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Selling/Acquiring Distressed Real Estate In Florida: A White Paper on the Advantages and Disadvantages of Six Alternatives, Including Contract and Due Diligence Considerations

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In the current economic climate, many mortgage lenders are seeking to dispose of their interests in distressed real estate, while many investors are seeking to take advantage of the numerous opportunities available for acquiring such property. **Six basic options exist for structuring the sale and purchase of distressed real estate at various stages of the mortgage foreclosure process, consisting of the following:**

> I. The so-called **“**short sale**,” in** which the investor acquires the property directly from the landowner prior to the initiation (or the conclusion) of a foreclosure, subject to the lender accepting a stipulated amount (less than what it is owed) to release its mortgage;
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> II. The sale of loan documents **by the lender to the investor;**
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> III. The sale of a Final Judgment **of foreclosure by the lender to the investor;**
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> IV. The **sale to the investor of a winning bid made by the lender at the foreclosure sale**;
>
> V. The placing by the investor of a competitive bid as an interested party at the foreclosure sale**;** and
>
> VI. The sale of the property by the lender to the investor **after the lender has concluded the foreclosure and** acquired title to the property following the foreclosure sale.

The first half of this article examines the nature of each of these options, and the primary advantages and disadvantages associated with each. The second half of this article discusses some of the more significant issues to be addressed when negotiating contracts and performing due diligence investigations pertaining to the sale and purchase of distressed properties under the options presented.

Part I Options for acquiring distressed real estate

Option 1: The Short Sale

The first option involves the investor's purchase of the distressed property directly from the landowner/borrower, under circumstances where the first mortgage lender agrees to accept a stipulated amount of money (usually the net proceeds) to satisfy its mortgage on the property. Under this approach, the purchaser enters into a purchase contract with the landowner, such contract being conditioned upon the landowner obtaining its lender's approval to accept less than the amount it is owed to satisfy its mortgage. This may or may not involve the lender releasing the landowner from further liability for any deficiency, such a decision being entirely up to the lender. The time involved in closing a short sale will be dependent upon the processing time required by the lender (and other lienholders, if any) to approve or disapprove it; however, the time period should be significantly less than that required to complete a foreclosure.

Short sales also offer the benefit to both the landowner and the lender of reducing the risks and attorneys' fees and costs involved in completing a foreclosure. A lender, for instance, may prefer to approve a short sale in order to avoid litigation if the landowner has defenses or counterclaims that are capable of being raised during foreclosure proceedings. Of course, the lender may still have to address these defenses if it chooses to approve a short sale and then elects to proceed against the landowner/borrower (or guarantors) for a deficiency. The landowner, however, may use the presence of possible defenses or counterclaims as leverage to negotiate the lender's release of the landowner and any guarantors from liability for any such deficiency.

An investor contemplating the purchase of distressed property may be similarly fearful of unknown defenses or counterclaims that a landowner may raise should the investor choose to purchase the loan documents and pursue the foreclosure itself, as discussed in Option 2 below. An investor who acquires property at a short sale, therefore, may be willing to offer a higher purchase price in order to avoid these potential risks.

Adding to the value of this option, a short sale allows the investor to deal directly with the landowner, thereby enabling the investor to negotiate with the landowner for the acquisition of certain development rights and entitlements that might not otherwise be acquired in a foreclosure, wherein the only rights and entitlements received by the foreclosing party are those which either run with the land or are specifically encumbered by the lender's mortgage. If other rights and entitlements exist that are needed by the investor for the development or re-development of the mortgaged property, a short sale offers the opportunity for the investor to acquire them from the landowner (or its affiliates, if applicable).

Since a short sale involves the sale of distressed property directly from the landowner/borrower to the investor, it can be complicated by the presence of junior lienholders such as second mortgage-holders, homeowners' or condominium associations which are owed past due assessments, local governments which may have code violation liens, and contractors who may have construction liens. There is obvious tension between the lender holding the first mortgage (who rightfully believes it is entitled to priority of payment) and the holders of these junior liens. All of them must cooperate in order to conclude a short sale, since any lienholder may refuse to accept less than the full amount that it is owed, thereby preventing the sale. It is not unusual in these circumstances for there to be significant negotiations among the lienholders as they play “chicken” with each other over the sales proceeds. The lender holding the first mortgage may have a minimum amount in mind that it will accept, but typically attempts to maximize its return by threatening (explicitly or implicitly) the other lienholders with a foreclosure, which will extinguish their liens. If real estate brokers were involved in bringing the landowner and purchaser together, it is not unusual for the lienholders, who are accepting less than what they are owed, to assert that the real estate brokers should also reduce their commissions in order to make more of the sales proceeds available for the payment of liens.

In addition to liens, there may be other matters affecting the title to the distressed property (such as, but not limited to, leases) that are junior to the lender’s first mortgage and may be objectionable to a purchaser. Such junior matters would be capable of extinguishment in a foreclosure of the mortgage; however, a short sale will not extinguish any interests in the property except to the extent that the party holding that interest agrees to it as part of the sale. For these reasons, it is difficult to conclude short sales of distressed properties having multiple lienholders, multiple junior leases with objectionable terms, or other title issues. In such instances, to rid the property of these junior interests it will be necessary for the lender holding the first mortgage (or its assignee) to institute a foreclosure. As such, if a short sale is not feasible, an investor wishing to acquire the property must be willing to either purchase the lender’s interest at some point in the foreclosure process and complete the foreclosure sale, or purchase the property at or after the foreclosure sale.

Options for acquiring distressed real estate

Option 2: Sale and Purchase of Loan Documents

The second option for the purchase of distressed property involves the sale and purchase of the promissory note, mortgage and other loan documents held by the lender. Under this approach, having stepped into the shoes of the lender, the purchaser succeeds to all of the lender’s rights and responsibilities under the loan. Consequently, although the purchaser has not yet acquired title to the property, as a result of the borrower’s default under the loan documents, the purchaser is empowered to initiate or continue foreclosure proceedings or, alternatively, to pursue obtaining a deed in lieu of foreclosure. This option provides the purchaser with the freedom to tailor the foreclosure process (including the Final Judgment) to the purchaser’s needs, including the determination of whether to include or exclude rights (as needed) that the borrower may hold as a developer or declarant under a recorded Development Agreement, Declaration of Covenants, or Declaration of Condominium affecting the mortgaged property, assuming that such rights were mortgaged to the lender.

This option further equips the purchaser to avoid the time and cost associated with a foreclosure action altogether by allowing the purchaser to negotiate other alternatives with the borrower, such as the borrower’s stipulation to the entry of a Final Judgment of foreclosure or execution of a deed in lieu of foreclosure, possibly in exchange for the purchaser’s release of the borrower and any guarantors from liability for a deficiency. It should be noted, however, that the purchaser’s acquisition of title to the property by deed in lieu of foreclosure will require the payment, upon recording of the deed, of Florida documentary stamp tax on the amount of the debt owed to the lender. In Florida, documentary stamp tax is assessed at the rate of 70 cents for each $100 of consideration (or portion thereof) paid by the purchaser. In a scenario involving a deed in lieu of foreclosure, the Florida Department of Revenue requires that the tax be paid on the amount of the debt secured by the property that the landowner/borrower will no longer have to pay. As such, it includes more than the outstanding principal balance of the loan at the time the deed is given. Since the landowner/borrower will not have the funds to pay this tax, the purchaser will have to do so. If the tax is significant, it may be more desirable for the landowner/borrower to stipulate to the entry of a foreclosure and allow the purchaser, who has bought the loan documents, to schedule a foreclosure sale and bid at the sale. In that scenario, the tax is based on the amount of the winning bid, which will likely be nominal and, in any event, much less than the amount of the debt.

Additionally beneficial, and unique to this option, if the mortgaged property is subject to past due homeowners' or condominium association assessments payable by the prior owner (in this case, the landowner/borrower), the purchaser of the loan documents will qualify for Florida's safe harbor protection against full liability for such assessments. Specifically, Chapter 718 (sometimes called the Condo Act) and Chapter 720 (sometimes called the HOA Act) of the Florida Statutes limit liability for a prior owner's unpaid association assessments for qualifying parties acquiring title by foreclosure or deed in lieu of foreclosure, to the lesser of either: (i) the assessments accrued during the 12 months immediately preceding the acquisition of title, or (ii) 1% of the original mortgage debt. To qualify for this safe harbor, the beneficiary must be either the first mortgagee or the successor or assignee of the first mortgagee. A purchaser who receives an assignment of the lender's loan documents under this option becomes the mortgagee and, therefore, qualifies for this protection. This may be an important consideration if there are significant amounts of unpaid condominium or homeowners' association assessments levied against the property.

In the event the purchaser elects or is otherwise required to proceed with a foreclosure action after acquiring the loan documents, the purchaser should be aware of certain disadvantages and risks associated with this option, including (but not limited to) the following:

(a) Obviously, the purchaser will be required to spend time and money, including legal fees and court costs (such as filing fees which can range from $400 to $2,200), in order to complete the foreclosure. While some foreclosures can occur relatively quickly (e.g., in the event of a summary foreclosure or the borrower's stipulation to a friendly foreclosure), proceedings can nonetheless persist for 12 to 18 months (or longer) in a contested foreclosure, and for 6 to 9 months (or longer) in an uncontested foreclosure. Time frames will also vary significantly depending upon how busy the courts are in the jurisdiction where the mortgaged property is located.

(b) The purchaser must overcome any defenses and counterclaims raised by the borrower and/or guarantors, such as defects or ambiguities in the loan documents, waiver, estoppel, improper acceleration and other equitable defenses which will further increase the cost and time expended by the purchaser to finalize the foreclosure.

(c) The borrower may file for bankruptcy after the purchaser buys the loan documents. If the filing occurs before the issuance of the Certificate of Sale by the clerk of court following the foreclosure, it will trigger an automatic stay of the foreclosure action, requiring the purchaser of the loan documents to obtain bankruptcy court permission to conclude the foreclosure. Although it is possible under the right circumstances to obtain such permission, it is not assured and depends on the facts of each case. Accordingly, although the lack of equity in the property may favor the lender, other factors may lead to the purchaser being forced to accept a loan modification (sometimes called a "cram-down") under a bankruptcy plan and, therefore, ultimately unable to acquire the mortgaged property, although remaining a lender under the terms of the loan documents (as they may be modified by the bankruptcy court).

On the other hand, the purchase price of the loan documents customarily reflects the fact that the prospective purchaser is accepting these potential risks. This means that this method of acquiring distressed real estate can be a low-cost option among the scenarios discussed in this article (unless, of course, one of the potential risks becomes a reality). Adding to the value of this option, Florida documentary stamp taxes are not assessed on assignments of loans, so the purchaser can avoid paying these taxes, which are typically the largest single expense associated with the purchase of property. Finally, the purchase of loan documents before the initiation (or at least before the conclusion) of the foreclosure process gives the purchaser some control over the foreclosure, ensuring that the purchaser can name the appropriate defendants and conduct the foreclosure properly. The other options mentioned below require the purchaser to rely on the lender to properly conduct the foreclosure action. As such, under those options the purchaser will need to be sure that the foreclosure has been prosecuted properly prior to consummating the purchase.

While ordinarily a better bargain, this option may present a financial disadvantage to the purchaser due to the potential issue of "phantom income." Specifically, the amount the purchaser pays for the loan establishes the purchaser's tax basis in the loan, since it is an asset that the purchaser is buying. If the purchaser subsequently acquires the property, either by completing the foreclosure or obtaining a deed in lieu of foreclosure, the U.S. Internal Revenue Service considers the purchaser to have exchanged one asset (the loan) for another asset (the real estate which secured the loan), a transaction which it considers taxable. If the market value of the real estate exceeds the amount that the purchaser paid for the loan, the purchaser will be required to report that differential as income for federal income tax purposes during the tax year in which the property was acquired. This will trigger the payment of income tax on the differential even though the purchaser (taxpayer) has not received any actual cash income; hence, the name "phantom income." This will not be a problem if the market value of the real estate approximates what the purchaser is paying to acquire the loan, but it could be a problem if the purchaser is getting a particularly good deal by buying the loan at well below the real estate's market value.

A hybrid approach: combining options 1 and 2

If a short sale under Option 1 would be feasible due to a cooperative landowner/borrower, but cannot be accomplished due to the refusal of junior lienholders to discount or release their liens on the property, it may be possible to structure a transaction that is a hybrid of Options 1 and 2. Under this scenario, the lender sells its loan documents to the purchaser in exchange for the purchase price. Immediately thereafter (i.e., moments later), the landowner/borrower gives the purchaser a deed in lieu of foreclosure, which recites that it is subject to the lender's first mortgage and all other liens and encumbrances (which remain in place). This puts the purchaser in the position of owning both the fee title to the property and the loan documents secured by the first mortgage on the property. Under Florida law, these two interests would normally merge upon being acquired by the same purchaser, thereby extinguishing the mortgage; however, it is possible to avoid this result if the deed specifically recites the intention of the parties to leave the mortgage in place and not merge the mortgage into the fee title to the property, notwithstanding that both the fee title and the mortgage may be owned by the same purchaser.

In this scenario, the purchaser can then approach the junior lienholders and advise them that, if they do not agree to release their liens, the purchaser will foreclose the first mortgage, consequently extinguishing them. This hybrid approach offers two significant benefits: (i) it takes the landowner/borrower out of the equation, and (ii) removes the leverage held by the junior lienholders to prevent the purchaser's acquisition of fee title (i.e., by refusing to discount or release their interests as part of a short sale). Such an approach is made possible because, unlike a landowner/borrower, it is much less likely that a junior lienholder will have defenses or counterclaims that would interfere with a foreclosure of the first mortgage. Accordingly, many junior lienholders will recognize the futility of their position and agree to release their liens for little or no consideration. The purchaser, however, may choose to give them something as an inducement, so that the purchaser can avoid the attorneys' fees and costs associated with a foreclosure.

Even if the initiation of foreclosure proceedings becomes necessary to extinguish the interests of uncooperative junior lienholders, the chances are good that the lienholders will not want to pay attorneys' fees to defend against a foreclosure which will inevitably extinguish their interests, thereby resulting in the lienholders choosing not to defend against the foreclosure. It should be noted, however, that, under the Florida Condo and HOA Acts, the foreclosure will not serve to extinguish the obligation of the purchaser to pay assessments due to a condominium or homeowners' association, but the purchaser (in its capacity as the holder of the first mortgage) may still have the benefit of the statutory safe harbor, which caps its liability for those assessments, as discussed in Option 2 above.

Options for acquiring distressed real estate

Option 3: Sale and Purchase of Final judgment

Once a foreclosure proceeding has been completed, the court enters a Final Judgment of foreclosure, which liquidates (i.e., reduces to a specified sum) all amounts owed to the lender. The Final Judgment orders the sale of the mortgaged property and allows the lender to make a credit bid at that sale up to the amount it is owed under the Final Judgment. A prospective purchaser may opt at this point to purchase the Final Judgment from the lender. This offers several advantages over purchasing the loan documents. Specifically, the purchaser can avoid the expenditure of time and funds required to file and proceed with a foreclosure action, as well as the risks associated with a foreclosure, discussed more fully above. In this scenario the purchaser also avoids documentary stamp taxes, since such taxes are not assessed on the assignment of a judgment.

Of course, to offset these advantages, the lender from whom the Final Judgment is being purchased will expect the purchaser to pay a higher price than would have been paid to acquire just the loan documents, since the lender bore the additional risks and expenses associated with completing the foreclosure. The purchase and assignment of a Final Judgment may also present other disadvantages. For instance:

> (a) If the Final Judgment does not contain a provision allowing the lender to assign it to a purchaser, the lender and purchaser may need to seek court approval to do so, if required by the clerk of court, which handles the foreclosure sale. While not a problem to obtain, it will cost some time and money. For this reason, it is important that the lender's attorney who is obtaining the Final Judgment draft it in advance to allow for its assignment.
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> (b) It is possible for the borrower to appeal a Final Judgment within 30 days after it is entered. If the Final Judgment is assigned before the 30-day appeal period has expired, the purchaser will have to defend against the appeal. For this reason, it is important for the purchaser of the Final Judgment to make the expiration of the appeal period, with no appeal having been filed, a condition to its obligation to close on the purchase of the Final Judgment.

(c) The purchaser of the Final Judgment will likely not qualify for Florida's safe harbor protection against full liability for past due condominium or homeowners' association assessments payable by the prior owner (in this case, the borrower), discussed above. Because the assignment of the Final Judgment does not include the assignment of the mortgage (since, as a matter of law, the mortgage merges into the Final Judgment), at least one Florida District Court of Appeal has held that the purchaser of a Final Judgment does not qualify as a successor holder of the mortgage and, therefore, will be liable for the payment of all past due association assessments upon acquiring the property (unless the terms of the applicable Declaration of Condominium or Declaration of Covenants contain exemptions from such liability). In view of this, if the mortgaged property is subject to considerable past due assessments, this issue should be fully analyzed before a purchaser commits to buying a Final Judgment. This would include a review of the governing documents of the condominium and/or homeowners' association, as these documents sometimes offer a successor to the original mortgagee greater protection than the safe harbor provisions of the Florida Condo and HOA Acts.

(d) As mentioned above, the borrower might file for bankruptcy after the purchaser buys the Final Judgment and before the issuance of the Certificate of Sale by the clerk of court following the foreclosure. Consequently, the purchaser of the Final Judgment may face the same bankruptcy risks as the purchaser of loan documents, albeit for a shorter period of time.

(e) The purchaser of a Final Judgment may also face the same "phantom income" issue as the purchaser of loan documents, if the value of the mortgaged property significantly exceeds the amount that the purchaser pays for the Final Judgment.

Options for acquiring distressed real estate

Option 4: Sale and Purchase of Winning Bid

After the foreclosure proceeding has been completed and the Final Judgment entered, the clerk of court conducts a foreclosure sale of the mortgaged property. At the sale, the lender has the right to bid up to the amount specified in the Final Judgment as a "credit bid" (meaning that the lender will not have to pay cash, but can use the Final Judgment amount as a credit). Third parties who are interested in purchasing the property may also bid (this method of asset acquisition is discussed under Option 5 below). At the conclusion of the sale, the clerk of court issues a Certificate of Sale. If no objection is raised within 10 days following the sale, the clerk issues the winning bidder a Certificate of Title, which is recorded among the public records of the county where the property is located, at which point the successful bidder becomes the record owner of fee title to the property.

A prospective purchaser may consider buying the winning bid from the party who made it at the foreclosure sale (typically, the lender). In this scenario, the purchaser is obtaining the right, per the winning bid, to have the clerk of court issue the Certificate of Title directly to the purchaser. Since the foreclosure litigation and the appeal period will have been concluded by the time the sale is held, the risks associated with those aspects of the foreclosure process will have been avoided. Additionally, in this instance, unlike Options 2 and 3 above, since the Certificate of Sale is typically issued within 24 hours after the successful bid is made at the foreclosure sale, there is a very limited risk to the purchaser that the borrower will file for bankruptcy to stay the proceedings. Further, even if a bankruptcy is filed by the borrower after a winning bid is made, a bankruptcy court is unlikely to set aside the sale.

Therefore, the only remaining obstacle to the issuance of a Certificate of Title to the purchaser in this scenario is an objection to the sale itself. This must be raised within 10 days of the sale and is typically asserted if there is some irregularity in the sale, which is unusual, especially since most counties in Florida now utilize an online sale process. For this reason, a purchaser of a winning bid may wish to wait until late in the 10-day period before closing on the purchase, since the risk of a sale objection is reduced with each passing day. Because the closing must occur before the Certificate of Title is issued, this presents a very narrow window within which the purchase must be concluded and the purchaser substituted for the lender as the grantee named in the Certificate of Title. Accordingly, it is critical to coordinate the timing properly.

The disadvantages of acquiring distressed property by purchase of the winning bid include some of the same issues discussed in Option 3 above:

(a) If the Final Judgment failed to specify that the winning bid may be assigned, the purchaser may need court approval to do so, if required by the clerk of court. For this reason, the lender’s attorney should provide for the assignment of the winning bid in advance when drafting the Final Judgment for court approval.

(b) If the mortgaged property is subject to past due assessments payable to a condominium or homeowners’ association, the purchaser of the winning bid will be jointly and severally liable with the borrower for the borrower’s unpaid assessments, since the purchaser will not qualify for statutory safe harbor protection as a successor or assignee of the first mortgagee. Accordingly, it will be critical for the purchaser’s due diligence investigations to include an analysis of this potential liability.

(c) It is not clear under the U.S. Internal Revenue Code whether the Internal Revenue Service would treat the conversion of the purchaser’s ownership interest in the winning bid to the ownership of the property as an exchange of one asset for another, so as to trigger the phantom income issue; however, the IRS may take such a position. There are valid arguments on both sides of this issue. If the value of the mortgaged property substantially exceeds the purchase price of the winning bid, it may be worthwhile to use this option instead of Options 2 or 3, and take an aggressive position with the IRS in an attempt to avoid phantom income that would otherwise clearly be attributable to the transaction if the purchaser had acquired either the loan documents or the Final Judgment.

A further disadvantage incurred by the purchaser at this stage, which does not exist in Options 2 and 3, is the assessment of documentary stamp taxes on the assignment of the winning bid (in addition to these taxes being assessed on the Certificate of Title issued by the clerk of court to the purchaser). The Florida Department of Revenue considers the assignment of a winning bid from a foreclosure sale to be taxable as a conveyance of an interest in real property, just like a deed. Accordingly, documentary stamp tax will be assessed on the amount that the purchaser pays the lender for the winning bid. Additionally, when the clerk of court issues the Certificate of Title to the purchaser, the purchaser must pay documentary stamp tax based on the amount of the winning bid itself. (Note that the state's imposition of documentary stamp tax on the assignment of the winning bid could be used to support the proposition that there is no phantom income to the purchaser because, under state documentary stamp tax laws, the purchaser is already deemed to have acquired equitable ownership of the real property by buying the winning bid. The IRS, however, would likely respond that state law is not controlling on a federal tax issue.)

Options for acquiring distressed real estate

Option 5: Bidding at the Foreclosure Sale

As an alternative to the foregoing options, a prospective purchaser may desire to place its own bid at the foreclosure sale in order to acquire the property. Under this option, the purchaser would not enter into a contract to purchase any interest of the lender in the loan or the mortgaged property, but would instead participate in the bidding process at the foreclosure sale along with the lender and any other interested bidders. Since the lender is able to credit bid the amount of the Final Judgment, it is clear that the lender could outbid any prospective purchaser who wants to acquire the mortgaged property at a substantial discount.

The only question, therefore, would be whether the amount bid by the prospective purchaser is high enough to warrant the lender letting the property go instead of bidding itself. Since most lenders do not wish to acquire mortgaged properties except as a last resort, many will allow a competitive bidder to acquire the property at the sale if the price approaches the amount the lender can expect a purchaser to pay for the property after the lender would have acquired it (with appropriate offsets for the costs of marketing and carrying the property while it is owned by the lender). Accordingly, any prospective purchaser should be familiar with the market value of the property, the estimated time it would take the lender to market the property and close on a sale, and the carrying costs that the lender would incur during that period. Some lenders are willing to tell other prospective bidders the amount at which the lender will stop bidding, so it may be worthwhile to make that inquiry of the lender. With respect to online sales, lenders will often disclose their maximum bid amount a few days prior to the sale.

If the mortgaged property is subject to past due assessments payable to a condominium or homeowners' association, the purchaser at the foreclosure sale, failing to qualify for statutory safe harbor protection as a successor or assignee of the first mortgagee, will be jointly and severally liable with the prior owner for their unpaid assessments. Accordingly, in this scenario it will also be critical for the purchaser's due diligence investigations to include an analysis of this potential liability.

Further, there can be complicated procedures governing foreclosure sales that a potential bidder will need to know. These vary between jurisdictions. For instance, some jurisdictions permit online bidding with prior registration and evidence of the availability of funds, while others require that bidders appear in person at the county courthouse. Generally speaking, state law will require a third-party winning bidder to deposit 5% of their maximum intended bid with the clerk of court, with the balance due in cash or certified funds, usually later that day. The purchaser will also have to pay state documentary stamp tax on the Certificate of Title, at the rate of 70 cents per $100 of the winning bid. In addition, state law requires the payment of a clerk's fee, calculated at 3% of the first $500 of the bid and 1.5% of the remaining balance. Upon receipt of payment, the clerk or court will issue the winning bidder a Certificate of Sale, followed by a Certificate of Title.

Once a Certificate of Title is issued, the property belongs to the winning bidder. Accordingly, if the prior owner or tenants (assuming they have been named in the foreclosure action) have not moved out of the property by this point an additional court order may be necessary to remove them.

Options for acquiring distressed real estate

Option 6: Purchasing from the Holder of the Certificate of Title

A prospective purchaser may choose to acquire title to the property directly from the winning bidder after the winning bidder receives a Certificate of Title from the clerk of court. Under this alternative, the purchase of the property is handled like the customary purchase of any other real property. Accordingly, the seller and purchaser would negotiate a traditional land purchase and sale contract, although it is very unlikely that the lender (or other winning bidder), which just acquired title following a foreclosure, would be willing to provide many warranties or representations in the contract. In this scenario, the purchaser is able to avoid the risks and challenges associated with the foreclosure process, such as the borrower's right of redemption, phantom income, and liability for past due assessments payable to a condominium or homeowners' association. Upon being issued its Certificate of Title, the seller will be responsible for those past due assessments, which will be limited to the statutory safe harbor amount if the seller is also the foreclosing lender. Consequently, the purchaser who subsequently acquires the property from the seller will need to be sure to require such assessments be paid by the seller so that the purchaser will only be liable for its own assessments. Disadvantages to this approach, however, include the likelihood that the purchase price for the property will be the highest of all the options discussed. Further, payment of documentary stamp taxes on the deed will always be required, but a purchaser may be able to negotiate for the seller to pay that expense, which is not unusual.

Part II Contract Issues and Considerations

When Purchasing Loan Documents

The governing contract ("Contract") between the lender and the investor for the sale and purchase of loan documents, a Final Judgment of foreclosure or a winning bid will contain many of the same terms as a typical contract for the sale and purchase of land. These include provisions for an earnest money deposit, a due diligence period, basic representations and warranties, a closing date, closing procedures, and much of what would be considered "boilerplate" clauses in any real estate contract. There are a few unique issues presented by the options discussed above, however, that should be given consideration. The following discussion addresses some of the more significant issues in that regard, but is not intended to be exhaustive.

If loan documents are being acquired, the purchaser will need to be able to demonstrate to the court in a foreclosure case exactly how much is owed under the loan. This means that the purchaser will need to obtain from the lender a payment history showing the dates and amounts of payments received and how they were applied, as well as a statement of the current outstanding principal balance, interest and other amounts due. The Contract should specify this, and provide for the lender to update that information as of closing. The inability to document this with the court could be fatal to the purchaser's successful prosecution of a foreclosure case.

The purchaser of loan documents should ensure the Contract provides that the lender is required to deliver to the purchaser at closing the originals of the Promissory Note and any Renewal Notes, Allonges or Endorsements to the Note(s), since the purchaser will need to file the originals of those documents with the court in order to complete the foreclosure. If they have been lost, it will be necessary for the purchaser to obtain copies and provide the court with what is sometimes called a "Lost Note Affidavit," containing a reasonable explanation of why the original documents are not available, and ask for court approval to "re-establish" the lost documents. To do this, the purchaser should specify in the Contract that, if the lender cannot provide the originals of the Note documents, it must provide a Lost Note Affidavit containing a reasonable explanation for their absence.

It is always possible for the landowner/borrower to make payments to the lender during the period after the purchaser signs a Contract with the lender to acquire loan documents. A prudent purchaser should require in the Contract that the purchase price of the loan be reduced by the amount of any loan payments which are accepted by the lender after the Contract is signed. Of course, the Contract should also provide for the lender to give the purchaser a written notice addressed to the borrower at closing, stating that the loan has been assigned to the purchaser, which the purchaser can then deliver to the borrower. Additionally, the lender should agree in the Contract to remit to the purchaser any loan payments that the lender may receive after closing.

A purchaser acquiring loan documents from a lender should consider whether the lender may be holding any escrow or impound accounts funded by the borrower for the payment of real estate taxes, property insurance, repairs, remediation or similar matters. If the loan is in default, it is likely that the lender has already appropriated any funds in such accounts and applied them to pay down the loan balance (which is usually permitted by the loan documents). However, if the funds are still available, the Contract should provide for them to be transferred to the purchaser at closing along with the loan documents. Of course, since the loan is presumably being sold at a discount, this will prompt the lender to consider the impact this would have on the lender's willingness to agree to the amount of the proposed purchase price.

A lender selling loan documents will be reticent about providing many representations or warranties in a Contract. A prospective purchaser should expect representations by the lender that the payment history is accurate, that the lender is the owner and holder of the loan documents, that they have not been assigned to any other parties, and that they are free from liens, pledges and security interests. Some lenders will provide minimum representations or warranties regarding their own actual knowledge of certain aspects of the loan, but this is the exception rather than the rule. The purchaser should not expect much beyond the basic representations and warranties mentioned above.

A lender typically obtains a lender's or mortgagee's title insurance policy insuring the lien of its mortgage on the property when the loan closes. When the purchaser buys the loan documents later, the title policy will travel along with the mortgage, so the purchaser will automatically obtain the benefit of that policy. However, the policy will have been dated as of the original loan closing. Therefore, the purchaser should provide in the Contract for the title to the property to be updated prior to closing in order to verify (as a condition to the purchaser's obligation to close) that the lender selling the loan is actually the record holder of the mortgage according to the public records of the county where the mortgaged property is located. This can be a problem in cases where a loan has been held by a succession of lenders (by virtue of loan assignments, bank acquisitions or mergers), since it is not uncommon in such instances for transfers of ownership of the mortgage to be undocumented in the public records, a circumstance which can present problems in the foreclosure of the mortgage. Additionally, a prudent investor should require in the Contract (again as a condition to closing) that the title insurance company which issued the lender's title policy be able to issue to the purchaser an "assignment of mortgage endorsement" to that policy at closing, insuring that the purchaser will be the holder of the mortgage upon closing.

Contract Issues and Considerations

When Purchasing a Final Judgment of Foreclosure

A purchaser of a Final Judgment of foreclosure faces some different issues that should be addressed in the Contract. If the Final Judgment has not yet been entered at the point the Contract is signed, the Contract should provide for the lender to use reasonable efforts to obtain it within a stipulated period of time, and for the Final Judgment to contain any necessary wording that will allow for its assignment to the purchaser. If the Final Judgment is not obtained within the specified period, the Contract should address what happens, including whether either party is allowed to terminate the Contract. In that instance, the purchaser should obtain a refund of the earnest money deposit. Perhaps one party would want the right to unilaterally extend the deadline for some further period of time before such a termination would be allowed.

As mentioned above, a Final Judgment can be appealed within 30 days after it is entered. If a purchaser signs a Contract to buy the Final Judgment before it is entered, or after it is entered but before the appeal period is over, the purchaser will want the Contract to provide that the appeal period must expire (without an appeal having been filed) before the purchaser is required to close. If an appeal is filed, the Contract should specify what happens. The purchaser will not want to close in the face of the appeal and, therefore, will want the right to terminate the Contract and obtain a refund of its earnest money deposit. Similarly, the lender may want the right to terminate the Contract in such an event. The purchaser may also want to negotiate in the Contract for the lender to be obligated to defend against the appeal while the closing is put on hold. Such a provision, however, may be an issue for the lender. The Contract should also contemplate how long the parties will agree to delay the closing. At some point, if the appeal is not satisfactorily resolved, either or both parties will want to walk away, in which event the purchaser's earnest money deposit should be refunded.

Contract Issues and Considerations

When Purchasing a Winning Bid

The sale and purchase of a winning bid presents its own unique issues to be addressed in a Contract. If the Contract is signed before the sale is held and the bid is made, the lender will be the holder of the loan documents or the Final Judgment, so the Contract issues discussed above will need to be addressed. Additionally, the parties must consider what could happen at the foreclosure sale. If the parties sign a Contract for the lender to sell a winning bid which it has not yet made, the closing must be conditioned upon the sale taking place and the lender being the successful bidder. A prudent purchaser will want to require the lender to credit bid up to the full amount of its Final Judgment if that is what it takes for the lender to be the successful bidder. The lender, however, may be unwilling to commit in the Contract to bid more than the purchase price at the foreclosure sale, because the purchase price will undoubtedly be significantly less than the amount of the Final Judgment. If a third- party bidder shows up at the foreclosure sale and bids more than the purchase price under the Contract, the lender will want to retain the right to stop bidding and let the third party acquire the property, since the amount paid by the third party will go to the lender. These issues are all negotiable and should be addressed in the Contract.

As previously mentioned, winning bids can be challenged if objections to the foreclosure sale are filed. The Contract for the sale of the winning bid, therefore, should provide for what happens in that event. The timing of the closing for the assignment of the winning bid should also be considered in that context. Specifically, if the purchaser has not yet closed when the objections are filed, the same issues arise as in the situation where the purchaser is buying a Final Judgment and it is appealed before the closing. Accordingly, the Contract must contemplate the following questions: Will the purchaser have the right to terminate the Contract and obtain a refund of its earnest money deposit? Can the lender terminate the Contract? Should the purchaser negotiate in the Contract for the lender to be obligated to defend against the objections while the closing is put on hold? How long should the parties agree to delay the closing? These issues are likewise all negotiable.

Contract Issues and Considerations:

Final Contract Considerations

In all cases, the Contract should provide for the parties to cooperate in obtaining recognition by the clerk of court that the purchaser has succeeded to the interest of the lender immediately upon closing. Depending upon which option is used, the timing for this may be different. If the investor is purchasing loan documents and a foreclosure has already been filed, the timing for the substitution of the purchaser for the lender as the plaintiff in the foreclosure action may not be as important as long as it gets done within a reasonable time. However, in the scenario involving the assignment of a Final Judgment, timing is more critical because there may be a short time period after closing within which the purchaser must be recognized by the clerk of court as the holder of the Final Judgment in order to permit the purchaser to credit bid at the foreclosure sale. In the case of the assignment of a winning bid, the purchaser will not be substituted for the lender as plaintiff in the foreclosure action, but court permission may be needed for the clerk of court to recognize the assignment and issue the Certificate of Title to the purchaser. In each case, it is important to establish in the Contract a deadline for the substitution of parties or the filing of court documents quickly following the closing, consistent with the nature and timing of the transaction.

Part III Due Diligence Considerations

It is beyond the scope of this article to discuss all of the due diligence investigations associated with acquiring distressed real estate under the options noted, but there are some basic due diligence issues to consider in all of these scenarios. In the case of a short sale, even if a seller makes representations or warranties in a sale contract, a purchaser cannot rely on the seller being around or having the financial wherewithal to honor them after the closing. In the case of the sale of the lender’s interest under the other options noted above, it is very unlikely that a lender will provide many warranties or representations about the property to a purchaser. If the purchaser bids at the foreclosure sale, the purchaser receives no representations or warranties whatsoever. As such, it will be incumbent upon the purchaser to perform all of its due diligence investigations thoroughly in advance. Many of the due diligence issues mentioned below are best addressed with the involvement of professional consultants, including an experienced real estate attorney, and all of them should (ideally) be concluded to the purchaser’s satisfaction before the purchaser’s earnest money deposit becomes non-refundable under the terms of the applicable Contract for purchase.

Due Diligence Considerations: Physical Condition of Property

The purchaser should always inspect the physical condition of the property and determine its current market value, taking into account its condition. Since distressed properties frequently require repairs and may have building or health code violations, inquiries should be made of those governmental departments, and renovation and remediation costs determined. Distressed properties may also have environmental problems, so many purchasers obtain a phase one environmental site assessment. This can be used to establish the purchaser's entitlement to an "innocent purchaser" defense under applicable environmental laws. Governmental agencies have typically imposed more significant liability on a purchaser who does not perform basic environmental due diligence before acquiring property that turns out to have environmental problems.

Due Diligence Considerations: Loan Documents

If the purchaser is proposing to buy loan documents in order to complete a foreclosure, it will be rare that the lender will share anything other than basic information about the loan, such as the payment history, copies of the loan documents and the lender's title insurance policy and endorsements. If the lender also originated the loan, the purchaser may be lucky enough to get copies of the phase one environmental site assessment, surveys, plans and some of the other due diligence documents examined by the lender in order to underwrite the loan. Some lenders will allow the purchaser to examine the lender's loan files (subject to maintaining the privacy of confidential information about the borrower and guarantors), but the lender's files may or may not be complete, especially if the loan was held by a succession of lenders. Communications between the lender and borrower may have been conducted by e-mail, and loan files may not include copies of those. If the foreclosure has already been commenced by the lender, then the borrower will have filed pleadings with the court raising its defenses and counterclaims. In this event, the court file should be examined by the purchaser's attorney and an assessment made of the risks posed by any such defenses and counterclaims, since they could significantly delay a foreclosure. However, if the foreclosure has not yet been commenced, the purchaser will not be aware of any such allegations unless they are disclosed by the lender's files (assuming the purchaser is given the opportunity to review them). All a purchaser can do is negotiate to obtain as much information as possible from the lender, and adjust the proposed purchase price to reflect the potential risks posed by the lack of adequate information.

Due Diligence Considerations: Land Use and Entitlements

If the distressed property is not already developed, or if it is intended to be re-developed, it will be necessary to determine what development entitlements exist, and whether they run with the title to the property or can be acquired in the context of a proposed purchase. Properties within a Development of Regional Impact (DRI), governed by Chapter 360 of the Florida Statutes, or governed by a Planned Development (PD) zoning ordinance, can present unique challenges, since the DRI and PD documents establish entitlements and impose conditions on development. Sometimes borrowers who were developers of larger tracts of land such as DRI's and PD's obtained entitlements in the names of affiliates, and the entitlements were not included in the description of the mortgaged property, nor do they necessarily run with the land which is the subject of the foreclosure. These situations can present unique challenges that are difficult to resolve without the borrower's cooperation. Issues involving concurrency, road and utility capacity, school capacity and moratoriums should also be considered.

Due Diligence Considerations: Leases and Tenants

If the property is occupied by tenants, a prospective purchaser should obtain and review the terms of their leases and any agreements that the tenants signed with the lender. Leases which provide for below market rent or other "sweetheart" deals given to tenants should be foreclosed and extinguished if possible. Whether a tenant's rights can be extinguished in a foreclosure depends upon the respective priority of the lender's mortgage vis-à-vis the tenant's lease, which is normally established by the dates they were entered into, with the first in time having priority. However, their respective priority might be adjusted by the lender and the tenant having entered into a Subordination, Non-Disturbance and Attornment Agreement (SNDA) at the initial loan closing, or by virtue of a self-operating subordination clause in the lease, making the lease junior to the mortgage even if the lease would otherwise have had priority. An SNDA is used when a lender wants a prior lease subordinated to the mortgage, and also wants the tenant to agree to attorn to (i.e., recognize as its landlord) a purchaser of the property who acquires it as a result of the foreclosure of the mortgage or receipt of a deed in lieu of foreclosure. The tenant, however, will not typically agree to these concepts unless the lender agrees to include a non-disturbance provision whereby the lender agrees, for itself and any successor, that it will not disturb the tenant's possession and will honor the lease so long as the tenant is not in default. As such, even if an SNDA has been signed making the lease junior to the mortgage, the lender may not be able to extinguish that lease in a foreclosure unless the tenant is in default, which will require some investigation.

In view of the foregoing, it may not be possible to extinguish the rights of all tenants in a foreclosure, and sometimes lenders do not elect to do so even when they have that right. If the purchaser acquires the loan documents and completes the foreclosure itself, the purchaser may choose to extinguish select junior leases during the foreclosure process. If the purchaser is buying a Final Judgment, however, and the foreclosing lender did not extinguish junior leases, it is possible for the purchaser to do so after the fact, but that is a complicated process. In such an event, the purchaser could engage in a "re-foreclosure," which requires court approval. This involves setting aside the Final Judgment, amending the foreclosure complaint to name any new parties, serving process on the new parties, and overcoming any defenses they may raise. Such a process may take significant time and money to conclude, so a complete analysis of leases during the due diligence period is particularly important if the purchaser is buying a Final Judgment or winning bid.

Due Diligence Considerations: Status of Title

As mentioned above in the context of Contract issues, a prospective purchaser should also review the status of title to the mortgaged property during the purchaser's due diligence period. A title insurance company or agent can examine the title (typically for a few hundred dollars unless it is a particularly large or complicated project) and issue the purchaser a title insurance commitment itemizing all matters affecting the title, including taxes and other liens, recorded restrictions, easements and similar matters. If the purchaser is buying loan documents from the lender, the title insurance company should still examine the title for the purpose of being able to issue the purchaser an "assignment of mortgage endorsement" to the lender's title insurance policy, insuring the assignment of the lender's mortgage to the purchaser as of the closing. If the foreclosure has been concluded and the purchaser is buying a Final Judgment or a winning bid, or is bidding at the foreclosure sale, the title company should examine the foreclosure proceedings for propriety and sufficiency so that no exceptions to title exist on account of deficiencies in those proceedings. A prudent purchaser will review the title insurance commitment and all exceptions and encumbrances in advance, and obtain an assignment of mortgage endorsement to the lender's title insurance policy (if the purchaser is buying loan documents) and an owner's title insurance policy when it acquires the title, so the amount of the title insurance premiums should be taken into account when negotiating the purchase price.

A purchaser acquiring loan documents, a Final Judgment or a winning bid is not technically acquiring real property, but rather personal property (although, as mentioned above, the Florida Department of Revenue equates a winning bid with real property for documentary stamp tax purposes). Accordingly, it is possible that a lender could have pledged its interest in the loan documents, Final

Judgment or winning bid by granting a security interest in them to a third party. If that interest has been "perfected" under the Uniform Commercial Code (UCC) and is not released, a purchaser will acquire the loan documents, Final Judgment or winning bid subject to the rights of the third party. A security interest in loan documents may be perfected by giving the secured party possession of the original Promissory Note, so it is important for the purchaser of loan documents to obtain possession of the original Note, if possible.

Additionally, a secured party may perfect its security interest by filing a UCC Financing Statement at the office of the Secretary of State of the state in which the lender entity was formed (in Florida this office is called the Florida Secured Transactions Registry), naming the lender as the debtor and describing the collateral (i.e., the loan documents, Final Judgment or winning bid) in which it has a security interest. The office of the Secretary of the State of Florida is also where federal tax liens on personal property owned by Florida entities are filed. These offices are not covered by a title search, which is limited to the public records of the county where the real property is located. As such, a purchaser of loan documents, a Final Judgment or a winning bid should consider obtaining searches on the lender from these offices in order to verify that no liens or security interests are on file there, and provide in the Contract for any such filings to be terminated as of closing. This is more likely to be an issue, if at all, with loan documents than a Final Judgment or winning bid, since the former are typically held by the lender for longer time periods than the latter. However, if the lender is willing to represent in the Contract that it has not granted any prior liens, pledges or security interests in the loan documents, Final Judgment or winning bid being assigned to the purchaser, the purchaser may be willing to rely on that instead of doing these searches, especially if the purchaser knows that the lender is solvent.

Due Diligence Considerations: Unpaid Real Estate Taxes and CDD Assessments

Unpaid real estate taxes and Community Development District (CDD) assessments can frequently be issues with distressed property. By state law they constitute a first lien on the property and will, therefore, survive a mortgage foreclosure (meaning that the purchaser will have to pay them after acquiring the property if they want to keep it). A title insurance commitment will disclose these unpaid taxes and assessments if they exist. High amounts of past due taxes or CDD assessments obviously affect what a purchaser will be willing to pay for the property. However, title insurance commitments may not disclose municipal or county liens (for utilities and other such services to the property) that are not recorded in the public records, but are granted by city or county code. These are typically the subject of separate searches that the title company can perform or obtain for an extra fee and should be considered.

In Florida, real estate taxes for each calendar year become delinquent if not paid by April 1st of the following calendar year. Once delinquent, a process begins by which the County Tax Collector can issue a Tax Certificate, which will entitle the holder who buys it (by paying the taxes) to apply in the future for a Tax Deed giving the holder title to the property if the property owner does not reimburse them for the taxes, plus interest. Generally speaking, the holder of a Tax Certificate can apply for a Tax Deed after two years have elapsed from the date the taxes became delinquent. A Tax Deed will transfer ownership of the property to the grantee named in the Tax Deed, so it is important for a prospective purchaser to investigate the status of real estate taxes, including whether and when a Tax Certificate was issued, to make sure that there is sufficient time to redeem the Tax Certificate by paying the past due taxes (plus accrued interest and administrative costs) before the issuance of a Tax Deed.

Past due CDD assessments pose a similar problem. A CDD has a lien on the assessed property to secure the payment of its assessments, and this lien can be enforced in two different ways at the election of the CDD. The CDD can choose to have the County Tax Collector bill and collect CDD assessments along with the County's real estate taxes. If this is done, the property is subject to the issuance of a Tax Certificate, followed by a Tax Deed, as with past due county real estate taxes. A CDD can also elect at any time to institute judicial foreclosure proceedings to recover its assessments. If it does so, the CDD assessment lien is foreclosed like a mortgage, and the property is sold at a foreclosure sale. If a property is subject to high amounts of past due CDD assessments, it may be possible to negotiate a settlement with the CDD, whereby the CDD's bondholders (who funded the CDD's improvements by purchasing its bonds, in exchange for which they became entitled to the assessments payable to the CDD as the return on their investment) accept less than what they are owed. The bondholders may do this if they are offered more than they could reasonably expect to receive from a tax sale or foreclosure sale. Additionally, it may be possible for a prospective purchaser of the property to buy all of the CDD bonds from the bondholder(s) at a discount and then direct the CDD to institute a foreclosure proceeding at which the property can be acquired by the purchaser bidding the amount owed under the bonds. Given that a CDD foreclosure will extinguish a first mortgage, this may be a valid option to acquire distressed property under the right circumstances. However, a CDD foreclosure will not extinguish county real estate taxes, since they have equal priority of lien as the CDD assessments. Properties within CDDs can present potentially significant complications, so any investor proposing to acquire property which is subject to high amounts of past due CDD assessments should seek legal advice on the issues presented by the particular property involved.

Due Diligence Considerations: Past-Due Condominium or Homeowners' Association Assessment

As mentioned above, if the property is subject to a condominium or homeowners' association, a purchaser should determine whether and to what extent there are outstanding assessments, since a purchaser may be liable for some or all of them. It is also possible that there are other violations of a Declaration of Condominium or a Declaration of Covenants affecting the property. It is not unusual for a condominium association to have a right of approval over purchasers or a right of first refusal to purchase. Inquiries to the applicable association can provide comfort on these matters. If the inquiries disclose issues, they will need to be addressed or the purchase price adjusted to account for them. Additionally, it may be possible for the purchaser to obtain title insurance coverage (for an additional premium) against potential violations of covenants and restrictions affecting the property as part of the owner's title insurance policy that the purchaser obtains at closing.

Conclusion

While understanding the alternatives to acquiring distressed real estate in Florida can be complex, it is crucial to ensuring a successful investment. Since each scenario discussed in this article will have varying risks and rewards depending on the particular facts, parties and circumstances involved, an in-depth analysis of each possible option, and the corresponding advantages and disadvantages to acquiring the property at that particular stage of the foreclosure proceeding, is essential to ensuring the best purchase possible.

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