

Real Estate and Banking Client Service Group Financial Institutions Client Service Group

To: Our Clients and Friends

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The Buying and Selling of Distressed Notes

Loan Sale Tips

The volume of purchase and sale of performing and non-performing real estate loans has picked up dramatically over the past year as banks seek to shrink their balance sheets as their capital base falls and other banks and investors seek to take advantage of the sale of assets from failing banks. What are the typical features of such agreements and what are the interests of buyers and sellers in such transactions?

Sellers

The bank which is selling a loan, whether it is performing or non-performing, seeks to cut itself off from the borrower and the collateral just as if it had never made the loan to begin with. To evidence such a transaction, the seller would essentially like to enter into the equivalent of a quit claim or limited warranty deed containing very few warranties and representations. The structure of such an agreement would typically provide for the following items:

1. Identification of the parties and the subject loans.
2. Listing of the loan documents including notes, loan agreements, mortgages, security agreements, UCC filings and related documents such as title policies, appraisals, engineering drawings, surveys, environmental exams, etc.
3. A due diligence period during which the buyer has full access to the loan documents and has time to conduct title exams, environmental audits and such other examination of the borrower and any collateral as it deems necessary.
4. Seller's representations and warranties will be limited to the following:
 - (i) Seller has the authority to enter into the transaction and there are no other parties who could claim ownership to the loans.

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(ii) The execution and delivery of all instruments and documents required hereunder to be obtained or authorized by the Seller in order to consummate this transaction have been or will be obtained and authorized as so required.

(iii) To the best of Seller's knowledge and belief without duty of inquiry or investigation, Seller has complied with, and has performed, all obligations required to be complied with or performed by it under the loan documents.

(iv) The outstanding principal amount of the loans.

(v) Seller is a sophisticated entity with respect to the sale of the loans; and has adequate information to make an informed decision regarding the sale of the loans.

(vi) The status of whether the loan is fully funded or not, and if not fully funded, the balance which the borrower can still draw.

5. Buyer's representations will include similar representations about its ability to enter into the sale agreement and the fact that it is a sophisticated party that understands the risks inherent in purchasing a loan.

With an agreement set up in this fashion the seller is comfortable that once the transaction closes it is no longer affected by anything which happens with the borrower or the collateral. The ability of a seller to obtain an agreement structured in this fashion, however, is dependent upon the leverage which it has. Oftentimes, if the sale is simply to another local bank it will not be difficult to structure the agreement in this manner since another local lender is familiar with both the borrower and the collateral. If the buyer is out of market, a private equity investor or simply a more demanding buyer, the seller will find it much more difficult to obtain a "quit-claim" type of agreement.

Buyers

Buyers have much more interest in obtaining stronger representations and post-sale protections from the seller. For example, a buyer may seek representations of the following:

(i) The seller has not engaged in any act, conduct or omission, or had any relationship with the borrower, that might reasonably subject seller or buyer to liability or result in buyer receiving proportionately less payments or distribution or less favorable treatment than any other similarly-situated creditor of the borrower.

(ii) Seller has not received any notice, claim, or demand from or on behalf of the borrower that (a) any transfer, including payments received from or on account of the loan, is or may be void or voidable as actual or constructive fraudulent transfers or (b) the loan or any portion thereof is or shall be voided, avoided, reduced, expunged, subordinated, disallowed, or subject to any defense, claim, counterclaim, setoff, or recoupment or other impairment of any kind, and seller has no knowledge of any fact or allegation that, if true, could have any such effect.

(iii) There are no delinquent taxes, ground rents, water charges, sewer rents, assessments, insurance premiums, leasehold payments, including assessments payable in future installments or other outstanding charges affecting any real property constituting the collateral.

(iv) Each mortgage, deed of trust or other instrument creating a lien on any real property collateral to secure the obligations arising under the loan creates a valid, existing and enforceable first lien on the real property collateral.

(v) Any and all requirements of any federal, state or local law including, without limitation, usury, truth in lending, real estate settlement procedures, consumer credit protection, equal credit opportunity or disclosure laws applicable to the origination, servicing and collection of the loan (including, with respect to each adjustable rate loan, all requirements pertaining to origination and servicing of adjustable rate loans) have been complied with.

(vi) Each of the loan documents to be sold is genuine and each is the legal, valid and binding obligation of the maker thereof, enforceable in accordance with its terms.

(vii) There is no default, breach, violation or event of acceleration existing under any mortgage or any promissory note and no event which, with the passage of time or with notice and the expiration of any grace or cure period, would constitute a default, breach, violation or event of acceleration, and the seller has not waived any default, breach, violation or event of acceleration. (This representation is one which can only be made for performing loans. Loans which are past due or which are in bankruptcy will require a different set of representations).

(viii) To the best of the seller's knowledge all parties to the promissory note and any mortgage had legal capacity to enter into the applicable loan and to execute and deliver the promissory note and corresponding mortgage, and the promissory note and the applicable mortgage have been duly and properly executed by such parties.

The interest of the buyer in such a transaction is to insure that should its due diligence fail to uncover all problems with the credit it will retain a claim back against the seller to make it whole. As a part of this the buyer may include a general indemnification provision which will require the seller to defend the buyer against any lender liability claims which the borrower brings which is based on actions occurring pre-sale. The seller thus maintains a certain amount of contingent risk that it may have to reimburse the buyer or repurchase the loan at some point in the future. This risk can be mitigated to some extent by establishing a time period when the representations and warranties will no longer be effective. Buyers also need to keep in mind though that rights of indemnification are only as good as the party standing behind them. Sometimes the financial condition of the seller is such that the buyer should focus more on its due diligence than trying to obtain rights against a seller that may not be around in the long term.

Other Considerations

Purchase and sale agreements can get much more complex when the borrower is in bankruptcy. In such an instance the parties may need to address how distributions from the bankruptcy case are to be treated. For example, what happens if adequate protection payments made by a borrower are

somehow required to be repaid to the debtor pursuant to an order of the court? Likewise, what happens if the claim is made subject to equitable subordination? These and other possible risks are beyond the scope of this client alert. Suffice it to say though that any party, whether a seller or buyer, should seek capable legal assistance when entering into a loan purchase and sale agreement, regardless of whether the loan is performing, non-performing or the subject of a bankruptcy case.

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