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LIQUIDATING DISTRESSED COMMERCIAL REAL ESTATE

Using Virtual Data Rooms to Close Deals Fast

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The Future of Commercial Real Estate

Anyone who's paid attention to the news over the last eight months is familiar with the residential real estate bubble, and how the bursting of that bubble has damaged the US economy. Buried in these gloomy outlooks is the fact that the commercial real estate sector appears to be on the verge of experiencing many of the same problems as residential real estate – easy credit leading to risky lending practices, followed by a rising tide of defaults. The national commercial property pricing index compiled by Moody's and Real Estate Analytics dropped 22.8 percent between its peak in October 2007 and March of this year, with no indication that it has bottomed out.

Evidence of this collapse continues to mount; and examples in the headlines are not difficult to find. On April 16, General Growth Properties, which with over 200 shopping malls makes it the second-largest mall developer in America, filed for Chapter 11 bankruptcy protection due to an inability to renegotiate its debts. Circuit City, Linens 'N Things, and Steve & Barry's, all companies with substantial real estate obligations, each filed for bankruptcy in 2009. The Federal Reserve put it bluntly:

> "Nonresidential real estate conditions continued to deteriorate…Demand for office, industrial and retail space continued to fall, and there were reports of increases in sublease space. Rental concessions were rising. Property values moved lower as reality "set in." Construction activity continues to slow, and several (Federal Reserve) Districts noted increased postponement of both private and public projects."
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> *Federal Reserve "Beige Book" April 15, 2009*

Ominously, this process seems to be forming something of a vicious spiral – the collapse of the residential real estate market… forcing homeowners into foreclosures… reducing consumer buying power… loss of jobs… retail store chains closing… commercial real estate loan defaults and bankruptcy.

Mezzanine Loans – Leading the Collapse

Just as Adjustable Rate Mortgages (ARM) have come to symbolize the beginning of the end for residential real estate, mezzanine loans may come to be seen as the leading edge of the collapse in commercial real estate. Mezzanine financing for commercial real estate lending is the ARM equivalent for residential lending--companies used short-term debt with unfavorable terms based on the idea that they could sell the property in three to five years, only to find that the value of the real estate had declined, and refinancing was impossible. Many highly leveraged companies entered the beginning of that rate-adjusting time frame in 2009.

Debt financing has dried up. Occupancy rates and rents are down. The potential impact of a collapse in the commercial real estate market is enormous. If an investor bought a property for $100 and borrowed $95, that property may be worth $75 now and no one is going to lend $95 to refinance on a property that's worth $75.

Considering that approximately $270.5 billion worth of commercial real estate loans are expected to come due in 2009, it seems reasonable that many experts are expecting a tremendous number of commercial real estate defaults.

Paul Waters, a New York-based executive vice president of brokerage operations in North America for NAI Global, a top-five commercial real estate brokerage with operations around the world, was quoted in the Miami Herald on April 30, 2009 as saying, "On the street, the rumor is it is coming and it's going to come fast and furious. Some people are predicting September."

Challenges in Liquidating Distressed Commercial Real Estate

Bankruptcy trustees and others who deal with distressed commercial real estate often face considerable administrative and logistical challenges in getting all of the due diligence materials collected, organized and presented to prospective buyers. These challenges increase as the number of parties needing to review documents, such as auctioneers, debtors counsel and other professionals, increases. Keeping all parties informed as documents are collected, updated and revised generally involves sending a bevy of emails, faxes and/or overnight mail. Invariably, the risk is that someone will be "left out of the loop" and not informed of some critical information.

Companies being liquidated as a going concern under Bankruptcy Laws (Chapter 11 and 7), State and Federal Receiverships and other restructuring efforts, in an environment of the destruction of shareholder value, will have to move quickly in order to ensure that the transaction is completed before there is further deterioration in asset value. In order to do this, the selling party must simplify the information-sharing process and involve more potential buyers, while shortening deal times and reducing transaction costs in order to preserve the property value in a declining market. This is where using "virtual data rooms" can help.

Streamlining the Marketing Process

So, exactly what is a virtual data room (VDR)? A VDR is a secure, password-protected website located on a secure server. This technology first appeared in the early 1990s, and, while adoption rates were initially slow, over the last several years VDR have been used extensively by financial and legal professionals to facilitate mergers and acquisitions transactions, corporate restructurings, and private equity fund reporting,

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About the Author

Dan R. Bradbary is a member of NABT and the Founder and CEO of Due Diligence Online, LLC, whose proprietary V-Rooms™ Virtual Data Rooms (www.V-Rooms.com) program is used to facilitate the exchange of critical information associated with complex financial and legal transactions.

as well as other financial and litigation-related matters.

Compiling the information that prospective buyers will need to review into a secure, well-organized central document repository allows the parties to focus on completing the deal, rather than searching for information. By replacing the traditional practice of assembling boxes of documents in a conference room, or emailing and overnighting documents back and forth between the various parties to a transaction (which are highly unsecure, time consuming and expensive methods), VDRs allow trustees and other parties to focus on the substantive aspects of a transaction and less on information management and other procedural matters. Also, by providing potential bidders with the convenience of conducting the bulk of their due diligence online, trustees can not only increase the pace of the transaction, but the number of bidders for a property as well.

VDRs have multiple features that provide a number of convenience and security advantages over traditional hardcopy-based due diligence rooms. In terms of convenience, VDRs eliminate the need to spend time scheduling exclusive access for one firm at a time into a physical due diligence "war room." Using the traditional paper data room for due diligence requires bankruptcy trustees to schedule times in blocks of consecutive days for each party that needs to conduct due diligence--if there were six firms with potential interest in purchasing an asset, and due diligence took a week for each firm, it would take a minimum of six weeks before the trustee could move beyond the due diligence phase.

Using VDRs, all interested parties are able to simultaneously access due diligence documents, PowerPoint presentations, and similar media at their convenience, so that the period of due diligence is greatly reduced. Clearly, this is a more efficient method of providing access than using a hardcopy data room. By speeding up the pace of the transaction, there is also less time for transactions to be delayed as a result of market forces or other changing conditions.

Document search capability is another prized feature of VDRs. Advances in technology have enabled most VDR providers to offer powerful search capabilities, so that a user is able to conduct a search for a given word or term either within a single document, or across an entire collection if necessary. Anyone who's spent time staring at a document collection, trying to remember which document contained a given term or concept, or who's needed to conduct the proverbial search for "asbestos" across a document collection, will recognize the utility of this tool.

By using a VDR, sellers and purchasers can be assured that all relevant documents are located in the online repository, and that they are always viewing the most updated version of a document. Providing the most recent version of documents in a central document repository also saves time and money by eliminating the need to send papers by overnight mail or courier. When a document or document collection is updated, email alerts can be automatically sent out. This procedure insures a "level playing field" among the bidders, in that the appropriate, security-level-approved individuals automatically and simultaneously receive any updated or modified information.

VDRs also provide increased security over paper data rooms. VDRs eliminate the need to send documents back and forth using email, a notoriously unsecure method of communication. In addition, a VDR room administrator is able to control access to the data room through the use of usernames and passwords. Once a party expresses potential interest in an asset, the room administrator issues a username and password to the party, who can then log on to the secure website and view documents immediately. Many VDRs feature multiple levels of security access control, enabling the administrator to provide access to more sensitive documents as prospects indicate more interest, sign non-disclosure agreements, etc. Most VDRs utilize an accountability system that further enhances security by watermarking any printed or saved document with a user's name, IP address, date and time of printing, and other relevant information. This feature deters the illicit sharing of confidential information with unauthorized parties.

In addition, accountability is also increased, and liability generally decreased, with the audit tracking tools available in most VDRs. These tools enable trustees to verify who accessed which documents, and when, so that in case of post-transaction litigation involving disclosure issues, trustees have the ability to prove that a purchaser received a specific document at a specific date and time. For trustees who must manage this process, the tracking functions also provide a powerful tool for indicating which bidders are actually serious about potentially making an offer for a property.

In sum, VDRs offer a promising tool for all insolvency professionals to assist in managing the administrative burdens related to the asset disposition process. With no upfront hardware or software requirements, a VDR can be set up within hours. The benefits of VDRs--speed, efficiency and cost effectiveness—make it a valuable tool in maximizing asset value amid the oncoming commercial real estate implosion.