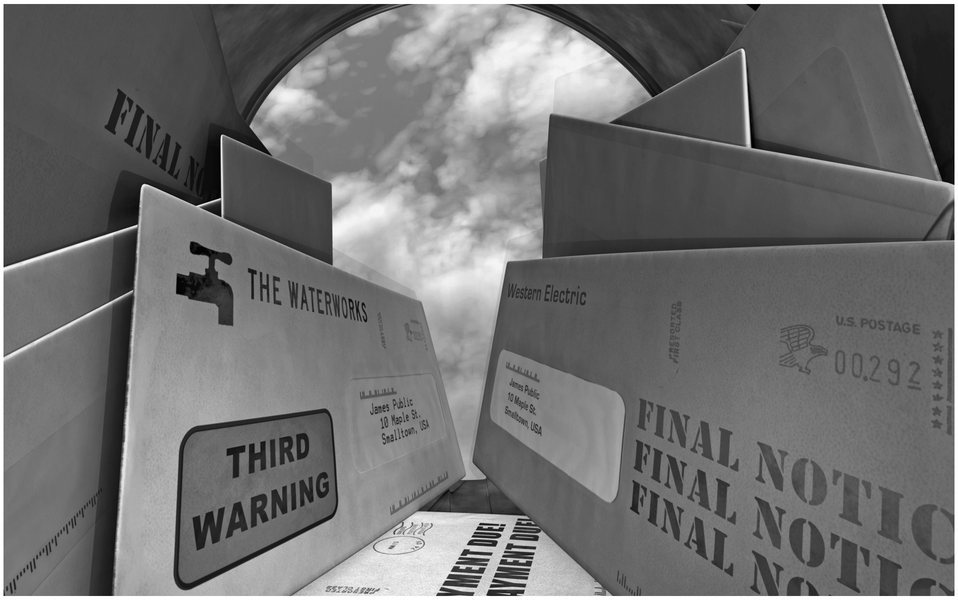
Managing Distressed Properties

When the Going Gets Tough...

BY LISA IANNUCCI



Almost any veteran property manager can tell tales of buildings that have fallen on rough times thanks to the economic meltdown of the last few years. Some have been beset by multiple unit foreclosures, others are dealing with defaulting sponsors, and more and more are struggling with budget shortfalls thanks to missing maintenance and common charge payments.

The recession has taken a devastating toll on the long-established and the newly-constructed alike—and the professionals who work with multifamily buildings are having to rise to the administrative challenges posed by these "distressed" communities.

Defining Distress

To Ed Kalikow, president and CEO of Kaled Management Corporation in Westbury, the term "distressed" covers a broad range of situations. "For example," he explains, "it could mean physical issues that the building doesn't have enough dollars to fix—or it could be that the value of the building has dropped because residents aren't paying their dues."

According to Maryann Carro-Caputo of Tribor Management in Flushing, financial hardship hits different types of buildings in different ways, and with different ramifications depending on whether the community in question is a co-op or a condo.

If the problem is residents in arrears, "In co-ops, the impact is usually more manageable," she says, "because the co-operative corporation has first position over the owner's mortgage company and can easily take the owner to landlord/tenant court to settle the matter. In most cases, the owner's mortgage company will step in and settle the outstanding balance. The sad part is that the shareholder may then face losing their apartment."

Condos are a different matter, however. "In a condo, a growing list of accounts receivable is a very dangerous thing," Carro-Caputo continues, "especially in times when real property values are declining. Common charges or association dues take second position to owners' mortgages. If the owner's mortgage is greater than the proceeds from an auction, the condominium stands to simply lose the common charges in arrears," something no building can afford to do these days.

Problems from the Start

While some established, well-funded buildings are only just now feeling the economic burn after decades of solvency, brand-new communities in particular are finding themselves distressed almost from the get-go. Owners who bought at the peak of the market are in many cases dealing with sponsors who can't deliver on promises made in the building's offering plan and marketing materials, or who can't find enough buyers to even populate the building.

A 50-unit building with only 15 units sold is obviously in some distress—but what does that mean? Are the handful of moved-in residents on the hook to pay for the entire structure's power, water, and other utilities? Can they sue the sponsor for not making good on his or her promises?

The short answer to the first question is no, says Manhattan-based real estate attorney Adam Leitman Bailey. "The sponsor is responsible for paying its share of expenses for all the units the sponsor owns and cannot sell," he says. "The sponsor may eventually rent these units out. Most offering plans allow the sponsor to rent out unsold units to raise income instead of selling them. Most developers have held off so far in turning their condominiums into rental buildings and have just kept units vacant, but I predict that this policy may change if the market worsens."

The answer to the second question is, sometimes. According to Leitman Bailey, "If the sponsor defaults and the unit owners are in control of the board, they need to foreclose on the sponsor's units. One of the attorney general's top priorities has been to ensure that sponsors pay their share of the common charges, and the AG's office aggressively prosecutes sponsors not in good standing. If a sponsor goes under or declares bankruptcy, court actions becomes necessary and a receiver is appointed to collect rents and pay the building's expenses."

Managing in Tough Times

According to property management experts, the first, best step in handling an established building that has fallen into distress is not to let it fall in the first place. Prevention is the best medicine—and as always, communication is key.

"The property management company must advise the board that it is important to keep shareholders' monthly charges close or equal to the building's actual operating costs," says Steve Osman, CEO of Metropolitan Pacific Properties in Astoria, "and advise the entire board of financial issues before it reaches the point of 'no return.' "

The biggest challenge in doing that is often getting a board to understand just what it means to balance the budget in the first place. "If the building itself begins to fall behind, the manager must try to make the board aware of the need to increase either its maintenance or common charges," says Carro-Caputo. "However, I have found that most boards struggle with this concept—they simply feel that 'spending less' or 'cutting costs' should be their primary focus. It becomes the job of the manager to get boards to understand the concept of fixed operating costs versus variable costs."

In the years leading up to this current recession, buildings have faced huge percentage increases in their fixed operating costs—costs which boards generally have no control over, and which can quickly become onerous if individual residents begin to fall behind on fees and monthly revenue becomes unstable.

"The increases over the past four years have been unprecedented," says Osman. "Today, the biggest issues facing cooperatives in New York City are high property taxes and water and sewer charges. To name just one example, we have a co-op in Queens where the property tax has risen from about $650,000 to over $1.2 million in only five years. At the same time, water and sewer charges have also gone up more than 20 percent. Fortunately, the board in that particular building acted on the advice [of management] and increased charges to keep up with those expenses."

And when serious money trouble is brewing—either because of dwindling reserves, inadequate revenue, or ballooning operating expenses such as the fees Osman cites—it falls to the manager to raise the alarm among board members and help them formulate an intelligent strategy to weather the storm. In situations where it's the sponsor's difficulties that have lead to a building becoming distressed, serious legal action must be taken.

"In dozens of buildings we're involved with, the sponsor's inability to sell units has become a growing concern," Leitman Bailey continues. "In these cases, our first goal is to make sure that owners obtain control over their board. Despite what might be written in the offering plan, we have had developers acquiesce and allow the owners to run their own building—and in other cases, we have needed to use legal force to convince the sponsor to give the owners control. In still other cases, we form homeowner associations that act independently of the sponsor-run board."

Unpopular, But Necessary

Rallying residents to take a defaulting sponsor to task is one thing—getting an established board to make difficult, unpopular decisions, even when it's for the best, can get tricky. Increasing maintenance and common charges is never popular, even in the best of times, but if a building's bank account is bleeding red ink and disaster is looming, what's popular simply has to take a backseat to what is necessary.

"Most individuals who own co-ops and condos believe that their monthly maintenance or common charges should never go up," says Carro-Caputo. "But if I see after a couple of months that a building is not generating enough income to cover their fixed costs, I'll advise the board that a maintenance increase is necessary."

A hesitant or skeptical board may need some encouragement or clarification— possibly from the building's accountant or legal counsel. "The longer it takes for a board to authorize a maintenance or fee increase, the tougher it gets to pay the bills," says Carro-Caputo, adding that the manager then is faced with deciding which bills should be paid and which must be put off—which may put the building on even thinner ice and push it another big step toward distressed territory.

Osman says that there are cases where boards have not acted in the best interest of the corporation, even with all the encouragement and clarification their manager can muster. "We have had a situation this past year where a large cooperative faced mounting payables and increased fixed operating costs," he says. "[But] the board didn't want to hear the bad news and opted not to pass the budget prepared by the management company and not one, but two CPAs. They went off and did their own budget—which was far from what was needed to cover their actual costs. The property in question is now in a position where they have $1 million in payables and a increasing deficit, yet they still refuse to implement the correct monthly increase."

Making it Through

Regardless of how a given building comes to be distressed, or the legal maneuvering involved, the indispensable tools of any good manager—a good understanding of accounting, budgeting, and building administration, but even more importantly, communication and people skills—are vital for getting any building through the rough spots in one piece.

"As a manager, it's your ability to educate and work with your board that makes the difference," says Carro-Caputo. "Personally, I love it when my boards ask me questions and show that they want to learn and understand their finances. If you are dealing with a board that takes the time to learn and understand their finances, then that building will be able to recover."

"Identify [problems] as early as possible," adds Kalikow. "Preserve your income and minimize your expenses. I don't know if the market has hit bottom in New York, but the costs of maintaining buildings has increased with time and it will still be a problem going forward. Obviously, this is going to have impact for some time to come."

And Osman points out a truism that's helpful no matter what the economy is doing. "It's important to remember that the vast majority of boards are intelligent people who volunteer their time, and who understand that a professional management company will only give them truthful, honest advice." ■

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