

Investing in Distressed Assets

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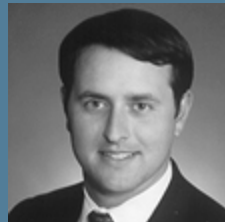
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Part I

General Overview

Opening Thoughts

- Several unknowns that will affect shake out
- Lenders waiting on “Bad Bank” decision
 - Until then, no large scale dispositions
 - Extending when possible; foreclosure as last resort
- Creative approaches will likely emerge
- Choice of buying debt or properties depends on what sins you are willing to inherit and who is willing to deal



Part II

Finding Distressed Assets

Sources – General Thoughts

- Reputation as to ability to get the deal closed will be very important
- Must get a decision maker's attention
 - Overwhelmed and understaffed
- Fastest and easiest bidders win if lenders forced to sell in bulk

Exposure by Loan Type

- Construction Loans
 - 4 largest commercial banks \approx 2% or \$11 Billion
 - 31-100 largest banks \approx 12% or \$66 Billion
- Core Commercial Real Estate
 - 4 largest commercial banks \approx 3% or \$33 Billion
 - 31-100 largest banks – 15% or \$165 Billion

Source – *Commercial Real Estate: Do Rising Defaults Pose a Systematic Threat?* Testimony of Richard Parkus, Analyst, Deutsche Bank, before Joint Economic Committee, U.S. Congress, July 9, 2009



Part III

Valuation and Financing

Investments in Distressed Assets

Considerations in Pricing

- Lender's liquidity and regulatory concerns
- Identifying hurdles to recovery
- Problems with future cash flow
- Problems with title and liens
- Construction defects
- Required permits to operate collateral
- Waste and cost to repair

Tax Implications in Value

- The tax consequences must be considered
- Cancelled debt treated as ordinary income; may arise in 4 scenarios:
 - Reduction of debt
 - Modification of debt
 - Conveyance of property for debt
 - Bankruptcy
- Tax implications for holders of debt to be addressed later



Part IV

Buying Debt

Buying Debt – General Issues

- Participation and co-lender arrangements
- Lender liability issues
- Will you be required to make any advances?
- Mezzanine Debt – Do you have the right to cure existing defaults?

Buying Debt – The Process

- Limited time to review collateral file
 - Confidentiality agreements often required
- Loan Sale Agreement
 - Expect standard terms (including representations)
 - Little negotiation
- Locate original note or obtain lost note affidavit
- **You are now the lender – Know your obligations**

FDIC Bulk Auctions

- FDIC to auction loan pools from seized banks
- Debt to be generally grouped by region, not by type
- May purchase an entire loan pool or partial ownership unit in LLC
 - LLC interest similar to a limited participation right
 - Securities issues will be important
- FDIC requires strict confidentiality and earnest money deposit to qualify as a bidder

FDIC Bulk Auctions

- FDIC requires specific representations about bidders
 - No SPE's
 - Detailed information about principals of bidding entity relating to securities issues, prior illegal acts, and prior dealings with seized banks
- Limited due diligence package and underwriting time period
- Sealed bidding
- Qualifications and bidding documents are non-negotiable

CMBS Debt – Unique Aspects

- Complicated Process
 - Loan must first be transferred from the Master Servicer to the Special Servicer (i.e., a “problem” loan)
 - Special Servicer **may** be able to sell the loan for “fair value” – Appraisal requirement
 - Dual Tracking

CMBS Debt – Unique Aspects

- Strict Requirements of the Pooling and Servicing Agreement
 - Servicing Standard
 - Option to Purchase
- Proposed Sale is subject to approval by the Controlling Class Certificate Holder

CMBS Debt – Unique Aspects

- Massive Conflicts of Interest
Example: Interests of the B-Piece Holder and AAA Bondholder
- Risks Compared to Buying Traditional Bank Loan
 - Non-Recourse Loans with “Bad Boy” Carveouts
 - Recent case law attacking underlying debt
- Warehouse Loans

Lender Liability

- A common tactic of a distressed borrower
- Revolves around conduct and course of dealings, including:
 - Control of borrower's business (not the collateral)
 - Threatening criminal prosecution
 - Breaking promises or commitments (oral or written)
- Every communication should first be reviewed by an attorney
- Good loan documents should mitigate risk

Owning Debt

- Understand your obligations upon taking ownership of the property
 - Security deposits
 - Tenant finish-out
 - Taxes and insurance
- SNDAs and springing termination rights
- Adverse third party providers?
- Understand remedies and limits on enforcement
 - E.g. statute of limitations, “single action rule”
 - Which state’s law applies?

Tax Aspects for Lenders

- §166 Bad Debt Deduction
 - Worthless or Partially Worthless: Timing does not match COD
 - Business vs. Non-Business Bad Debt
- Foreclosures and Deeds in Lieu
 - FMV equals payment
 - Taxable Gain if Low Basis in Debt
 - Example: Lender buys \$1MM loan for \$400K, forecloses on property and bids \$500K, taxable gain of \$100K
 - Modification of Debt - Potential Gain/Installment Sale
- No Gain or Loss for Seller Financing of Real Estate
- No Gain or Loss Upon §368(a)(1)(E) Reorganization
- Reporting Requirement for COD (§6050P)

Part V

Buying Real Estate

Avenues to Distressed Real Estate

- FDIC Sales
- Foreclosure Sales
- OREO departments of Banks
- Bankruptcy Court 363 Sales
- CMBS

FDIC Sales of Real Estate

- Similar requirements as with bidding on debt to qualify as a bidder on real estate
- Bid on individual assets by submitting written contract and earnest money
- Top 3 bidders are contacted and asked if they would like to increase bid

Foreclosure Sales

- Each state is different
- Cash or cashier's checks are usually required
- Normally sold "AS-IS"
- Leases, liens may be wiped out depending on state law

OREO Departments

- Banks have certain requirements for “Other Real Estate Owned”
- Banks generally must actively market property
- Banks use brokers or handle in-house
- Quick close favored
- Minimal representations from Bank

Bankruptcy Court 363 Sales

- Bankruptcy Court may allow a 363 Sale
- Court will allow parties to submit bids to purchase
- Court may allow a “Stalking Horse” bidder
 - Pre-negotiated sales price between buyer and debtor
- Effective way to clear up title issues?
- Primarily office and industrial properties

Investing in Distressed Assets in Bankruptcy

- Properties may receive Debtor in Possession Financing (“DIP Financing”)
 - Receives a priority lien
- Coordination with debtor’s and creditors’ counsel essential

CMBS Real Property

- Foreclosed upon property held by REMIC Trust
- REMIC Trust may hold property for time permitted by Pooling and Servicing Agreement and REMIC Rules
- Little difference than buying property from a traditional lender
- Brokers normally retained to market properties
- Access to special servicer relationship driven



Part VI

Tax Issues Revisited

Cancellation of Debt Income ("COD")

- General Rule: Taxed as Ordinary Income
- Does not include:
 - Medium of Exchange
 - Settlement of Disputed Claims
 - Release of Guaranty

Cancellation of Debt Income ("COD")

- Trap for Unwary: Modification of Debt

Example: Assume \$1MM Note bearing interest of 8% is modified to provide for 0% interest (principal remains \$1MM); assume that imputed interest equals \$50K

Result: New "issue price" equals \$950K and debtor recognizes COD of \$50K

- Related Party Acquisition of Debt

COD vs. Gain from Sale or Exchange

- COD: Ordinary Income
 - Exclusions may apply
- Sale or Exchange (Property Conveyed):
§1001 Gain
 - Foreclosure or Deed in Lieu of Foreclosure
 - Not COD
 - Potential Capital Gain (FMV Exceeds Basis)
 - No Exclusions

(Sale or Exchange continued)

- Non Recourse Debt
 - Sale or Exchange: Debt is amount realized
 - Value irrelevant
 - No COD
- Recourse Debt: Bifurcate
 - FMV of Property Reduces Debt: Sale or Exchange
 - Foreclosure: Bid price equals value (presumption)
 - Deficiency Amount
 - COD if reduced
 - Planning for Debtor:
 - Capital Gain vs. COD

Example:

- Debt: \$1,000,000
- FMV: \$800,000
- Basis: \$700,000
- If Debt is Non-recourse:
 - Amount Realized: \$1,000,000
 - Basis: \$700,000
 - Gain: \$300,000

Timing of COD to Debtor

- Agreement
- Court Order
- Statute of Limitations
- See §1.6050P
- Modification of Debt
- Contingent Agreements
 - Conditions Precedent and Conditions Subsequent

Exceptions to COD (Not Taxable COD)

- (1) Qualified Real Property Indebtedness
 - Debt to Acquire or Improve Real Estate
 - Secured by Property Used in Trade or Business
 - Limits:
 - Only Excess of All Debt on Property Over FMV
 - Aggregate Basis of All Depreciable Real Estate
 - Not for C Corporations
 - Reduce Basis of Depreciable Realty

Exceptions to COD (continued)

(2) Bankruptcy

- No limits
- Taxpayer (not entity)
- Attribute Reduction
- Timing: 1st day of following year

(3) Insolvent Taxpayer

- Limited to Excess of Liabilities over FMV of Assets
- Problem Areas:
 - "Exempt" Assets
 - Guarantees
- Attribute Reduction

(4) Seller Financing - Price Reductions (§108(e)(5))

2009 Stimulus Act – Provides Deferral of COD

- Applies to debt incurred in a trade or business
- COD is deferred for 5 years; then taxed over 5 years
- Election: Entity makes election
 - Consequence: No COD exceptions available
 - Conflicts: Partners having differing tax positions (e.g. insolvent or bankrupt)

Partnerships

- COD Exceptions Apply at Taxpayer Level (not entity)
 - Bankruptcy
 - Insolvency
 - Qualified Real Property Indebtedness
 - Partner's Depreciable Realty
- Negative Basis and Minimum Gain Issues
 - Reduction of Debt
 - Shifting Debt Allocations
 - Recourse vs. Non-recourse
 - Planning: Retain a nominal interest in entity or "Bottom Guaranty"

Part VII

Capital Markets Financing

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Common Challenges in a Distressed Situation

- Cooperation vs. Opposition/Mutual Distrust
- Does the lender want to be a property owner
- Is there a market value – can the asset be sold?
- Personal recourse trade-off
- Borrowers need to bring something to the table
- Business plans
- Who is best equipped to manage the property?
- Does time help or hurt the situation?

Knowing Your Lender

Special Servicers

- Hard to get their attention absent default
- Reactive, not proactive
- Must live with a pooling and servicing agreement
- Conflicts among holders must be addressed
- Fees and structure may influence decision
- Depth of real estate capabilities vary
- Limited flexibility

Portfolio Lenders

- Flexible but institutional
- More customer accommodating, not easier
- Local knowledge is an asset
- Pretend and extend
- Timetable can get elongated
- Syndicated deals can get messy

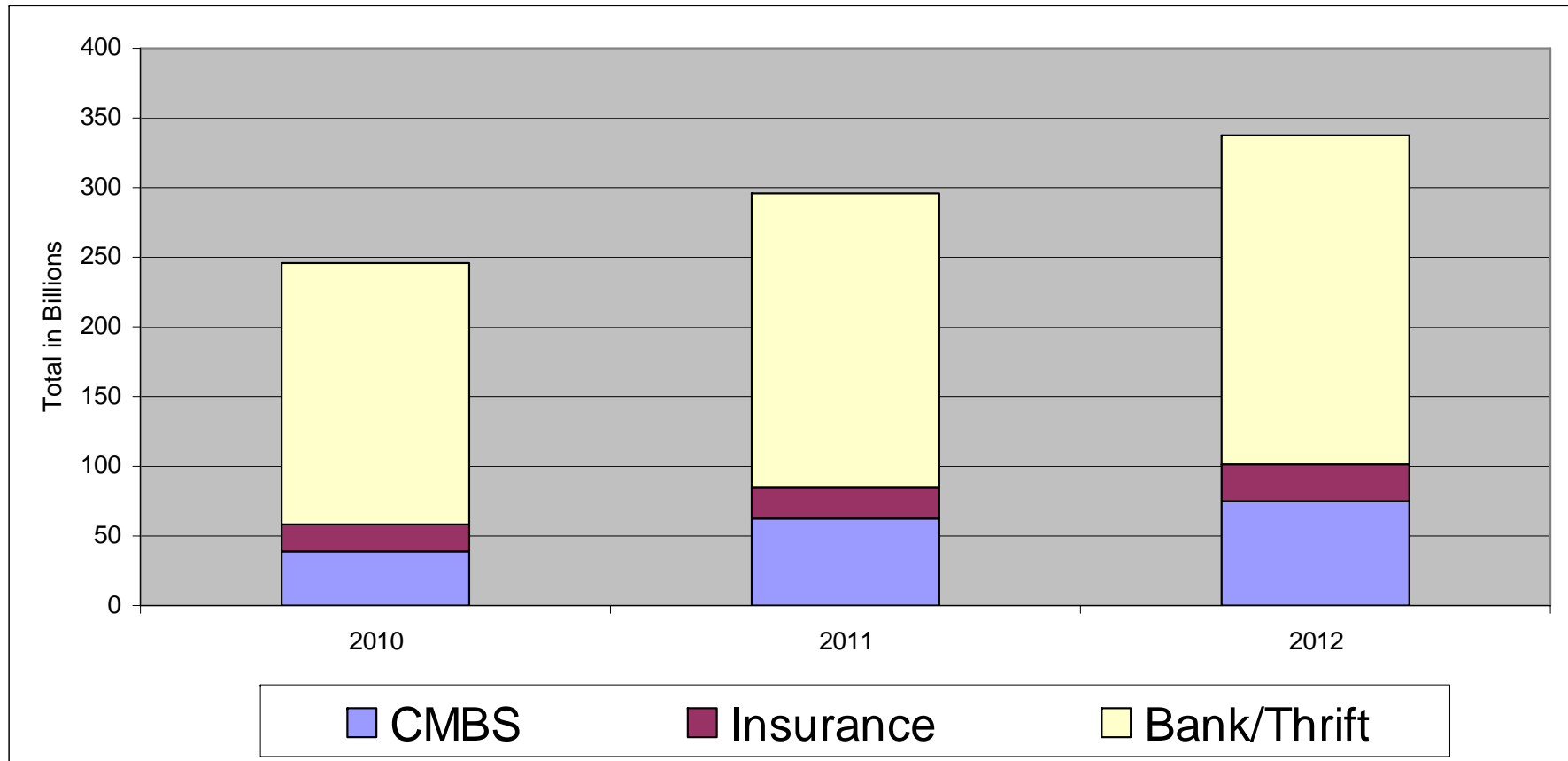
Workout Options

- Extension
- Debt Moratorium
- Debt Reduction
- Rate Reduction
- Additional Collateral
- DPO
- A/B strategies

Financing Options

- DPO/REO Acquisition / Note Acquisition
- Stringent Underwriting – each deal unique
- Some banks, credit companies, life companies, high yield funds
 - Max LTV 65%
 - 8-12% interest rates
 - Short term bridge (3 years +/-)
 - Fees – 1% in (some charge 1% exit)
 - Non-recourse (standard carve outs)
- More entrants into market
 - Mortgage REITs
- Bring us in early – before pricing is negotiated preferably
- Think of us as a consultant not just a mortgage broker

Est. Commercial Mortgage Maturities



Question & Answer

To ask a question, please use the chat box located in the lower left hand corner of your screen.

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