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Receiverships

Bearish Real Estate Loan Climate Creates Bull Market for Emerging Breed of Receivers

A growing and—as it happens—beneficial trend in the topsy-turvy distressed property market is the now common choice by lenders or special servicers to work out failing loans through receivership rather than through foreclosure.

Until recently, if a borrower became unable to keep up with payments, the institution that held the note eventually would foreclose, take possession—however reluctantly—of the asset, and seek whatever remedies were available through the courts. But that option has a number of disadvantages, not the least of which is the delay incurred while the process works its way through the system. And time is money.

Perhaps worse yet, the lender then becomes responsible for managing the property, an unwelcome duty for an organization that may have little to no expertise in the field.

David Barksdale, a partner in the Real Estate Department at Ballard Spahr LLP, told BNA a notable trend toward increased use of receiverships has developed just over the last six to 12 months.

''Receiverships are something that's come into regular use with respect to foreclosures and lenders' enforcement of loan documents . . . '' Barksdale told BNA. ''A good example would be the special servicers who are working out CMBS [commercial mortgage-backed securities] loans and have adopted the practice of getting the receivers appointed at a stage when this is feasible without commencing foreclosure and then negotiating into the receivership order or requesting in the receivership order the power to sell the property so that they can keep the existing debt in place.''

When the buyer is found, they can modify the debt through a writedown of the principal or other restructuring actions so that a prospective buyer can acquire the asset subject to the existing deed of trust.

This is particularly critical for CMBS loans, which are held in real estate mortgage investment trusts (REMICs). Barksdale explained Tax Code rules governing REMICs forbid them from issuing new debt and this approach allows the lender to avoid that.

At the urging of real estate groups such as the Real Estate Roundtable, the Internal Revenue Service in September 2009 issued guidance that offers servicers of commercial real estate loans greater latitude in making modification necessary to prevent default (2 REAL 752, 7/28/09) (2 REAL 889, 9/22/09).

''There is more flexibility for the special servicers now and that may be another reason why a receiver makes sense because while the receiver is in place, the loan still exists,'' said Bob Wordes, operating partner for landlord services at The Shopping Center Group.

Variations on Receivership Theme. The technique has come into common use by special servicers and others, Barkdsdale said, not only to assume control of the property and preserve its value, but also to facilitate its eventual marketing and sale.

Although receiverships themselves, which are court-appointed entities, are not new, the trend has spawned variations on the receivership theme. Some still perform the traditional functions of providing required court reports and property management.

But other types of receivership companies now offer a full range of services, including brokerage and leasing, as well as the standard set of services, Barksdale said. ''And there are some companies that are starting to negotiate receivership fees such that they are willing to drastically reduce the fees they would normally charge for receivership functions in order to be able to get commissions for selling or leasing the property, depending on what type of property it is,'' Barksdale said.

Other entrants joining the new wave of receivers may target more specific roles that generally are not performed by conventional receivers. For example, in some cases a property that enters receivership may have been midway through a construction project when the borrower defaulted.

''Some of that work may involve continuing construction, or at a minimum shutting a project down and securing it,'' Barksdale said. ''And those are skills that traditional developers have, some of whom are now positioning themselves as receivers.''

This new wrinkle has generated a degree of controversy as some conventional receivership firms suggest those that assume greater involvement as brokers may have a conflict of interest. The new breed of receivers, Barksdale said, counter that by performing the full set of services, the receiver will be able, as well as motivated, to add value to the project by taking the action necessary to make the property attractive for leasing and sale, thereby maximizing recovery for the lender.

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Room for New Participants. Many of the companies offering the range of services required to meet the new demand for receivers are familiar names in real estate brokerage, property management, and development, including CB Richard Ellis and Cushman & Wakefield.

No single organization so far tracks the level of activity by new and existing firms to meet the demand for receivership services. But anecdotal evidence suggests the response has been robust. Wordes, for example, acknowledged that The Shopping Center Group has ''increased the size of our property management and leasing staff over the past couple of years.''

One of the larger receivership companies is the Douglas Wilson Companies, which is based in San Diego but also has offices in Orlando, Miami, San Francisco, Las Vegas, and Atlanta. Douglas P. Wilson, the company's chairman and chief executive officer, told BNA May 27 that his firm has tripled its receivership business over the past three years. The company current has 60 projects valued at $2.2 billion throughout the country.

Wilson said that as the real estate sector began to decline, his firm ramped up its capabilities, adding 15 professionals to its previous payroll of 35 employees. Over the past six months, however, ''it has stabilized,'' Wilson said. ''I don't see it going up appreciably. I think it's going to continue for the next couple of years.''

But the sheer scale of the demand for receivership services has unlocked opportunities for newly formed enterprises. That poses the potential hazard of unproven or even disreputable operations that capitalize on a seller's market. Barksdale acknowledged that such prospects exist, but noted, ''That's why reviewing a receivership prospect's qualifications is important, and lenders and special servicers that have worked with will ask for proposals from three or four receivers to accurately assess skill and experience levels.''

Asked if he was aware of ''fly-by-night'' receivership operations seeking to enter the business, Wilson said, ''Bluntly, yes, and that's a concern to the more sophisticated lenders and their lawyers.'' In some cases, the new entrants are real estate practitioners that are looking for engagements during the down cycle. ''They don't really understand some of the pitfalls, the nuances, the liabilities, the exposure.''

Barksdale underscored how much the climate of resolving distressed properties has shifted in the most recent real estate cycle. ''Receiverships, certainly in this cycle, have been very, very active. It's rare now, I think, that I handle a workout or loan restructuring where we go ahead with the enforcement of the loan documents'' without using a receiver.

Further, receivers are more attractive in states where foreclosure is a more cumbersome process, Barksdale said. In many of the Western states such as California, Arizona, and Nevada, a non-judicial foreclosure can be carried out in three to four months. But in many Eastern states, a foreclosure must go through the courts, and that can take a year or more, he said.

Bad Loans in Abundance. Another factor in the increasing use of receiverships is the elevated frequency of commercial real estate loan defaults.

''You are seeing so many properties that are in trouble,'' Barksdale said. ''The lenders who have lost confidence in the borrowers act to get a receiver appointed, number one to get a handle on what's going on at the property level—to get information that they don't feel they're getting from the borrower—and also to get the project into more capable management hands.''

Barksdale said the phenomenon of special servicers hoping to sell properties out of receivership rather than out of foreclosure began with CMBS loans and has since moved to loans originated by portfolio lenders, such as banks.

Wordes told BNA CMBS loans account for the preponderance of new cases that his firm sees in which the loan holder selects the receivership alternative. That may relate to a more conservative approach adopted by many portfolio lenders.

Individual banks ''mostly have loans that are not only secured by the real estate collateral but also personal guarantees of the borrower . . . '' Wordes said.

That suggests another cause of the newfound popularity of receiverships was the cavalier attitude among some CMBS lenders that prevailed during the real estate bubble years.

''I think that the CMBS loans had a lot looser underwriting because they weren't on the balance sheets of the institutions that created them,'' Wordes said, adding, ''I'm not an expert on the bond side of this thing, but from what I've read and heard, it got pretty creative.''

Barksdale, however, said that in regard to any given loan the question of pursuing the receivership route is the same whether it came through a securitization or a portfolio lender.

''I'm seeing balance sheet lenders with the same attitude as special servicers,'' Barksdale said. ''They would rather have a receiver in control of the property.''

Barksdale emphasized that whether the party seeking receivership is a bank lender or special servicer acting on behalf of a securitizer, the concern is what to do with a property that the lender perceives a borrower is incapable of handling.

The receivership is sought not because the lender or special servicer wants ''control of the property or the way it is maintained or managed, but because it wants control in the hands of somebody other than the borrower,'' Barksdale said.

Turning Up the Volume. As CRE credit quality declined at the end of the recent real estate boom, the number of troubled loans rose. Then as the economy fell into recession, bad loans came in torrents. The industry found itself totally unprepared for an unwelcome new kind of boom: demand for distressed loan workouts.

''Five years ago the default rate on commercial loans was almost nothing,'' Wordes said. ''A couple of years ago when we got on the front end of this economic crisis, people curtailed their spending and [stores] just weren't doing the sales it took to support the rents they had contracted to pay and they failed.''

That translated into eroded net operating income for many property owners and eventually into bad loans.

''When we actually started to reach out to the lending community a couple of years ago, there was nobody to talk to,'' Wordes said. ''These institutions did not have workout groups and REO [real estate-owned] departments because the default level was negligible. They didn't need them. They all have them now.''

In addition to the ballooning number of loans facing credit default are the hundreds of billions of loans that could be subject to maturity defaults in the near future.

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"Unless something happens that's unforeseen with the economy, we could be doing this for a while," Wordes said.

A Service to the Sector? Although the commercial real estate industry has had a relatively brief experience with the new applications of receivership services, Barksdale said they generally have made a positive contribution.

"I think it is constructive to the extent that you have brokers who may not be as busy as they used to be, people with development skills, construction skills, property management skills who may not be as busy as they used to be, who can provide that same type of value to properties in a receivership role . . . " Barksdale said. "I think that's a good thing."

The alternative to a speedy disposition in such matters can be to prolong the period in which all parties at interest remain uncertain about a property's status.

"Whether it's the lender, whether it's the borrower, or the general public, it doesn't do anybody any good to let properties wither and not be taken care of," Barksdale said. Even though the action generally is taken by a lender who seeks receivership to boost its recovery of assets, he said, "I think a lot of people benefit from that."

The process can make the difference between retaining an acceptable level of productive activity at a retail or office property and abandoning the site to disuse, Barksdale said.

Contrasts With Early 1990s. The recent bulge in demand for receivers is not a completely new phenomenon. "This is very reminiscent of what happened during the RTC [Resolution Trust Corporation] days" in the early 1990s, Wilson said. But one of the significant differences between that downturn and the current circumstances is the RTC itself, he said.

"Then, you had the RTC and you had a mechanism to get all these assets out into the market," Wilson said. "The banks were desiring to get them back into the market quickly. Today that's not happening. To the contrary, the banks are holding on to these assets for a longer period of time."

Many in the real estate business believed two years ago that, based on the number of troubled loans on banks' balance sheets, they would see even more foreclosures than are in process now. But the current prevailing attitude, which receivership helps to foster, Wilson said, is to "keep them on the books for a longer period of time and, hopefully, with the rising economic tide their losses will be diminished."

That has been reinforced by the Federal Deposit Insurance Corporation and other regulators, Wilson said, which have issued guidance that encourages institutions to continue holding the distressed assets.

"When the FDIC brokers healthy banks buying bad banks, they have these loss share agreements, and in those agreements they really are incenting the new buyer to not just dump these assets but to hold on to them for a couple of years, so hopefully they'll have greater value," Wilson said. "It's an interesting time."

By Richard Cowden