

SALES OF REO PROPERTY

by

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In Texas, commercial real property loans are generally secured by a deed of trust under which the borrower grants a lien on the real property in favor of the lender. The deed of trust allows the lender to foreclose the lien and sell the real property if the borrower defaults under the loan documents. Upon foreclosure, the lender takes title to and becomes the owner of the real property if it is the highest bidder at the foreclosure sale. When the lender becomes the owner of the property, the property is often referred to as REO (real estate owned) property.

The property acquired by the lender through foreclosure is often in a distressed situation, which can be for numerous reasons. For example, if the property is an office building or retail center, the tenant leases may not have been generating enough income to cover the debt service on the loan, perhaps as the property is not fully-leased, or tenants themselves are in distress and cannot pay rent or have filed for bankruptcy. If the property is under construction, perhaps the borrower could not meet its funding obligations under the construction loan or market circumstances have changed which made construction and pre-leasing of the property unfeasible. If the property is raw land, the loan may have matured and the borrower could not sell the property or find refinancing. It is also often the case that when the borrower defaults on its obligations to the lender, it also defaults under obligations with other third parties, such as contractors, management and leasing companies, tenants, and taxing authorities.

By acquiring the property, the lender steps into the distressed property situation often with incomplete information and must determine what it has acquired, what events have impacted the property and may presently be impacting the property, and what the lender must do to manage and sell the property in order to recoup losses under the original loan.

I. Pre-Foreclosure Due Diligence.

The lender should conduct due diligence prior to foreclosing in order to understand as fully as possible the status of the property that it will be acquiring through foreclosure.

A. Title Update. A title and lien search should be conducted in order to determine if there are any liens such as mechanic's liens or property or income tax liens affecting the property or any new encumbrances of record. It is often helpful to use the title company that provided the lender with its mortgagee policy of title insurance in connection with the loan to conduct the title update. If the title and lien search shows that there is a federal tax lien against the property, a notice must be given to the Internal Revenue Service (IRS) prior to the foreclosure sale, and the IRS has a right of redemption following the sale.

B. Lease and SNDA Review. A foreclosure sale will terminate a lease that is subordinate to the deed of trust; however, a valid subordination, non-disturbance and attornment agreement (SNDA) between the tenant and the lender will keep the lease in place. Under an SNDA, a tenant subordinates (agrees to make later in priority) its lease to the deed of trust. The lender agrees that even though the lease is subordinate, the lender will not disturb the lease upon foreclosure (i.e., will keep the lease in place after foreclosure). The tenant agrees to attorn to the lender by performing its leasehold obligations to the lender as the successor landlord. Note that SNDAs can have all kinds of lender protections built in such as that the lender is not obligated for rent paid more than one month in advance, construction obligations, or amendments to the lease made without the lender's consent.

C. Environmental Review. The lender may consider obtaining an updated environmental report on the property. There are also certain protections under federal law in favor of the lender if the lender markets the property for sale after foreclosure.

D. Property Appraisal. The lender may consider obtaining an appraisal in order to establish the value of the property for purposes of calculating a bid price and any deficiency.

E. Contract and Entitlement Review. Existing construction contracts, management and leasing agreements, development agreements, service contracts, permits and entitlements should be reviewed in order to ascertain the status of the same and evaluate what needs to be done to keep any desired agreements or rights in place after foreclosure.

II. Consider Note Sale.

A. Alternative to Foreclosure. The lender may wish to consider the possibility of a note sale as an alternative to a foreclosure and REO property sale. In a note sale, the lender sells the note and lien covering the real property as opposed to foreclosing and then selling the underlying property itself. The purchaser that buys the note steps into the lender's position under the loan, and can exercise the remedies that the lender has under the loan documents, including foreclosure. The note sale allows the lender to recoup losses without having to go through the time, expense and uncertainty of the foreclosure process and of owning, managing and selling the property.

B. More Complex and Risky for Purchaser. From the purchaser's perspective, the purchaser will have to conduct due diligence on two levels - on the loan documents and risks involved in enforcing the loan documents - and on the underlying property itself. This adds to the risk and complexity of the deal for the purchaser as the purchaser will be saddled with any enforcement issues caused by inadequacies or problems with the loan documentation and as the purchaser must assume the risks of initiating and completing the foreclosure process before the purchaser can take title to the property.

III. Plan for Managing the REO Property.

A. Property Management. If the lender is the highest bidder at the foreclosure sale, title to the property will pass to the lender on the date of the foreclosure sale. In light of the same, the lender will need to have a plan in place for the

management of the property. The lender may desire to engage a property manager to manage the property if the lender does not want to manage the property itself. If the property has tenants, notices to all of the tenants need to be prepared informing the tenants of the foreclosure sale and providing the tenants instructions on where to send rent. The borrower may have retained all of the security deposits under the leases, and therefore, the lender will not have the security deposits as a remedy for tenants' defaults or the ability to transfer security deposits to a new purchaser. Sections 92.105 and 93.007 of the Texas Property Code provide that the lender is not liable for the return of the security deposits.

B. Insurance. The lender should make sure that insurance covering the property is in place upon the date of the foreclosure.

C. Continue Due Diligence After the Foreclosure Sale. The lender should continue due diligence after foreclosure in order to discover any additional issues that have to be addressed or that may need to be taken into account with respect to the sale of the property.

IV. Sale of the REO Property.

A. Confidentiality Agreement. The lender should require any prospective purchaser to execute a confidentiality agreement prior to receiving any information from the lender with respect to the property. The confidentiality agreement should contain a disclaimer of any representations and warranties with respect to any information provided by the lender and an acknowledgment by the prospective purchaser that it is not entitled to rely on the information.

B. Contract Form; "As Is" Sale; Release. The lender should have a contract form prepared in advance for sales of REO property. The form will reflect that the property was acquired through foreclosure and emphasize the "as is" nature of the transaction and will contain limited or no representations or warranties. If any representations and warranties are made, they can be limited by qualifying them to the knowledge of only a certain individual, providing that they survive closing for only a specified period of time, requiring a floor threshold amount of damages that must occur before a claim can be made, and capping the lender's liability at a specified amount. The contract should also require the purchaser to release the lender with respect to any environmental liability relating to the property.

C. Earnest Money and Inspection Period. Most commercial real estate contracts require that the purchaser deposit in escrow with the title company an amount of money which serves as both an expression of the purchaser's interest in the property and a source of funds for the seller to retain if the purchaser defaults. In Texas, this deposit is often referred to as "earnest money". The earnest money is often not at risk until the end of an inspection period during which the purchaser performs due diligence on the property. When the earnest money becomes at risk, the parties typically refer to the earnest money as being "live" or "hard". Contracts containing inspection periods in which the purchaser has a termination right have been held to constitute options that need to be supported by consideration other than the earnest money. Generally, consideration for the inspection period can be handled through the recital and payment of nominal "independent consideration" which the lender may retain notwithstanding the purchaser's termination of the contract during the inspection period.

D. Title and Survey. In preparing the property for sale, the lender may provide the title company that it has selected with appropriate information about the foreclosure sale so that it can prepare an updated title commitment for prospective purchasers that shows the lender as the new owner of the property. The lender may consider obtaining an updated survey of the property for prospective purchasers if the lender is willing to spend initial funds on the same in order to help market the property. Under the contract of sale, the lender can require the purchaser to reimburse the lender for the cost of the survey and any updates as part of the closing costs of the transaction. Also, the lender's contract form should not require the lender to provide an affidavit of debts and liens relating to the property to the title company.

E. Mechanic's Liens. Contractors providing labor or materials for the property may not have been paid by the borrower and may have filed mechanic's and materialmen's liens against the property. Even though these liens may arise after the date of the lender's original deed of trust, such liens are not cut off by foreclosure as to certain "removable" items. Care should be taken in the deed to the new purchaser to carve out from any title warranty all liens, including mechanic's and materialmen's liens.

F. Estoppel Certificates. The purchaser will likely want estoppel certificates from existing tenants on the property in order to verify the facts of the tenants' leases. If a tenant executes an estoppel certificate verifying the terms of the tenant's lease, the tenant will later be legally prevented from claiming that the terms are different from those expressed in the estoppel certificate. The purchaser will therefore want as many estoppel certificates executed as possible, particularly from larger or anchor tenants. This is often easier said than done from the lender's perspective as it does not control the tenants, and the lender will not want to obligate itself to produce a certain number of estoppel certificates. However, the lender may often agree to make obtaining estoppel certificates from tenants leasing a certain percentage of space in the improvements on the property a condition to the purchaser's obligation to close. Even though the lender and the purchaser may agree upon a form, larger tenants will frequently have their own form of estoppel certificate attached as an exhibit to their lease. Therefore, the lender may want the contract to provide that the lender will try to obtain either an estoppel certificate in the form agreed to by the lender and purchaser or in the form required by the tenant's lease.

G. Interim Operating Covenants. The purchaser will want approval over how the property is operated during the pendency of the contract in order to make sure that no costly capital improvements are made and no below-market leases or new service contracts are entered into. Prior to the earnest money being at risk, the purchaser typically has less approval rights over the operation of the property. Once the purchaser's earnest money is at risk, however, the purchaser is typically accorded greater approval rights.

H. Closing Costs. There are closing costs related to the sale of real property, such as title policy premiums, survey costs, recording fees; and in states other than Texas, there are also often transfer taxes due on a sale. The allocation of these costs, although negotiable, is often determined in typical real estate transactions by custom in the particular jurisdiction; however in sales of REO property, the lender often asks the purchaser to pay all closing costs. The purchaser can account for such costs in its purchase price offer.

I. Default and Remedies. There is often negotiation as to what remedies will be allowed for each party. The lender will typically desire to retain the earnest money as liquidated damages for the purchaser's default. In the event of the lender's default, the lender will often give the purchaser the option of terminating the contract and receiving back the purchaser's earnest money or suing the lender for specific performance, with a waiver as to the remedy of damages. The purchaser may want the right to receive reimbursement for its out-of-pocket due diligence costs in addition to receiving back the earnest money; and if the lender agrees to a reimbursement provision, the dollar amount of reimbursement should be capped. If the parties desire to limit remedies, this intent should be clearly expressed in the contract. Texas courts have held that unless the contract clearly expresses that contractual remedies are limited to those specified in the contract, the remedies specified will be deemed to be permissive as opposed to exclusive.

J. Focus on the Goal of Closing. In negotiating real estate contracts, it helps to focus on the goal of closing. It is important to determine what needs to be accomplished to close and obtain funding of the purchase price for the lender. Market conditions and resulting leverage drive the negotiation of many contract provisions. If there is good communication between the parties, reasonable compromises can be made. The lender can hopefully obtain a fair price for the property.

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