

In Practice

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Investing in distressed real estate

Recent uncertain market conditions have contributed to an increased number of 'distressed' real estate loans. However, following the recent improvement in market sentiment, some banks are now taking the opportunity to clear their loan book by selling on such loans. With distressed debt trading at significant discounts, investors are capitalising on the opportunity to buy distressed real estate loans as a means to acquiring ownership of the underlying property. This In Practice article will highlight some of the practical and legal issues which investors embarking on 'loan to own' strategies should consider.

Structure: In view of restrictions on self dealing (*Williams v Wellborough BC* [1975] 1 WLR 1327), if a consensual arrangement cannot be reached between the borrower and the investor acquiring the loan, the investor will invariably need to establish two separate entities. One vehicle will be established to acquire the loan from the lender ('LoanCo') and a second entity to take legal title to the property on enforcement ('Propco'). Further, depending on the transfer and tax provisions in the underlying loan agreement ('Loan Agreement'), LoanCo may also need to be a Qualifying Lender and satisfy certain 'New Lender' criteria in order for the Agent to countersign the transfer certificate and effect the sale of the loan. The Agent may also be entitled to a transfer fee under the Loan Agreement which LoanCo will be obliged to pay, although this is usually a *de minimis* amount.

Entitlement to enforce: Investors need certainty (reinforced by warranty protection in the loan sale documentation) that an Event of Default ('Default') under the terms of the Loan Agreement has occurred, rendering the loan enforceable. Diligence on the Loan Agreement should highlight whether the Default has occurred and is continuing unremedied and unwaived in order to trigger enforcement and investors should obtain warranty protection that this is the case.

Defects in documentation: In addition to carrying out a review of the Loan Agreement and related security to highlight any errors or any perfection issues, such documentation should also be reviewed by the investor to clarify the mechanics of acceleration and enforcement. The relationship between the finance parties is a common source of defects in loan documentation. The investor will require certainty that the Agent and Security Trustee are obliged to act in accordance with lender instructions and that the lender will be able to control the enforcement process. One example would be the exercise of a Security Trustee's discretion to appoint a receiver. Investors should assess the ease with which the lender may replace the Agent and Security Trustee.

Enforcement process: The investor will need to decide on a method of enforcement, for example, direct enforcement over

the property, indirect enforcement (for example, enforcing share security over the borrower), whether to appoint an administrator or a receiver or (unusually) enforce as mortgagee in possession. In the event that a receiver is appointed, additional costs will be incurred in drafting appointment documentation and indemnities may be required by the receiver from the investors.

Furthermore, any receiver will have duties to the creditors generally in realising the property. For example, a receiver has a duty to sell for the best price and on the most favourable terms. Depending on the circumstances of sale, this means that there is a risk that Propco may not be the preferred purchaser. In practice

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this is unusual as Propco is effectively able to bid up to the face value of the debt and if the property is worth less than the loan, this is likely to be the highest bid.

Fair value: Fair dealing rules (*Tse Kwong Lam v Wong Chit Sen* [1983] 1 WLR) require that the property is transferred to Propco in good faith and for the best price reasonably obtainable at the time. In assessing what constitutes the best price, investors should obtain an independent valuation of the property and consider what price could reasonably have been obtained for the property if it had been placed on the open market.

Purchase price: The investor either needs to have sufficient funds to finance both the acquisition of the loan by LoanCo and the purchase of the property by PropCo or will need an agreement between LoanCo and Propco, whereby Propco acquires the property in consideration for LoanCo discharging the loan. If the latter option is used, this will require agreement of the receiver.

Additional documentation will also be required and investors should ensure that prior to appointment, the receiver accepts this proposal as valid consideration and will not sell or prefer the offer of a competing cash buyer. ■

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