BUYING AND FINANCING DISTRESSED ASSETS

In our previous newsletters in the summer and fall of 2008, we examined the legal and practical foundations of addressing distressed properties, with a special emphasis on hospitality properties. As we prepared these updates, the recession has taken a predictable course and many investors and lenders, having recovered from the initial shock are considering a buying cycle of distressed and pre-bankruptcy properties. Many hope to have properties under contract during the first quarter of 2009 with closings scheduled in the early second quarter. Assuming Lenders have proper documentation and security (see June Newsletter) and the property is a good candidate for rehabilitation (see October newsletter), we now take the third step and review the issues which can derail a "work-out" purchase, with an emphasis on the contractual provisions and due diligence which need to be addressed by the Seller's lender, the Buyer/Borrower and the new lender (if any).

DISTRESSED ASSETS AND DISTRESSED BORROWERS

We will examine some of the pitfalls to expect in what will almost certainly be a bargain basement sale of "pre-filing" properties soon to be on the market. In short, it is time to consider the risks of purchasing and financing distressed properties.

Note that earlier newsletters have discussed some of the ways in which distressed properties may be found to have or develop values. (See our latest posing at our website below.) However, the focus in this issue will be the considerations to be given when a Seller may be out of business the day after the sale, or perhaps even during the contract period. It is important to maximize the protections to the Buyer and his lender and preserve the benefit of the bargain which has been made by the Buyer.

WHY NOW?

Consider why it is that there is a surprising absence of across the board foreclosures and other legal action with respect to distressed businesses as of January 1, 2009, although economic activity has reached a standstill and industries dependent upon transactions, such as finance, real estate, warehousing and retail no longer are generating the fees required to maintain their overhead. There are probably two reasons. First, should all distressed business be dismantled at this time, the resulting surplus in real estate, manufactured goods, and retail products would only further depress an economy which Assistant Secretary of the Treasury Neel Kashkari described as slowly moving away from a tipping point as recently as December 5. Secondly, no lender wants to force a liquidation at a loss when a government-subsidized workout may be just around the corner. Consequently, lenders have shown remarkable patience and pragmatism in holding their fire as of the close of 2008. With the first quarter of 2009, however, regulatory pressure will push lenders into action.

CONTRACTING FOR DISTERESSED PROPERTY

The problem with contracting for the purchase of distressed property is the fact that distressed property is owned by distressed borrowers, i.e. borrowers with a higher than normal likelihood to file for bankruptcy (or be forced into involuntary bankruptcy) in the near future. So the first inquiry should be, "Is the Seller eligible for bankruptcy?"

Some selling entities may not be eligible for bankruptcy, either as a matter of fact or law. Very generally, in order to file, the seller must be a U.S. resident and not have had a bankruptcy proceeding during the preceding 6 years. However, it is most likely that any entity owning distressed property will be an entity established for that purpose, and that any prior bankruptcy would have liquidated the Seller, so it is safe to assume that your Seller is eligible to file, and that no contractual provision will be effective to prevent such a filing (11 UCS 365 (e)).

However, single asset entities which own nothing but the property to be purchased are subject to expedited relief from the automatic stay against the debtor property afforded by the code 11 USC 362(d)(3). Normally, this will apply to any real estate business in which rents are the major source of income (office, warehouse, etc.) However, as in other instances, hospitality properties generally have "non-rent" or other income unassociated with the real estate. Full service hotel properties are generally not considered single asset real estate (SARE), but limited service hotels have been found to qualify. Many of the same considerations applied to qualifications to do business and to the requirements of REIT status would arguably be applicable

Finally, many Seller may have bankruptcy remote provisions in their organizational documents which in effect means that unless one has the cooperation of a director usually "sympathetic" to the primary lender (usually the beneficiary of such provisions) bankruptcy cannot be filed and a sale may be effected without the concern of a bankruptcy being filed during the due diligence or after closing. While these provisions have been around since the 1990's, cases involving their application are only now being brought. (See the article *"Speed Bumps" in the Road to Bankruptcy for Hotels and Resorts* by Jim Butler & Robert B. Kaplan, Sunday, 23rd November 2008 at http://www.4hoteliers.com/4hots_fshw.php?mwi=3538)

In the majority of cases, the selling entity should be considered eligible for bankruptcy protection, and the following issues need to be addressed:

Shortened due Diligence

Review of the property (See the October 2008 article) must proceed quickly for two reasons. First, the longer the due diligence, the higher the likelihood of bankruptcy prior to conveying title from the seller. If this should happen, the contract would not automatically terminate, but as an executory contract, it would be subject to rejection under 11 USC 365 in a chapter 11 workout. If however, the contract is not rejected immediately, and should an extension be required, there should be some provision for reimbursement to the Buyer for due

diligence costs incurred in preparing for closing should the contract be disaffirmed. This could be in the original contract, though its enforcement may be assured though a bankruptcy court order at the time of extension.
Second, it is to be hoped that the market does have a bottom, and the prices set for the closing at the time of the contract may seem insufficient if the closing is much later. This perception is amplified by the fact that by the time this issue is brought before the court, the market may further improve.

Other Creditors and Operating Contractors

It is obvious that the contract must provide that the Buyer assumes no obligations or any liability or debt of the Seller. Of first importance are claims which will attach to the property and survive the closing. Filed lien claims against the Property, the or any of the appurtenances are obvious, but note that "secured" claims can include any of the lien claims which can become successor liabilities (usually sales, ad valorem and other taxes, some labor and wage claims, WARN act claims etc.). Also included are hidden claims such as amounts owing on any of the appurtenances assigned to the Buyer (assessments, dues, and subdivision costs and the costs of any additional entitlements necessary to operate the property).

Unsecured claims raise two concerns. First, are they from essential suppliers or contractors of services or rights, so that a failure to pay may result in issues with the operation of the property? Consider utilities, franchise fees, and management fees. The manager and the franchisor must evidence their consent to the sale and the introduction of the Buyer in the trade area of the Project. Second, are they substantial enough to warrant an involuntary bankruptcy petition? By their nature the only way to go behind the representations of the Seller is a physical inspection of the property, discussions with the management and franchise parties and perhaps with some of the major suppliers. As in any acquisition, however, it is the suppliers who are not listed who will appear with claims after the transaction.

Other than due diligence, the Buyer may wish to employ deferred payments, escrows, or other arrangements to protect against unknown claim, but any such arrangements must be balanced against the requirement of reasonable value discussed below in connection with avoiding the transfer after closing. Variations would include:

Holdbacks and Earnouts. A portion of the purchase price can be held in escrow pending the satisfaction of conditions, including the passage of time. In the event of a subsequent bankruptcy, it is the deposit which become as part of the debtor's estate.

Bonus Payment As opposed to the negative connotation of holdbacks, a premium for meeting certain post closing conditions may be established. Very little precedent exists on such an arrangement, and care must be taken to set forth the conditions for redemption carefully. This is more fully discussed below.

Purchase of Existing Prior Liens Most commonly, this involves the purchase of the existing lender's mortgage, followed by foreclosure or possibly a simultaneous purchase of the property by a related entity. The loan could also be purchased by the new lender and modified to meet the requirements of the new financing, though care must be taken to avoid a novation which can defeat many of the objectives of such an arrangement.. The advantage sought is to maintain the priority of the existing primary indebtedness and to use that priority to defeat inferior claims by the unsecured or potentially secured creditors. It should be noted that this approach generally does not defeat the successor liability statutes, but it is effective against any second mortgages or inferior liens, including tax liens if the proper steps are taken. Those proper steps include a review of the title file to make certain that inferior liens do not include FDIC loans or loans which may become the property of the FDIC through a bank failure, as well as SBA or other government liens which may be afforded special redemption rights under the terms of 28 USC 2410 (C).

OCCURANCE OF BANKRUPCTY DURING TRANSACTION

The Purchaser or the Purchaser's lender may become aware of the bankruptcy of the Seller either during or after the closing of the transaction. Indeed, it is not uncommon to discover after the closing of the transaction that the Seller was in a bankruptcy proceeding (and may have been in a chapter 11 workout for a great period of time prior to the contract.) When the bankruptcy of the Seller is discovered, certain steps should be immediately taken.

First one should check to see that the Seller was not in bankruptcy at closing. If such is not the case, the only effect the subsequent bankruptcy should have is a possible claim for fraudulent transfer (as a matter of law). Otherwise, and in general assuming reasonably equivalent value has been given, the subsequent bankruptcy should have no effect.

But what happens where the bankruptcy occurred prior or during the contract period and is only discovered after the closing? In this case, and with respect to realty only, the issue becomes one of constructive notice. The bankruptcy code provides that the Purchaser will be protected in his title to real property if the bankruptcy filing has not been made a part of the applicable legal records affecting the real estate. That is, simply filing of the bankruptcy is not necessarily constructive notice of the bankruptcy proceeding, and the good faith purchaser may retain the purchased property. Note also that this rule applies only to realty, not personalty, and hotel beds, gas station equipment and warehouse racks may be removed from the purchased property. Such would seem to be the case whether the bankruptcy was filed before or after the date of the contract.

If the bankruptcy is filed after the date of the contract, another consideration is raised in that the trustee or a debtor in possession may treat the contract as executory, and in such a case may elect to continue or reject the contract. If the purchaser is trying to meet the requirements of a 1031 exchange, or if there are options or due diligence drop dead periods, or periods in which a deposit may become non-refundable, these may be affected by the timing of the bankruptcy filing. In general, the trustee or the debtor in possession has only the rights and is subject to the obligations of the terms of the contract which comes into the bankruptcy estate, but having said this, how do real deadlines get rearranged to accommodate the election periods applicable to an executory contract?

The consensus is that Bankruptcy courts will take every reasonable step possible to preserve the terms of the contract and to eliminate any difficulty caused by, for example, a 1031 replacement contract where no other property has been identified in the 45 day period. Perhaps it is arguable that such a contract is no longer executory, due to the reliance placed on the seller's performance. In any event, recourse to the court should be immediately sought where the Seller files pending the contract.

In the event that a contract should be rejected, the deposit of funds or earnest money deposit left with the debtor would be a lien against the property itself as "partial payment". This would generally not be an issue, since such deposits are customarily held by third party escrow agents, such as the title company, and as such, do not become part of the debtor's estate upon the filing of the bankruptcy petition.

CLOSING ON DISTRESSED PROPERTY

Payment. While a decision on the terms of payment should be made at the time of the contract, the practicalities of how the purchase price is to be handled are a part of the closing. The objective is to provide the most protection against the unknown claimant as may be available in the situation. Although the applicability of the Bulk sales provisions was originally limited to retail business under the majority view, it did afford some additional comfort in other acquisitions. Now that the majority of the states no longer have the bulk sales provisions of the UCC, it has become even more important to protect against the claims of unknown creditors.

One common application is the escrowed portion of the purchase price, which is either used as a reserve against such claims and released at the end of a certain period, or is otherwise earned out against the general revenues and trade payables over a period of time. Upon filing bankruptcy, this fund can become an asset of the debtor, but only to the extent of the debtor's rights in the same. Disputes about the validity of deductions against the reserve may be pressed more vigorously by a trustee or other creditors, but the protection to the Buyer generally afforded should remain.

A more positive approach is the bonus payment available if certain claims are not made or if certain events do not happen. It is conceivable that such a condition to the payment of a bonus amount might be the passing of any fraudulent transfer period provided by state law. State law might be the better rule, in order to avoid a conflict with 11 USC 365 (e) (invalidation of filing bankruptcy as a sole condition). While no controlling case is on point, it would appear that such an arrangement, if enforced, would hedge some of the exposures of a subsequently filed bankruptcy. It should also be noted however that issues as to whether reasonable value (see below) was paid at the time of closing might be introduced.

Passing of title. At the time of closing it is important to insure that title has passed and the asset is no longer a part of the debtor's estate upon the subsequent filing of a bankruptcy petition. Thereafter if any effort is made to recover the Property (as opposed to the debtor/seller's interest in any holdback or reserve) then the asset must be brought back into the estate and the mechanism for doing so is the fraudulent transfer provisions of the bankruptcy code. The first issue is therefore determining when the title to the Property has actually passed out of the estate. While there is no statutory provision with respect to fraudulent transfers, the time of transfers are defined with reference to preferences as the point at which a bona fide purchaser from the debtor would have inferior title to the transferee, and brings into consideration the race notice provisions of various state statutes regarding recording. (11 USC 547 (e) (1)). Such an approach would most likely be applied to fraudulent transfers as well.

Less than Reasonable Value. There is little case law establishing what reasonable value is for the purpose of establishing a fraudulent transfer, but there are certain situations in which reasonable value has been found. One is in the acquisition of property at a tax sale. If a state court has approved the sale and the state statutes (e.g. Pennsylvania) provide adequate protections, the transfer is not fraudulent. It has also been held that even though the proceeds of a sale are insufficient to meet the debts of the selling entity, that in itself is not evidence that reasonable value as not given. Some other factors include the good faith of the parties, and whether the transaction was arm's length.. Issues which have yet to be presented however are what happens in the event that the property appreciates in value substantially during the contract period, or even more likely, during the post-filing period during litigation.

The answer would seem to be to provide a foundation for the value, including opinions of appraisers or at the very least, brokers effective at the time of the contract. Such opinions should reasonable take into consideration the market as well as the need for a quick sale. The approval of major unsecured creditors (who stand to receive some of the proceeds) may be helpful as well.

WALKING AWAY

Distressed Sellers can assume a sense of entitlement and it can rapidly become the Buyer's (and the Buyer's Lender's) responsibility to get the Seller out of their distress, even at the Buyer's own peril. However, the Buyer's due diligence can discover issues which cannot be solved at the contract price, and it may become clear that the potential for unknown creditors is much too great to justify the risk the lower price may reward.

It is imperative that he Buyer be able to freely terminate the contract during the due diligence period without the Seller claiming reliance or misrepresentation. Experience has proven it useful to include in the contract a provision making it clear that Buyer undertakes no obligation to make any determination by any date and providing that while the Buyer shall use its best efforts to determine the condition of the Property and the nature of the obligations to which the same is subject, the Buyer's determination of the sufficiency of any information and the effect it may have on the operation of the Property must be dispositive.

Keep in mind that in the event of the subsequent reorganization or liquidation, a new opportunity to acquire the property with the full protections afforded by a bankruptcy court order will present itself. While the price may be somewhat greater, it should in most likelihood be on the lower side of fair market value (as creditors will be wanting immediate payment) and that the Seller's lender (whether in a single asset or other case) will be diligently pursuing the removal of the property form the proceedings, and should in most instances be very accommodating to the Buyer.