

Memorandum

November 3, 2011

“An investment strategy that reflects the unique features of CRE loans and anticipates potential hurdles to liquidity in the developing CRE loan market will enhance the upside potential of this asset class and protect against downside risk.”

## A Loan Trader’s Guide to Commercial Real Estate Loans

By Jon Kibbe, Paul B. Haskel, Michael Friedman, Kenneth E. Werner and Charles D. Thompson, II

The secondary market for corporate leveraged loans is well established in the United States. Trading conventions and streamlined transfer documentation have evolved over two decades, and loan market participants have benefited from increased liquidity and transparency. The most liquid leveraged loans are (i) broadly syndicated at origination by an established commercial or investment bank, (ii) made to commercial and industrial borrowers and (iii) secured by a first-priority lien on all of the borrower’s present and after-acquired property.

How far and wide can this market expand? A robust European loan market and an emerging market for bank loans in Asia suggest that national borders will not limit expansion of the secondary loan market. Similarly, an established and growing market for distressed loans suggests that declining issuer credit quality will not hinder expansion. A prime candidate for growth in the secondary market is the category of loans backed by commercial real estate. But can the established market accommodate the unique aspects of these “CRE loans?”

At first glance, the secondary market for distressed debt is a natural fit for these loans. There are plenty of them—more than \$2.4 trillion of debt is backed primarily by commercial real estate in the United States. In addition, many CRE loans trade at distressed levels because the value of the real estate backing the loans no longer covers the outstanding loan balance.

While CRE loans may present an attractive investment opportunity for hands-on managers familiar with real estate collateral, there are abundant traps for the unwary loan trader. This memorandum describes CRE loans and the growing liquidity of the asset class, while outlining unique attributes of CRE loans that merit special attention. An investment strategy that reflects the unique features of CRE loans and anticipates potential hurdles to liquidity in the developing CRE loan market will enhance the upside potential of this asset class and protect against downside risk.

### BACKGROUND

During the past decade, developers took advantage of easy credit and rising real estate markets to borrow funds to build multifamily housing, office buildings, malls, medical centers, resorts and other high-profile, high-quality assets.

Lenders—predominantly community and regional banks in geographic proximity to the real estate projects—enthusiastically originated loans for the construction, acquisition and refinancing of these projects. The loans were specifically tailored to individual real estate projects and contained negotiated covenants that contractually benchmarked the expected future financial performance of the projects.

As the economy began to falter, however, developers and owners of commercial real estate were unable to meet the overly optimistic financial tests and covenants universally embedded in CRE loans—those tests and covenants had assumed continued appreciation of commercial real estate values, robust local employment figures and continued underlying strength in specific regional economies.

Instead, declining employment statistics and depressed regional economies set the stage for a rapid decline in the commercial real estate market. Stressed borrowers—developers and owners of commercial real estate projects—and pragmatic lenders were forced to choose between foreclosing upon nearly complete, vacant, commercial properties and selling them into a depressed real estate market, or amending and extending loan facilities to postpone or avoid an expensive day of reckoning. Amending and extending loans backed by commercial real estate was by far the favored outcome.

## THE CURRENT OPPORTUNITY

Today, after amending and extending many of these loans, the original CRE lenders find themselves pressured by regulators and investors to clean up their balance sheets. The pressure to de-lever bank balance sheets has the potential to create an active market for loans backed by commercial real estate and presents an opportunity for participants in the traditional (commercial and industrial) leveraged loan market to purchase commercial real estate loans at stressed or distressed prices.

Because of the enormous breadth and scale of commercial real estate development during the past decade, buyers can acquire loans secured by high-quality commercial real estate at a discount. Often, the projects backing the loans are nearly complete and have been built to high standards, but regional economies have not cooperated, the expected rental streams have not materialized and the loans must be restructured or modified. In many cases, current projected revenues will not be sufficient to service the debt. There is ample

opportunity for investors to pursue strategies ranging from passive (“buy-and-hold” the loan) to active (“loan-to-own” the real estate) depending on the circumstances of the underlying commercial real estate asset.

## THE EVOLVING MARKET

Traditional buyers of syndicated leveraged loans in the secondary market would appear to be a natural fit for the distressed commercial real estate market. These sophisticated investors are familiar with the arcane details of bank loan trading and they are well-versed in the legal and practical aspects of debt restructuring and bankruptcy proceedings.

However, despite many similarities between the commercial and industrial loans that currently trade in the secondary loan market and the burgeoning numbers of distressed CRE loans, there are important differences between the two categories of loans, and those differences will inform the way they are traded. A successful purchase or trading strategy must address the unique features of CRE loans and recognize the fundamental differences that set CRE loans apart from commercial and industrial loans, including differences in (i) loan documentation, (ii) collateral, (iii) assignment and transfer restrictions, liquidity expectations and trading conventions, (iv) servicing requirements after the trade is settled, (v) state law foreclosure and restructuring strategies, and (vi) tax treatment. The remainder of this memorandum discusses these differences in more detail and describes potential frameworks for investors and traders seeking to purchase CRE loans in the secondary market.

## CRE LOAN DOCUMENTATION

There are myriad ways to slice the market for commercial real estate loans, but CRE loans can be distilled into at least three broad categories organized by size and lender participation, ranging from relatively simple, small bilateral loans to very complex, large syndicated loans. Each category includes construction loans, the proceeds of which are used to finance the construction of a commercial property and the

repayment of which is typically based on performance of the completed project. The distinctions between the three categories form a basic map for gauging the applicable documentation and diligence strategies for an investor trading or purchasing a CRE loan.

### **Bilateral Loans**

The most straightforward category is the bilateral CRE loan, which is simply a loan made by a single lender (often a regional bank) directly to a borrower (often a single purpose entity formed by a real estate developer). Bilateral loans typically range in size from \$3 - 30 million. Credit documentation standards vary enormously from lender to lender and the loan files (which should contain financial reporting, correspondence, and construction status updates) held by the originating lender may be inaccurate, incomplete or altogether missing. The lender is solely responsible for monitoring and servicing the bilateral loan, which typically may be transferred by the lender to another bank or investor only with the consent of borrower, unless the borrower is in default, in which case the consent of the borrower is generally not required. Recently, regulatory and balance sheet pressures have prompted many regional banks to shed portfolios of bilateral CRE loans. Because the single lender can effectively direct and control enforcement and restructuring negotiations with the borrower, pursuing a loan-to-own strategy through aggressive enforcement and foreclosure of a troubled loan may be relatively straightforward for a buyer of a bilateral CRE loan.

### **Club Deals**

The second category of CRE loan is commonly referred to as the "club" deal. These loans are more substantial in size (\$30-200 million) than a typical bilateral loan and are originated by a small group of lenders (often regional banks) that may routinely collaborate to originate CRE loans. At origination, the loans are not offered or syndicated to lenders outside of the "club." One of the club members will serve as agent for the lenders, taking on the responsibility for monitoring and servicing the loan and the collateral in return for a modest fee. Transferring the loan may require consent of both the existing lenders and the borrower (unless the

borrower is in default). Amending or modifying the loan generally requires the agreement of (i) the borrower (unless it is in default), (ii) the agent, and (iii) depending on the nature of the change, a majority, a super-majority, or all, of the lenders. An investor with a loan-to-own strategy can buy a portion of a club deal and, depending on the size of the position, either (i) influence the recovery strategy (which may include enforcement of the loan terms and foreclosure of the property) through discussions with the other lenders, or (ii) learn more about the loan and the borrower and negotiate with the other club members to acquire additional loan positions, thereby increasing its ability to influence an enforcement and recovery strategy.

### **Syndicated Loans**

The third category of CRE loan is the broadly syndicated loan. These are the largest CRE loans—they are usually too big to be made by regional "club" lenders, and are generally underwritten by a lead bank or banks on a best-efforts basis. Similar to club deals, transferring the loan may require consent of both the agent (acting on behalf of the syndicate) and the borrower (unless the borrower is in default), and often there are minimum transfer amounts chosen to encourage liquidity. Consent of other syndicate banks to a loan transfer is generally not required. Modifications to the loan documentation generally requires the agreement of the borrower (unless it is in default) and the agent and, depending on the nature of the change, a majority, a super-majority, or all, of the lenders. Whereas the size of, and resources allocated by, community and regional banks in club deals tends to limit the extent to which they will actively engage in or oppose modifications to the loan documentation, the same cannot be said of lenders in syndicated transactions; as a result, modifications to syndicated CRE loans can be cumbersome where the consent of multiple, actively engaged lenders is required.

## **COLLATERAL**

Because the collateral securing the loans is generally a specific real estate asset and related personal property and fixtures, as opposed to a blanket lien on all present

and future assets of an operating business, asset-specific (as opposed to operating-business specific) due diligence must be completed before executing a trade. As described below, requisite diligence can include environmental diligence, on-site construction inspection, detailed mechanic and real-estate lien searches, review of material contracts affecting the project, including anchor leases (if applicable), and a review of any existing intercreditor or co-lender agreements.

There are many different types of real estate collateral that may secure a CRE loan. Construction loans may be secured only by the land itself and a guarantee (often personal) from the developer, while CRE loans secured by operating real property will have the benefit of the completed improvements on the land and will often include an assignment of rents or other income derived from the property. In each case, focused diligence must be undertaken to ascertain the validity of a lender's security interest.

Before purchasing a loan, a lien search should be completed to ensure that any security interest granted in favor of a lender has not been primed by tax or mechanics' liens on the property. Some states require that a commercial loan agreement be filed in order to obtain absolute priority over mechanics' liens; if the property is located in one of these states, a prospective buyer should ensure that the loan agreement has been filed.

Because of the potential for lender liability under various federal and state environmental laws, diligence of environmental issues affecting the real estate collateral is of primary importance for a secured lender. In particular, for bilateral loans and most club deals it is best practice to obtain at least a "Phase 1" environmental site assessment of the property or properties securing the loan. A Phase 1 report provides the buyer with an overview of the environmental condition and history of the property and is designed to identify any actual or potential environmental problems based upon a review of specified environmental and historical databases. If any problems are identified, further diligence will be necessary.

If foreclosure is a reasonable possibility, even more environmental diligence may be necessary prior to purchasing the CRE loan or taking possession of the property. To minimize the risk of lender liability at the distressed (pre-foreclosure) stage, lenders should ensure that they do not become actively involved in the management of the property (for example, by directing that available cash be spent in a particular manner) and that they stay within certain safe harbors available to a secured lender under certain environmental laws. Consultation with counsel is a necessity at this stage.

Large syndicated loans, which typically have a well-compensated security agent looking after continuing collateral perfection, environmental and related issues, present fewer concerns for a potential purchaser of a CRE loan. Those agents are generally well versed in the issues of lender liability in the context of CRE loans and, if foreclosure is a possibility, will generally manage the process to ensure that necessary diligence is completed and the syndicate is represented by knowledgeable real estate and environmental counsel.

## TRADING CONVENTIONS AND ASSIGNMENT PROVISIONS

The trading conventions and legal transfer documentation for commercial real estate loans are very different from the well established trading conventions and familiar transfer documentation used in the liquid secondary market for commercial and industrial loans. Traders familiar with best practices in the commercial and industrial loan market and the suite of documents published by the Loan Syndications and Trading Association, Inc. (the "LSTA") used to transfer commercial and industrial loans will need to re-tool their best-practice and documentation expectations when trading CRE loans.

Unlike the LSTA trading framework, commitments to buy bilateral and club CRE loans are often subject to purchaser's satisfactory due diligence and may contain detailed provisions governing scope and timing of such diligence. A standard form LSTA trade confirmation

does not include a provision allowing a buyer to terminate its commitment to purchase if the results of the buyer's diligence are unsatisfactory.

The underlying CRE loan documentation may contain restrictions on transfer that should be reviewed as a matter of priority. CRE loans often contain surprisingly restrictive eligibility requirements and impose substantial minimum transfer amounts. Unlike the more liquid LSTA secondary market in commercial and industrial loans, which is built upon credit agreements that (i) include broad definitions of those assignees eligible to hold a loan and (ii) permit small lot sizes to be transferred by routine assignment, the evolution of CRE loan documentation has not paralleled the evolution of syndicated commercial and industrial loans, and current CRE loan agreement provisions related to transferability are not drafted to promote liquidity.

The allocation of risk embodied in purchase and sale documentation also differs in the CRE loan market. Participants in the LSTA market take for granted the nuanced and buyer-friendly transfer documentation that has evolved to support the trading of distressed commercial and industrial loans. The well-established suite of LSTA transfer documentation contains detailed representations and warranties about a distressed loan and seller's activities in respect of the loan made by a seller in favor of buyer. Those representations and warranties allocate business and legal risks and, in practice, often serve as a proxy for detailed due diligence by a loan buyer. In contrast, the buyer of a CRE loan should not assume that the seller is familiar with LSTA documentation standards or worse, that due diligence is unnecessary, because CRE loan transfer documentation rarely protects the buyer and thorough diligence is essential to any CRE investment strategy.

#### **Bilateral Loans**

Bilateral CRE loans are, by their very nature, the easiest CRE loans to transfer, particularly if the borrower is in default. In the CRE loan market, business and legal due diligence is key and the buyer's ultimate commitment to buy is conditioned upon satisfactory due diligence. Once an agreement is reached, the existing lender will

assign the entire bilateral loan to the buyer, typically on an "as-is, where-is" basis. Representations by the selling lender, if they are made at all, typically have a limited survival period of three to six months. The framework may include a limited put-back right, allowing buyer to put non-conforming loans back to seller. The limited seller representations further highlights the need for effective, thorough due diligence. A potential investor should consider the seller's capacity to correctly account for the loan; seemingly simple things, such as the principal amount outstanding, are inaccurately recorded to an astonishing degree. Often, this is a result of the complexity of these loans. Some CRE loans, for example, have principal paydown ratios that vary based on specific criteria such as the sale price per foot of a particular condominium unit. This and other unique features make record keeping more difficult than accounting for traditional amortizing or bullet loan. The familiar LSTA trading and documentation framework is not designed for bilateral loans and the tendency of sellers to sell portfolios of bilateral CRE loans with a seller-friendly legal documentation means that bilateral CRE loans are likely to be sold on the basis of heavily negotiated, customized transfer documentation.

#### **Club Deals**

A potential investor in a club deal may be confronted with a number of challenges. First, obtaining the agent consent for an assignment of a CRE loan in a club deal can be difficult, possibly because the agents are typically undercompensated, understaffed and unfamiliar with trading that takes place in the more liquid commercial and industrial bank loan market. Second, unlike the commercial and industrial syndicated loan framework, credit agreements and related documentation for commercial real estate loans is decidedly not standardized. The documentation is narrowly negotiated and tailored for a particular project, and may contain provisions that are confusing, conflicting and sometimes simply wrong. As a result, negotiating and documenting the purchase of a slice of a club deal can be a challenging process. A potential investor may discover, for example, that it is not an eligible assignee of a \$10 million transfer of a \$100 million loan because the loan documentation requires an assignee to have

\$10 billion of capital. That investor may be further surprised to discover that it does not qualify as an “eligible participant,” because the requirements for eligible participants are even more onerous than those for eligible assignees. In many club deals, obtaining the consent of other lenders in the “club” may be required for an assignment to a new lender. Existing lenders may not consent to a transfer if it is perceived that the transfer could disrupt on-going negotiations with the borrower. Just as with bilateral loans, the seller’s capacity to correctly account for the loan should be considered.

### Syndicated Loans

The documentation for broadly syndicated loans is more standardized, and the loans are more liquid, than club deals. In most instances, a potential investor can take comfort that the risks associated with the real property securing the loan have been well-vetted. Syndicated CRE deals often contain familiar (and liberal) definitions of “eligible assignee” and require only modest minimum transfer amounts. The sale of participations in the loan is often not restricted. One possible reason for the difference is the committed resources of experienced administrative and collateral agents. The syndicate lender in such a deal is often removed from the day-to-day management of the loan. In addition, the collateral securing a large syndicated CRE loan may contain significant non-real estate assets; for example, it may include equipment, cars and/or trucks, intercompany guarantees, patents, and miscellaneous other collateral. For these reasons, broadly syndicated CRE loans are the most likely category of CRE loan to be traded within the familiar LSTA trading and documentation framework.

### LOAN SERVICING REQUIREMENTS (POST-TRADE)

Enhanced operational resources and continuing day-to-day involvement in the legal and commercial details related to the underlying real estate assets are generally essential for a successful CRE loan investment platform. In a typical construction loan, principal is advanced only upon certified completion of technical milestones, and, as mentioned above, repayment is

often governed by complex formulas that can depend on the sale price per foot of a particular unit, the average sales price per unit, or even average lease prices.

The management of a distressed commercial real estate loan can be time consuming. As the borrower nears default, lenders will spend countless hours negotiating amongst each other over enforcement strategies and with the borrower over repayment and restructuring alternatives. This is particularly true with club deals. Fortunately, the administrative agent and lender counsel in a broadly syndicated CRE loan will generally undertake substantial negotiations on behalf of the syndicate and, as a result, individual lenders will not be required to closely monitor day-to-day status and reporting information provided to individual lenders in the syndicate may be sufficiently detailed to allow monitoring the CRE loan at a distance.

Holders of CRE loans often enter into an arrangement with a third-party loan servicer, which will perform many of the day-to-day tasks associated with managing and servicing a loan portfolio secured by real estate. Such a servicer may also perform financial and environmental diligence of potential CRE loan purchase opportunities.

This heightened post-trade involvement has its limits. As mentioned above, to minimize a lender-liability claim, an investor must not become too involved in the day-to-day operations of the borrower. For example, a safe harbor exists under the Comprehensive Environmental Response, Compensation and Liability Act (“CERCLA”) which exempts a secured lender from CERCLA liability unless the lender “participate[s] in management” while the borrower is in possession of the property. A lender participates in management by exercising decision-making control over environmental compliance issues or controlling operational functions (as opposed to financial or administrative functions) of the property. This important safe harbor can affect a lender’s enforcement strategies because, in the event of foreclosure, in order to stay within the safe harbor, a lender must dispose of the property at the earliest commercially reasonable time.

## STATE LAW FORECLOSURE AND RESTRUCTURING STRATEGIES

Purchasers of distressed commercial and industrial loans are familiar with the well-ordered federal bankruptcy and uniform state-law uniform commercial code (“UCC”) foreclosure processes. Specifically, the relative ease (both in terms of time and cost) of foreclosing on personal property under the UCC without the need to obtain prior court approval provides lenders with a great deal of certainty and leverage when negotiating with distressed borrowers. Where parties cannot negotiate an out-of-court restructuring solution, even if a borrower files for bankruptcy protection to stave off a foreclosure sale, the lender will have well-established rights and collateral safeguards in the bankruptcy case.

On the other hand, because real estate foreclosure is not governed by the UCC, purchasers of CRE loans will not enjoy the lender-friendly foreclosure mechanism the UCC affords. In certain states, known as “non-judicial foreclosure jurisdictions,” borrowers may grant lenders the ability to foreclose without obtaining prior court approval. These non-judicial foreclosures can occur in approximately 90 days. Other jurisdictions, known as “judicial foreclosure states,” however, require lenders to obtain a court order prior to foreclosing which may take several years to obtain. In either type of jurisdiction, the borrower, as a strategic option or last resort, may also file for bankruptcy in order to stave off foreclosure. To protect against such a defensive bankruptcy filing, a lender may require a guaranty from the developer or sponsor that provides recourse if a bankruptcy petition is filed by the borrower. A lender may also require the borrower to grant a *present* assignment of its rents and revenues to the lender, coupled with a revocable license from the lender to the borrower allowing the rents to be utilized until there is an event of default. The threat that a lender could revoke the license should deter a defensive bankruptcy filing because revocation would severely limit the borrower’s ability to utilize rents and revenues during any bankruptcy proceeding. Accordingly, exercising remedies with respect to CRE loans, in particular in judicial foreclosure jurisdictions, is more time consuming and costly than enforcing commercial and industrial loans. Therefore, the threat of

foreclosure may not provide CRE lenders with the same amount of leverage and the time-related certainty that is afforded to lenders of commercial and industrial loans. These differences may impact CRE lenders’ rates of return and investment thesis.

## TAX TREATMENT

Purchasers of CRE loans will want to carefully consider potential tax issues in structuring their investments, particularly with respect to potential unrelated business taxable income (“UBTI”) with respect to U.S. tax-exempt investors and income effectively connected with a U.S. trade or business (“ECI”) with respect to foreign investors. While interest (and gain) received with respect to CRE loans will generally not generate UBTI as long as they remain loans, tax-exempt investors will have to consider the potential negative tax consequences that may result if the collateral securing such loans is foreclosed on. The same is true for offshore investors, who in addition have to consider whether purchasing CRE loans with the expectation that many will be restructured or foreclosed upon will cause the purchase of such loans to be considered part of a U.S. trade or business.

Depending on the type of property involved, income generated by the property may or may not constitute UBTI. Offshore investors will generally not want to hold any type of U.S. real estate due to The Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”), which causes any gain from the sale of U.S. real estate to be taxed as ECI. Advice from tax counsel is an essential element of a CRE investment strategy.

## CONCLUSION

As a result of the recent financial crisis in the United States, the large and liquid commercial real estate market may now present an attractive opportunity for investors purchasing CRE loans. Any investment strategy should take into account the unique features of CRE loans and the limitations of liquidity in the secondary market. CRE loans differ in documentation and trading practices based upon size and lender composition. Transferability is not assured and



seller-friendly transfer documentation places heightened importance on thorough diligence, both of the underlying property, and the legal documentation that governs the economic terms of the loan and the grant of a security interest in the collateral. Post-trade servicing of CRE loans can be burdensome, and any attempt to enforce rights and remedies against a defaulting borrower must be tailored to the specific collateral and the state-law foreclosure regime.

Successful planning, based on a thoughtful approach to CRE loans that recognizes their unique features, can mitigate many of the risks inherent in this asset class. While many CRE loans will not fit into standard trading frameworks developed for commercial and industrial loans, the LSTA documentation and trading framework may be suitable for large, syndicated CRE loans. That framework, if suitably modified to reflect this emerging asset class, will also provide valuable precedent for investors developing documentation and trading practices tailored for both bilateral CRE loans and CRE loans originated in club deals.

## QUESTIONS

If you have questions about trading CRE loans or would like to discuss how they may fit into your trading, compliance and operational framework, please call your usual contact at Richards Kibbe & Orbe LLP or one of the following individuals:

### **Jon Kibbe**

New York, NY  
212.530.1860  
jkibbe@rkollp.com

### **Paul B. Haskel**

New York, NY  
212.530.1823  
phaskel@rkollp.com

### **Michael Friedman**

New York, NY  
212.530.1846  
mfriedman@rkollp.com

### **Kenneth E. Werner**

New York, NY  
212.530.1961  
kwerner@rkollp.com

[Click here to view additional publications on related topics.](#)

---

## DISCLAIMER

This memorandum may be considered advertising under applicable state laws.

This memorandum is provided by Richards Kibbe & Orbe LLP for educational and information purposes only and is not intended and should not be construed as legal advice.

© 2011 Richards Kibbe & Orbe LLP, One World Financial Center, New York, NY 10281, 212.530.1800, <http://www.rkollp.com>. All rights reserved. Quotation with attribution is permitted. If you would like to add a colleague to our mailing list or if you need to change or remove your name from our mailing list, please email [publications@rkollp.com](mailto:publications@rkollp.com).

Any advice concerning United States Federal tax issues provided in this memorandum is not intended or written to be used, and cannot be used by any taxpayer, for the purpose of (i) avoiding penalties that may be imposed on the taxpayer or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.