THE NATIONAL
LAW JOURNAL

Monday, September 29, 1997 B11

Acquisition Loans Pose Added Risks for Lenders

With careful drafting, lenders can reduce risks arising from 'mortgages on mortgages.'

BY JAMES I. HISIGER
AND JOSHUA STEIN
SPECIAL TO THE NATIONAL LAW JOURNAL

THERE HAS been a resurgence in the real estate finance market of loans secured, not by real property, but by a pledge of the lender's rights under a separate mortgage loan—itself secured by real property. Depending on the state, this transaction might be called a "hypothecation," a "collateral assignment" or a "pledge" of the original mortgage loan. In each case, it amounts to a mortgage on a mortgage.

Lenders typically make these "acquisition loans" to finance an investor's purchase of an existing mortgage loan, which in many cases is in default. Thus, the purchase may be at a discount. As security, the investor, now the holder of the mortgage loan—known as the "mortgage holder"—collaterally assigns the mortgage loan to the lender making the acquisition loan—known as the "acquisition lender." That assignment will include the note, the mortgage, personal guaranties and any other security—the entire collateral package.

If the mortgage loan is in default, the mortgage holder will try to use that loan to acquire the underlying real estate through foreclosure or the threat of foreclosure. The mortgage holder might also try to persuade the borrower under the mortgage loan—i.e., the property owner—to pay off the mortgage loan at a discount, but at a payment higher than the price the mortgage holder paid to acquire the mortgage loan. Finally, the mortgage holder might hold the mortgage loan as an attractive investment.

An acquisition lender will face risks that go beyond those of a typical mortgage lender. If identified and recognized, those risks can be mitigated or eliminated. An acquisition lender that does not consider the risks may face unpleasant surprises. The risks involved arise from three general areas: the existence of two obligors rather than one, the nature of the lender's collateral, and the general complexity that the transaction entails. An acquisition lender can mitigate or eliminate each of these risks.

'Double Bankruptcy' Problem

As with any other loan, the ultimate test of an acquisition loan takes place in bankruptcy court. The bankruptcy process can be twice as difficult, and take twice as long, as for a mortgage loan.

If the acquisition loan goes into default, the acquisition lender may want to take control of the mortgage loan and exercise all rights of the mortgage holder under the mortgage loan. The acquisition lender would then presumably carry through on the mortgage holder's plan to negotiate an attractive payoff of the mortgage loan or to acquire the property.

Before the acquisition lender can do either of these, however, the transaction might make two trips through bankruptcy court. First, the mortgage holder might file bankruptcy just before the acquisition lender tries to take over ownership of the mortgage loan. (This involves a process similar to foreclosure, and, like foreclosure, it invites a last-minute bankruptcy filing.) Second, once the acquisition lender has taken over the mortgage loan and is about to foreclose, the property owner may file bankruptcy, on the eve of that second foreclosure.

During each tour through bankruptcy, the acquisition lender faces all the risks and delays of that process, directly (as a

Messrs. Hisiger and Stein are real estate and finance partners in the New York office of Los Angeles' Latham & Watkins.

secured creditor of the mortgage holder), indirectly (vicariously suffering the same risks and delays as the mortgage holder) or sometimes both.

If the court decides the acquisition lender is undersecured, the acquisition loan might be treated as partially unsecured and perhaps be "crammed down" in the mortgage holder's bankruptcy reorganization. If the acquisition lender acquires the mortgage loan, the acquisition lender might face the same risks a second time as holder of the mortgage loan.

Bankruptcy could be particularly frustrating because of the extra complexity of an acquisition loan. In short, enduring the bankruptcy process—twice—may differ substantially from a typical single-asset real estate bankruptcy. The potential for bad outcomes and the delay and deterioration of the property may grow exponentially.

Even without a bankruptcy, the acquisition lender relies on the mortgage holder, or its servicer or designee, to service the mortgage loan properly by collecting payments, tracking outstanding charges and balances, granting consents and monitoring maintenance and insurance for the property.

> Lenders make these loans to fund an investor's purchase of a mortgage loan, which is in many cases in default.

If the mortgage holder administers the mortgage loan poorly, the mortgage holder's ineptitude may reduce the value of the mortgage loan—the acquisition lender's collateral. Even if the acquisition lender knows about the problem, it may be able to do little about it, because the mortgage holder has no direct relationship with the property owner.

The mortgage holder may be worse than incompetent and may misapply or misuse mortgage loan payments, falsely assure the acquisition lender that the mortgage loan is in good standing, waive or adversely amend the documents governing the mortgage loan, or take other actions that diminish the collateral value of the mortgage loan.

Misapplied Payments

In an extreme case, the mortgage holder could receive and misapply, or lose, substantial payments of principal, including voluntary prepayments, amortization due upon casualty, or even the payment due on maturity of the mortgage loan.

In each case, the property owner would have paid everything it was required to pay. While no one could force the property owner to pay again, the value of the mortgage loan to anyone holding it, whether mortgage holder or ac-

quisition lender, would have been permanently diminished or destroyed. Because the property owner's payment was not applied to reduce the balance of the acquisition loan, however, the acquisition lender would be left with a substantial unpaid obligation, namely, the acquisition loan, but with diminished or no collateral to support it.

Enforcement of Mortgage Loan

If the mortgage loan is in default or goes into default, the acquisition lender and the mortgage holder may disagree about exercising rights and remedies under the loan. If the mortgage holder refuses to act, the acquisition lender faces the same practical problems as if the mortgage holder were incompetent or fraudulent. In each case the acquisition lender's ability to obtain the benefit of the ultimate security—the mortgage loan and the property— may depend on acts or omissions of a third party it cannot control, the mortgage holder.

If the mortgage holder does enforce the loan, the mortgage holder may ultimately acquire the property. Unless the acquisition lender has protected its position, the mortgage holder will own the property outright, free and clear of mortgages, and could theoretically sell it and pocket the proceeds. If the property is sold to a third party at foreclosure, then the mortgage holder will receive sales proceeds, which raise the same concerns as any other payment on the mortgage loan.

The nature of an acquisition loan forces the acquisition lender to rely on the mortgage holder to act responsibly and to preserve the mortgage loan; the only collateral for the acquisition loan.

A property owner can easily impair the value of real property collateral by, for example, stealing rental income, security deposits or insurance proceeds. But a property owner can destroy all value only with difficulty. In administering a mortgage loan, however, whether the mortgage holder acts in good or bad faith, its mistakes can in the worst case totally destroy the value of the mortgage loan—not merely impair it. In this sense, the mortgage holder plays a more pivotal and potentially destructive role than a property owner.

If the mortgage holder is a "shell" or is otherwise noncreditworthy, or if the mortgage holder agrees to look, upon default, solely to the mortgage holder's interest in the mortgage loan, then the acquisition lender bears the entire risk of the mortgage holder's incompetence or bad faith. Yet the acquisition lender has no one to look to for losses it might suffer from that incompetence or bad faith.

> If the mortgage is in default, the acquisition lender and mortgage holder may disagree about seeking remedies.

Unrelated Disputes

If the property owner can claim defenses or offsets against the mortgage loan because of other disputes with the mortgage holder, those defenses and offsets can impair unexpectedly the value of the mortgage loan. Although the mortgage loan documents should contain language waiving defenses and offsets, the property owner might try to assert them anyway. To the extent that the property owner succeeds, that success will impair the value of the mortgage loan.

The acquisition lender relies on the property as the ultimate source for repayment of the acquisition loan. An acquisition lender therefore must analyze and potentially control all the property-related risks that arise in any mortgage loan.

This list of risks is not exhaustive. Each transaction will raise its own risks based on its particular elements and terms and the positions of the parties in-

volved. Risks also will vary depending on the state laws where a mortgage loan is located.

Risk Mitigation

Once the acquisition lender has identified the risks, the lender must decide how to mitigate or eliminate them.

The acquisition lender can insist that the mortgage holder agree to preserve and enforce the mortgage loan in a way that preserves the acquisition lender's collateral, and assure the acquisition lender that the mortgage holder will do nothing to impair the mortgage loan. The mortgage holder can also provide assurances about the validity of, and lack of defenses against, the mortgage loan. To make these promises meaningful, the acquisition lender can insist that the mortgage holder and any loan servicer be creditworthy or institutional. As an alternative, the servicing and enforcement obligations could be guarantied by such an entity.

Requirements like these are common in securities transactions based on pledged mortgages. They recognize that the mortgage holder's role in an acquisition loan needs to be backed by substantial assets, particularly in an absence of other measures to protect the acquisition lender's position fully.

Because a mortgage holder can so easily cause so much damage to the acquisition lender's collateral, the holder-lender relationship, without special measures, would not appear to be suited to the "nonrecourse" structuring still common in most mortgage loans.

* Even with a creditworthy mortgage holder and without mortgage holder cooperation, the acquisition lender might want the right to enforce the mortgage loan in its own name. Direct enforcement might be particularly appropriate for letters of credit or other credit enhancement devices and in a property owner bankruptcy.

Even before default, the acquisition lender might want to collect payments on the mortgage loan—or even rental income from the property, through a lockbox—in its own name. Receipts would be applied first to payments on the acquisition loan. Any balance would be released to the mortgage holder. These arrangements should give the acquisition lender control, similar to a lockbox, over cash.

The mortgage loan documents could also provide that any foreclosure or other enforcement of remedies require the acquisition lender's affirmative consent. This measure might help the acquisition lender protect its position if the mortgage holder acquired the property.

Acknowledgments

The acquisition lender can mitigate many risks by obtaining suitable acknowledgments and undertakings from the property owner, sometimes even in the mortgage loan documents themselves. The acquisition lender might ask the property owner to agree to some or all of the following:

- Acknowledging "direct pay" to the acquisition lender.
- Requiring the acquisition lender's agreement to any waiver, amendment or consent.
- Acknowledging that payments made directly to the mortgage holder are void.
- Authorizing the acquisition lender to enforce the mortgage loan directly.
- Waiving defenses and offsets that might be available against the mortgage holder.
- Simultaneously sending a copy to the acquisition lender of any notice given by the property owner to the mortgage holder
- Acknowledging that any enforcement of the mortgage loan requires the acquisition lender's participation; and
- Giving assurances about the outstanding balance of the mortgage loan, lack of defenses and counterclaims, and similar matters.

The property owner will not always want to give comfort to the acquisition lender. If the property owner regards the mortgage holder as an unwelcome opportunist taking advantage of the property owner's distress, the owner would do everything it could to frustrate the mortgage holder's acquisition or financing of the mortgage loan. In that case, the acquisition lender might need to rely more heavily on other risk mitigation measures.

*UCC § 9-607 provides some of this. (As Revised in 2001)

To the extent that the acquisition lender imposes measures that bring it into the relationship between the property owner and the mortgage holder, the mortgage holder should consent to and acknowledge these measures. Even with such consent and acknowledgment, the acquisition lender faces lender liability concerns, based on excessive involvement in its borrower's affairs, like those in any other loan. The acquisition lender might mitigate those risks through appropriate acknowledgments and consents from the mortgage holder.

An acquisition lender might want to monitor actively a mortgage holder's administration of a mortgage loan.

The acquisition lender can monitor aggressively the mortgage holder's administration of the mortgage loan. Proper oversight would require frequent reporting by the mortgage holder, copies of statements, prompt notice whenever the mortgage holder or servicer is advancing funds to cover mortgage loan payments not made and other loan administration measures.

Security Protection

The acquisition lender should take possession of the original promissory note that evidences the mortgage loan. This can help prevent the mortgage holder from enforcing the loan without the acquisition lender's involvement and control. Taking possession of the note also is legally necessary to "perfect" the acquisition lender's rights against the mortgage holder.

Mortgage holders have been known to circumvent these protections, thereby forcing acquisition lenders to devise more complicated anti-fraud mechanisms. Because these mechanisms are still not always 100 percent bulletproof, acquisition lenders can minimize this risk by carefully choosing their borrowers.

If the mortgage holder ever acquires the property through foreclosure, then the property (or a new mortgage loan on the same property) should become "substitute collateral," in place of the original mortgage loan, to secure the acquisition loan. The mortgage holder should agree to give the acquisition lender this new collateral if the mortgage holder ever acquires the property. The mortgage holder's promise to deliver that collateral is, without more, just an unsecured obligation. The acquisition lender may have no reliable way of assuring that the mortgage holder will actually perform that obligation. Again, the acquisition lender needs a creditworthy mortgage holder.

If the mortgage holder does mortgage the acquired property to the acquisition lender (or the mortgage holder's designee mortgages the acquired property to the mortgage holder, and then the mortgage holder assigns the new mortgage to the acquisition lender), that mortgage will be new. Someone, presumably the mortgage holder, will need to pay title insurance premiums, mortgage recording taxes and other transaction costs for that mortgage. Because the old mortgage is gone, those transaction costs will be as high as they would be for any other mortgage.

Property Risks

To mitigate the "real estate risks" of the underlying property, an acquisition lender needs to consider the usual menu of real property security measures: lockboxes, tax escrows, lease approvals and springing guaranties.

Depending on the circumstances, the acquisition lender might want to control and administer some of these security measures directly or might be willing to have the mortgage holder do so. In the latter case, the mortgage holder would assign all its rights to the acquisition lender, in assigning the mortgage loan. The acquisition lender would not actually take over administration until a default occurred. In the meantime, the acquisition lender would continue to bear the risk of mortgage-holder incompetence or bad faith.

Loan Restructure

If the mortgage holder cannot or will not provide these protections, or if the acquisition lender wants extra comfort, the acquisition lender might restructure the transaction: The mortgage loan would no longer be held by the mortgage holder, but instead by a subsidiary of the acquisition lender. The acquisition lender and not the mortgage holder would therefore control the mortgage loan. The mortgage holder would merely have the right to a future assignment of the mortgage loan if the acquisition loan were repaid in full. While such an arrangement has some appeal, it also will create new issues and concerns.

Measures of the types suggested in this article should mitigate and may eliminate most risks of an acquisition loan. These measures can, however, add complexity and hence a new risk: the possibility that various elements of the transaction will not mesh and that some potential problem will fall between the cracks. In some particular set of unforeseen circumstances, the acquisition lender might still suffer an unpleasant surprise—and circumstances sometimes seem to play out in whichever way exposes the fatal defect.

The acquisition lender and its attorneys need to anticipate each possible outcome and event and deal with each one appropriately. While this usually can be accomplished, it creates complexity. It may give the mortgage holder or the property owner fertile ground to manipulate the situation or to invent creative theories to circumvent the intentions, expectations and written agreements of the parties.

Finally, the acquisition lender should consider the general effect of complexity, entropy and unexpected future events. An acquisition loan involves a large number of elements. Numerous factors need to go right, at two tiers of ownership, for the acquisition loan to be repaid. By identifying and mitigating risks, the acquisition lender increases the likelihood that those things will go right. But the acquisition lender might not think of everything.

If the feasibility of the acquisition loan structure depends on the creditworthiness of the mortgage holder, then the quality and reliability of the security is ultimately no greater than the creditworthiness of the mortgage holder—the weakest link in the chain. In that case, the mortgage loan security adds little to the acquisition lender's package except complexity and issues—and the possibility of secured status if the mortgage holder goes bankrupt without first having had an opportunity to breach its covenants to the acquisition lender. NLJ