# Japanese Participation in US Real Estate Workouts

Japanese kinship and corporate relationships color every business decision.

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Real property projects in the United States in which Japanese companies have participated as lenders and owners aggregate over $100 billion. Most of that investment occurred between 1982 and 1992. It is estimated that probably half of these projects are sufficiently troubled that some "restructure" of the transactions and debt liquidity relationships may be necessary.

## DIFFERENT JAPANESE AND AMERICAN APPROACHES TO BANKING AND BUSINESS RELATIONSHIPS

Everyone agrees that "relationship" is a critical concept in corporate/partnership and bank/borrower dealings. But "relationship" means different things to US and Japanese businessmen. The Webster definitions focus more on personal and individual connections than do the Japanese definition, which speaks of connection between blood kin or "organizations" at comparable levels. (See sidebar.)

American businessmen realize this only when projects become troubled and the Japanese, who until then had been relatively passive participants, are obliged to become involved. The search for a solution to the difficult circumstances reveals that each party has radically different expectations about how each expects the other to behave.

### Business "Transaction" Versus Business "Relationships"

When a business transaction evolves in America, the parties concentrate on the transaction rather than on the relationship. The coming together of two or more parties in the business deal makes the creation of a relationship a necessary "byproduct" of the transaction, but it is the deal that is paramount. "Relationships" are formed more on the personal or individual level than on the institutional level. In Japan, the relationship between organizations usually precedes the transaction. Without the relationship there may be little or no hope of doing business. The transaction is a "byproduct" of the opportunities created by the existence of relationship. Japanese business lore is rich with the approving stories of the executive who spent months or years developing a business relationship that ultimately enabled a transaction to occur between companies.

Thus when Japanese executives first meet, they may ascribe more importance to the other's company, to the *Keiretsu*, or group of companies of which the firm is a part and to the organizations with which it does business, than to the possibility that it will engage in any particular transaction. Knowledge of the executive's title and rank is critical to establishing his proper place and role and makes it possible for the executive to address others properly and to be addressed appropriately in return; it establishes immediately a clear understanding and expectation in others of the executive's authority and ability to represent the company.

All of this, and much more, is communicated by a simple exchange of business cards. The Amer-

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## American vs. Japanese Definitions of "Relationship"

American Definition (Webster's Dictionary)

(1) the state of being related or interrelated (entered in the marriage relationship); (2) the relation connecting or binding participants in a relationship; (3) a: a state of affairs existing between those having relations or dealings (had a good relationship with his family), b: a romantic or passionate attachment.

Japanese Definition (Kojien Dictionary)

(1) a situation in which one thing and the other thing have a connection with each other, and (2) a particular connection in human society, i.e. (a) an affair between man and woman, (b) a connection in terms of blood kin or organizations, (c) to be engaged in a matter, and (d) a field of a specific business.

ican executive who receives a Japanese business card from his Japanese counterpart usually does not understand its implications. For an American the most important function of the business card is that it reduces the risk of forgetting the other person's name, and is a convenient repository of addresses and phone numbers. It is little more than a thoughtful convenience. A typical American introduction starts . . . "This is Mr. White of the ABC Company . . . he is the man responsible for the XYZ deal." These remarks tell you that in the US, the record of a person's individual successes qualifies him and identifies him, not the multiple-layered and intertwining relationships of which he is a part.

### Transaction Solution versus Relationship Solution

When a project becomes troubled, Americans usually seek a clinical solution. They are not devoid of concern over relationships, but they place more emphasis on the creation and application of a wide array of tools and mechanics to repair or reposition the transaction in the most efficient way. However, agreement on the solution is often inefficient and uncertain because the absence of strong relationships among the parties sometimes results in a wasteful contest of competing interests. The conflicts that arise are sometimes resolved by litigation, bankruptcy, arbitration, or sometimes by hard negotiation. Transaction-oriented negotiations reject the importance of relationships and can be most distressing for the Japanese participants. (However, the Japanese company's rejection of certain types of income maximization does not mean that it abandons the pursuit of self-interest. In its own way, a Japanese firm vigorously pursues its goals, but through the forum of relationship pressure.)

Because American individuals have "transactional" identity, they attribute the failure of a deal to the individuals involved, and the relationship with them may be sacrificed. But the Japanese, who are at all times concerned with lasting and broad relationships, find that type of fault allocation and the sacrifice of individuals to be more difficult. The Japanese do not believe that an enduring relationship should be significantly changed because of a bad deal. To change the transaction to meet changed circumstances may call into question the initial and continuing integrity of the parties to the deal; not only of the executive who was point man in the deal, but of the entire team and the company it represents, whose commitment stands behind the project.

If a project involving only American parties fails, the nonrecourse lender (bank) may have to foreclose and take a loss. This does not mean the bank would not do business with the borrower (or its principal) again. If the borrower kept its obligations faithfully, cooperated with the bank at all times, and is perceived as being not responsible for the problems, the bank might very well enter into another deal with that borrower. At least that's how the parties would behave during the workout. And if the borrower returned to the bank for a loan on a subsequent deal, the bank might look at the request strictly from a risk underwriting viewpoint. Even the biggest and best developers and banks make mistakes or have projects that lose money for reasons outside of their control.

For the Japanese, the workout issues are much more complex. They must simultaneously preserve relationships while assigning respon-

sibility for the failure and demanding accountability. Arriving at a consensus among participants is delicate, time-consuming, and serious. The ongoing importance of relationships between Japanese companies may be so much more significant than the disposition of the subject project that the workout solutions are incomprehensible to Americans. Americans may look at what appears to them to be inaction or indecision and complain that the delay is damaging the project or that the Japanese fail to act or perhaps do not understand the changed circumstances. Of course, this is not true; Japanese executives can read and understand appraisal reports and market analyses as well as anyone, probably study them harder than their American counterparts, and understand (or misunderstand) the markets just as well. But they feel the consequences of a problem differently and therefore are constrained to approach its solution differently. In addition, the full recourse nature of most Japanese borrowings, and the fact that they are not usually "project finance" identified with a specific property, make it harder for Japanese lenders and borrowers to have developed any inventory of transactional techniques to deal with special project issues. Once they have addressed the relationship issues, the lender and borrower may take actions that may not appear to be directed towards the highest transaction recovery. But the actions are usually the best decisions for the continuing relationship.

> The Japanese may be unable to restructure failed deals because they focus on the deal's effect on corporate relationships.

### The Price of Failure

Another interesting cultural difference affects the consequence of failure to both Japanese and American executives. An American who is part of a company that fails because of underperforming real estate projects may escape with his career intact if the failures were projects for which he had little or no responsibility. As long as his transactions were "winners," and his individual reputation remains strong, he should be able to find new job opportunities with other companies.

However, the American is accountable for his projects. It is not uncommon that a transaction failure leads to dismissal and the disgraced executive may have difficulty relocating because he is closely identified with the failure. Nevertheless, many Americans seek out the risk and responsibility of potential failure for several reasons. One is that success and advancement often depend on building a personal history of successful transactions. Another reason is the forgiving grace of a "no harm-no foul" mentality. An executive can make a mistake, but if he recognizes it, acts quickly to correct it and achieves transactional success, his initial error is forgiven. American business lore is rich with approving stories of the failed individual who suffers humiliation, but through hard work and skill rebuilds to and surpasses his original position.

The threat to the Japanese executive is the stigma of company failure, or (since complete company failure is rare in Japan) severe company setback or reversal. Company failure is felt and shared by most company executives. Japanese executives from such poorly performing companies cannot find other employers who will give them opportunities to prove their personal worth.

If a Japanese executive's project fails, he receives no transaction opportunity to recovery, for he can find no relationship strong enough to support its creation. Though he may not be forced to resign, he is shunted off to a position of less responsibility in a bypath with little or no chance of rejoining the main trunk to continue a career ascent. In fact, his new assignment may allow him no role or authority in the action taking place around him. He becomes a "window man," gazing out of his office and effectively exiled, though visible to all as a living reminder of the source of failure. The damage to relationships of such a career diversion may not be repairable, so the finality of such discipline in the Japanese company is ameliorated by a decision-making system that diffuses and spreads the blame for all failed projects, and that inhibits aggressive, individual risk-taking that may threaten others.

### Recognizing Each Other's Perspective

The differences that have been described create an interesting challenge for anyone who is seeking effective and practical solutions to a troubled real estate transaction that involves Japanese lenders or owners in an American market.

First of all, American business executives must recognize that Japanese lenders (especially

lenders with participated loans) and Japanese equity investors (especially participants in multiple investor partnerships) are likely to frustrate a purely transaction-oriented approach to a workout. Because the Japanese will treat the problem as primarily a Japanese business relationship problem, they will treat the issues as relationship issues to be solved in Japan without the use of American-style restructure techniques. This means that many American "opportunists" who see transaction opportunities, similar to those that existed in RTC disposition, corporate portfolio restructures, packaged sales of American bank loans, and foreclosures, will be disappointed. Americans who gather around a Japanese bank seeking to buy at a discount notes secured by real property, have a real chance of affronting the institution, because such a sale challenges the bank's commitment to relationships with its customers. The chance of doing business after that kind of start is not promising.

> The issue is not the limited partners' obligations but the long-term relationship between the LPs and the bank

Many restructuring problems will be eased when the Japanese realize that the myriad of techniques developed in America can be selectively and usefully applied to reduce adverse financial consequences, and thus to reduce the pressure on relationships.

## TREATING A TROUBLED JAPANESE/AMERICAN PROJECT: A HYPOTHETICAL CASE

An example that is characteristic of many of the larger transactions concluded with Japanese owners or lenders during the last decade is presented.

### The Project Description

The project was a $100 million office development. The owner was a limited partnership with an American General Partner (GP) and three Japanese limited partners. To start the project, the GP approached the US agency or branch of a Japanese bank (the "Bank") for a loan, forecasting 14 to 18% yields on the $100 million project value for seven years. The proposal looked good to the Bank, but its "conservative" underwriting policy required that it advance no more than 70% of completed value. In addition to the land, it demanded $20 million of hard cash investment. It offered attractive libor plus 100 basis point financing for seven years on a nonrecourse construction/"miniperm" loan.

### Raising the Equity Capital

The GP planned to use a broker or investment banker, or possibly the Bank itself, to locate investment partners. As it turned out, the Bank found the investors, who paid a fee to the Bank. Of the three Japanese investors, the lead investor was a construction company, a second and smaller investor was a real estate company that invested in Japanese office buildings (built by the same construction company and financed by the same bank, evidencing two separate long-term relationships); and the third investor was owned outright by the Bank.

The Bank actually loaned the $20 million of "equity" to its clients in order to put them into the limited partnership. These loans were on typical revolving corporate full recourse lines, the Bank receiving in return guarantees or "comfort letters" from the parent companies of the limited partners.

### The Structure of the Limited Partnership

The limited partnership agreement called for a 50/50 profits split between the GP and the Japanese limited partners (LPs), after the partners had received a return of all capital contributions plus an annual 9% "preferred" return on the hard cash investment. The LPs were to receive the "preferred" return before the GP received any return on its capital. The partnership compensated the GP for developer services. The Japanese construction company LP was the nominal general contractor, or it had a related company act as contractor, and it received some fees for that function. The loan had an unusually large interest reserve or "stabilization" reserve for lease absorption, in exchange for which the GP agreed (but without guarantees) to be responsible for cost overruns and operating deficit capital contributions.

The Bank requested, and received, irrevocable standby letters of credit from all of the partners, proportional to their ownership shares, for construction cost overruns risk.

### The Project Construction Loan

The Bank sold participations in the secured loan to four other Japanese financial institutions. (Interest rate swaps, or caps, or collars, were also a

part of the transaction.) This created a new overlay of relationship issues. The Japanese participants in the loan had no direct relationship with the LPs on this transaction.

Later, when the project got into trouble, the bank was caught in the middle of a difficult mix of relationship pressures. Loan participant issues can be difficult for a lead bank in any culture, but whenever significant writedowns of the loan balance are a possibility, a refusal of participating banks to share in losses becomes a major obstacle to practical resolution of the problem. The problem is especially difficult when a small participant simply demands full payoff using "relationship" pressure.

The bank believes that the American GP's restructure suggestions reveal lack of integrity.

### The Present Status of the Project

It is now four to six years after the loan was signed, and the situation has become grim. Although the GP has been honest, professional, and hardworking, and the core and shell were completed on time and on budget, the property is obviously troubled. Recession and office oversupply have stalled the leasing program at 60% occupancy. Cash flow is lower than projected, not only because of slower than forecast lease absorption, but because of lower rent rates and longer free rent concessions. Some tenants have troubled businesses, and in order to keep some income flowing, the landlord renegotiated a few leases at lower rates. The loan reserves are now exhausted. Larger than budgeted tenant improvement allowances (as the project desperately sought tenants) have drained that account, and the property manager has asked the partners to contribute $8 million to build out the remaining space, pay leasing commissions, and in addition, to pay $1.5 million during the next 18 months to service debt interest payment shortfalls.

The loan matures in less than two years, and the current fair market value of the building is estimated at $45 to $50 million. The FDIC is applying "mark to market" pressure on the bank's US agency office; the Japanese Ministry of Finance is pressuring the bank on domestic real estate, stock speculation, and nonbank finance company loans at home. The consequences of the collapse of the bubble economy on traditional corporate lending are severe: the contractor LP has numerous other troubled projects throughout the world and a bidding scandal problem locally that may inhibit its ability to participate in lucrative government contracts for several years. Interest rates in Japan and the US are starting to rise.

### Conflicting GP and LP Interests

The LPs turn to the GP and ask the American partner to put up the money needed to complete the leasing and to carry the project to stabilization, according to its commitment under the agreement of limited partnership. Unfortunately, the GP is either unwilling or unable to do so. Perhaps the GP has other problem projects that have reduced its previously substantial net worth and cash reserves. Or perhaps it is because the partnership agreement specifies that additional contributions are to be subordinate to the preferred return payable to the LPs, and it is clear that the GP will never receive a return of this additional capital contribution, let alone of the initial investment. Even if the LPs did not have priority of return for additional capital investments, the $20 to $25 million gap between current project value and the loan balance makes it likely that any new GP contribution will be completely lost.

Antagonisms and anxieties simmer beneath the surface. The construction company LP is worried that it may lose its limited liability protection because of its nominal general contractor role. The bank discloses to its American lawyers for the first time that it had introduced the LPs to the deal, that it had collected a commission from the LPs through its subsidiary, that it had loaned the "equity" to the LPs, and that the third LP in the project is actually a bank affiliate. Finally, nobody ever disclosed these facts to the GP. The attorneys send the bank a memo on lender liability risks under United States law that creates a panic.

The GP is fighting for its financial life and needs the cash flow from management and leasing fees to pay its overhead. The assets of the GP's parent company are illiquid, and there are thin capitalization, alter ego issues that may expose those assets. Worse yet, the GP's principals are worried about personal liability for representations made to induce the LPs to invest and for the bank to make the construction loan.

The bank is disturbed by the GP's numerous restructure suggestions, suspecting that they

reveal a lack of integrity, because they "change the commitments" of the original transaction/relationship. The GP believes that the LPs and the bank are denying reality, or lack understanding to such an extent that they are damaging the transaction's restructure opportunities. The GP suspects that the large all-powerful and rich Japanese LPs and the bank are working in league to appropriate this losing project and punish the GP by increasing the GP's share of losses. All this paranoia on both sides has no basis in fact.

> The parties must focus on smoothing out relationships rather than on ingenious structure solutions.

### The Partners Discover Initial Misunderstandings

When he initiated the transactions, the GP thought of himself as a fee developer with a 50% profits participation. But the Japanese thought of him as a partner who would share the pain of failure with them. They believed that the GP had demonstrated a willingness to do so when he effectively subordinated his capital position to bear first risk of loss. Although he probably would have funded certain shortfalls in a viable project, there is no way to force the GP to make that contribution in this situation. Because the GP did not have a Japanese style "relationship" bond with the LPs, he felt no obligation to advance the moneys. The GP is surprised by the deep disapproval of the LPs and the bank (something much more fundamental than simple unhappiness at a loss of money) and he cannot understand their reaction. The GP views the partnership as a "transaction."

The LPs entered the transaction believing that they were second priority lenders with participations in profits. The LPs believe they have no obligation to fund the shortfall—either to the bank, the GP, or to each other.

The GP believes that if he can get the LPs to make a cash infusion of $8 million, in four more years the project will be worth at least $95 million. Believing that the LPs have substantial resources and convinced that relatively few additional dollars will solve the partnership's problem, the GP cannot understand why the LPs do not just put up the money. He cannot understand that the relationships among the three LPs and among the four lenders, and between the LPs and the lenders, make it very hard to arrange additional contributions.

The bank is in an embarrassing position. It is reluctant to ask the LPs to fund shortfalls, because the bank introduced the LPs to the deal and it therefore has relationship responsibility to the LPs. Indeed the LPs may be pressuring the bank to lend them additional monies in addition to the bank's original equity loan. The LPs hope to use these funds to solve the partnership's problem. In addition to being embarrassed, the bank may be concerned about its exposure to lender liability claims by the GP.

If the LPs conclude that the GP is considering strategies like filing for bankruptcy, the LPs may be troubled by the implications of these strategies for their image and for their relationships with the bank.

An overriding issue that concerns both the LPs and the bank is the deterioration of the dollar relative to the yen. The transaction was initiated when the exchange rate ranged from ¥125–145 to the US Dollar, and now the value of the dollar has dropped to little over 100 yen per dollar. An asset disposition in the current market followed by capital repatriation to Japan, if there is anything to repatriate, is not attractive either to the LPs or to the bank.

### Finding Solutions

It should now be clear that the bank does not wish to foreclose the project. If the parties are reasonable and not vindictive, they will recognize the true present value of the property, preserve the relationships, and maximize whatever returns the project is able to produce.

It may be possible to restructure the notes and dispose of them, and even to sell the project. Securitization is another path that could be followed. Infusion of new capital and realignment of partner percentage interests is also possible. All of these solutions involve the flexible tools available in the American "transaction" inventory; at the same time, when properly applied they may enable the parties to strengthen and fulfill the "relationship" obligations.

## CONCLUSION

As issues of relationships are resolved, it becomes possible to work out troubled real estate deals. Occasionally, in the larger prestige projects, if

the deals have financially strong Japanese owners and lenders, opportunities arise for non-Japanese participants in the workouts. Opportunities in these deals, like ripening apples, will fall when they are ready, but they cannot be rushed.

Many observers assert that restructure transactions will occur with great frequency during the next two years. One reason is that many of the Japanese equity owners or LP corporations are completing internal corporate reorganization, and are now able to take losses in a manner acceptable to their parent companies and banks. They can now transfer property interests from one subsidiary or related corporate group to another. The transfers will result in losses that they must recognize for accounting and tax purposes, but because they are not selling the property to unrelated third parties (at least not now), they also set up possible recovery gains.

Restructurings will also accelerate, because the banks have now set aside loan loss reserves. In appropriate cases, they are prepared to share the pain of workout with their borrowers. A third incentive to engage in workouts is that many of the construction companies will realize lower profits two or three years out due to reduced government contract work in the Japanese domestic market. They may prefer to take extraordinary losses now rather than at that time.

American investors who wish to become involved in this activity should attempt to develop deep and sincere relationships with their Japanese counterparts. US investors who rush impatiently into deals will only waste their time and money, and upset and frustrate the Japanese LPs and banks.

US investors must understand that they are becoming involved in Japanese problems that incidentally happen to involve US real estate. To the Japanese investor or lenders, the resolution of project-related real estate issues are secondary in importance to solving the Japanese "relationship" issues. In cases in which relationship issues are not present, the Japanese banks will package and sell notes, conduct foreclosures, and otherwise act similarly to their American bank counterparts.

An American transactionalist who reads this article focusing on the transactional solutions may observe that there is nothing unusual about the basic concepts that have been discussed. But he will fail in efforts to do restructure transactions with the Japanese if he is unable to recognize and accept the need to respect delicate relationship sensitivities and to use the restructure tools in his inventory in sometimes novel ways. A Japanese LP or bank who reads the above will be surprised that the simple and basic discussion of relationship should be of interest to and should not already be understood by Americans, and may not fully appreciate the vast array of techniques readily available that can be used to help in the preservation of important relationships.

Like two people who have fallen into a hole too deep to permit one to escape unaided, Japanese and American partners must learn to save themselves by saving each other.