

# What You Need To Know

*(But nobody will tell you!)*

## About Buying Distressed Commercial Real Estate

**JUNE 15, 2010**

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**RedRiver**  
asset management

  
**REAL DILIGENCE**  
FINANCIAL VALUATION & ANALYSIS



## The Three Biggest Mistakes People Make When Buying Distressed Commercial Real Estate

A presentation by Bruce Stern, Red River Asset Management, LLC



# Don't Be Stupid

- Mistake #1:  
Buying too early.
- Mistake #2:  
Underwriting the past,  
not the New Normal.
- Mistake #3:  
Not having multiple exit  
strategies.



# Just Say No: Don't Buy Too Early



# Just Say No: Don't Buy Too Early

- Who is selling?
  - Owners
  - Lenders
    - Banks
    - Special servicers
    - Balance sheet lenders
- Who is buying?
  - Funds with money (OPM) burning a hole in their pockets.

“I Guess We Are Not in 2007 Anymore.”



# Underwrite the New Normal

- Do your own underwriting.
- Challenge every assumption.
- No one knows what the future will hold. The past is no longer a predictor of the future.

# Avoid Catastrophic Failure: Have Multiple Exit Strategies





# Have Multiple Exit Strategies

- Bruce's Four Rules of Real Estate
- Assume nothing changes: Can you still get your money back?
- Sale exit: What will cap rates be in three to five years?
- Refinance Exit: Will take-out financing be available?

# Thank you!

Bruce Stern, Principal  
Red River Asset Management, LLC

280 Madison Avenue, Suite 800  
New York, NY 10016

Phone: 212.376.4209

Cell: 732.670.1772

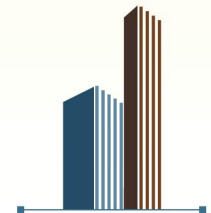
Email: [bruces@redriveram.com](mailto:bruces@redriveram.com)

Web: [www.redriveram.com](http://www.redriveram.com)



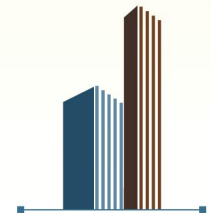
*Digging Deep: Financial Due Diligence  
for Distressed Real Estate*

Presented by  
David Tesler, Esq., CEO  
Real Diligence, LLC  
June 15, 2010



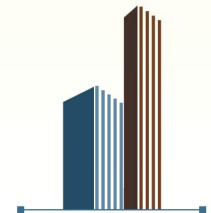
Financial Due Diligence is **valuable** at all points in the Acquisition Process

- Pre-Acquisition Due Diligence
- Acquisition Due Diligence - debt acquisition / valuation, etc.
- Post-Acquisition Due Diligence – full-service lease administration



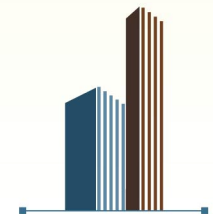
## Standard Acquisition Due Diligence Steps (NOI Diligence)

1. Rental Income Verification
2. CAM Income and Methodology Review
3. Expense Verification
4. Recovery Analysis



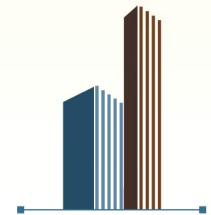
Financial Due Diligence is even more **critical** when buying distressed assets.

There are three types of distressed asset purchases.



## Types of Distressed Assets Purchase opportunities:

1. REO
2. Short Sale
3. Note

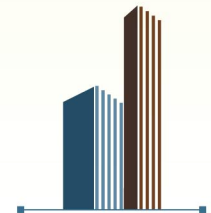


## REO Advantages

- Bank is motivated to sell quickly.
- Better pricing is available.

## REO Disadvantages

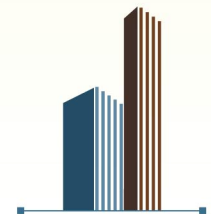
- Asset is sold “as is” – no seller covenants.
- Since the owner is “gone”, you need to dig deeper into the asset.
- There is less access to documentation and operating history of the asset.





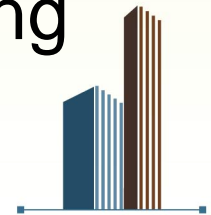
## Short Sale Advantages

- Lender selling asset below the unpaid principal balance of the loan.
- Borrower can be better/mostly controlled – save on legal costs.
- Get possession and control of the asset without much delay.



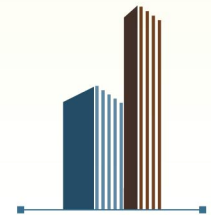
## Note Disadvantages

- You are uncertain to get possession of the real estate
- Take subject to property defects
- Since the owner is “gone”, need to dig deeper into the asset.
- No access to Borrower and Borrower information.
- Double Due Diligence - Purchaser is acquiring both a fixed income and real estate product.



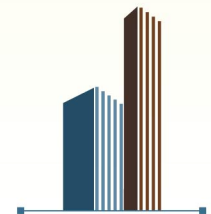
## Major steps in the process:

1. Valuing the Note
2. Valuing the Real Estate
3. Loan Due Diligence
4. Seller Due Diligence
5. Property Due Diligence
6. Standard Due Diligence



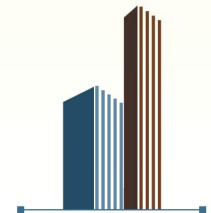
## Valuing the Note:

- The fixed income component of a note is valued by discounting the value of the interest expected to be received over the unpaid principal balance at maturity.
- The relative risk of the income stream is accounted for by using different discount rates to determine the present value.



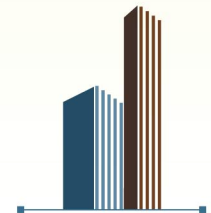
## Valuing the Real Estate:

- The RE is valued using traditional real estate valuation metrics, including comparable transactions, cap rates, discounted cash flows, alternative use analysis.
- This type of valuation becomes very difficult in a note sale where you will not have access to much information.



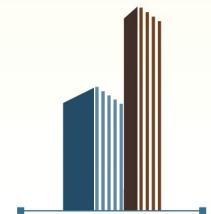
## Loan Due Diligence:

- Know your loan documents
- Stepping into the pre-existing position of lender
- Position in capital stock
- Terms, rights and obligations, enforcement strategy and impediments
- Any guarantees?



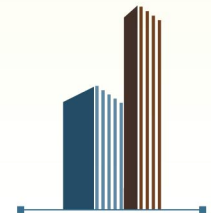
## Seller Due Diligence:

- Removal of creditor rights endorsement requires that the purchaser shall thoroughly investigate the financial condition of the seller / borrower and analyze the impact of the transaction on such party and its creditors moving forward.
- Perform lien and judgment searches and look for any creditors – even if there is no direct lien on the property.



## Property Due Diligence:

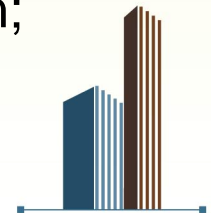
- Property Type
- Completed or under construction
- Tenant questions / issues
- Standard Due Diligence





## Standard Due Diligence:

- Analyze every document concerning the building and its operation.
- Thorough review of the leases - The income stream being purchased is contained in the leases. The value and pitfalls of an asset are typically in the leases: termination clauses, rights of first purchase, etc.
- Payment History – In this distressed market, what the tenant is obligated to pay and what the tenant pays is not often the same thing.
- The risk factor must be adjusted for every due diligence item requested but not provided.
- Insurance Policies – Could be a treasure trove of information; should always be available even in a distressed scenario.
- Title Review

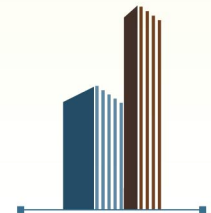


# About Us

**REAL DILIGENCE**  
FINANCIAL VALUATION & ANALYSIS

Real Diligence is a commercial real estate **financial due diligence** company.

We provide a host of services at every step of the acquisition and ownership of a property.

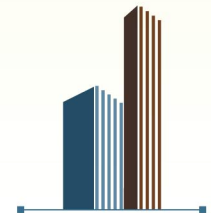


# What We Do

**REAL DILIGENCE**  
FINANCIAL VALUATION & ANALYSIS

## Four Areas of Expertise

- Financial Due Diligence
- Lease Abstracting
- CAM Services
- Tenant Estoppel and  
SNDA Preparation

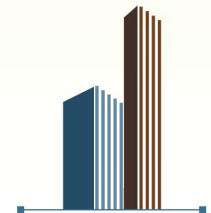


# Real Diligence, LLC

**800-379-7300**

**[www.realdiligence.com](http://www.realdiligence.com)**

**[info@realdiligence.com](mailto:info@realdiligence.com)**



**HERRICK**

Committed to Your Success.

# Averting Legal Problems in Acquiring Distressed Assets



June 15, 2010

Herrick, Feinstein LLP



## How to Avoid Trapping Yourself

- Don't ignore warning signs
- Review documents
- Review communications with borrower - the borrower's attempt to "leg-up"
- Verify a default has occurred
- Do proper searches



## How to Avoid Trapping Yourself (cont.)

- What does the borrower owe?
- Where is the money?
- What is the collateral? Does the borrower own the collateral it has liened?
- Is there a PNA? What is a PNA?



## Understand Where The Lender Was

- Who is suing whom, and for what?
- What records exist? How can the purchaser access more of them?
- Have any of the loan documents been modified?
- Appraisals and valuations - shared with borrower?





## Understand Where The Lender Was (cont.)

- Understanding the capital structure - are there junior liens? Mezz debt? An intercreditor agreement?
- Negotiations with senior or junior lenders/lienors
- Impact of ongoing discussions on document provisions



## Bad-Boy Guarantees – Do They Work?

- Purpose is to deter a bankruptcy filing
- Recent decisions regarding bad-boy guarantees
- Full recourse
  - Bankruptcy
  - Additional liens
  - Violation of separateness covenants
- Partial recourse
  - Misappropriation of funds
  - Waste / real estate taxes
  - Misrepresentation



## Bad-Boy Guarantees – Do They Work? (cont.)

- Trend is that they do
- Bankruptcy filings
  - Dismissal of the bankruptcy proceeding is irrelevant
    - *111 Debt Acquisition* (S.D. Ohio)
  - Additional liens
    - *First Nationwide* (N.Y.)
  - Violation of separateness covenants
    - *Prince George* (4<sup>th</sup> Cir.)



# Enforcement

- UCC foreclosures
- Mezzanine loans and pledges
- Mortgage foreclosures
- Actions on notes
- Interim remedies



## Enforcement (cont.)

- Determine if foreclosure by power of sale permitted to foreclose judicially
  - Power of Sale or Judicial
    - Power of Sale - publish and serve notice; conduct sale by auction - Texas, Georgia, Massachusetts - typically under 60 days
    - Judicial - file lawsuit, obtain judgment, schedule judicial sale, conduct sale, confirm sale - New York, New Jersey, California, Florida, Illinois, Ohio, Pennsylvania - undetermined time
    - Public Trustee - modified power of sale, expedited judicial authorization, process extends longer than power of sale - North Carolina, Colorado, Arizona - typically around 120 days



## Auction Sales

- Conduct of sale - referee or auctioneer; terms of sale; disclosure
- Consider a video tape
- Bidding at sale - unconscionability
- Real property transfer taxes
- Required in bankruptcy?
  - *In re Philadelphia Newspapers*



# Recovering The Deficiency

- Timing
- Calculation of bid
- Fair Market Value Credit
- Hearing



# Tips To Avoid Lender Liability

- **Avoid “classic” lender liability claims, brought by a borrower in connection with the administration of making of a loan**

When a workout is being contemplated:

- Many commentators suggest that, after default, outside counsel who closed the loan should *not* handle the workout; they should be *replaced with counsel expert in workout and lender liability*.

Lawyers have an understandable loyalty to their work product. This can cause several problems, including (i) closing counsel may refuse to acknowledge inherent *weaknesses* in the documentation that need to be addressed, and perhaps fixed, as part of the workout, and (ii) the closing lawyer may counsel the lender to interpret and enforce the loan agreements *strictly*, when courts today are increasingly *reluctant* to hold to the strict letter of agreements.

- Similarly, administration of the loan in many cases should be moved from the current loan account officer and given to a new “*workout*” officer who is not tied to the borrower and can view the borrower, and the file, with *objectivity*.





## Tips To Avoid Lender Liability (cont.)

- The workout officer should *document every communication* and agreement with the borrower and any guarantors; set a complete *record* of everything that transpires, **including emails**
- *Avoid “sudden moves”* that might adversely affect the borrower’s project and avoid adhering too closely to the exact letter of an agreement
- Be careful with the *tone* of default letters and written communications, *avoiding “saber rattling”* and “tough talk” that may not be appreciated by a jury (outside counsel should take care here as well)



## Tips To Avoid Lender Liability (cont'd)

- Refusing to make an advance in a construction loan, can lead to adverse consequences for the borrower; *err on the side of making the advance*, even if an issues exist, but carefully document and make a record of all the extant issues so that the borrower cannot claim “waiver” later on
- *Always be truthful to third parties*, such as potential replacement lenders, or contractors
  - As a general rule, to the extent possible, *avoid contact with third parties* and provide no assurances
  - If a borrower makes a misstatement in front of third parties, and lender is present, it must correct the record



## Tips To Avoid Lender Liability (cont'd)

- As part of any forbearance or workout agreement, be sure to obtain a *general release* from the borrower (and guarantors) so as to avoid later claims of lender liability; also, use to opportunity to fix any defects in the loan documentation or collateral perfection
- Always operate in “good faith,” or as one authority has stated it: *just “be fair”*; do not assume the strict letter of every loan document clause will be enforced precisely as written



## Bankruptcy and the Chapter 11 Plan Confirmation Process

- Chapter 11 Plan Confirmation
  - What may be done under a plan?
    - Sell property - exemption from transfer taxes
    - Shed/restructure/reinstate debt
    - Rewrite mortgage over mortgagee's objection

# Bankruptcy and the Chapter 11 Plan Confirmation Process (cont.)

- Chapter 11 Plan Confirmation (cont.)
  - Plan must include:
    - Method of property disposition - auction with credit bid is best
    - Can provide new equity issuance in debtor as an alternative
    - Must pay administrative and priority claims in full - including debtor's legal fees
    - Consider unsecured creditor treatment - impaired or unimpaired



# Bankruptcy and the Chapter 11 Plan Confirmation Process (cont.)

- Defeating the debtor's plan
  - Typical plan stretches maturity, lowers interest rate, crams principal down to collateral value
  - Expert needed to establish interest rate
  - Appraisals key to value, but Supreme Court precedent favors market scrutiny
  - Controlling the plan votes
    - Deficiency claims
    - Purchases of claims

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Bruce Stern  
Principal  
Red River Asset Management, LLC  
(212) 376-4209  
[bruces@redriveram.com](mailto:bruces@redriveram.com)

David Tesler  
CEO  
Real Diligence, LLC  
(732) 333-2705  
[david@realdiligence.com](mailto:david@realdiligence.com)

Gary Eisenberg  
Partner  
Herrick, Feinstein LLP  
(973) 274-2055  
[geisenberg@herrick.com](mailto:geisenberg@herrick.com)