

6 Key Components to a Successful Distressed Assets Fund

Brecht Palombo and Warren Kirshenbaum



PODCAST TRANSCRIPT

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Brecht: Good afternoon everybody. I am psyched to have Warren Kirshenbaum on the phone today. Warren's an attorney I met maybe a year or two or maybe even three years ago now. He is local to me, he's just outside of Boston and I'm excited to have him on the phone today mainly because of one thing in particular that he's been pretty involved in and that's been structuring distressed asset funds.

In fact, Warren's been the lead attorney in assembling and structuring distressed asset funds and creating the equity raise strategies for four separate distressed asset investment funds in 2009. Fully leveraged the fund size Warren's been working on range from \$3 million to \$35 million.

The funds range from those seeking single family homes to three to six family homes and commercial properties both retail, industrial, flex, multi-family and really the whole gamete.

Warren has a law degree from New England Law and a master's in corporate law from NYU. He practiced in New York both in-house for Wall Street Investment House and in private practice for a law firm.

He was the general counsel to a large real estate developer, manager and builder based in Texas and now uses his corporate securities background in real estate tax background to the great benefit in structuring distressed asset funds.

So Warren thanks for being on the call.

Warren Kirshenbaum: Thank you Brecht that was really nice. Thank you.

Brecht: Well, the reason I wanted to have you on the call is recently I saw something that you wrote and it just really struck me because in my position I have a lot of people who are talking to me about funds and they're putting together a fund or they're just closing on a fund or they're bird dogging for a fund or what have you where you are really getting a lot of experience with this quickly right in the thick of it that you'd be just the right guy to talk to.

So, tell me without revealing too much about a fund maybe that you've set up recently?

Warren Kirshenbaum: Okay. There's two funds that are interesting. One is a fund that is focusing on commercial, I'm sorry, residential assets. And they're looking for single-family type distressed assets like single family homes and small multi-family up to about 12 units.

Brecht: Okay.

Warren Kirshenbaum: And they have an intricate structure in that they are putting together the holding company and then raising the funds, several funds, subsequent to that.

The first one will be this one that focuses on single family and small multi-family and then it's going to move on to different types of assets. Some will be large apartment type complexes as well as they're looking to purchase the mortgages and notes and things like that and put that into a fund.

So it's kind of a complex fund which is starting out raising money right at the top at the holding company level and then going down from there.

Brecht: Okay.

Warren Kirshenbaum: The second, one just briefly, is purely focusing on commercial assets and it is a bunch of developers that are experienced in a particular area that have the local contacts. They know it's their back yard, if you will, and so they're raising a large amount of money and they're looking to purchase assets that they know are undervalued in the marketplace and that is a good one because they're very focused. They're knowledgeable in their particular area and the investors are investing in somewhat of a known quantity.

Brecht: Okay. Well let's get into the details then a little bit or maybe about the specific funds or however you want to do it. But I know that you had laid out some very clear points, six of them, and I kind of want to move through those a little bit. And the first one that you had was know your purpose and I wonder if you could talk about that a little bit and sort of the conversations that you're having with your clients as you're putting these funds together and knowing their purpose.

Warren Kirshenbaum: Okay. What we – I started this as I sensed in the market that capital was becoming very difficult for my clients to secure even though the opportunities were out there in terms of undervalued properties and good buys for the clients.

Although we didn't invent the concept we started to try and refine it in the sense that these particular clients that I'd be talking to would try and create a pool of investor funds which they would hold in a fund type entity and thereby be creating the equity that they need to go out and purchase distressed assets and the concept is that this will give them two things; one being they'll be able to meet even more restrictive underwriting requirements from banks or they'll be able to negotiate with one institution in particular that takes a look at their business plan and is prepared to ride with them in acquiring these assets knowing that they have a pool of capital.

Brecht: Okay.

Warren Kirshenbaum: Okay, and secondly we've found that there are a number of investors out there in the market particularly with the residential type distressed assets, more if it's single family home type properties where these investors become cash poor and they have secured purchase and sale agreements or even closed on some assets but they need to get rid of these assets quickly. And they're happy if they've purchased or met 50 cents on the dollar to make a 10 or 15 cent profit and then give them off to clients of mine.

So having a fund in place makes my clients have a preferable position with the sellers of assets and they have a source to get rid of their distressed assets when they have purchased too many or they need to loosen up some cash.

Brecht: Okay. And so as I understand it then, let me just kind of recap that because maybe I'm a little dumb but I just want to make sure I understand. So your clients, in this particular fund anyway, in terms of know your purpose, what theirs is is they're sort of – it sounds like they're almost a rescue fund where they've assembled capital and they're going to come out and kind of swoop in on some other people who are digging up the opportunities or am I getting that right? Am I close?

Warren Kirshenbaum: Yeah, that is close.

Brecht: Okay.

Warren Kirshenbaum: I think that they would also talk to people like you who have knowledge of assets in the marketplace. Maybe even lenders that have a block of assets that they would be prepared to let go.

Brecht: I see.

Warren Kirshenbaum: So but the concept is, is if there's a fund in a pool of capital they'll be able to get better pricing or a slew of better assets.

Brecht: Okay.

Warren Kirshenbaum: So in a sense it means that the concept is to pull investor equity and go out and purchase these assets but know what your business plan is before going into it.

So, for instance, if you're only looking at single family homes or you're looking to purchase blocks of properties from banks or approaching people like you these are all different sources and I think they require different planning and strategies.

So I'm saying create your business plan in detail up front.

Brecht: Okay, all right. So number 1, know your purpose. Number 2, create a soft offering. What's a soft offering?

Warren Kirshenbaum: Well the way that I've been doing it is a private equity offering. Which means that we are setting up an entity and then selling off a large percentage of that entity to investors so it's a sale of securities but it's exempt from registration under both the federal and the state securities laws so long as you follow the legal requirement.

So I'm saying that you should be creating a set of offering documents whether that's a private placement memorandum or an investor presentation coupled with the operating agreement or limited partnership agreement, subscription agreements, investor questionnaires and you're meeting all the legal requirements such that you're fully disclosing to investors what the deal is, what they're getting. And you are getting appropriate investors for the investment.

Brecht: Okay. So in the soft offering is this family and friends money is that where they generally start?

Warren Kirshenbaum: It is family and friends money but it needs to expand a little bit beyond that to get the fund off the ground.

Brecht: Sure.

Warren Kirshenbaum: So you will be – inevitably it's going to be family and friends and then some.

Brecht: Okay. And so are you limited at all to the scope? I guess this takes us to number 3, raise capital. Are we limited at all in scope in terms of who we're talking to or how many people we're talking to or how much money we're taking from them individually?

Tell me about how that works?

Warren Kirshenbaum: Yeah, excuse me. It's all of those things in variations.

Brecht: Okay.

Warren Kirshenbaum: Basically the securities law defines accredited investors and non-accredited investors. With accredited investors having a particular requirements as to what their net worth annual income prior and expected annual income is their knowledge of these type of investments and there's a specific set of parameters that the federal securities laws go into which ensures that people are, so called, accredited investors.

And you can limit your offering to accredited investors if that is all the people that are investing in your particular fund then it is unlimited in how many you can have.

Brecht: Okay. So I see a lot of funds where you do have to be an accredited investor. What's the difference when you don't have to be? How do you make it okay that they're not accredited investors, your investors?

Warren Kirshenbaum: Well it's much riskier and clearly a non-accredited investor could be somebody that the investment is not appropriate for them.

And a good example usually is that you may have an investor because the securities law parameters talk about annual income, net worth, things like

that so you may have a person that actually has a high enough income or a large net worth, for instance, from an estate yet that person is not sophisticated in this type of investment so it would be inappropriate for them.

And those are the kind of legal issues that I get afraid of and I'm advising my clients to be careful about.

Brecht: Sure.

Warren Kirshenbaum: So in that circumstance if you have a non-accredited investor they might be coming to the table with a financial advisor and if that financial advisor is going to be receiving all the documentation, analyzing it and then making the decision together with their client then that might turn out to be appropriate.

Brecht: Okay.

Warren Kirshenbaum: But it's a factual based consideration. So if you are an accredited investor then it's clearly a much more appropriate investor from the funds perspective.

Brecht: Okay. And are you seeing the principles in the fund show up and start the fund with some significant initial deposit or what's happening there?

Warren Kirshenbaum: They can do it either way. I've seen that the funds tend to be more successful in raising money and given the investors confidence if the founders have invested actual money into the fund themselves in addition to paying the startup expenses or the sweat equity that they are obviously putting in.

Brecht: Right.

Warren Kirshenbaum: So those deals that come up with founders of the fund not having put their own money in those become more difficult.

Brecht: Okay. And so get some credibility by putting some skin in the game. Go to your family and friends and that sort of a thing to kind of start and then how else are people raising capital?

Warren Kirshenbaum: People are raising capital through appropriate contact with individuals and industries that they know.

Brecht: Okay.

Warren Kirshenbaum: The clear legal parameter here is that for an offering to be what you call the soft offering so it would be exempt from registration. It cannot be widely distributed or advertised and you must be able to be in control of who receives these documents so that you can determine whether it's appropriate or not.

So it is possible that if there's several founders together with their professional advisors and each of them compile a list of persons that may be appropriate they could spreadsheet that and do some investigation and come up with a list of people beyond family and friends that they believe are appropriate.

Brecht: Okay.

Warren Kirshenbaum: As long as you are making sure that they have nondisclosure documentation in affect with all these people. You know who has received the documentation, you have control numbers and you can identify that then you're complying.

Brecht: Okay.

Warren Kirshenbaum: It's where you widely distribute it or hire a broker dealer or go into a mass distribution of these documents and you cannot tell where these documents have landed that you may become – of the regulations.

Brecht: Okay. All right, so it sounds like professional networking is probably the third piece of that in order to kind of keep it under control?

Warren Kirshenbaum: Yes. And also I would say just from experience that even if you're following all the rules and regulations and you have a very well crafted set of documents that complies with the securities regulations you have to execute on that appropriately.

So for instance if you then, one of the people working with you went over to a nursing home and attempted to sell these kind of fund securities to an elderly person that would tie up 90% of their net worth or more than that would be inappropriate despite the fact that your documentation is good.

Brecht: Okay. Okay, so definitely it sounds like there's some moral hazards in there too. And you're going to just make sure – well, I guess you've got to have proper counsel on how you're approaching who you're approaching.

Warren Kirshenbaum: Correct.

Brecht: Okay. And so number 4 you have here, identify appropriate opportunities. And I know that that's something that I spend a lot of time with and certainly the members of the site that's largely why people are members looking for appropriate opportunities with banks and that sort of thing. How else are you – the funds that you've helped put together, how are they finding opportunities?

Warren Kirshenbaum: Subscribing to Web sites like yours. Some professional networking sites like LinkedIn may have a subgroup there where people need each other and some people are privy to certain lists that financial institutions have.

They're networking with brokers. It's just who you know I would say.

Brecht: Right. Okay. So number 5, I've kind of surmised it, and these are my words and not yours so I'd like to hear your words. I put know your limits.

It kind of – I got a sense for what you had written. Tell me a little bit about that point.

Warren Kirshenbaum: I think that's very smart on your behalf. I think the underlying theme here is that you need a business plan and that goes through step – that's behind the step 1 point, the step 4 and now step 5.

And if you've identified which type of assets you are going to target in which particular area and you have a set of investment parameters in terms of evaluating the asset knowing what it's going to take to rehabilitate that in terms of money and effort, the pitfalls that are in particular types of assets. You'll be more successful.

So I think if you don't know your limits and you're just going out there and thinking that you'll be able to snag any type of undervalued asset whether it be a four family home or a single family home or something more than that I think that is a strategy that may lead to issues.

Brecht: Okay.

Warren Kirshenbaum: I also think that you need to – if you are going to develop a fund once you've raised the money and you're out there there's a lot of work and there's a lot of paperwork as administration.

For example, there would be leasing issues. You've have to fill the units up, you have to have the legal documentation in place, you've got to have a property manager either on site or available at odd hours to deal with tenant issues but you've got to have in the office the ability to manage the property from the standpoint of financing and those behind the scene factors.

So it takes up a lot of time, effort and energy and I think you need to know or make sure that you're capable of executing on that.

Brecht: Especially after you've made promises and taken money and this sort of a thing I would assume.

A little higher stakes then if you're just in the game as kind of the loan wolf.

Okay, so it takes us to our next point which was point number 6, communication or communicate. Tell me a little bit about sort of what you recommend or how that – what's appropriate in this sort of a fund situation?

Warren Kirshenbaum: Well, I tried to be as simple as I could in these tips but it can get very complicated. And once again going back to the business plan they'll be certain things which you may or may not promise in your offering documents and so by way of example you may be making distributions on an annual basis or every two years or you may be a fund where there's no distributions that are going to be made at all. And I think you need to be clear in your offering documents as to whether or not you're making distributions. And what – and therefore what type of an investment this is because firm investors will equate this to an investment where they have the ability to retrieve their funds in three years if they feel like it whereas this is not that type of investment.

So that needs to be made clear. But if you have made the kind of promises, if I could use that word in you offering documents, that you are going to be making distributions then that now leads to an obligation to make sure that you are reporting appropriately to the investors. Create a compliance function because you may have to be selling assets at pre-

determined times in order to make these distributions versus just running the operation on cash flow.

And so I'm saying that you need to be careful. You need to keep your investors informed. You need to fulfill every one of these obligations or promises you made in the offering documents. And to do that you're going to have to have some kind of back office operation.

Brecht: Okay.

Warren Kirshenbaum: And I think that needs to be thought through very clearly as to how you're going to execute this, how much it's going to cost and how you're going to keep your investors informed and communicate with them.

Brecht: Okay, good stuff. So what's the biggest mistake or is there more than one that you see people making when they want to get a distressed assets fund going?

Warren Kirshenbaum: They are not focused enough in their business plan and they're kind of shooting all over the place. I think that people also don't – they don't understand how difficult it is to raise money and what is involved in that. So that process is always more arduous than people really believe.

I would say those are the two big ones I would focus on here.

Brecht: Okay. So let me ask you this and we won't hold you to anything. I'm not going to – we're not going to call and see how this works out but this is something that I like to ask everybody I'm having these calls with.

Use your crystal ball and tell me how long this distressed real estate opportunity is going to last and why if you would? Why you think that.

Warren Kirshenbaum: Okay. I think that it's still going to be quite a while.

Brecht: Okay.

Warren Kirshenbaum: Meaning definitely 2010 and probably 2011 and may be beyond.

I think that the factors, the underlying economic metric factors are the same now as they were when the world was falling apart in fall of '07.

Brecht: Okay.

Warren Kirshenbaum: In the sense that I think there is a feeling that we're out of the recession and things are better and certainly they have improved but a lot of the same factors are still prevalent and I think that the default situation has, in terms of residential, has shifted to consumers that had ordinary type loans and not just the exotic loans or the subprime type product.

There's high unemployment and job losses and things of that nature and I think in terms of the things that the government was able to advocate should be done like loan modifications. I don't know that they made a lot of sense to the financial institutions so I don't know that they did or completed a lot of them and so I think there were certain laws put in place, for example, in Massachusetts we have to give a consumer a 90 day break if they fall behind in the mortgage. That and the fact that I think financial institutions may have just been holding back on actually moving forward or foreclosures.

There was the court decision in Massachusetts that seemed to invalidate foreclosures based on assignment back dating issues.

So there's a lot of factors which signal if there's been a stability in foreclosure percentages of foreclosures or it looks like it may even be dropping that that's a false positive, if you will.

So I think that that's still going to be out there and still be a threat to our marketplace and there's been wide speculation that the commercial marketplace hasn't really seen its worst days yet.

So for these reasons I would think that we're going to see this through 2010 and into 2011 at least.

Brecht: Yeah, I think you're right and just to pick up on one point that you mentioned there where you talked about maybe banks not, my words, not pulling the trigger on certain assets that maybe should be moving through the foreclosure process and this sort of thing.

You definitely can see that in the bank prospector data that the bulk of the problems are in non-accrual. It's not – there's many, many billions of dollars that just haven't moved out of the non-accrual stage into where they're actually being processed and becoming REO or else being sold off.

And so I think you're right on a lot of those points there.

Warren Kirshenbaum: Thank you.

Brecht: And time will tell.

Warren Kirshenbaum: Yeah, exactly. You won't call me up though, right?

Brecht: So who are you looking to meet and network with out there? Just who's – where can you work I guess is one thing people might want to know. If somebody's sitting in Kentucky can you put together the paperwork for them to do a distressed assets fund or is it Massachusetts only?

So tell me a little bit about who you're looking to meet and work with and anybody else that ought to contact you.

Warren Kirshenbaum: Okay. Well the securities laws are federal securities laws. So the primary part of how I fund would be organized and structured in order to comply. The federal securities laws would be the same whichever state you're in.

Then each state does have its own security statute which they refer to generally as the blue sky laws and so if you are doing an offering in a particular state then you need to pay attention to the blue sky laws in that particular state.

But it would be possible for somebody wherever they are in the country to be able to talk to me or hire me because we – even if we were setting up a fund in Massachusetts we don't know where those ultimate investors are coming from.

So somebody's family and friends may be in Florida or Chicago or New York. So even a local fund here we may be looking at the blue sky laws of three, four or five different states.

So it wouldn't really matter to me or impeded me in any way if somebody was sitting in the state of Kentucky and they were going to be raising their money there in Tennessee or Texas. It wouldn't matter at all.

Brecht: Okay.

Warren Kirshenbaum: I think I've developed a good blueprint and the formula and being in the trenches on this and I think that experience is what's valuable.

Brecht: Okay. And so people that should contact you or anybody who's looking to put together a fund, are there other types of distressed asset type business that you're doing today or is that the main focus?

Warren Kirshenbaum: That's the main focus. It's just that the product itself may differ. For instance, there's talk of certain funds which may involve tax credits or affordable housing or be limited to a particular asset class like I said before the paper, instead of buying the physical assets a particular fund may focus on purchasing the mortgages or notes for a discount.

So the fund concept is all that we're concentrating on but the actual asset class is doing to differ.

Brecht: Okay. So how do people get a hold of you? How do they find you?

Warren Kirshenbaum: Telephone, email. They could check out the Web site, the blog, where I described how to set this out.

Should I just go ahead and list all of this?

Brecht: Yeah, shoot.

Warren Kirshenbaum: The telephone is 781-239-8900. Email is wkirshenbaum@oarlaywers.com.

Brecht: Okay, great. And what's your blog?

Warren Kirshenbaum: The blog is <http://distressedassets.wordpress.com>.

Brecht: Okay, awesome. Warren I really appreciate you coming on today and I know that this is helpful for me especially like I said, I've got a lot of people calling me with – they're dreaming of a fund or they're starting a fund or they've just closed a fund and this sort of thing and so you've really brought some clarity for me on a few things.

And I'd love to talk with you again down the road. So thanks for being on today.

Warren Kirshenbaum: Well thanks Brecht. And I just wanted to say that this has to be brief in having the conversation because these things can get technical. So there may be points that I wasn't able to cover or went over very briefly and so there's a much larger level of detail on the blog and certainly we could follow-up on this.

But I wanted to just let you know that this isn't an A through Z of every issue that a person could come across.

Brecht: Oh sure, absolutely not. Well we appreciate you laying out here today what you did and look forward to talking to you again.

Warren Kirshenbaum: Thank you very much.

Brecht: Okay, thank you.

Warren Kirshenbaum: Okay.

Brecht: Bye-bye.

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