DUE DILIGENCE ON DISTRESSED AND FORECLOSED PROPERTIES

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This section covers some emerging trends, observations, and guidelines that may be of use in advising buyers of distressed and foreclosed properties. I will use "distressed property" to mean one that is in or threatened with foreclosure, and "foreclosed property" to mean one that is owned by a foreclosing lender. This section is oriented toward the lawyer whose client wants to buy a distressed or foreclosed property.

Distressed Property

In a substantial transaction between solvent parties, the lawyers often spend time negotiating the conditions of the transaction and the representations and warranties that the seller will give the buyer. Conditions (also called contingencies) are a substitute for information that the buyer doesn't have now, but expects to have later. For example, a buyer may make its offer subject to the buyer receiving and approving the report of a structural engineer who will inspect the building. The contingency covers information -- in this case, the physical condition of the building -- that the buyer doesn't have now, but will have presently.

Representations and warranties are substitutes for information that the buyer doesn't have now, and likely can't get from anyone except the seller without a great deal of effort. (I'm oversimplifying a bit here.) For example, a buyer of a shopping center will make its offer subject to inspection and approval of the leases. The buyer doesn't have the leases when it makes the offer, but will get them from the seller after the seller accepts the buyer's offer, and will be able to review them then. The buyer will also insist on a representation and warranty from the seller that the seller is turning over complete copies of every lease affecting the shopping center. The reason is that the buyer can't assure itself that the seller's package of leases is complete. The buyer can try to get estoppel certificates from the visible tenants, but some tenants may refuse to sign, or may not be obligated under their leases to give estoppel certificates. Hence, the representation and warranty from the seller.

Sellers in distress are motivated to give representations and warranties to get the distressed property sold. The representations and warranties are worth as much as the seller is, and if the seller is in the same distress as the property, a set of representations and warranties that would suit a transaction with a solvent seller won't provide any real remedy to one who buys from an insolvent seller.

The distressed seller who faces a firm foreclosure date may be happy to give warranties, but unwilling or unable to allow a long period for contingencies. The contingency period is extremely important to these sellers, because each day that the seller waits for the buyer to make a final decision is a day that isn't available to a replacement buyer if the first buyer elects not to buy the property.

A buyer of distressed property should be prepared to start an independent due diligence process without waiting to receive leases and other documents from the seller. I've found it helpful to my buyer clients to work out where they can get outside information on the properties they want to buy, from sources independent of the seller. In addition to consulting obvious sources of information such as the local zoning authority, buyers can look at state business registrations and local business license records (to see how long the tenants have been in business), building permit records (to assess the risk of construction liens popping up after closing), Dun & Bradstreet (to assess the tenants' creditworthiness), Google (look for news stories about the project and for references to its street address), local court records (has the landlord been suing the tenants for rent; have the tenants been suing the landlord for breaching leases?), and state environmental quality agency records (why wait for the Phase I report if your state's put these records on line?)..

It's particularly important when advising buyers of distressed new construction to be up to date on your state's construction lien laws. In many states construction liens recorded after closing can take priority over your client's title. Your seller's warranty against unrecorded construction liens isn't useful if the seller is an insolvent single-asset entity, and the seller's unlikely to persuade a title company to give "early issue" coverage against unrecorded construction liens if it can't persuade the title company that its indemnity to the title company is collectible.

Our firm's recent experience has been that lenders on distressed property are more willing to give a seller additional time before foreclosure if the seller has a sale agreement with a credible buyer. Banks own enough real estate already and are trying to sell off the properties they've taken back (see the next section); the sheer quantity of distressed and foreclosed property is making lenders more willing to work with borrowers and prospective buyers to avoid having to take in even more real estate by foreclosure. This applies to lenders who hold their own loans; it's not yet the case for the servicers of residential loans that have been securitized, but may be soon.

Foreclosed Property

Banks that take in real estate by foreclosure want to sell it. During the boom years, banks that had foreclosed property to sell tended to respond slowly to offers, mainly (as far as I could tell) because all but the smallest banks had some sort of committee structure through which transactions had to work.

Banks are still responding slowly, but for different reasons. Many banks have reduced their staff to save money, even as they've had to take in more property, and they're not physically capable of keeping up with the flood. The good side of this, for a buyer, is that a bank seller is likely to allow the buyer a reasonable time to do its due diligence on a foreclosed property. The tradeoff is that a bank seller will resist giving any warranties except a warranty of title and a warranty of authority.[1]

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1 "Warranty of authority" means that the bank will warrant that it is lawfully organized and has the power to sell the property, that it has duly authorized the sale of the property, and that the person who signs the deed for the bank has been duly authorized to sign the deed. None of these warranties are of any use to a buyer who

For example, a bank seller may cheerfully turn over copies of the leases it has on file, but it won't represent that the leases are correct and complete or that they are still in force. It's up to the buyer to compare the leases to the actual occupancies and to solicit estoppel certificates from the tenants. A bank may provide a copy of an environmental report in its file, but won't warrant that the report is the only report it has.[2]

Special cases

1. **The accidental developer**

Your client who wants to buy the remnants of a foreclosed subdivision or condominium should consider whether it wants to succeed to any special rights of the developer, and whether under state law it will succeed to any obligations of the developer. For example, Oregon allows the developer of a condominium or planned development to reserve the right to build more units or add property to the project. This right may be valuable when the market recovers; someone who buys the unsold lots or units may be able to succeed to that right. Conversely, our state laws provide that someone who buys in a bulk purchase a certain proportion of the lots in a subdivision is deemed to be a developer, and picks up some obligations with the purchase.

2. **The D'oench, Duhme doctrine**

It used to be that banks worried about the solvency of their borrowers; today borrowers have to worry about the solvency of their banks. Under the D'Oench, Duhme doctrine (*D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942)), the FDIC as a receiver of a failed bank is not bound by modifications to a loan unless those modifications are contained in the records of the bank. "Contained in the records" means that some formal approval has made its way into the bank's official loan file; a phone call from the loan officer doesn't count. Your client who wants to assume a loan, with modifications, on a distressed property, should consider insisting that the modifications be incorporated into a recordable amendment to the mortgage or trust deed, even those portions of the modifications that wouldn't ordinarily be recorded -- just in case the bank turns out to be in more trouble than the property was.

3. **Assuming security deposits**

If your seller can't or won't give a meaningful warranty that the tenants' refundable security deposits and prepaid rents are as scheduled on the closing statement, consider having the assignment and assumption agreement list the specific security deposits and prepaid rents that are being transferred at closing and have your client assume the liability for only those deposits, instead of giving a generic statement that "all security deposits are assigned and transferred to the buyer." Otherwise your client may discover after closing that it's assumed the responsibility for security deposits and rents that it didn't know about.

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discovers that the long-term tenants are really month-to-month.

2 A bank that acquired the loan or the property when the FDIC gave it ownership of a troubled bank may not even know where the complete loan file is.