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Profits and pitfalls of buying promissory notes

The continuing recession in the commercial real estate industry presents opportunities for the savvy investor to purchase distressed real estate loans at a discount.

Whether those opportunities lead to profits or unexpected financial pitfalls depends on the skill and persistence of the investor.

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Don't let the discount fool you. Everyone loves a bargain, and buying a promissory note at a substantial discount is no exception. In order to avoid buyer's remorse and the purchase of a distressed loan with unforeseen problems, due diligence is key.

Only those investors with the deepest pockets and the greatest tolerance for risk can purchase distressed promissory notes, relying solely on the amount of the discount and their ability to solve problems later when they inevitably arise.

Due diligence – Part 1. Although it is always tempting to leap ahead to the end result, it is important to remember that the investor purchasing a distressed real estate loan is not purchasing the real estate. While the investor may end up owning the real estate that secures the loan, the asset that is being purchased is the promissory note and related loan documents. Part 1 of the investor's due diligence begins here.

Is the note negotiable? Under the Uniform Commercial Code, a purchaser in good faith for value becomes a holder in due course of a negotiable instrument and takes the note free from certain defenses that the borrower might be able to assert. If the promissory note is not negotiable, further examination of possible defenses available to the borrower will be required.

What is the balance? Enforcement of a promissory note requires at a minimum that the noteholder be able to prove the amounts owed by the maker under the note. The purchaser must obtain from the seller an accurate, certified payment history that discloses the current outstanding principal balance, accrued interest, late charges and other amounts owing under the loan documents.

Even if the note purchaser does not envision suing the defaulting borrower under the note, this information will be necessary in completing an accounting of sale with the commissioner of accounts following a foreclosure sale.

Are the loan documents accurate and complete? Regardless of the seller, never assume that loan documents are accurate or complete. Everyone makes mistakes and loan processors and underwriters are no exception.

If there is a commitment letter for the loan, compare the loan documents with the commitment to make sure that the basic loan terms are correctly set forth. Confirm that the correct parties have signed the necessary loan documents, and review and verify collateral descriptions and the steps taken to perfect security interests in that collateral.

The accuracy and completeness of deeds of trust, security agreements, and other security instruments can be of the utmost importance, particularly if the solvency of the borrower or any of the guarantors is suspect.

Have the loan documents been modified? Part of the note purchaser's due diligence involves determining whether there have been any amendments to the loan documents or waivers of the loan provisions that will impair the ability of the note purchaser to enforce the loan.

Review of written modifications to loan documents, correspondence between the lender and the borrower and even email communications between lender and borrower can be essential if unpleasant surprises are to be avoided.

What happens if the borrower files for bankruptcy? The filing for bankruptcy by the borrower results in the imposition of the automatic stay under federal bankruptcy law. The automatic stay means delay. While not necessarily fatal to the note purchaser's economic analysis of its investment, delay can impair the projected profitability of the note purchase transaction.

Due diligence – Part 2. If the review of the loan documents is satisfactory, the second part of the purchaser's due diligence involves a careful assessment and practical valuation of the real property and other collateral.

Any assumptions about the borrower's valuation of and plans for the property should be critically examined. Even with the discounted purchase price for the promissory note, the investment may prove unsuccessful if the property cannot be practically developed or put to a more appropriate use within a reasonable period of time.

Are survey and title satisfactory? The note purchaser must carefully examine the survey, title insurance policy and all exceptions to title of the property. This review is particularly important if the note purchaser plans to develop or use the property for a purpose different than that proposed by the borrower. Even if the note purchaser plans to use the property for a similar purpose, the note purchaser should not rely on the due diligence of its predecessors.

The careful note purchaser assumes nothing about the property and questions all assumptions and conclusions until independently verified.

What is the zoning for the property? Existing special use permits, nonconforming uses, zoning and other land use laws and regulations can all impact the potential profitability of the acquisition of a distressed real estate loan.

The careful note purchaser resists the urge to accept unquestioningly any assumptions about how the property can be used. The passage of time, changes in laws, regulations, and codes and even local reassessment of comprehensive plans can adversely affect what were once reasonable plans of development for a particular property.

Leases – what leases? If the cash flow generated by the operation of the collateral is important, the note purchaser must analyze factors such as the remaining term of existing leases, the financial condition and stability of existing tenants, and the prospects for lease renewal.

Conversely, if the note purchaser intends to redevelop the property for a different use, it is critical to determine if and when existing leases can be terminated.

Transaction costs. The costs of acquiring a distressed real estate loan and ultimately the real estate collateral can be significant. A careful investor will take time to determine anticipated transaction costs and the impact of those costs on the potential profitability of the investment.

If you are considering purchasing a distressed real estate loan, the purchase price is important, but don't forget the details.

Careful due diligence is necessary to a good investment decision and to making that decision pay off over time.

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