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Loan Sales: Should the Borrower be Permitted to Bid?

By: Laurence M. Smith[1]

Following the collapse of Lehman Brothers, many commercial mortgage lenders have sold more loans than they have originated. Escalating vacancy rates and a precipitous decline in property values are among the causes of the defaults which have led to the loan sales. Rather than examine causal factors, this article explores a procedural phenomenon underlying many loan sales: the refusal by the lender to sell the loan at a discount to the borrower or its affiliate some or all of whose principals are the same as the principals of the borrower. Why?

A precise understanding of the relevant facts will help focus the analysis. The asset class in question is a commercial mortgage loan which is owned and serviced by one lender, is fully disbursed and is in default. Moreover, the commercial real estate collateralizing the loan has appraised recently at a value far below the outstanding principal balance of the loan. To complete the picture, the loan is non-recourse, so the lender cannot look to the outside assets of the borrower or its principals as a source of repayment, and this is the only loan on which the lender has exposure to the borrower; thus, there are no concerns about how the administration or disposition of one loan may affect other loans to the same or an affiliated entity. Foreclosure proceedings have been commenced, but the backlog of actions in the state in which the mortgaged property is located renders foreclosure a costly, protracted and generally unappealing option. The lender therefore elects to pursue, on a parallel track, the sale of the mortgage loan.

Should the lender consider selling the loan to the borrower? In the author's experience, a lender's reaction to this question ranges from reluctance to peremptory dismissal, often borne of an institutional bias against allowing a borrower to purchase its own loan. The reasons proffered for the lender's position include the "sanctity of contract" argument. That is, the borrower and its principals originally bargained for a non-recourse loan, with the full understanding that if the loan was not repaid in full in a timely manner, the borrower would lose the property; the borrower, therefore, should not be permitted to retain ownership if the lender will not receive payment in full. In contrast to repaying a loan at a discount, which results in cancellation of indebtedness income to the borrower,[2] the purchase of a loan by an affiliate of the borrower may, with careful tax planning, enable the borrower to delay or avert completely the recognition of

[1] The author is a member of the law firm of Wolff & Samson PC and co-chair of the firm's corporate and securities department. Mr. Smith would like to acknowledge the contributions of his tax partner, Sean Aylward, in the preparation of this article.

[2] See Section 61(a)(12) of the Internal Revenue Code of 1986, as amended (the "Code"), which includes income from the discharge of indebtedness as an element of gross income. However, pursuant to Code Section 108 a taxpayer may, under certain circumstances, be able to avoid the recognition of income. Further, the impact of forgiveness of indebtedness income may be mitigated pursuant to provisions of the American Recovery and Reinvestment Act of 2009. A detailed discussion of these tax issues is beyond the scope of this article.

cancellation of indebtedness income. Among the tax rules that have to be satisfied in order to avoid cancellation of indebtedness income to the borrower are (i) the borrower and the purchaser cannot be "related parties" which, for purposes of this article and subject to detailed attribution rules, means that the purchaser cannot own more than 50 percent of the borrower, and the same person or entity cannot, directly or indirectly, own more than 50 percent of both the borrower and the purchaser[3] and (ii) the underlying debt cannot be "significantly modified."[4] Likewise, the affiliate who purchases the mortgage loan at a discount may reap significant benefits, such as receipt of amortization payments that far exceed the amount paid for the loan. Allowing the borrower and its principals to profit from the very default that compelled the sale of the loan at a discount is anathema to most lenders. Further, lenders are wary that a borrower who believes it can purchase its loan at a discount may be motivated to present a more dismal picture to the lender—regarding environmental issues, the prospect of attracting new tenants to fill vacancies or the magnitude of other problems associated with the mortgaged property—than a borrower who understands that anything less than full payment equates to a loss of the property; even more Machiavellian, a borrower may be tempted to default on its loan as the first step of a plan designed to culminate in the purchase of the loan by an affiliate of the borrower. Lastly, lenders are aware that confidentiality obligations are difficult to police and enforce, so allowing a defaulting borrower to purchase its loan may have unwanted, precedential consequences when the lender negotiates with other, unrelated borrowers.

There are, however, countervailing factors which a lender may want to consider when marketing a mortgage loan for sale. Commercial real estate owners are invested, literally and figuratively, in the success of each project they undertake. Having a property wrested from them through foreclosure results in a loss of the time and equity invested in the property, as well as reputational damage; most successful business people do not like to admit that they made a mistake, and their desire to avoid defeat may impel them to place an inflated value on a property when bidding for the mortgage loan. Moreover, the borrower likely knows more about the property and the true extent of its problems than will an independent investor who may be afforded two weeks of due diligence prior to bidding on the mortgage loan; if the risk of the unknown is less, the discount sought by the prospective investor may be proportionately less. Perhaps most significant, if the purchaser of the loan is an affiliate of the borrower, there is no need to endure the foreclosure process in order to obtain title to the property; here, again, an element of uncertainty--which might otherwise depress the amount that an investor is willing to bid—is eliminated. If an affiliate of the borrower buys the loan, the lender can demand as one of the closing deliveries an unconditional release from the borrower, an added modicum of comfort that is not available if the loan is sold to an outside investor. In a similar vein, the lender's representations and warranties in the loan sale agreement will be especially Spartan if the purchaser is an affiliate of the borrower, and the loan sale agreement need not provide for a due diligence "out". Finally, a lender should be

[3] See Code Section 108(e)(4) and Treas. Reg. 1.108-2.

[4] See Code Section 108(e)(10) and Treas. Reg. 1.1001-3.

mindful that, in a competitive bidding situation, allowing an affiliate of the borrower to submit a bid may serve to increase the amount realized by the lender, even if the borrower's affiliate in not the successful bidder.

The decision of whether to allow an affiliate of the borrower to bid for or purchase a defaulted mortgage loan requires a careful analysis of all relevant facts. Cogent arguments can be made in support of either result. The author does not believe that, under all circumstances, a borrower or its affiliate should be invited to bid. However, a *per se* rule prohibiting a borrower or its affiliate from purchasing a defaulted mortgage loan may frustrate the goal of maximizing the lender's ultimate recovery.