabilities are all-encompassing and include the initial structuring and closing of finance transactions, loan administration, workouts, and loan restructures.

Contacts for the Cox, Castle & Nicholson LLP Real Estate Finance, Restructuring and Workouts Practice:
Douglas Snyder at 310.284.2253 or at dsnyder@coxcastle.com
Adam Weissburg at 310.284.2270 or at aweissburg@coxcastle.com

Los Angeles
2049 Century Park East, 28th Floor
Los Angeles, CA 90067
P (310) 277-4222
F (310) 277-7889

Orange County
19800 MacArthur Blvd., Suite 500
Irvine, CA 92612
P (949) 476-2111
F (949) 476-0256

San Francisco
555 California Street, 10th Flooor
San Francisco, CA 94104
P (415) 392-4200
F (415) 392-4250