TROUBLED ASSETS: HOW TO PUT HUMPTY DUMPTY BACK TOGETHER AGAIN

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This panel will discuss the various ways in which the Developer, Lender, MSHDA and Investors may be able to achieve a reasonable and beneficial resolution of a troubled affordable housing property that maintains the affordability of a project experiencing economic difficulties and actual or potential loan defaults, defaults under operating and partnership agreements and minimizes losses to some or all parties. The presentation will address and discuss the following aspects of this situation:

Debt Considerations

1. An initial overview of the current economic factors which have produced the negative economic operating results for the project and whether or not loan or other defaults have actually occurred. In making this analysis, the following factors need to be analyzed:

- A realistic analysis of historic, current, and projected income and expense results as compared to those contained in the original development proforma.

- Physical characteristics/deficiencies, if any, which may be negatively impacting marketability of the property, requiring the expenditure of funds in excess of available resources.

- Analysis of whether the current circumstances are temporary in nature or are likely to continue for the foreseeable future.

- Management issues as to the project, i.e. – is it time for a change?

- The bottom line here is: if a project has a problem – you as owner must complete a thorough analysis of the situation, so that when you approach your lender or investors, you know and appear to them as though you have done your homework. When you approach your lender or investor, you want to do so with a plan, a reasonable plan!

2. Where a serious economic problem exists, it is critical to assemble a team of independent disinterested professionals to assist all constituents in analyzing the nature, extent, reasons for and strategy to be designed to address the economic circumstances adversely affecting the project. The team often consists of:

- Market Analysts / Appraiser: Thorough analysis of the market, the demographics, the project's competition.

- Accountants: Are the historic, current, and projected operating numbers properly and consistently presented?

- Attorneys: Understand the existing legal documents and related obligations including the mortgage note (recourse vs. nonrecourse, prepayment restrictions), regulatory agreement requirements, partnership or LLC collateral agreements (cash flow and completion guarantees, etc.).

- Mortgage Bankers: Two reasons – (1) What is the nature of the current lender (i.e., likelihood of completing a loan modification, will the lender be cooperative or non-cooperative?) and (2) Are other refinancing sources available and on what terms and conditions?

- Workout Strategists/Consultants experienced with affordable housing: To coordinate above, develop strategy, and implement.

This is particularly compelling because developers and operators are often unrealistic (the developer as the "ultimate optimist") as to the reasonable likelihood of achieving an economic turnaround within a realistic period of time. This team will also assist to determine if there is a feasible restructuring plan and convincing all constituents that it makes sense.

3. "Down and Dirty" analysis of the reasonable likelihood of achieving a favorable turn around result. This type of analysis addresses the likelihood of a favorable result in

performance which affect the project and a determination of whether a restructuring is worth making.

4. Tools which are likely to be available to address the economic circumstances which are adversely affecting the project. Among other things, these consist of:

- A realistic operational analysis to determine the causes of the economic distress to the project and whether the causes are temporary in nature or are likely to be in place for a long period of time. This would include cash flow improvements, expense reduction and the need for capital expenditures as discussed below.

- An evaluation of the physical characteristics or deficiencies of the project and the costs associated with their correction.

- A review of a properly prepared marketing analysis and whether changes in marketing strategies or resources should be employed. Are the existing income/rent restrictions part of the problem?

- A review of the costs and expenses which the project have been incurring in its day-to-day operations to determine the reasonable likelihood of a reduction in such expenses (such as reductions in PILOT payments and/or ad valorem real estate taxes, utility utilization and the like).

- Sources of potential additional capital required, including capital contributions or loans from the General Partner, the Developer, the Limited Partner/Syndicator and/or Governmental Agencies or Community Resources.

- Debt modification, which can take a variety of formats, including loan forbearances and loan modifications. The reasonable likelihood of achieving an adjustment of the terms of mortgage financing is largely dependent upon who holds the debt.

  - With respect to HUD-insured financing, other than for minor possible temporary reductions in the monthly required payment into the reserve for replacements, and/or special withdrawals of funds to pay operating expenses, HUD is limited in its consideration of any such adjustments to its newly refreshed Partial Payment of Claim program.

  - With respect to MSHDA held financing, MSHDA appears to have different approaches to so-called "workout arrangements" depending upon whether or not the project has achieved final completion and the issuance of an 8609; as to those projects which have achieved completion and the issuance of an 8609, a work-out program has fairly predictable policy approaches, while those which have not achieved completion and the issuance of an 8609 are considered on an ad hoc basis.

- With respect to financing held by others, the likelihood of achieving concessions from the Lender will be largely dependent upon the legal and business constraints which affect the Lender. Experience has shown that Fannie Mae and Freddie Mac have little or no interest in or capacity to deal with work-out arrangements. CMBS Lenders and other lenders (banks and insurance companies) may allow such arrangements if a case can be made that such concessions will cause the property to become a performing asset again.

- The income tax implications of any modification or concession must be analyzed and considered.

5. In analyzing what corrective or remedial measures to pursue, all parties are likely to consider what legal duties exist. In this respect consider:

- In typical Section 42 syndicated affordable housing limited partnerships, guarantees of operating deficits and other matters exist. To the extent that the guarantors are financially capable of performing, such guarantees will, no doubt, be called upon.

- It is highly unusual to see recourse debt financing with respect to affordable housing ventures. However, even where the debt is non-recourse in nature, there are certain so-called "carve-outs" from non-recourse liability which may impose upon certain collectible parties duties which may be called upon.

- Furthermore, loan documentation and, where applicable, laws and regulations, often restrict the utilization of project income so that such revenue may not be available to hire consultants, accountants, attorneys and the like without the specific consent of the Lender or the applicable agency, which consents are hard to come by.

6. If a negotiated work-out with a Lender does not materialize and if other alternatives are not effective to address the economic problems of a project, the following are likely to occur:

- Enforcement of Loan Documents.

  - Foreclosure by advertisement and the advantages and disadvantages of a foreclosure by advertisement.

  - Judicial foreclosure and the advantages and disadvantages of the judicial foreclosure process.

- Assignment of rents and perfection as it relates to borrower and tenants.
- UCC sales where this is mixed real and personal property.
- Other miscellaneous enforcement action strategies and concerns.
- As a General Partner or Managing Member, what are the consequences of the above related to my LIHTC investor?

- Note Sales.
  - One possible way to deal with responding to efforts to enforce loan documents is to attempt to work out a note acquisition (even if the note is in default) by either all or some of the principals of the Borrower.
  - With respect to HUD PPC transactions, the Borrower needs to recognize the possibility that the subordinate debt may be sold in the future by HUD to a third party.
- Deeds in Lieu of Foreclosure.
  - Advantages and Disadvantages of a Deed in Lieu of Foreclosure vs. Foreclosure proceedings.

- Structuring of Deed in Lieu of Foreclosures.
- Waiver of redemption rights.
- Use of a deed in lieu of foreclosure as part of a forbearance agreement, bankruptcy plan, loan modification and workout agreements.

- Receivership Proceedings.
    - The reasons for receivership.
    - The rights to a receiver.
    - Receivership orders.
    - Receivership administration.
    - Miscellaneous issues with respect to receiver.
    - For review of receivership legal issues, see, Honorable Mark A. Goldsmith and Gregory J. DeMars, *Receiverships in the Real Estate Setting*, The Michigan Business Law Journal, Vol. XXVIII, September 2008, p. 36.

- Overview of Bankruptcy Process for Single Asset Real Estate
    - What is a Chapter 11 filing?

- Single asset bankruptcy and relief from stay.
- Pre-packaged Plan of Reorganization.
- Cram-down process.
- General discussion of effects of bankruptcy.
- Exceptions to non-recourse guaranties with respect to bankruptcy filings.
- Remedies resulting from bankruptcy filing (personal liability, springing guaranties and liability from actual damages).
- Difference between entity bankruptcy filing and individual guarantor bankruptcy filing.
- See, Judy B. Calton and Sarah H. Seewer, *What You Should Know About Single Asset Real Estate Bankruptcy Cases*, Michigan Real Property Review, Summer 2008, p. 82.

Equity Considerations

- Sponsor, general partner and investor/limited partners should immediately meet to determine the likelihood of a successful restructuring.

- There should be discussion about operating shortfalls and capital expenditure needs. The partners should try to find possible sources of new capital.
- The partners should try to minimize the loss of qualified tenants and tax credits.
- There should be realistic discussions concerning sale of property, refinancing options, possible general partner replacement and management company replacement.
- Enforcement action: Demands on guaranties, general partner removal and other judicial action.

St. James Capital, L.L.C.

XYZ Apartments - Anywhere, Michigan

Project Executive Summary

Prepared By: ____________

Date: *4/27/2010*

History and Projected Operations

A. Project Name / Location: XYZ Apartments
Anywhere, Michigan

B. Project Description: 100 one, two, and three bedroom apartments
2 Story Walk-Up
Completedin 2005

C. Existing Indebtedness

-Rate:	7.50%		
-Amortization	30	8.39%	Constant
-Original DCR	1.2		
-Original Loan	$4,710,000	$32,930	Monthly Payment
-Current Balance	$4,481,000		

D. Unit / Rent Summary:

Unit Type	#	AMI	Orig. Restricted / & UW Rent (1)	Orig. Annual Rent Potential	Current Actual Rent (2)	Current Annual Rent Potential	Annual % Potential Chg.
1 BR/1 BA	6	30	370	26,640	370	26,640	0.00%
1 BR/1 BA	12	50	615	88,560	615	88,560	0.00%
1 BR/1 BA	12	60	748	107,712	685	98,640	-8.42%
2 BR/1 BA	10	30	440	52,800	440	52,800	0.00%
2 BR/1 BA	20	50	740	177,600	730	175,200	-1.35%
2 BR/1 BA	20	60	900	216,000	800	192,000	-11.11%
3 BR/2 BA	4	30	590	28,320	590	28,320	0.00%
3 BR/2 BA	8	50	860	82,560	845	81,120	-1.74%
3 BR/2 BA	8	60	1,045	100,320	900	86,400	-13.88%
	100			880,512		829,680	-5.77%

Notes:

(1) - Original restricted rents were all below the then current market rents as determined by the appraisal.
(2) - Current Actual Rents are below maximum restricted rents.

Note: This is an Example Only

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E. Operations History and Projection:

	Original Development Proforma Annual (Prepared in 2004)	Original Development Proforma Per Unit	Current Development Proforma Annual (Prepared in 2010)	Current Development Proforma Per Unit
Revenue				
-Gross Potential Rent	880,512	8,805	829,680	8,297
-Vacancy Factor (Physical, Financial, Bad Debt)	(52,831)	-6%	(124,452)	-15%
-Net Rent Revenue	827,681	8,277	705,228	7,052
-Ancillary Income	18,000	180	18,400	184
-Net Revenue	**$845,681**	**$8,457**	**$723,628**	**$7,236**
Expenses				
-Administrative Expense	28,500	285	39,000	390
-Property Management	42,284	423	36,181	362
-Operations & Maintenance Expense	75,000	750	94,000	940
-Gas Expense	11,600	116	21,500	215
-Electricity Expense	7,250	73	8,750	88
-Water & Sewer Expense	54,000	540	76,000	760
-Payroll Expense	65,000	650	74,500	745
-Real Estate Taxes (4% PILOT)	30,193	302	23,959	240
-Property Insurance	32,500	325	30,000	300
-Replacement Reserve	25,000	250	25,000	250
-Total Operating Expenses	**$371,327**	**$3,713**	**$428,891**	**$4,289**
-Net Operating Income	**$474,354**	**$4,744**	**$294,737**	**$2,947**
-Scheduled Annual Debt Service	**$395,160**		**$395,160**	
-Projected Cash Flow	**$79,194**		**($100,423)**	
-Estimated Value				
-7.75% Capitalization Rate	**$4,791,320**			
-9.0% Capitalization Rate			**$3,274,861**	