

Blakes Bulletin

Real Estate

Key Issues in Mortgage Loan Purchases

JAMES PAPADIMITRIOU AND THOMAS VON HAHN

With the rapidly changing environment in the mortgage loan industry since the advent of the credit crunch, the sale of mortgage loans in the secondary market is increasingly becoming a source of liquidity. This is particularly the case due to the demise of the CMBS market.

Several key issues for buyers of single mortgages and portfolios in Canada are outlined below.

REGULATORY MATTERS

If the value of the portfolio being acquired exceeds thresholds applicable to the value of the mortgages and the size of the parties, *Competition Act* approval may be required. Exceptions may apply if, for example, the transaction is structured as individual mortgages being purchased at the option of the buyer from time to time, or if the transaction is structured to involve only a partial interest in a pool of mortgages, thereby perhaps qualifying for a securitization exemption.

As a threshold consideration, the restrictions on foreign banks carrying on business in Canada should be reviewed. Often foreign banks that simply hold such mortgages may be exempt from registration requirements.

DUE DILIGENCE

As in most transactions, the extent of the required due diligence depends on the particular circumstances of the deal.

For example, the due diligence to be performed may be more extensive if an entire loan or a distressed loan is being purchased as opposed to the due diligence to be performed if a participation or partial interest is being purchased, especially if the seller retains an interest and provides representations and warranties as to the assets being acquired.

The scope of due diligence will usually include a review of the loan documents with a focus on the commercial terms and the more important provisions such as

prepayment rights, due-on-sale, due-on-encumbrance, prohibition on subordinate security, limited recourse clauses, cross-defaults, and assignability by lender. Typically, a review of title insurance or title opinions is undertaken. If a lender's policy of title insurance was originally obtained, a new assignment endorsement in favour of the buyer as well as a "date down" of the existing policy should be considered. Often, initial due diligence will also involve a subsearch of title to confirm ownership, priority, subsequent mortgages or construction liens, assignments of mortgage, partial discharges and registered renewals or amendments. Personal property searches to confirm the continued effectiveness of prior registrations and any required amendments and renewals as well as bankruptcy, execution and realty tax searches are normally undertaken.

The buyer will also confirm the financial strength of the borrower and other usual underwriting such as a review of leases, operating and management agreements, insurance coverage, repair and other reserves, and rights to future advances.

If a single large loan in default is being acquired, the due diligence involved will likely be extensive and require a complete underwriting of the property secured by the loan. It is likely that the loan will not be repaid in full if the reason for the default is that the underlying cash flow does not support the debt payments. The value of such a loan in default is not a function of the outstanding balance, but rather depends on the likely proceeds from enforcement after deducting all costs and factoring in the risks of delay and frustration inherent in the enforcement process.

As well as performing due diligence on the loan documents and re-underwriting the property subject to a loan, the purchase of a non-performing loan would usually require a review of the actions taken by the lender and the borrower prior to and during the period the loan has been in default. Any actions that will provide a valid defence to enforcement are, of course, extremely important. Any waivers, amendments or correspondence would need to be carefully reviewed.

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Another important factor in determining the extent of due diligence is the time afforded for the task. If the seller has a need to sell without delay, due diligence may be shortened and to an extent may result in a lower purchase price to account for the additional risk taken by the buyer. In addition, a more complete set of representations and warranties may be required from the seller.

REPRESENTATIONS AND WARRANTIES

Often the most heavily negotiated provisions of the mortgage purchase agreement are the representations and warranties of the seller. A more complete "set" may be expected when a seller is selling a participation or partial interest in which it remains as co-owner as opposed to an outright sale of the entire interest of the loan. Typically, on the sale of a distressed portfolio, the representations and warranties will be minimal as these sales are often conducted on an "as-is, where-is" basis given the deep discounts associated with distress sales.

Besides the usual corporate authority representations and warranties, a buyer will typically seek representations and warranties from the seller that:

- a) the purchased assets are owned beneficially and of record by the seller, free of any liens or encumbrances;
- b) seller is not aware of any litigation that might adversely affect the assets;
- c) there are no restrictions on sale or assignability;
- d) complete copies of the loan and security documents have been delivered;
- e) the security has been validly perfected and has not been amended, waived or released;
- f) there are no cross-defaults or cross-collateralization;
- g) the loans are full recourse, the outstanding balance at time of closing; and
- h) the seller is not a non-resident of Canada for purposes of the *Income Tax Act*.

As additional representations (particularly for performing loans), a buyer may seek comfort that:

- a) there have been no defaults during a certain period of time prior to the sale;
- b) the seller performed customary due diligence on origination;

- c) all the conditions precedent on origination were fulfilled;
- d) there are no rights of set-off; and
- e) all applicable laws relating to usury, anti-terrorism, anti-money laundering or similar "know your customer" legislation have been complied with.

Only representations and warranties that are provided by an entity with a strong covenant and that survive closing for a reasonable period are of value. Typically, survival periods run anywhere from one year to the life of the loans purchased, subject to any limits on survival periods imposed by law. Buyers will often require that the seller agree to repurchase the mortgage if there was a material breach by the seller of representation and warranty with respect to that mortgage or if the mortgage security becomes unperfected.

If a co-ownership interest is sold, the agreement will usually contemplate the administration of the loans by the seller or existing servicer and restrictions on each co-owner's ability to sell without the other co-owner's consent (often including rights of first refusal and tag-along rights) and arrangements to deal with the resignation of the seller as servicer. A default under a distressed loan may trigger the requirement that the loan be serviced by the special servicer instead of the master servicer which may result in higher servicing fees, which should be taken into account when pricing the transaction.

Closing and post-closing adjustments are also of importance and often tie into the representations and warranties. For example, consideration of the status of accounts with tenants on properties where the loan is in default can be important as the sums at risk can be substantial and tenants will require recognition of these accounts from the ultimate owner of the property.

PURCHASE OF SUBORDINATE DEBT

If mezzanine or other junior debt is being purchased, a review of intercreditor rights is required. For example, the purchaser of a mezzanine loan would want to ensure that default under the mezzanine loan would not trigger a default under the senior loan to allow the subordinate lender an appropriate period in which to deal with defaults or exercise remedies. The subordinate debt buyer would also want to confirm that a cash sweep is

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not triggered under the senior loan which would deprive the subordinate lender of any available cash flow to service the mezzanine debt. A separate acknowledgment from the senior lender should be obtained to ensure that the senior loan is not already in default. Standstill provisions should also be carefully considered as they may negatively impact the distressed loan buyer's ability to recover losses in a timely fashion.

CONCLUSION

This article sets out a general overview of some of the issues arising on a mortgage loan purchase. Numerous permutations and combinations may well arise in the upcoming months as the market continues to adjust to the new economic situation.

Leases for Sale-Leaseback Deals – How do they Differ from Traditional Lease Transactions?

JOSEPH GRIGNANO

The topic of sale-leaseback transactions is always timely. In a hot real estate market, sale-leaseback transactions are popular as businesses seek to monetize the high values which they can obtain for their real estate holdings. In a cold real estate market, the overall economy is also often weak. As such, sale-leasebacks tend to remain popular as they offer companies a means by which to raise much-needed cash for their operations.

Unfortunately, all too often the form of lease utilized in a sale-leaseback transaction does not take into account the peculiarities of a sale-leaseback deal. The parties simply use the same precedent which they would use for a traditional lease transaction. This results in a lease document that does not reflect, and sometimes conflicts with, the overall intent of the parties. This article describes some of the issues that are often overlooked in drafting and negotiating sale-leaseback leases.

MANAGEMENT/CONTROL/INSURANCE ISSUES

In all lease transactions, the parties need to turn their minds to the allocation of responsibility for the ongoing maintenance and management of the property. However, this is particularly important in sale-leaseback deals as the “off-the-shelf” apportionment of responsibility, as contained in counsels’ precedent form of lease, usually does not work for the parties. The vendor/tenant may wish to retain maintenance and management duties as it already has the personnel and facilities in place to carry out these duties or because it feels uncomfortable relinquishing control of the property. On the other hand, in order to better protect its investment, the purchaser/landlord may wish to assume control over maintenance and charge the costs back to the tenant. The purchaser/landlord may also wish to assume control so that it may charge the tenant a management fee (thereby increasing its return on investment). Of course, the opposite may be true for both parties: the purchaser/landlord may simply want to collect rent and transfer all maintenance responsibilities onto the tenant, or the vendor/tenant may want to sit back and have the landlord take care of the maintenance

and real estate management issues. There is no “right” or “wrong” way in which to allocate responsibility – it all depends on what the parties intend – but the parties must be careful to ensure that the lease properly reflects this allocation.

The same holds true for insuring the physical structure of the building which houses the premises. In most commercial leases, this is the landlord’s responsibility. However, in a sale-leaseback transaction, the vendor/tenant may wish to obtain such insurance as it is a matter of simply continuing on with the policy which it already has in place.

OPERATING COSTS EXCLUSIONS

In any real estate transaction, it is not uncommon for the purchaser to seek a price reduction if, during its due diligence period, it has uncovered items in need of repair or replacement. Typical examples include price reductions for roof, HVAC and parking lot repairs and replacements. Where the vendor has agreed to a price reduction, it should ensure that the lease does not permit the purchaser/landlord from later recovering the cost of the repair or replacement as an operating cost under the lease. In other words, the lease should prohibit the purchaser/landlord from later performing the work and recovering the cost of any repair or replacement for which it has received a price reduction. This will prevent a double recovery on the part of the purchaser/landlord.

If the purchaser/landlord has sought a price reduction but the vendor has refused, then the parties still need to consider whether the cost to rectify the deficiency should be recoverable as an operating cost under the lease or whether it should be an express exclusion.

PRE-EXISTING ENVIRONMENTAL CONDITIONS

In most real estate transactions involving the sale of commercial property, the parties expressly turn their minds to, and allocate risk for, pre-existing environmental conditions. This allocation of risk is normally addressed in the agreement of purchase and sale or closing documents, or both. It is imperative that any such risk allocation scheme be carried through and be reflected in the lease agreement. By way of example, where the purchaser has had an opportunity to conduct its own environmental investigations and is purchasing the property “as-is” (thereby agreeing to assume the

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risk for pre-existing contamination), the lease should reflect that the vendor/tenant is not to be responsible for any contamination which was present as at the commencement date of the lease. All too often, the parties leave the boilerplate environmental clauses in a lease unchanged with the result that they contradict what was agreed to elsewhere.

"AS-IS, WHERE-IS" ISSUES

This is an extension of the pre-existing environmental contamination and operating cost exclusion issues described above. Where a purchaser/landlord has agreed to acquire a property on an "as-is, where-is" basis, it may be appropriate for the lease to release the vendor/tenant from all responsibility and liability associated with other pre-existing conditions such as a failure of the property to comply with laws if such contravention was in existence as of the commencement date of the lease. Similarly, it may be appropriate to delete from the lease any obligation on the part of the vendor/tenant to remove leasehold improvements or other fixtures present in the premises as of the commencement date. As most leases also require the landlord's consent for the installation of signage, satellite dishes and generators, the vendor/tenant should consider including an express acknowledgement from the purchaser/landlord of its approval of these and other pre-existing items.

REGISTRATION/LENDER SUBORDINATION

Most leases permit the tenant to register a notice or other instrument evidencing the existence of its lease. However, the timing of the registration is not normally addressed in a lease. In a sale-leaseback transaction, the tenant should seek the right to register notice of the lease immediately following the registration of the property transfer/deed and prior to the registration of any financing which the purchaser/landlord may be securing for closing. This will provide the tenant with security of tenure should there be a default under the financing and the lender assumes the landlord's position. The purchaser/landlord's lender may also require the lease to be registered in priority so as to ensure that the tenant remains bound to the lender should the lender assume the landlord's position. If this is the case, then the purchaser/landlord should ensure that the lease contemplates the required priority.

Of course, where the tenant is not permitted or unable to register its lease prior to the purchaser/landlord's financing, then the tenant should insist on obtaining non-disturbance protection from the lender.

FUTURE RE-SALE OF PROPERTY

Admittedly, issues associated to the future re-sale of the property are not limited to sale-leaseback deals. However, in a sale-leaseback transaction, the vendor/tenant often has more leverage to negotiate a right of first offer or refusal, option to purchase, or restriction on the sale of the property to a competitor of the vendor/tenant. Where appropriate, the vendor/tenant should seek to secure these rights.

AREA DETERMINATION/RENT

Most leases contain provisions requiring the landlord to certify the area of the premises and to adjust rent accordingly. However, in a sale-leaseback transaction, the purchase price for the real estate is often calculated based on the rent payable under the lease. Accordingly, in order to avoid a situation where there is an unexpected rent increase or decrease after closing due to a measurement of the premises, but no corresponding right to adjust the purchase price, the parties should proceed on the basis of a deemed rentable area of the premises (thereby doing away with the need for measurement). Alternatively, rent should be expressed as a total annual sum and not as a per square foot amount.

ENTIRE AGREEMENT CLAUSE

Most leases contain "entire agreement" or "four corners" clauses. These provisions stipulate that the written lease agreement constitutes the entire agreement between the parties and that any other terms, covenants or conditions not contained in the lease have no force or effect. Of course, in every sale-leaseback transaction, there is an agreement of purchase and sale and a myriad of closing documents that usually have a bearing on the relationship of the parties and the premises. These other documents should be considered and, if necessary, the entire agreement clause should be amended to reflect the existence of these documents and their applicability to the lease transaction.

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