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Selling Distressed Assets

Three types of distressed-loan sales are options worth considering for financial institutions seeking to improve their balance sheets.

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The current economic climate and ongoing attention from regulators have financial institutions under growing pressure to raise capital to improve balance sheets. Not every financial institution can afford to hold its distressed assets until the market improves enough to generate capital recovery and satisfy regulatory requirements.

What are a financial institution's strategic options in today's market? At the most basic level, financial institutions can raise capital or sell assets. To meet today's challenging market, Manatt, Phelps & Phillips, LLP has formed an interdisciplinary Distressed Asset Task Force of lawyers with the specialized skills to represent financial institutions in these transactions.

This article focuses on distressed-loan sales as a strategy to improve financial institution balance sheets; reduce costs associated with servicing and carrying distressed assets; improve asset quality; achieve positive effects on stock price and market perception; and free up time and attention to focus on more profitable businesses. Notably, however, in our experience, poorly conceived or executed sales can leave the selling institution with its worst assets, significant trailing liabilities and a big bill for transaction expenses.

Distressed-loan sales can take one of three basic forms: 1) bulk sales to targeted groups or to the open market; 2) individual loan or loan portfolio sales using online distribution channels; and 3) sales to borrowers or related parties.

In addition to the strategies discussed in this article, a financial institution might also consider other "asset sale" strategies (such as good bank/bad bank and joint-venture structures).

To illustrate the different approaches financial institutions can take to

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manage their loan portfolios through asset sales, this article examines three case studies. These examples show how institutional lender clients employed different strategies to dispose of underperforming loans, and illustrate the advantages and disadvantages of each approach.

Bulk Sales of Portfolios

Financial institutions considering the bulk sale of a portfolio of underperforming and nonperforming loans must first decide whether to limit the pool of potential buyers to a specific target audience or open the sale to a more diverse group. In addition, the selling institution must also choose whether to manage the valuation and sale process in-house or through an outside financial adviser or broker.

During this downturn and the last cycle, our firm has executed dozens of loan and portfolio purchase and sale transactions for national and regional banks as well as diverse institutions, including investment banks. In 2008, our firm closed one of the first significant asset sales in the current cycle and has since been engaged by banks, private equity firms and other buyers and sellers dealing with private and Federal Deposit Insurance Corporation (FDIC) pool and individual purchases and sales.

Our firm recently advised a regional bank in connection with a bulk loan sale offered only to a targeted group of potential buyers.

Our client elected to hire a valuation and marketing consultant, and tailored the sale transaction to the bank's needs and capacity, starting with buyer selection and setting up an online data site and an actual "war room."

The transaction proved to be a very successful execution for the client, with a relatively high realization of 35% (as shown in the table below) taking into account the extant market environment and the sale of the entire pool of loans. Selecting the loan pool in advance and selling the entire loan pool to a single buyer allowed the bank to realize closing and documentation efficiency. However, this approach identified certain issues of which a selling bank should be aware.

Time-intensive negotiations: Unlike the last cycle, today's sellers (with the exception of the FDIC) lack the market power to dictate terms to prospective purchasers. In this deal, the parties spent substantial time over a two month period negotiating the mortgage loan purchase agreement. The most heavily negotiated provisions included representations and warranties, assumption of liability provisions and indemnity obligations.

Buyer due diligence: Although this transaction allowed buyers to conduct due diligence using an online data site, buyers still carried out significant diligence, including a review of the loan documents, financial strength of the borrowers and the underlying real estate collateral, which increased the total transaction time.

Some buyers, realizing they were in a competitive bid situation, simply refused to incur the cost of this upfront diligence, and declined to participate in the transaction. Certain buyers also contacted the borrowers during their diligence review, in violation of their confidentiality agreements--a violation that led us to believe the sale had become public knowledge, and caused administrative issues, as the seller had to address an array of questions from the borrowers and unsolicited offers from various brokers and intermediaries.

Seller due diligence: Seller due diligence proved to be equally as important as buyer due diligence. A careful analysis of the loan information was found to be the most effective way to accurately assess any ongoing or contingent liability of the seller and to determine the price of the loans.

By conducting seller due diligence, potential breaches of representations and warranties could be discovered and disclosed to the prospective buyers in order to carve such matters out from the seller's representations. As a result, risk of retrading by the buyer or post-closing breach resulting in the obligation to repurchase the asset could be avoided.

Additionally, this seller due diligence also facilitates sale treatment for accounting purposes in transactions where the buyer insists on a right to "put" a breach asset back to the seller, as the seller has in good faith determined through its due diligence and disclosure of potential breaches of representations that there is little or no risk of any breach occurring. Equally important, problems with the loans could be discovered and addressed in advance. (Such problems might include whether there were any consent requirements for participated or syndicated loans; any prohibition against the sale of the loans or against disclosure of borrower information; and if there were any obligations that would continue after the sale, such as set-aside letters or funding obligations.) The result of this seller due diligence was better, smoother and faster execution.

Also, as part of the seller's due diligence, financial institutions often take the time to organize their files to ensure that the files are complete and present the relevant information regarding the loans for sale in a consistent manner. By doing so, they avoid giving buyers the impression they are disorganized or, worse, incompetent, which could foster a perception of increased risk that would likely lead to higher discounts.

In our case-study transaction, the extent of seller diligence certainly increased the bank's cost by an estimated 30% as compared with the sales to borrowers, and added an additional diligence period of approximately one month, but it created a better final product for sale and ultimately led to decreased exposure of the bank to trailing liabilities.

Another important benefit that the portfolio sale afforded the seller was the ability to require the buyer to accept the less desirable assets as the cost of acquiring the more desirable assets. This was accomplished by carefully constructing the portfolio sale to include some more desirable assets together with some less desirable assets.

Online Auction Sales

Online auction transactions are typically conducted via a fee-based, online marketplace with the following basic structure: 1) The seller posts loan information online, including loan documents, the borrower's financial information and third-party property appraisals. 2) An investor can register with the auction market to become an approved bidder. 3) The investor is then allowed to conduct due diligence based on information posted to the online data room.

The offering and sale documents are provided and are nonnegotiable. Use of an online auction allows the highest bidder to secure the specific assets the bidder wants to purchase.

We assisted a regional banking and financial services provider with a sale of approximately 30 distressed and performing mortgage loans secured by commercial and residential subdivision property via an online sale to multiple self-selected bidders conducted through an online marketplace and broker (intermediary). Our primary role as counsel included seller due diligence, modification of the intermediary's standard form asset sale agreement, recommending supplemental disclosures designed to lower our client's risk of breaches of representations and warranties, and closing the transaction.

While the auction sale did allow our client to successfully dispose of a large number of the loans that it initially selected for sale, this approach resulted in significant issues. Additionally, we confronted complications similar to those encountered when conducting a portfolio sale to tailored buyers, including the need for seller due diligence and the lead time created by such diligence.

Moreover, the buyers' ability to select which specific loans they wanted to bid on meant the seller was left--after the transaction closed--with the worst of the assets initially offered for sale.

Review of sale documents: As mentioned earlier, our firm reviewed the Intermediary's standard form sale agreement and found that modifications were necessary to make it more protective of our client, the selling institution. Added protections were needed with respect to buyer assumption of ongoing loan liabilities and seller representations and warranties.

Seller due diligence: The intermediary provided an online data room

platform to post loan information provided by the seller. In fact, seller diligence again proved to be a significant aspect of the transaction similar to the bulk sale situation described earlier. The seller recognized the importance of spending significant counsel time and effort to compile a complete loan file to include all material information including loan documents, financial information, borrower information, payment history, appraisals and various correspondence files, and the need to compile the information from multiple departments within the bank and its outside counsel.
Buyer due diligence: The intermediary contacted potential investors and solicited prospective buyers from its inventory of approximately 4,000 registered investors. To our knowledge, these buyers did not obtain third party inspections, surveys, title reports or appraisals and relied primarily on the information posted on the datasite.
Buyer's choice/leverage: The intermediary essentially created a marketplace and then allowed the market participants to set the price for the loans. This approach enabled the buyers to purchase specific loans. As a result, the seller did not have any leverage to negotiate with the buyers, and at the conclusion of the offering, the seller was left with loans that arguably were the least marketable. In other words, the seller sold the "cherries" and got stuck with the "pits."

An online auction sale is a viable component of managing distressed debt. This is particularly true if the selling institution anticipates potential issues and is willing to effectively minimize its exposure to trailing liabilities. This can be done through actively engaging in the sale and marketing process, requiring modifications to the form sale agreement and investing in diligence efforts.

Structured Discounted Payoffs or Sales to Borrowers
Financial institutions have traditionally utilized loan workouts as a strategy to address distressed loans. However, even when restructured, these loans remain on a financial institution's balance sheet without providing a permanent exit solution.

Alternatively, the financial institution can select a pool of loans and propose to its borrowers discounted payoffs or direct purchases of the debt in a streamlined process with bottom-line results not unlike a bulk loan sale.

We recently worked with a bank that elected to think proactively about the disposition of its nonperforming and performing commercial real estate loans. In lieu of a bulk sale, it decided to sell the loans back to the borrowers or related parties either through structured discounted payoff arrangements or sales of the loans to the loan parties themselves based on discounted payoff amounts set by the bank in advance.

Central to this process was the preparation of standardized prenegotiation agreements, term sheets, and loan sale and discounted payoff agreements (borrowers were given the choice of buying, or having an affiliate buy their note or simply paying the note off at a discount). Substantial thought and careful drafting went into the loan sale and discounted payoff agreements, which are cornerstone documents in any loan sale transaction.

After completion of the form documents, the bank methodically approached the selected borrowers through its outside counsel to determine whether they were willing to accept the discounted payoff amounts proposed by the bank.

This concept worked for borrowers and the bank for several reasons.

Pre-existing relationship: Unlike a typical loan sale agreement with a third party, the borrower's familiarity with the loans and relationship with the bank provided a basis for the bank to require that the borrower and guarantors provide full releases and indemnities, and to require that the borrower, as the note buyer, assume all liabilities. The borrower, as the party most familiar with the loan and the collateral, can assess the risks of liabilities and, as between the borrower and the bank, the borrower is the more appropriate party to assume the risk.

Borrowers were also inherently more optimistic about the continuing development of their projects and were not as concerned about protecting themselves against unknown or otherwise unpredictable risks, at least when compared with arm's-length buyers. In addition, selling a loan to a borrower or its affiliates negates the need for buyer and seller due diligence. This cuts down the related legal costs by approximately 60%. In addition, from the initial conception to closing, the negotiated sale in the first case study took almost 6 months to complete while the "friends & family scenario" took about 2 months.

Greater ability to manage balance-sheet impact: The bank also had greater ability to manage the balance-sheet impact of the sale. In the bulk-sale context, a bank would only have a general sense of its capacity to absorb the write-off and the attendant loss, and essentially must wait until the bids come in to know for certain the balance-sheet impact of the sale.

In the "friends and family" context, the bank dictated the pacing of the individual sales (i.e., it could roll them out one at a time or in smaller or larger groups, as the circumstances dictated) and the discount it was willing to accept, and determined whether any counterproposals were acceptable by looking at the amount of loss that would be generated by the discount. As a result, the bank was better able to manage the sale to the available loss-recognition capacity.

Contact with borrowers: The bank asked Manatt, Phelps & Phillips, LLP, as its outside counsel, to be the primary contact with the borrowers throughout the entire process. We then served as a gateway between the borrowers and the bank, and provided consistent responses to each borrower and tightly controlled all communications. As a result, the bank felt that its potential liability was diminished.

Streamlined process: Arguably, a pool loan sale to one buyer may be the easiest transaction to facilitate. The strict adherence to the standardized forms as a condition for receiving the discounted payoff enabled each transaction to be conducted efficiently and smoothly. However, this approach is not without potential shortcomings.

Lack of financing: The point at which the bank sought an early exit of the loans may be the least opportune time for the borrowers to refinance the loans. However, more than half of the borrowers we approached were able to find financing either through another institutional lender or equity partners. A discount proved to be great motivation for the borrowers to seek alternative financing.

Precedent: A certain psychology works against discounting a note directly with a borrower, and banks normally steer away from a discounted payoff out of concern that the transaction would set precedent for discounting debt. However, the ability of this bank to view these factors within the larger context of the potential benefits allowed the pathway for a successful exit strategy.

Marketing Strategies

Effective marketing depends on a bank's selection of a disposition strategy. The bank has to balance its ability to maintain confidentiality while maximizing distressed asset exposure to qualified potential asset buyers.

There is no cookie-cutter approach when dealing with distressed assets. The key question is which type of exit strategy is best suited to institutional business objectives and resources.

All three types of loan sales described in this article are appropriate in the right situations (see Figure 1 for a side-by-side comparison of the three strategies). Although many financial institutions may choose to do an online auction sale, a well-organized, streamlined approach to sell a tranche of loans to borrowers at a discount may better serve the needs of the financial institution.

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	Online Portfolio Sale	**Traditional Portfolio Sale**	**Friends & Family**
Realization on Assets as a percentage of outstanding principal balance*	30%	Mid-30%	70%
Retained Liabilities	Liability to third parties based on seller's action occurred prior to closing	Liability to third parties based on seller's action occurred prior to closing	None
Ability to Manage Balance Sheet	Low	Low	High
Familiarity with Purchasing Party	No control over buyer selection. Highest bidder buys the loan	Moderate. Seller has control over initial buyer pool selection, but generally awarded loan to highest bidder.	High
Lead Time	Long. Consists of initial pool selection, review of standardized documents, compilation of files, data scrubbing and buyer valuation process.	Long. Consists of initial pool selection, compilation of files, data scrubbing, buyer valuation process and negotiation of sale documents	Minimal. Consists of initial pool selection, setting the discount amount, and preparation of standardized documents.
Buyer Leverage	High	High	Low

* Recovery rates are approximations provided for illustration and comparative purposes only. The recovery rates may differ for a variety of reasons, including, but not limited to, the passage of time and the nature of assets

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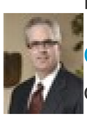

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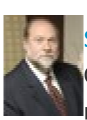

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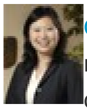

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