

Viewpoint

One of a series of opinion columns by bankruptcy professionals

Change In Control In Real Estate Workouts

By Seth A. Bakes

The personality and character of the principal owners and managers of a borrower are very relevant today as lenders confront how to handle non-performing loans and the decision of whether or not to seek a change in control of a property, portfolio or company. The quality of the borrower will define the lender's alternatives just as much, if not more than, economics, documents and jurisdiction.

Consider this situation: The real estate is underwater, the borrower is in default, financial and market analyses are complete, and restructuring professionals have advised. What now? Let's leave behind the results of these investigations and ask a basic question: What is the quality of the borrower? Evaluate character, credibility, core competence, accounting skill, time perspective and interest in maintaining relationships. In this business, personalities run the gamut from well-rounded, credible types to those who are incompetent, antisocial or narcissistic.

The recovery dollars may not materially change if you leave a good quality borrower in charge, but they will surely diminish otherwise. Absent overriding concerns, if the borrower is poor quality then it's wise to take control and do so quickly. Waiting will not make things better.

What can happen if a bad borrower is left in place? The collateral may be wasted for one thing, leaving behind weak cash flow and asset value caused by diverted rents and deposits, deferred maintenance, vacancy, high-priority liens, disgruntled employees and vendors. The list goes on, and many of these problems will begin years before a monetary default.

At this juncture, character and personality come into play. Imagine a conference room during a workout meeting as the bank officer becomes dramatically upset with a recalcitrant borrower. Picture the bank officer rising from a chair, knuckles on the table and leaning toward a borrower, red-faced, neck veins popping, harsh words flying.

Meanwhile, the borrower waits it out until the meeting is over. The borrower just wants to stay in control to divert rents to pay other bills and lifestyle expenses. The borrower does not care about the real estate, lenders, vendors and tenants. Label the personality and character as you may; there is nothing to be gained by appealing to a person's sense of responsibility and integrity if those virtues are lacking.

Unless there is an overriding concern, take control via loan modification, interim management, consensual or court-appointed receiver, foreclosure, deed in lieu or involuntary bankruptcy. Whatever method suits the situation, get started and move that process along quickly.

Now consider a situation in which a responsible borrower is in charge. Is it best to end the relationship and bring in a new operator? Can the borrower maintain interest if out of the money? Under what conditions should the borrower remain in control? Taking a property or portfolio back in order to hire someone else to manage it when a capable, cooperative, and interested manager is already in place isn't likely to have any benefit but will incur startup costs and delays.

What conditions are important to this borrower? Any borrower's actions will be driven by economic considerations, including tax matters, but other things may be on the borrower's mind.

If the real estate is underwater and the borrower's net worth has collapsed, one important goal for the borrower is to survive the downturn with their platform intact so they can continue to earn management fees and wait for a better day. Perhaps family members are employed in the venture and losing the platform would result in hardship, loss of face, or loss of community investment capital.

Does the lender want to liquidate and recover? If the lender has the right to pursue the borrower for deficiencies in loan recovery it's a tough request to ask the borrower to sell a portfolio only to wind up with deficiency judgments and no platform. This request is bound not to elicit much enthusiasm, but more likely lip service, lengthy negotiations, and deals that fail to close.

If the lender wants to liquidate in an orderly fashion and thinks the current borrower is: (a) not able to pay deficiencies, but (b) a capable manager, then the lender should consider waiving the personal guarantees and deficiency language (contingent upon the borrower managing responsibly and meeting performance targets) and let the borrower proceed with sales (subject to lender approval).

If the lender thinks it's best to hold some of the properties and wait for a better day, then work with the borrower to reduce holding costs. It's a balancing act that may benefit both parties. The lender should soften

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debt service requirements enough or fund adequately to protect its collateral.

If the borrower exacerbates the situation by making unreasonable demands, it's best to seek a change in control. It's always disruptive to change owners or managers, but frequently not that difficult. The indispensable person or company is rare in practice. Loyalty quickly moves to whoever signs the paychecks.

Remember also that markets can improve just as quickly as they deteriorate. There was a case involving a borrower trying to sell single-family houses for \$175,000 in a terrible down market who was under pressure to liquidate. Several years later, post recession, the houses were selling for about \$350,000. Management and the key stakeholders were so focused on surviving the moment that the possibility of a strong near-term recovery was not kept in view. A liquidation event occurred just before the market rose.

In conclusion, "amending and extending" with a good borrower is a much better strategy than "amending and extending" with a bad one. Recognizing or realizing losses prematurely is not appealing, so consider the alternatives carefully. It's more tenable to postpone the day of reckoning with today's low interest rates and with a good operator in charge. At some point, however, waiting for a better day becomes a fool's errand and it's better to recover and redeploy capital.

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