THE PROFESSIONAL APPRAISER:

An Overlooked Resource in Bankruptcy Proceedings

Increasing numbers of international investors in the United States real estate market find themselves in the U.S. Bankruptcy Court, as creditors, debtors or owners. For many, a better understanding of how to work with a professional appraiser would help to solve problems and shorten the time spent in this complex and potentially treacherous legal arena.

Even with the Savings and Loan crisis and its fallout, bankruptcies pose a critical problem for today's real estate industry. Many properties developed during the double-digit-inflation days of the early 1980s are not performing according to expectations, while properties syndicated under the accelerated cost recovery system, ACRS, have suffered since that rule was modified by the Tax Recovery Act of 1986. The need for skilled valuation services has never been more urgent.

There is a seeming irony here. It was "appraisers," or at least people who called themselves that name, who originally provided the values for the real estate that is now in bankruptcy. But the irony is more apparent than real. Qualified professional appraisers, i.e., those with real credentials, well-schooled in the procedures and methodologies of the profession, were systematically excluded from many of the original transactions. (In fact, their participation might well have helped prevent the worst excesses of the past decade, since they would have insisted on more realistic valuations of assets.)

Active steps toward appraisal reform are now under way, but the debate on this issue is sure to continue long into the future. In the meantime, the following overview of the professional appraiser's role and potential contribution may guide investors in making the best use of his/her expertise.

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The appraiser's roles.

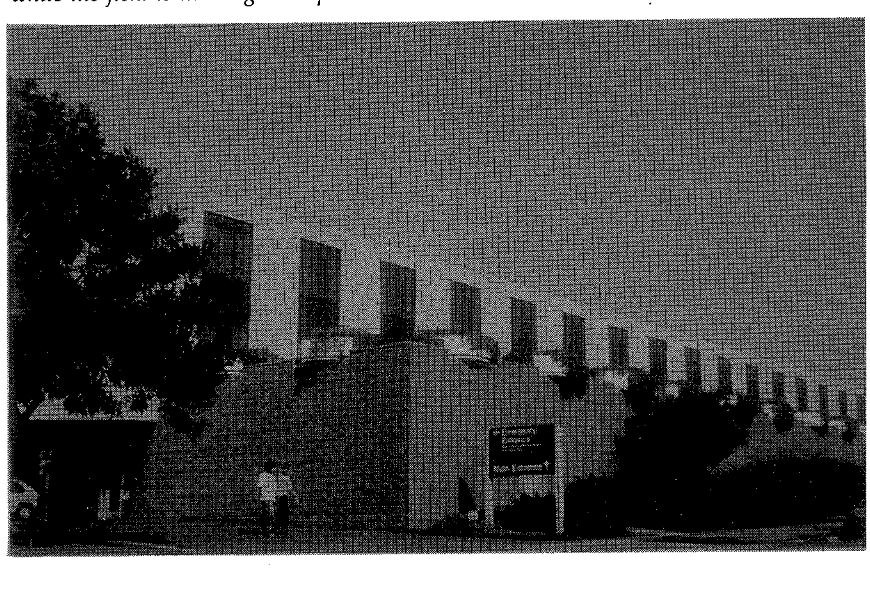
Today's professional appraiser usually plays two broad and substantially different roles in bankruptcy proceedings, as (1) an independent expert witness and (2) as litigation support for attorneys.

As independent expert witnesses, appraisers, by definition, are called upon to value the assets on an unbiased basis. Professional appraisers may also be called upon to testify in the Bankruptcy Court. In this capacity the appraiser performs a complete, detailed valuation of the property, considering the three traditional approaches to value - i.e., the cost, sales comparison and income capitalization approaches. A detailed analysis of the relationships between market forces and the subject property can also be provided.

If, for example, there are significant differences between contracted and actual current market rents for the subject property, it would be the professional appraiser's responsibility to establish to what extent this situation was a factor in bringing about the bankruptcy, and how it should affect any contemplated settlement.

In providing litigation support services, on the other hand, the professional appraiser is retained as review appraiser for the counsel or attorney representing the bankruptor or the creditor. His role is to analyze and dissect the other appraisals being presented, and advise counsel, for the purpose of litigation, as to the pros and cons of the appraisal, the techniques used, and any errors or vulnerable points in the report. He may work with documentation alone, or his assignment may include independent field trips to verify the comparable data used by both the opposition's and the client's appraisers.

Health care facilities may be subjects of bankruptcy proceedings, even while the field is in a vigorous phase.



The appraiser increasingly finds himself acting as what might be called a "facilitator" in settlement negotiations between debtor and creditor. Often, the appraisers can help counsel on both sides, as well as the courts, in reaching equitable solutions.

A counterpart to these traditional bankruptcy appraisal roles has evolved within the past decade. Today, many major law firms retain appraisers specifically to perform review appraisals on a full-time basis. Such an on-staff review appraiser is called upon to act as a "Devil's advocate" and raise issues that will help counsel be as well prepared as possible for any possible future challenges to the material he intends to present.

In either case, the appraiser looks for errors or weak spots. The mathematics could be incorrect; there may be no justification for the capitalization rate; or the factors used for the income and expense rates or the discounted cash flow may be inappropriate or inadequate. Even a professionally prepared appraisal may have surprisingly important gaps or errors. Having an appraiser on the team while preparing for bankruptcy can be a very effective way to minimize the "human error" factor.

The appraiser as negotiator.

The appraiser's newest role is to actually assist in settlement negotiations between debtor and creditor, by objectively reviewing the proposed settlement plan. This may entail, for example, assessing the reasonableness or feasibility of future values for liquidation or cash flows for running the business and paying off the debtors. Here, as before, the appraiser is an expert witness, but more significantly he plays the role of advisor. The following case histories, representing assignments on which Marshall and Stevens' professional appraisers have been engaged within the past few years, suggest ways in which those involved in real estate bankruptcies can derive "extra" benefits from the appraiser's expertise.

1. Health care facility, U.S. Atlantic Region.

We were asked to assist the law firm representing what I will call Hopeful Hospital. Part of our work was to assist the hospital in understanding the differences among three appraisals that had already been prepared: one for the bankruptor, one for the secured creditors, and one for the unsecured creditors.

While there were differences in the capitalization rates based on the perceived risks by each appraiser, it turned out that the significant differences between values actually lay in each appraiser's interpretation of market value. All three had used a "traditional" definition of the term, commonly defined as the most probable price, in cash, terms equivalent to cash, or other precisely revealed terms, at which the appraised property will sell in a competitive market under all conditions requisite by fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.

But the three arrived at strikingly different conclusions. The appraisal prepared for the unsecured creditors arrived at a valuation similar to a forced liquidation; the effect was to make even the secured creditors virtually "unsecured." The secured creditor's appraisal could be characterized as similar to an orderly liquidation. The bankruptor's appraiser reached a value approximately equal to the value-in-use of the hospital's assets.

After reviewing each of the appraisals, we discussed them with our client as well as with other appraisers and attorneys. Having an extensive background and experience in the healthcare field, we found it was possible to explain the underlying causes for the wide differences among the three values (which ranged from $7 million to $11 million). In essence, each appraiser was looking at the same assets through the eyes of their clients - not objectively, through the eyes of an independent buyer in the marketplace. They therefore had differing perceptions of risk, which each built into his appraisal.

With this insight, we were ultimately able to help the parties reach an accord on value that was substantially acceptable to all. This agreement was hammered out before the start of the formal bankruptcy proceeding, the result being that the court and all parties unanimously approved the reorganization plan quickly without further dispute. The proceeding were concluded much more speedily than would have been possible otherwise, and the Hopeful Hospital continues to function today, providing health services to its community.

2. Apartment complex, Missouri.

The bankruptor in this case engaged us to value a 200-unit, approximately $7-8 million apartment complex. Some of the problems with the property involved damage from inadequate management, particularly the failure to adequately screen tenants, resulting in loss of revenues and physical damage to the premises. Other problems came about because of improper construction - i.e., because the project had not been built according to plans and specifications. It became the appraiser's responsibility to determine exactly what portion of the damage should be attributed to improper construction.

Our key role was in the litigation with the developer over construction problems, and there we assisted by estimating the diminution in value caused by initial defects, including poor asphalt, improperly seasoned wood and sub-code wiring. We were also able to establish the probable additional maintenance costs attributable to those defects. This in-depth valuation made it possible to quicken the process of getting a reasonable reorganization plan approved by the major creditor. Result: the property, after only six months, is now operating out of bankruptcy – far less than the usual 12-18 month workout period typical in real estate bankruptcy cases. In addition, the resulting valuation showed, among other things, that the property had not been valued equitably with others in the neighborhood for real estate assessment purposes. Thereby, as a side result of our involvement, it was possible to win a reduction in real estate taxes.

3. Garden apartment development, Houston.

Marshall and Stevens' professional appraisers were brought in to appraise a 310-unit garden apartment development. The client was counsel for a second-mortgage creditor who wanted to take control of the apartment complex to protect his secured position. The bankruptor's position, to the contrary, was that the second mortgage holder was unsecured, and therefore enjoyed no preferred position with respect to the property.

Here, an issue that might have appeared to be a purely legal question - the secured or nonsecured status of a creditor - turned out in this case to hinge on a valuation issue: whether the subject property did have sufficient value to secure their position. Our review quickly established that the opposition's appraisal was totally lacking in credibility. Older properties in less attractive localities had been offered as "comparables" for example. When the case reached the Bankruptcy Court for the Southern District of Texas, Houston Division, our appraisal, including detailed field inspection notes and photographs, enabled our counsel's clients to obtain control of the property.

Getting full value from the professional appraiser.

These assignments give some idea of the appraiser's potential contribution in bankruptcy proceedings. Most players in the real estate market tend to view the appraiser as a necessary evil, usually slated to play a perfunctory role in the proceedings. But as these cases show, the appraiser can make a unique contribution that leads to a good resolution; i.e., to the best possible outcome for all parties. To get the most benefit from your professional appraiser, we suggest these three mildly revolutionary steps:

1. Get the appraiser involved from the beginning, not at the tail end of the process when he has to try to fit the pieces together at the last moment. The appraiser should be involved as soon as it becomes clear that a bankruptcy proceeding is going to take place. It is essential to know what assets you may ultimately be able to claim, and at the very least, some sort of preliminary survey can give you a basis for timely action and help to establish the claim.

2. Be sure the appraiser has been told of all pertinent legal theories that may be involved in the bankruptcy case. Each bankruptcy court has its own local rules and traditions, which may affect the valuation. As an example, many bankruptcy judges will try to look ahead no more than five years in order to make a judgment as to whether the property or business can work its way out of bankruptcy. Professional real estate appraisers, in contrast, are used to working with projections of ten, fifteen years or more. In such cases an appraiser's projections may assist the judge in determining that a proposed reorganization plan is unrealistic. The result, in effect, is to develop a new plan, incorporating the appraiser's insights, that will be genuinely workable and supportable.

3. Insist on full documentation. We cannot overstress the importance of following professional, logical and scientifically consistent techniques to reach a supportable value. In many cases involving appraisal review, our consultants find that an original appraiser did in fact reach a correct value for the subject properties, but failed to provide proper documentation. Once the legal bankruptcy proceedings begin, it is essential to have the necessary backup material to defend that value in court or during negotiations. Every valuation report should be a complete, self-contained document. As with any vital documentation prepared for courtroom use, all essential documentation should be clearly identified and delineated for instant retrieval.

Summary

There is a difference between a real estate "appraiser," as the term is often employed, and a true professional appraiser - a person thoroughly trained with a professional designation. Such a professional appraiser is an often overlooked but very valuable resource in bankruptcy proceedings.

About the Author

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About Marshall and Stevens

Founded in 1932, Los Angeles-based Marshall and Stevens Incorporated is one of the largest and most respected appraisal and valuation consultants in the United States, with offices nationwide. The firm offers a wide range of valuation consulting services including real estate, machinery and equipment valuations and financial analyses for purposes of financing/leasing; construction cost allocations; insurance; ad valorem; allocation of purchase price; and fairness and solvency opinions.

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