Loan Sales: Who's Buying and Why

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PRACTICE AREAS

Banking and Commercial Lending

As a matter of basic contract law, a lender will almost always reserve the right to sell its interests in the loans that it makes to borrowers. This article will briefly explain the typical loan sales that occur in residential and commercial loans, and we will also explore scenarios where individuals may want to consider purchasing a loan.

Typical Residential and Commercial Loans

The most common loan sales occur when a lender that originates a residential loan subsequently sells that loan on the secondary market to investors like Fannie Mae, Freddie Mac, pension funds or other large investors who desire the long-term income stream that residential loans provide. By selling the loans it originates, a lender can ensure that it has capital available to continually make loans to other customers. Buying and selling loans is a long-standing industry practice that most of us were unfamiliar with until the housing boom went bust in 2009. Based on the economic recession which followed, and numerous government investigations to determine "what happened", most of us now have at least some awareness that residential loans are routinely bought and sold on a secondary market.

Commercial loans are also routinely bought and sold, but in most cases the goal of selling a "participating interest" in a commercial loan is to allow the originating lender to either (i) originate a loan in an amount that is greater than its own lending limits, or (ii) reduce its risk of having too much capital deployed with a single borrower or in a certain industry. For example, a single lender may not have the capital available to make a $100,000,000 loan for construction of a new manufacturing facility – or even if it has the capital, it may want to diversify its loan portfolio and not tie up so much capital in the manufacturing industry. In either case, the originating lender may sell participating interests in that loan to other lenders and, by doing so, reduce its risk in having so much capital tied to a single borrower or industry.

In both of the loan sale scenarios outlined above, the goal for the buyer is to purchase a performing loan. However, there are also occasions when individuals or investors may want to purchase a non-performing loan.

Guarantors as Loan Purchasers

When making a loan to a borrower that is a closely-held entity (*e.g.*, an "S" corporation or a limited liability company), the lender will often require that the borrower's owners guarantee all or some portion of the loan. If the borrower subsequently defaults on the loan, there may be disagreements between the owners/guarantors on how to address the default. For example, some may want to contribute additional capital to the borrower to bring the loan into compliance, and others may want to let the lender foreclose on the collateral (which could include calling on the guaranties). In circumstances where the owners/guarantors have differing financial wherewithal – or differing opinions on whether the borrower is worth saving as a viable business – a guarantor with adequate financial backing may desire to purchase the loan from the lender in order to (i) avoid being sued on his/her guarantee, (ii) gain some control over the loan terms that the borrower may need to have waived, or (iii) gain some negotiating leverage against the other owners/guarantors.

If a guarantor is in a position where he/she may be liable for the entire debt of a borrower, the guarantor may desire to "step into the shoes of the lender" by buying the loan rather than paying off the loan under the terms of his/her guarantee. By doing so, the guarantor will maintain a security interest in the collateral of the borrower (*i.e.*, the guarantor becomes the secured lender) and the guarantor also obtains rights against any other guarantors in accordance with the terms of the loan documents. Circumstances will vary widely with regard to whether the underlying facts make it advantageous for a guarantor to purchase a loan rather than making payments to the lender under the terms of his/her guarantee. Accordingly, a guarantor must understand the reasons for the borrower's default, determine if the borrower is a viable business, determine if it makes sense to control the collateral that secures repayment of the loan, and also determine the rights of other creditors to the borrower's assets. In the right circumstances, it can make good business sense for a guarantor to purchase a defaulting loan and, by doing so, gain some control over the process of either continuing the borrower's business or liquidating its assets.

Investors as Loan Purchasers

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Another scenario where it may be advantageous to purchase a loan is when the underlying goal is to acquire the collateral that secures repayment of the loan. When a borrower goes into default on a loan that is secured by real estate or other assets which, if liquidated, would not be sufficient to fully repay the loan, the lender may desire to sell the loan to an investor rather than going through the process of liquidating the collateral. By selling the loan, the lender receives immediate funds without going through the process of (i) foreclosing on the collateral, (ii) taking title to the collateral with the inherent risks and obligations of ownership (*i.e.*, paying taxes, buying insurance, maintaining utilities, repairing damage to the collateral, etc.), and (iii) liquidating the collateral.

For an investor who desires to obtain title to the underlying collateral, it may be advantageous to purchase the loan from the lender and, by doing so, obtain the right to foreclose on the collateral and eliminate any ownership interests of the borrower (and also potentially eliminate any rights that other creditors may have in the collateral). By buying a loan in this manner, an investor can usually obtain rights to the underlying assets for a discounted price because the investor will take responsibility for foreclosing on the collateral and take the risk of any claims or defenses raised by the borrower or other creditors.

Prior to purchasing a loan for purposes of obtaining title to the underlying collateral that secures the loan, an investor needs to ensure that it understands (i) all other liens that may be secured by the collateral, (ii) how the priority of those liens will be determined in the event that the investor forecloses on the collateral, (iii) that the foreclosure process can take many months and is subject to challenges by the defaulting borrower, any guarantors, and other creditors, and (iv) any redemption rights that the borrower (or other parties) may have after a foreclosure. Although there are risks and numerous considerations to be made before purchasing a loan for purposes of obtaining title to the underlying collateral, a deeply discounted loan could make the acquisition of such collateral worthwhile.

If you have any questions with regard to loan sales or circumstances where you should consider investing in a loan, please do not hesitate to contact a member of our Banking, Finance and Creditor's Rights Practice Group.

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