

A Practical Guide to Distressed Debt Acquisition: The Illinois Example

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The issues and challenges involved in the disposition and acquisition of distressed real estate debt can range in complexity. Understanding the fundamentals of the types of distressed debt to be acquired and the various remedies available once acquired is essential to those considering a real estate loan purchase and sale transaction. The authors of this article provide a guide to distressed debt acquisition in Illinois.

As the global impact of the novel coronavirus pandemic (“COVID-19”) rages on, the anticipation is there will be an increasing number of non-performing commercial real estate loans. The loan market is likely to become an opportunity for well-prepared sellers and buyers. Rather than sue non-performing borrowers, lenders sometimes prefer to sell loans in order to offload risk, reduce the number of real estate owned assets on their books and better leverage their balance sheets, especially in an environment where buyers may become unable to make their scheduled payments. For investors, this environment provides a way to invest in real estate at less than par value, albeit with associated risks.

Further, acquisition of distressed debt can serve as a vehicle to acquire real estate. Once an investor acquires distressed debt from a lender pursuant to a loan purchase and sale transaction, the investor steps into the shoes

of the lender and may therefore pursue the remedies previously available to the lender, such as foreclosure of the collateral, breach of guaranty actions on the personal guarantor, and other related legal remedies.

Before entering into a real estate loan purchase and sale transaction, a buyer should consider the nature of the loan and underlying collateral and evaluate its ability to administer the loan and, in the event of a foreclosure, manage the collateral. Since distressed real estate debt can often lead to a foreclosure, the loan purchase and sale ultimately includes the purchase of a lawsuit. It is therefore critical buyers understand the myriad of challenges that accompany the purchase of a lawsuit and foreclosure, which include inherent time delays in the judicial system, and can include unforeseen and costly expenses, such as receiverships, delinquent real estate taxes and water bills relating to the underlying collat-

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eral property, building code and street and sanitation violations, as well as legal fees and court costs.

In addition to the considerations set forth in this article, both buyers and sellers should engage professionals experienced with the type of debt under consideration and familiarity with the local court system, as it is critical at each stage that the parties consider and understand the road to an exit strategy and tailor the transaction accordingly.

The Process

1. *Term Sheet.* The term sheet will establish the baseline terms for the loan purchase and sale transaction. Loan purchase and sales often function like a property acquisition, with a purchase agreement pursuant to which a deposit is made and due diligence period occurs prior to a formal closing. Some of the essential points covered by the term sheet include price, scope, key diligence items, whether the loan is being transferred on a servicing-released basis or whether the seller or the existing servicer will continue to service the loan, termination rights and remedies and allocation of transaction costs.
2. *Due Diligence.* The scope of due diligence in a loan purchase should generally include a review of the loan documents, the borrower, any guarantor, the underlying collateral, and procedural posture of pending litigation.
 - a. *Loan Document Review.* Buyers should receive the original signed loan documents from the seller in order to verify signatures, proper re-

cordation and notarization, as well as to review for any other evidentiary flaws. It can be helpful to have a litigator review the documents to evaluate potential issues relating to evidence that may arise at the trial or summary judgment stage. It is important for a buyer to fully understand each of the following:

- (i) The payment terms under the loan;
- (ii) Any other financial covenants with respect to the loan;
- (iii) Any and all default provisions and remedies detailed in the loan documents;
- (iv) Exculpation and recourse provisions;
- (v) Guarantees or other credit support; and
- (vi) The borrower covenants or even lender obligations.

In addition to reviewing the full set of loan documents, buyers should have a complete understanding of the borrower's payment history and the status of real estate taxes as they relate to the collateral. It is also critical to determine if the loan documents allow for the use of receiverships, the standards for appointment of a receiver, notice required to be given and the requirement of a bond. A clear provision for the appointment of a receiver in the loan documents gives the lender a strong argument for the appointment of a receiver (in Illinois, it then becomes practically automatic by statute with an allegation of a loan default),¹ since the borrower has already agreed to such remedy by signing the loan documents. Even if the loan documents are silent on receivership, Illinois permits the appointment of a receiver with a showing of good cause under the Illinois Mortgage Foreclosure Law,² but that will likely become the subject of contested motion practice.

Receivership is an important diligence consideration as it is a valuable tool in collecting on the debt and protecting the underlying collateral, particularly where foreclosure will not provide immediate protection.

- b. *Property Review.* An updated preliminary title, including minutes of foreclosure, should be ordered to evaluate the current status of the property, liens that may have arisen, and to identify necessary parties in the event of foreclosure. One can also obtain an endorsement substituting the buyer as the named insured on the existing lender's policy. Because a purchaser of distressed real estate debt might eventually succeed to ownership of the underlying collateral property, the buyer should: (i) assess risks to which it may be exposed as a lender (i.e., mechanic's liens, tax liens, litigation on the property), and (ii) identify and assess those risks that a property owner could encounter (i.e., regulatory compliance, building code violations, and whether receivership is in place and adjoining property issues). *Practice Tip* - many jurisdictions will allow a buyer to issue a Freedom of Information Request (often referred to as a "FOIA Request") to the local building code agencies to determine if there have been any violations. This information can prove useful in a buyer's diligence and review of a property.
- c. *Borrower/Guarantor Review.* The diligence review should also include the borrower itself, along with any

guarantors of the loan. It is important for a buyer to understand the organizational structure of the borrower/guarantor, but the focus of this inquiry should be on such party's financial capabilities and ascertaining whether the party is solvent and adequately capitalized to timely satisfy its obligations with respect to the loan. It is often the case that, upon a loan default, the buyer's recourse (if any) in excess of collateral is against the guarantor under any applicable guaranty. Lien, UCC, judgment, bankruptcy, and litigation searches on the borrower and any guarantor are recommended.

- d. *Litigation Review.* It is critical during diligence review to determine whether a foreclosure action has been filed or if there is other pending litigation, the procedural status of such litigation and whether the court has appointed a receiver. Special attention should be given to ensuring that appropriate parties are identified, proper service on unknown owners and non-record claimants has been obtained, and the lender's reinstatement and redemption rights are tracked. As noted in the Loan Document Review section above, a skilled litigator can evaluate evidentiary issues and can also provide practical guidance on the judge handling the matter and the court system and can review the court file for defenses raised and obstacles that may need to be overcome.

3. *Transaction Documents.* The primary

transaction document is the loan purchase and sale agreement (“LPA”). Additional documents, such as the allonge, recordable assignments of recorded documents, mortgage, and note, will be required to effectuate the transfer at closing. *Practice Tip* - in the LPA, buyers should have the seller provide an Affidavit of Amounts Due, which satisfies the requirements of the Illinois Mortgage Foreclosure Law, so that it is possible to prove up the loan history for the period in which the buyer did not own the debt. Also, representations and warranties are a key part of the LPA the buyer and seller typically receive from the other customary corporate representations. Most other representations will be from the seller regarding the loan, the borrower, and the underlying asset. Common seller representations and warranties include:

- Identification of all loan documents, including true and correct copies thereof;
- Specification of outstanding principal balance, unfunded loan amount and reserve amounts and an affidavit from the seller with respect thereto;
- Whether any default on the part of the lender has occurred and whether borrower/guarantor has any defense, counterclaim or right to offset;
- Whether any claims, waivers or releases have occurred under the loan documents;
- Whether the seller is the owner of the loan, free of any encumbrances;
- Whether the diligence materials pro-

vided are true, correct and complete copies;

- Whether the seller has knowledge of any borrower or guarantor defaults;
- Whether the Seller has knowledge of the borrower disputing the amount of the debt, raising defenses or asserted any lender defaults or other challenges; and
- Representation that the seller is not withholding any information intentionally.

Generally, the buyer and the seller will indemnify one another for losses from circumstances or events caused by the indemnifying party during its respective period of loan ownership, with the seller being responsible for any future intentional or grossly negligent misconduct, which does not occur during its period of ownership. The LPA will also address closing logistics. Reserves and other accounts may need to be transferred or credited. The original loan file should also be delivered to the buyer.

Conclusion

The issues and challenges involved in the disposition and acquisition of distressed real estate debt can range in complexity. Understanding the fundamentals of the types of distressed debt to be acquired and the various remedies available once acquired is essential to those considering a real estate loan purchase and sale transaction. Proper legal guidance and careful evaluation of the underlying circumstances, as well as utilizing the proper structure to acquire the distressed assets, will be paramount in the new COVID-19

environment. However, while challenging, there can be significant value in acquiring distressed debt that can yield substantial returns.

NOTES:

¹Under Section 15-1701(b)(2) of the Illinois Mortgage

Foreclosure Law, a mortgagee is entitled to be placed in possession of the property, “provided that the mortgagee shows (1) that the mortgage or other written instrument authorizes such possession and (2) that there is a reasonable probability that the mortgagee will prevail on a final hearing of the cause.” *CenterPoint Properties Trust v. Olde Prairie Block Owner, LLC*, 398 Ill. App. 3d 388, 392, 338 Ill. Dec. 18, 923 N.E.2d 878 (1st Dist. 2010).

²735 ILCS 5/15-1704.