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GUEST COLUMN

Distressed Debt: The Art Of The (Half-Built) Work Out

By **Billy Procida**

When picking this title, I was thinking of two forms of art—the art of war and the art of a great painter. Working out distressed debt on a partially-completed project is truly a form of art that requires the mastery of many skills. Being a developer is a form of art. But being an executive in charge of or looking at buying a distressed loan on a partially-built project requires all the skills of a developer, combined with those of a crisis manager, mediator and lawyer. But the most important trait required is that of a field commander in battle.

Like art, there is a lot of creativity involved in working out a commercial real estate loan. A successful asset manager must constantly survey the battlefield and make adjustments as needed, even if it is contrary to the professional advice he or she is given. The asset manager must always keep in mind how every decision affects the objective, which is to maximize net recovery. Net recovery is the final amount of proceeds received after taking into account the legal fees, personnel time, overhead allocations, carrying cost, cost of capital and everything associated with monetizing the position.

Workouts

Today's workout executives at banks and large institutions have a very difficult task. First, they likely weren't involved with the project they're working out from the onset, so they have to get up to speed with the history. Second, they are shackled by their lawyers and other third parties with whom it seems the higher-ups have put in sole charge of what can and can't be done. Perhaps the biggest challenge is in the process and the amount of authority (or lack of) given to them.

In these situations, the workout executives are often left with the job of trying to interpret and decipher information from professionals they didn't choose or from people they didn't hire. When you're the field commander of a Special Forces unit, you know and have trained with those you go to war with. Everyone's loyalties and objectives are clear. This isn't always the case with a workout.

Rest assured that working out a loan is a war. The war has more than one enemy: the borrower, the constant deterioration of the value of the construction completed, your local building department and possibly subcontractors who have liens on the project. Just remember: keep your friends close and your enemies closer.

So, a note to those higher-ups at lending institutions who put in place the processes and procedures that hamstring the workout executive: you need creative, strong people who know development, construction and bankruptcy but if they are not given appropriate authority and clear objectives, they can't effectively do their job, no matter how good they are. You wouldn't send a soldier into a fox hole and try to micromanage how many bullets they use or who to shoot first. Same goes for your asset manager: every shot won't be a hit and every battle plan doesn't work. But some do.

In today's workout environment, the legal process of foreclosing is truly one of last resort. The time and cost are simply unacceptable. It's clear that loan documents have gotten bigger and bigger over the years, which give lawyers more to argue about. The loan documents on my first construction loan in 1983 were five pages in total. Now they are a foot thick! The unwind has gotten just as cumbersome with releases and indemnities argued over ad nauseam. I settled my first deed in lieu on a yellow pad in 1982. Now those documents are also an inch thick.

Foreclosure

On a finished building with a certificate of occupancy, the concept of just foreclosing and putting in place a receiver could work, as long as the receiver is one of your choosing with appropriate management skills. With a partially constructed piece of collateral, however, a receiver is definitely not recommended, except in limited circumstances.

Let's first get clear how and what gets you your money back. No, it's not your lawyers and it's not the loan documents. It's the asset. Like it or not, if you own a defaulted loan, you own the property and need to act like it and be the developer. What's that mean? A good developer/owner wants to know and see for themselves everything and everybody involved with the asset. Every day the asset sits idle, it deteriorates in many ways: physically due to weather, and then there is vandalism and sabotage. In addition, the value of the asset can be negatively affected by expiring permits, the erosion of tax abatements, carrying costs, not to mention the perception of the idle asset in the market place.

There is nothing more important than the asset. The mortgage and the lawyers are a distant second to the asset. If you think of it as a partnership dispute, it's easier to comprehend. The loan agreements are more like operating

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agreements in a disputed partnership. Two people own a restaurant, one partner doesn't make his capital call, and the partner that steps up and makes the capital call starts a legal battle with the one who defaulted. But you still have to run the restaurant.

The conclusion and suggestion on legal strategy is simple: immediately start the foreclosure, but every single day talk to your borrower *mano e mano*, without the lawyers (settlement discussions are business and do not require lawyers), and never give up. Find a way to settle. Sometimes a developer needs their dignity, sometimes it's money and sometimes it's hope. Remember, you are about to take the borrower's child (most developers think of their projects as their children — I know I did). They created them and raised them, and this is the most painful and humiliating experience of their lives. Settle, settle, and settle. And don't forget, when you get to the end of a lengthy foreclosure, you still have bankruptcy to worry about.

I have an appropriate approach to this situation that is one I have applied in this field for the last 30 years. Construction can never stop, and if it has, get it going as fast as possible. The question is who and how? I'll answer an easy money question first. Any new money you put into construction (of course spent wisely) is money good and only enhances the value of the existing mortgage. So start funding construction as soon as possible.

So who, what, how and why? The why is easy: a building with a certificate of occupancy is marketable to a wider audience than a half-built property and has fewer variables. If you want to achieve an even better return, fill the building with tenants or sell condos to consumers. Unless you have a perfect file on the historical work completed, expect big discounts regarding trades and busted closings.

As to the who and what? First, get out of the office and into the battlefield. Meet and know all who were involved: the marketing agents, architects, general contractors, the expeditor, and definitely the plumber and electrician, without whom you'll never get a certificate of occupancy (and who always know where the bodies are buried). Determine who to keep and who to replace. Also meet the adjacent property owners. They are always helpful (even if they are suing your borrower, you'll need to get them settled and make nice). Remember, Mr. and Mrs. Workout Executive, you are a developer and owner now.

Now, for the what, which is a little trickier. Depending on the circumstances and the percentage of work completed, you may modify the finished package, the building skin and, if early enough, possibly even the layouts. Remember what was designed for the go-go years may not be appropriate today. Test everything: concrete tests have been a problem of late due to the many indictments and convictions that have occurred in that field. Make sure no one has poured concrete in the sewer lines or put drywall screws purposefully thru the water lines (sub contractors do strange things when they're not paid). Also, check the building department folders: many developers empty them out so you may not have the permits and interim sign offs which you will need to proceed.

Now, prepare a budget and a schedule, and leave a big miscellaneous and contingency line item. As to the how: work with your borrower the former developer to permit construction to recommence. If that doesn't work, go to court and plead that these are protective advances to protect the collateral. Getting the community on your side is easy. They always want the work completed, and if all else fails ask for a receiver (specially selected, one with construction and development skills) to be appointed by the court to finish the building while the foreclosure continues. By the way, be prepared to settle the subcontractor liens.

Even if your directive from above is to sell the note, all of this work and the cooperation and information you accumulate from your face-to-face endeavors will enhance the value of the loan you are marketing. All buyers want what your developer's third parties have.

A word to developers on default: you get more with honey than you do with spice (grandma taught us all that). Remember the note holder has a bazooka and a tank. You have a six shooter. You might be able to inflict some pain for a while but they will eventually win. Also, you need them to finish the job for all the same reasons. So, I say to you, keep talking and cooperate as much as possible... and settle, settle, settle.

Lastly, let us be mindful that a half-built eyesore affects a lot of people, not the least of whom are the neighbors and the community. They have to live with seeing this thing every day and, in many instances, their property values have been negatively affected. We as real estate professionals have a duty to do our best to mitigate this circumstance, which resuming construction generally does.

So, in conclusion, settle, settle, and settle. Don't throw the baby out with the bath water, don't cut off your nose to spite your face, and be willing to make mistakes. Like any good battle plan you need a plan A,B,C and D. Finish construction quickly, and we will all be doing our part to help the economy.

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