Client Alert

How Financial Institutions Can Effectively Manage and Dispose of REO Assets

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Part I ─ April 2011

Introduction

The Great Recession is producing unprecedented levels of foreclosures[1]—deeds-in-lieu of foreclosure, bankruptcies, receiverships and other transactions in which financial institutions acquire control of real estate assets that must then be managed and sold.[2] Interrelated, of course, is the fact that real estate values have fallen—and continue to fall—to varying degrees for most property types and in most markets and sub-markets.[3] This two-part article will examine the background of the financial crisis and the impact of the financial crisis on financial institutions' management of real estate owned (REO) assets and will discuss a triage process institutions might use from the time they take control of those assets until they are sold.[4] Part One will discuss the first two milestones of this process—examining all aspects of the real estate assets acquired by the financial institution and formulating a management and disposition strategy. Part Two, to be published in the May issue of the *Banking & Finance Law Report*, will cover the last two milestones of this process—managing and disposing of the REO assets—and will also contemplate what the future may hold for commercial real estate.

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[1] Thomas F. Cooley and Peter Rupert, “The Great Housing Recession Continues,” Forbes.com, April 21, 2010, www.forbes.com/2010/04/20/housing-foreclosure-unemployment-opinions-columnists-thomas-cooley-peter-rupert.html. ("The behavior of the housing sector over this recession is unlike anything in recent history. In the current recession several factors have aligned to drive the large and rapid increase in foreclosures, and it appears likely that foreclosure rates might stay high for some time.").

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[3] A sub-market is a geographic, economic or specialized subdivision of a market. We will refer mostly to sub-markets in this article, for two reasons. First, the metrics of a market are subsumed within the analysis of the relevant sub-market. Second, a sub-market provides a more specifically defined and precise unit of measurement.

[4] We use the term "REO" (real estate owned) to refer to assets that were once held as collateral for loans made by financial institutions and were subsequently acquired by the same or different financial institutions by foreclosure, deed-in-lieu of foreclosure, bankruptcy, receivership or otherwise. The terms "REO" and "OREO" ("other real estate owned") are often used interchangeably.

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Déjà Vu All Over Again—But Worse

There is no shortage of books and articles describing the causes of the "Great Recession." [5] This article does not purport to revisit those topics. Instead, it examines and suggests strategies to deal with the REO assets that financial institutions now, or will, control.

But even a forward-looking view should be informed by the past. What has occurred—and will continue to occur—is not unlike what happened between 1987-1994,[6] when the last major real estate recession caused a fundamental restructuring of the values and ownership of commercial real estate and marked the beginning of the shift—from Main Street to Wall Street—in the manner in which real estate is financed. During that time period, the confluence of a number of factors, a "perfect storm" if you will, occurred—the Tax Reform Act of 1986 (which outlawed deep tax shelters for syndicated real estate transactions) became effective, the economy took a downturn, the savings and loan industry collapsed, many commercial banks faced severe financial difficulties and, as a result, suffered a lack of liquidity—and caused a major real estate crisis.

The manner in which that crisis was managed and ultimately resolved, and the lessons learned, helps us understand how to approach the current situation in a prudent and informed manner.

Understanding What You Have Acquired

The first step a financial institution should take after it acquires control of an REO asset is to understand all aspects of the asset itself and the issues that will affect its management and sale. Most REO assets have at least one thing in common—one or more property-specific issues.

REO assets, in fact, tend to have multiple issues that can be market driven, property level, financial or otherwise. The issues must be identified, understood and resolved, because any issue will adversely impact the pricing and timing of the sale of an REO asset. There frequently is no rational correlation between an issue with an REO asset and the negative impact it will have on market value. While the reduction in market value is often due more to perception than reality, the market will discount an REO asset for virtually any issue.

A financial institution's knowledge of an REO asset at the time it takes control will vary. Some financial institutions will have performed significant diligence, thereby possessing a detailed understanding of the REO assets they acquire. Often, this knowledge comes from the manner in which financial institutions underwrote and administered the loans secured by those assets. On the other hand, a financial institution may have acquired a loan, or portfolio of loans, as a result of its acquisition of another financial institution. While the acquiring institution would have performed some level of diligence, it is typically less extensive than would have been conducted had it originated the loan.

A seller of REO assets that understands all of the market- and property-specific issues and has a cogent strategy for selling them will typically achieve higher sales prices and sell the assets more quickly, while also minimizing post-sale liability. A well-informed financial institution will understand all the characteristics of an asset—the good, the bad and the ugly.

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[5] The "Great Recession," triggered by a liquidity shortfall in the United States banking system, began in 2007. Its impact continues to affect commercial real estate in 2011. See, e.g., Mortimer Zuckerman, “The Great Recession Continues,” *Wall Street Journal*, January 21, 2010; Doyle McManus, “Great Recession's Psychological Fallout,” *Los Angeles Times*, July 15, 2010, articles.latimes.com/2010/jul/15/opinion/la-oe-mcmanus-economy-pessimism-20100715.

[6] On Black Monday of October 1987, a stock collapse of unprecedented size caused the Dow Jones Industrial Average (DJIA) to fall by 22.6 percent, affected by the savings and loans collapse and ultimately leading to a slump in the United States real estate market.

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The Asset Itself

Location, Location, Location

Location has always been, and remains, one of the most important elements in determining the value of real estate. Real estate analysts and the news media often refer to the "real estate market," the "commercial real estate market," the "residential real estate market" and so on, but those categories are broad and imprecise. The real measure of value of the location is the condition of the sub-market in which the asset is located.

It is impossible to have too much information about an REO asset and the sub-market in which it is located. Both the relevant sub-market and property-level characteristics should be analyzed at the same time.

A Note About Appraisals

A financial institution will almost always have an appraisal in its files indicating a value for an REO asset. The appraisal may have been prepared at the time the loan was underwritten. Or, it may have been obtained during the administration of the loan pursuant to a financial institution’s internal policy or at the suggestion or direction of an institution’s regulators. Some institutions prefer not to incur the cost of obtaining new or updated appraisals and instead rely upon in-house valuation analyses or broker price opinions (BPOs).

Appraisals and other valuation analyses provide helpful statistical data. In these times of volatile market conditions, however, it must be remembered that all valuation analyses, no matter who prepares them, provide merely one opinion of the value of an asset at a specific point in time. While all valuation analyses are helpful, their limitations must be understood and the information they provide must be supplemented with current data, forward-looking projections and historical perspective to attempt to ascertain current and projected future value.

The Relevant Sub-Market

As previously discussed, it is essential to understand and analyze the applicable sub-market in which the REO asset is located. Sub-markets vary widely throughout the United States and few are identical. Moreover, sub-markets are dynamic; what was true six months ago likely has changed. Accordingly, there is no substitute for careful, detailed and continual analysis of each sub-market in which a financial institution owns an REO asset.

Current Status of Sub-Market

It is difficult in today's volatile economy to analyze existing economic and financial conditions in, and predict the future economic health of, a given sub-market. The factors to be considered obviously depend upon the specific characteristics of the asset itself. For example, a sub-market for office space depends upon a number of factors, such as: job growth or loss, competing space, construction of new space, the ability and willingness of owners to expend capital for tenant improvements, the difference between the "bid" and "ask" rental rates, and other financial indicators. The factors applicable to other property types are similarly varied.

It is in this context that the information provided by appraisals, BPOs and internal valuations is most valuable. Statistics demonstrating existing space, supply and demand, space absorption, the fluctuations in rents, and other financial terms are generally available. Those statistics, when carefully and realistically analyzed, provide the basis for estimating NOI[7] and EBITDA,[8] cap rates[9] and, accordingly, the current "as-is" value of an REO asset.

Future Outlook

As daunting as it may be to undertake the task of estimating the current "as-is" value of an REO asset, estimating an REO's future valuation trend is even more speculative. Following are factors to consider:

New Construction

A favorable factor in the supply and demand analysis is the general lack of new construction that has occurred in most sub-markets over the past 23 years. Following are some interesting statistics:

New Privately Owned Housing Units Started in the US by Purpose and Design

[Thousands of units]

One-Family Units (built for sale)

	Northeast	Midwest	South	West
2007	60	105	394	183
2008	34	57	217	92
2009	24	40	156	70

Units in buildings with 2 units or more (built for sale)

	Northeast	Midwest	South	West
2007	35	18	31	31
2008	29	8	14	13
2009	6	2	4	5

Source: U.S. Census Bureau (Manufacturing, Mining and Construction Statistics), Quarterly Starts and Completions by Purpose and Design - US and Regions (2009)[10]

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7 Net Operating Income (NOI) is a company's operating income after operating expenses are deducted, but before income taxes and interest are deducted.

8 Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA) is essentially net income with interest, taxes, depreciation and amortization added back to it, and can be used to analyze and compare profitability between companies and industries because it eliminates the effects of financing and accounting decisions.

9 Capitalization rates (cap rates) measure the rate of return on a real estate investment property based on the expected income that the property will generate. This is done by dividing the income the property will generate (after fixed and variable costs) by the total value of the property.

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It is easy to understand the reason for the lack of new construction. Many sub-markets were overbuilt some time ago. As a result, new construction starts have decreased because developers able to raise the required equity are unwilling to take the risk of starting new projects in these uncertain times, and lenders lack the appetite to make new construction loans. It will take some time for the oversupply of space in most sub-markets to be consumed, but the lack of new construction should ultimately return equilibrium to the supply and demand equation.

Nevertheless, new construction will inevitably commence again. To analyze the impact of potential new construction on an REO asset, the metrics of the relevant sub-market again must be analyzed. Essential data to be analyzed include new building permits, and zoning and other land use proceedings because they are the leading edge of new development or re-development initiatives. While it is difficult to forecast with certainty the impact of potential new construction on an REO asset in a specific sub-market, it is an essential consideration.

Market Movements—Upward and Downward

For a long time tenants sought better and better space. However, the opposite trend has occurred over the past few years with the economic downturn, the reversal of the fortunes of many companies and the flight to reduce operating expenses. Consider, for example, an REO asset that is a Class A office building. Assume that building has significant vacancy and that the owner of a Class B building located in the same sub-market elects to upgrade that building to make it more competitive with the Class A building. At the same time, the owner of the Class B building, which has less debt than the Class A building, elects to offer rents that are substantially lower than those being offered by the owner of the Class A building. Tenants in this highly competitive and cost-conscious time may very well elect to accept less expensive (albeit less desirable) space in the Class B building rather than pay the additional rent charged for a Class A building. As a result, the value of the Class A building will decline solely as a result of these market forces at work over the term of the leases in that building.

Prospective Demand

Prospective demand for income-producing assets varies greatly, depending upon the property type and sub-market. While accurate demand projections are difficult to make, they are an essential element in attempting to determine the value of an REO asset.

For example, demand for apartment units, and therefore the value of the apartment complexes in which those units are located, will vary in the future depending upon whether renters elect to buy or rent their residences. People who currently own their residences but cannot afford the debt service and other ownership expenses may elect to sell them (or allow their lenders to take them back), thereby increasing the demand for apartment units and increasing the supply of residences for sale.

Similarly, there are a number of factors that will affect the demand for residences for sale. For example, the recent expiration of the federal income tax credit for first-time homebuyers will reduce the demand for homes. Following are statistics that indicate the effect of the tax credit on home sales. The current sales rate for existing homes seemed to bounce back slightly from the low hit in July, but it remains well below the tax-credit-driven pace earlier in the year.[11]

[10] U.S. Census Bureau (Manufacturing, Mining and Construction Statistics), Quarterly Starts and Completions by Purpose and Design - US and Regions, p. 2-5 (2009), www.census.gov/const/www/quarterly_starts_completions.pdf.

[11] Center For Economic and Policy Research®, Existing Home Sales, December 2004 - August 2010 (September 28, 2010), www.cepr.net/index.php/graphic-economics/graphic-economics/existing-home-sales-dec-2004-aug-2010.

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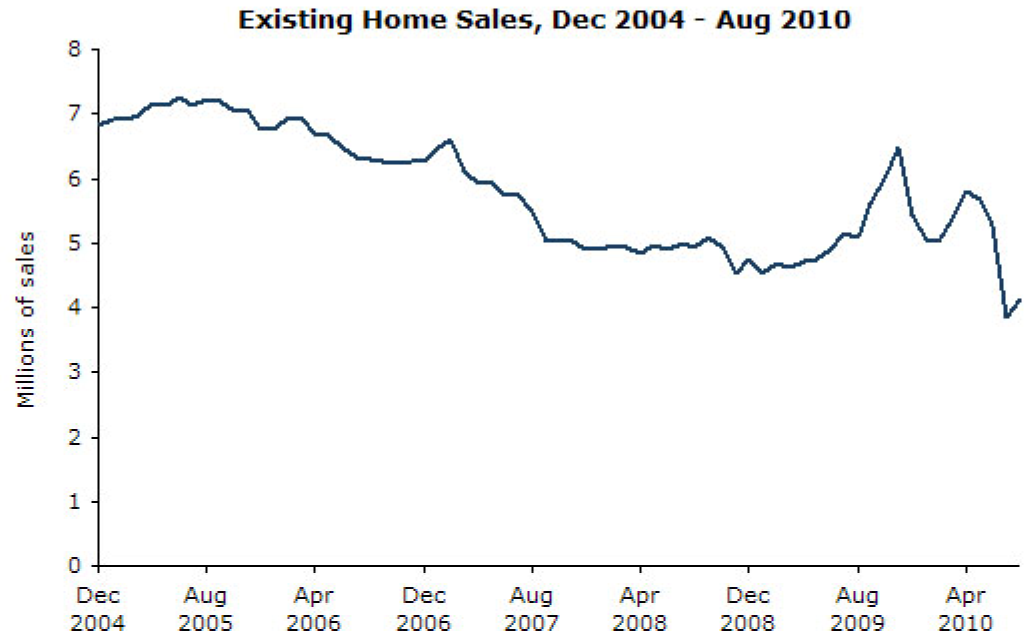

Source: National Association of Realtors®, seasonally adjusted existing home sales

(single-family, townhomes, condominiums and co-ops)

Interest rates are another major factor affecting home sales. Interest rates have remained at near-record low levels for a sustained period of time. Those rates will inevitably rise and when they do, demand to purchase residences will decline. Moreover, any significant increase in interest rates will likely cause a further increase in foreclosures. Many homeowners have financed their home purchases with adjustable interest rate mortgages. Homeowners who currently are struggling to make their monthly mortgage payments and pay other expenses of home ownership will no longer be able to do so when their mortgage payments increase.

Similar challenges face financial institutions attempting to project future demand for retail space located in shopping centers, shopping malls and other retail facilities they own or control. Consumer confidence is currently low due to, among other factors, the sluggish economic recovery and persistent unemployment and underemployment. The result is modest retail sales. An unrelated but essential consideration is the future growth of Internet shopping. Following are statistics that demonstrate the increase in retail sales over the Internet during the past 10 years:

FY End	**Retail Sales ($[M])**			**% Change Year-Over-Year**	
31-Dec	**Total**	**E-commerce**	**% of Total**	**Total**	**E-Commerce**
2001	$3,067,725.00	$34,451.00	1.1%		
2002	3,134,322.00	44,925.00	1.4	2.2	30.4
2003	3,265,477.00	56,719.00	1.7	4.2	26.3

2004	3,474,340.00	71,087.00	2.0	6.4	25.3
2005	3,687,364.00	87,846.00	2.4	6.1	23.6
2006	3,869,536.00	107,014.00	2.8	4.9	21.8
2007	3,994,823.00	126,697.00	3.2	3.2	18.4
2008	3,959,957.00	132,257.00	3.3	-0.9	4.4
2009	3,683,087.00	134,957.00	3.7	-7.0	2.0
2013	4,035,615.00	172,966.00	4.3		

Source: U.S. Census Bureau Quarterly Retail E-Commerce Sales and Tully & Holland estimates[12]

If that growth continues, the demand for retail space will decline. That will, in turn, affect the value of REO assets in the retail sector.[13]

The Numbers

Let us now look at the numbers. Listed below are key factors to consider in ascertaining the value of REO assets. Because all valuation analyses require a number of assumptions, the use of net present value (NPV) models is essential because that is the only way to ensure that the analyses provide valid bases for comparison.

Fair Value

Fair, or "as-is," value can be defined as an estimate or opinion of property in its current state, under current market conditions. There are three classic approaches to ascertaining the value of income-producing real estate: (a) the replacement cost approach (i.e., the method of appraising real estate based on adding the reproduction cost of improvements, less depreciation, to the market value of the site); (b) the income approach (i.e., the method of appraising real estate based on the property's anticipated future income);[14] and (c) the comparable sales approach (i.e., where the value of real estate is estimated by analyzing sales prices of similar properties [comparables] sold recently).

Stabilized Value

The stabilized value of a real estate asset is the value of a property after it reaches a normal occupancy rate and operating expenses. Estimating the stabilized value of an asset requires making a number of assumptions, such as the time to rent vacant space, the cost to fit out that space, the terms of new leases and the likelihood that existing tenants will move out or become insolvent.

The stabilized value of a real estate asset is derived by estimating the time period within which, and cost at which, it would take to achieve a range of occupancy percentages under realistic financial terms.

[12] Tully & Holland, Inc., Internet Retail Industry Update, March 2010, www.tullyandholland.com/tl_files/documents/Internet%20Retail%20Industry%20-Update%205.10.2010.pdf.

[13] John S. Baen, “The Effects of Technology on Retail Sales, Commercial Property Values and Percentage Rents,” *Journal of Real Estate Portfolio Management*, April 1, 2000.

[14] Also known as the "capitalization approach," the result is derived from the following equation: Market value = expected annual income / capitalization rate.

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Inherent in that calculation is an estimate of the amount of time it will take to lease the vacant space and for the tenant to begin paying rent and other charges. The cost component of the equation relates to an estimate of the cost to the landlord of the tenant improvements, brokerage commissions, professional fees and other transaction expenses. All calculations should then be reduced to NPV.

Formulate Preliminary Management and Disposition Strategy—Triaging the Asset

After the analysis of the REO asset and its sub-market is complete, a financial institution should formulate a preliminary management and disposition strategy. There are many possible alternatives. Most fall into one of the following three categories: (i) sell the asset immediately on an "as-is" basis, (ii) retain and manage the asset until the market improves while making minimal capital expenditures or (iii) take the steps necessary to achieve a stabilized value.

Alternative 1: Sell REO Asset Immediately on an "As-Is" Basis

Selling an REO asset on an "as-is" basis is a straightforward strategy that is easy to implement provided there are no issues with the asset that will impede a sale. Obviously, the proceeds that an immediate, "as-is" sale will bring may be disappointing due to depressed market conditions and issues with the assets. Most financial institutions will not want to sell an REO asset in this manner until they have completed the market analysis described above to ensure that more profitable (or less unprofitable) strategies do not exist. Of course, institutions could have other reasons for needing to sell REO assets immediately. An institution, for example, may need to monetize its real estate assets to raise capital or may have a disproportionate amount of real estate assets on its balance sheet and desire, or be required, to dispose of a significant portion of them.

Alternative 2: Retain and Manage REO Asset Until Market Improves While Making Minimal Capital Investment

A second alternative is to retain and manage the real estate asset until the market improves. As with Alternative 1, this is a straightforward process that is relatively easy to implement. The key, of course, is to monitor the relevant sub-market in order to be able to select the optimal time to offer the asset for sale. A private equity fund or other privately held and unregulated entity would often be willing to implement this alternative because it is less likely to feel the need to effect a prompt sale of an REO asset.

Alternative 3: Achieve Stabilized Value

The third alternative is to retain control of the REO asset for as long as it takes for it to achieve a stabilized value. This alternative entails the expenditure of capital and holding the asset while physical improvements are carried out and efforts are made to lease vacant space and resolve property-level issues to achieve a stabilized value.

Federal Regulation of REO Property

Another factor in determining how and when a financial institution disposes of an REO property comes from the government. Federal law regulates the length of the holding period and disposition of REO property by national banks.

Holding Period

Pursuant to 12 C.F.R. § 34.82, a national bank is required to dispose of REO assets "at the earliest time that prudent judgment dictates but not later than the end of the holding period (or an extension thereof) permitted by 12 U.S.C. 29."[15] The current permitted holding period is five years. Pursuant to the Office of Thrift Supervision, the holding period does not apply to equity investments; however, real property is excluded from the definition of "equity investment" under 12 CFR § 567.1(i)(4) if the real property was

[15] 12 C.F.R. § 34.82(a).

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obtained in satisfaction of a debt or acquired under a judgment or mortgage.[16] The holding period starts on the date that "(i) ownership of the property is originally transferred to a national bank, (ii) a bank completes relocation from former banking premises to new banking premises or ceases to use the former banking premises without relocating, or (iii) a bank decides not to use real estate acquired for future bank expansion."[17]

Disposition

A national bank is in compliance with federal regulations with respect to REO property in general, "(i) by entering into a transaction that is a sale under generally accepted accounting principles (GAAP); (ii) by entering into a transaction that involves a loan guaranteed or insured by the United States government or by an agency of the United States government or a loan eligible for purchase by a Federally-sponsored instrumentality that purchases loans; or (iii) by selling the property pursuant to a land contract or a contract for deed."[18] With respect to REO acquired through the full or partial satisfaction of a debt previously contracted, a national bank is in compliance "by retaining the property for its own use as bank premises or by transferring it to a subsidiary or affiliate for use in the business of the subsidiary or affiliate."[19]

With so many national banks currently holding on to REO property due to the rash of foreclosures and similar transfers across the country, it is important for those financial institutions to stay abreast of any federal rules and regulations that dictate the acquisition or disposition of real property.

Conclusion

This concludes Part One, which analyzes the many aspects of real estate assets acquired by financial institutions and how those institutions can triage the situation and begin formulating a management and disposition strategy. Look for Part Two in next month's issue, which will discuss next steps for the financial institutions—deciding how to manage and dispose of REO assets.

The co-authors practice law with Hunton & Williams LLP, an international law firm. Mr. Walsh is a partner and head of the commercial real estate practice, and Mr. Labitue and Mr. Tuthill are associates in the practice. Mr. Walsh is based in Richmond, Virginia; Mr. Labitue is based in Atlanta; and Mr. Tuthill is based in Dallas. This article does not provide legal advice. Readers who wish legal advice should consult their lawyers.

[16] Office of Thrift Supervision, *Examination Handbook*, Asset Quality Section 251, April 1999, p. 4.

[17] 12 C.F.R. § 34.82(b)(1)-(3).

[18] 12 C.F.R. § 34.83(a)(1).

[19] 12 C.F.R. § 34.83(a)(2).

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Part II ─ May 2011

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Managing the Asset

A key aspect of the financial institution's strategic plan is determining how its REO assets will be managed for the time period beginning when the financial institution takes possession of such assets until they are sold.

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[1] "The behavior of the housing sector over this recession is unlike anything in recent history. In the current recession several factors have aligned to drive the large and rapid increase in foreclosures, and it appears likely that foreclosure rates might stay high for some time." Thomas F. Cooley and Peter Rupert, "The Great Housing Recession Continues," Forbes.com, April 21, 2010, available at www.forbes.com/2010/04/20/housing-foreclosure-unemployment-opinions-columnists-thomas-cooley-peter-rupert.html.

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Considerations for Different Management Agreements

A fundamental decision that must be made as soon as possible, and certainly no later than when the financial institution obtains control of an REO asset, is the manner in which the REO asset will be managed. There are a variety of alternatives but the most typical are (i) outsourcing management responsibilities for *all* REO assets to a qualified property management firm while the financial institution maintains only general supervisory oversight, (ii) having some of the assets managed under individual management agreements with qualified property management companies while retaining management authority over the remaining assets or (iii) managing the assets internally with personnel employed by the financial institution.

There are many factors to consider in determining the structure that best fits the needs of the financial institution. Some of these factors include the effectiveness of the management function, the economic terms that can be obtained (including any cost savings), whether an asset will simply be managed in its current state or improved, and the anticipated time period during which the asset will remain under management. Financial institutions must also carefully assess which management company will best prepare the asset for sale. As with all aspects of dealing with REO assets, flexibility is essential. REO assets, by their very nature, have values that fluctuate significantly, and the conditions in most sub-markets are volatile and will remain that way for some time. The financial institution must retain the greatest possible flexibility to ensure that it is able to move rapidly when market conditions dictate. An institution should, for example, have the right to terminate a management agreement with little advance notice and no penalty. A financial institution also will usually want the management arrangement to be separate from the listing arrangement.

Oversight by Institution's Personnel

The financial institution must also consider the resources—both human and financial—it is prepared to devote to managing an REO asset portfolio. Large financial institutions typically have sufficient resources to oversee and direct the management function, whether performed internally or outsourced. Smaller financial institutions, however, may need to rely almost entirely on independent property management companies. Notwithstanding these constraints, it is essential that a financial institution maintain close oversight of the property management function. Otherwise, values will decline and the time periods for disposing of assets will be extended—perhaps beyond the optimum time for bringing them to market.

Management Strategies

The management plan selected by a financial institution will depend largely upon the strategic plan for that asset. For example, an asset that the financial institution elects to hold long term may be one for which the management company is provided with incentives based upon the profitability of the asset. If an institution plans to sell an asset quickly, however, it may want to provide the management company with incentives based upon how soon it is made ready for sale and the sale price that is achieved. Such sale price-based incentives may reflect the sale price received by the institution or be tied to the work that the property management company performed.

The RFP Process

The request for proposal (RFP) process often is a valuable tool in selecting a property management company because it provides a direct comparison of the fees and other amounts management companies propose to charge. It also gives the financial institution an opportunity to compare the experience, depth of personnel and other resources, particular areas of expertise, and personalities of the personnel who would be charged with managing the asset.

Key Provisions of Management Agreements

The form of the management agreement may be simple or complex depending upon the nature of the property, the relationship between the financial institution and the management company, the anticipated

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term of the agreement, the financial terms and the extent to which the financial institution wants to improve the asset and achieve a stabilized value.

Issues with Managing Real Estate Assets Under Receivership

A financial institution often seeks to have a receiver appointed to manage assets owned or controlled by that institution's borrowers. The reasons for seeking a receiver vary. A financial institution may find that a receiver is beneficial where (i) the borrower has actually or effectively abandoned the asset, (ii) the borrower is perceived to be negligent (sometimes grossly so) in discharging its management responsibilities or (iii) the borrower lacks the financial wherewithal to continue to pay the debt service and operating expenses or to entice new tenants to lease vacant space during a protracted foreclosure process.

In most states, the decision of whether to appoint a receiver is within the sole discretion of a court—typically the state court having jurisdiction over the property. Loan documents usually give financial institutions the right to seek the appointment of a receiver. Sometimes loan documents even purport to give the lender the absolute right to have a receiver appointed. But those provisions can be misleading. The loan documents are obviously not binding on a court, and a court is free to appoint (or decline to appoint) a receiver as it sees fit.

The appointment of a receiver can have both positive and negative implications for an asset. The positive implications include improving the management of the asset through oversight from a responsible third party. Another positive implication is that the receivership typically maintains the status quo of an asset. Negative considerations, however, may include (i) additional fees that are incurred for the receiver and any persons or firms that the court or receiver employs, (ii) knowledge within the local market that the asset is unlikely to be improved in the near term because a foreclosure or other ownership transition appears certain and (iii) sharing the decisions of the operation and possible sale of an asset.

Another complicating factor of receivership is that, by the time the receiver is appointed, the lending institution will have exercised its right to collect rents due under the leases. Moreover, the financial institution may have begun applying rents to pay debt service and even to reduce the principal balance of the debt because rents are typically the only (or the only significant) source of revenue for the property. Accordingly, the financial institution will be faced with a Hobson's choice—it may either surrender all or a portion of the rents to the receiver to pay operating expenses and maintenance costs or continue to apply all rents to pay debt service and leave the receiver no alternative but (i) to seek financing to pay the operating expenses or (ii) to seek an order from the court supervising the receivership requiring the financial institution to remit a portion of the rent to the receiver to pay for the asset's continued operation.

Receivers are required to report periodically to the court that appointed them. Copies of those reports are provided to the holder of the mortgage loan, other creditors and all other parties in interest. The frequency of the reports is specified in the court order establishing the receivership. Most court orders require monthly reports. The frequency of reports may increase where various activities (e.g., repair work, intensive lease-up activities and efforts to sell the property) merit additional reporting. Conversely, when the activity level is limited, less frequent reports may be required.

Receivers are often granted the right to sell the asset under their control with the approval of the court even if the borrower/owner does not approve of the sale. Obviously, the proceeds of such a forced sale may be insufficient to pay the entire balance of the loan. Depending on state law and the applicable provisions of the loan documents, the financial institution may have a claim for a deficiency judgment based upon the difference between the sale proceeds and the total loan balance.

It would be inaccurate to infer from this discussion that a financial institution loses all control over the management and sale of an REO asset when a receivership proceeding is initiated. The financial institution having the mortgage on the REO asset typically will be the largest creditor and its views will be given great deference by the receiver and the court that is supervising the receivership. In most states, however, the receiver is intended to be an independent party and not the alter ego of the mortgagee.

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Accordingly, it cannot be assumed that the receiver will always act in precisely the manner desired by the financial institution.

A note of caution should be sounded about receiverships. Generally speaking, a receivership should remain in existence for the briefest period of time feasible under the circumstances. A receivership is usually a stopgap measure to deal with one or more issues that are adversely impacting, or reasonably likely to impact, the REO asset. The receiver typically has no equity interest in the asset and receivers possess varying levels of experience and expertise in managing commercial real estate. Moreover, irrespective of the skill and competency of the receiver or the management company employed by the receiver, the borrower will argue that the condition of the asset deteriorated during the receivership due to the action or inaction of the receiver and persons or entities the receiver engaged. Furthermore, claims that the receivership effectively imposed mortgagee-in-possession status on the financial institution can also be expected. For all of these reasons, a financial institution (in most cases) should seek to expedite the foreclosure of the mortgage loan or the sale of the asset during the pendency of the receivership.

Management Oversight of an Asset

No matter which management strategy is selected, it is essential for the financial institution to maintain close supervision over all management activities through written reviews and reports, conference calls and, where necessary, meetings. These communications are designed to analyze all aspects of the performance of the management company. The reviews and reports should include (i) comparisons of budgets against the actual expenses, (ii) reports on maintenance issues, (iii) leasing updates, (iv) analyses of competing projects and new construction, (v) analyses of changes in the sales prices of similar projects and (vi) any other information relevant to the status of the asset or the price it would likely bring in a third-party sale.

As noted above, timing the sale of an REO asset so it occurs at the most opportune time is extraordinarily difficult, particularly when market conditions are as volatile as they have been and are expected to continue to be. Clear, direct and frequent communication is essential to both maximizing the management function and attempting to time the sale to produce the maximum proceeds as quickly as feasible under the circumstances.

Selling the Asset

The final and most important step in the process is to finalize the strategy for selling the REO asset and completing the sale.

Revisit Preliminary Strategy and the Numbers

The financial institution must initially develop a preliminary strategy and decide upon one of the following courses: (i) immediate "as-is" sale, (ii) holding the asset until the market improves without investing significant additional capital or (iii) investing the resources necessary to stabilize the asset to facilitate its sale. After the initial decision, the financial institution will obtain significant additional information regarding the REO asset and the sub-market in which it is located, the cost to stabilize the asset, and the economic and financial outlook—both generally and for the particular REO asset. Based upon all of those considerations, as well as the potential need of the financial institution to monetize its illiquid assets, the financial institution is in a position to finalize its strategy for selling the REO asset.

The Sale Process

REO assets will generally be sold in one of two ways: (i) sales of a single asset or a small number of assets or (ii) sales of portfolios of assets. Once the decision is made to sell one or more REO assets, the financial institutions will need to:

- Select a broker and sign a listing agreement;

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- Collaborate with the broker to devise the marketing strategy;
- Place the REO asset on the market; and
- Execute the sales strategy.

Selecting the Right Broker

The key is to find the broker who has the most experience selling the same category of real estate as the REO asset being sold. Significant research should be conducted to ensure that the most qualified brokers are identified. Other financial institutions, trade associations and professional advisers that have recently sold similar types of assets are good sources of broker recommendations.

There is no single characteristic to look for in a broker, nor are there hard-and-fast rules as to where the broker should be located geographically. Sometimes, the most qualified broker will be located in the same geographical area as the REO asset. Other times, the broker who will perform in the most exemplary manner will be one that has particular expertise with specific categories of real estate or particular knowledge of the relevant sub-market. In that case, the broker may be located in an entirely different geographical area of the country than the financial institution or the REO asset.

The RFP Process

Once the universe of brokers is determined, the RFP process is an excellent means of soliciting competitive proposals. The RFP process enables the financial institution to compare terms being offered by the competing brokers, the qualifications of the personnel who would work on the engagement and other relevant factors. The mere fact that brokers realize that the selection process will be a competitive one will typically produce terms more beneficial to the financial institution than will a brokerage arrangement reached through a negotiation.

The RFP process is relatively simple and can be completed promptly. Two key considerations are (i) whether to include *all* brokers that are qualified to perform the work without including so many brokers that the process becomes cumbersome and (ii) whether to include all of the terms that are relevant to the brokerage engagement. Once the RFP process enters the negotiation phase, it would be counterproductive, and not in the best interest of the financial institution, to add new material terms.

Establishing and Executing the Sale Strategy

In almost all instances, a financial institution will want to sell its REO assets quickly while also attempting to maximize the price received. The sales strategy should be agreed upon in collaboration with the broker. There are many variations of strategies that could be used. Where the institution elects to sell the REO asset as quickly as possible and on an "as-is" basis, the customary *quid pro quo* is that the purchaser will receive a favorable price but, in return, must perform its diligence investigation and complete closing on an accelerated schedule.

In contrast, the financial institution may have elected to make the requisite improvements and achieve the necessary level of lease-up to reach a stabilized value. In those cases, the terms of the sale will be similar to an arms-length purchase and sale between a sophisticated seller and a sophisticated purchaser.

Regardless of the sales strategy, a financial institution should observe the following best practices when carrying out a sale:

- Prospective purchasers should sign confidentiality agreements;
- Upon receipt of signed confidentiality agreements, diligence materials should be made available to prospective purchasers before they sign the purchase agreement;

- All documents should be on forms prepared by the financial institution;
- The forms should be clear, concise and as brief as possible;
- The financial institution's personnel should be thoroughly trained to understand the content of the forms and how they will be used;
- The purchaser should be given a limited diligence period;
- Closing should be completed shortly after the diligence period expires;
- Time should always be of the essence for all parties; and
- A title company/escrow agent should be preselected.

Bulk Sales of Assets

A financial institution owning an extensive number of REO assets may elect to sell the assets in bulk. The same principles and issues described above are equally applicable to bulk sales. However, by their very nature bulk sales will require more advance planning than one-off or small-portfolio sales.

Areas of particular challenge include:

- Compiling extraordinary amounts of data;
- Developing a process that is efficient, transparent and user friendly; and
- Devoting sufficient resources to the process to ensure that it runs smoothly.

There are numerous websites that will conduct bulk sales (and, for that matter, one-off and small-portfolio sales) in an efficient and professional manner. Some also have the ability to conduct real-time auctions, although the financial institution must perform its own analysis to ascertain if such a process will result in the highest possible price.

Conclusion

It is difficult to accurately predict the long-term impact on the commercial real estate market of the large (and growing) inventory of REO property and mortgage loans that will be converted through foreclosures or other means. It is also hard to imagine, given the amount of property that is and will be put on the market and ultimately sold, that the glut will not result in a continuing negative impact on real estate values. On the other hand, however, similar depressing predictions were made during the last significant downturn between 1987-1994, which over time proved to be unduly negative. We can only hope for the same result in this current market. As we have mentioned above, the only way to ensure that a financial institution is managing its inventory of REO assets with a current understanding of real estate values is to follow a consistent and calculated management and disposition strategy. When engaging in the acquisition and triage of those REO assets and ultimately when it is time to sell the REO assets, a financial institution must constantly revisit those real estate values associated with the REO assets and update them as appropriate.

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