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A Primer for Lenders: Practical Solutions for Defaulted Residential Development Projects

By McFarland, Beverly & Crispin, William*

[Part I of a series on lenders' crisis issues; Part II will discuss evolving legal developments in this national real estate crisis. Ed.]

News media nationwide report doom and gloom for residential lenders and builders/borrowers. This article focuses on residential development projects in default and how lenders may minimize damage and maximize possible returns. Recent bankruptcies show that home developers often wait too long to file bankruptcy; there is not much left of the company to reorganize (or even liquidate). Lenders who continue to negotiate with borrowers beyond a practical time frame may fare similarly; waiting too long to seek appointment of a receiver may result in unnecessary (or complete) loss.

The situation is evolving rapidly. Here are a few points for lenders, their counsel and receivers to think about from business and legal perspectives.

• Is It Worth the Lender's Time to Negotiate With a Developer That Has Standing Inventory and Finished or Unfinished lots to Sell?

Prior to negotiating on a developer's defaulted loan, a lender should: require evidence that current insurance is in place; review loan documentation to assure that its UCC-1 filings are current (must be renewed by the secured party every five years to avoid lapsing); and obtain an updated preliminary report of title to reconfirm its priority position.

Current market appraisals become essential if the lender acquires the property; they are of little value for purposes of negotiation in a rapidly declining market, however. A developer sincerely seeking a solution to the problem may propose alternatives to the lender, i.e. selling standing inventory through an auction, discounting asking prices to the surrounding market, and the like. The lender may be asked to lower release prices per unit (with no profit to the developer) with agreed upon expenses to be paid from the proceeds. If funds remain in the loan the lender may agree to fund fencing for partially constructed areas of the project to protect standing inventory from theft and vandalism, or require that security systems be installed.

The lender can encourage (and set a deadline for) the developer to obtain an equity partner for the balance of land holdings to pay down or retire the loan, with an agreement that if no equity partner is obtained the finished and unfinished lots will be transferred via a friendly foreclosure or deed in lieu of foreclosure in exchange for negotiated lender concessions.

• What if Construction and Marketing Have Halted?

"Oh my gosh! I just inspected our $10 million single family construction project and all the model homes doors are locked, flags are gone, no real estate brokers signs are visible, partially constructed houses are wide open (with condensers, heaters and other equipment affixed or sitting in boxes), there are open trenches, exposed and kids are skate boarding on the cement foundations with protruding pipes."

What is a bewildered bank to do? Consider calling the borrower for an explanation and hope for an answer or a return call. If this fails and your certified letter is returned unopened, tell counsel to file an ex parte application for a temporary receiver to protect the collateral.

There must clearly be an emergency for ex parte application for this drastic but effective pre-judgment remedy. The application must state the defaults, but more importantly must include your observation that the project has been abandoned, and that there are health and safety issues to be addressed as soon as possible "to protect the general public." The application should be supported by a declaration from the loan officer who personally inspected the property!

The lender must also show that there is no adequate remedy other than obtaining the immediate appointment of a receiver. If approved, your application may even prompt the developer to give you a call! The borrower/developer will receive an order to show cause returnable not later than 15 days (22 days for good cause shown), giving it an opportunity to challenge the confirmation of a permanent Receiver (or the ex parte appointment).

The lender must be careful about the accuracy of the supporting declarations. If the lender obtains the appointment of a receiver based on false declarations the developer may seek damages. Remember to keep the ex parte receivership application focused on current facts and make your presentation as clear and simple as possible. Remember that the judge has only limited time to review applications in an ex parte hearing setting.

• Is There Still a Market for the Condominiums, Townhomes or Detached Single Family Houses or Lots?
Your defaulted developer tells you it seems there is no market for three-story walkup condos in Modesto, even though Brownstones sell well in Boston. She says that it isn't her fault that you funded 30 pads and two model homes that have not sold in a year!

While you are beating yourself over the head with the newspaper's latest foreclosure statistics, order a market study of competing area projects. Determine what is still selling in the area and at what price. A workout for a difficult project may be to allow the developer to sell the models and change the product. Or, you may fund sufficient remaining capital to scrape the balance of the foundations or pads and the developer can sell the vacant land. It isn't likely an equity partner will be interested in venturing such a difficult project. The lender should try to cut its losses any way possible. The problem is not just a troubled economy; sometimes the project was a "special" loan from the start!

• Would Builder or Lender Incentives Boost Sales?
Assume a developer with a solid business plan is on the verge of default in a market that is slow but with some pent up demand. A workout now may be better than the foreclosure option. Assuming some funds remain in the loan, carefully review the construction cost allocations in the loan with the developer. Ask him if it is feasible to delete some items and enhance others that may be appealing to buyers under new market conditions. After doing market research to identify the target buyer, the developer may offer more competitive below market pricing and favorable financing options to move existing inventory (this may be less expensive than receivership and foreclosure in the long run). Such a developer may successfully find an equity partner to enable him to retain partially developed (or undeveloped) project land. Pay attention to workout timing!

• When Should the Lender File a Notice of Default?
You have been more than patient on the defaulted construction loan for 20 town homes. Your loan is fully funded, and workout options have been fully explored. You believe that if the project were owned and controlled by the bank you might be able to do a retail sale (with incentives) or an auction of the units. The developer happened to leave a card on his seat from a local bankruptcy lawyer after your last meeting (by accident of course).

The time may be right to file a notice of default and start the ninety day clock ticking, and bring a noticed motion to appoint a receiver to protect the collateral. If a bankruptcy petition is filed, you may have less time to wait to foreclose after relief from the bankruptcy stay is obtained. A lender can file a relief from stay motion at any time after the petition is filed, but may have to wait 30 days or more for hearing on the requested relief.

• Is Taking a Deed in Lieu of Foreclosure a Smart Risk?
Taking a deed in lieu may be a quick option, but is a smart one? It may be fraught with peril. The potential of lender liability looms. The lender is basically stepping into the shoes of the developer – and liability on unpaid mechanic's liens, potential code violations, construction defects, etc. The legal pros and cons of this option will be addressed in Part II of this article.

Should You Seek a Receiver Sooner Rather than Later; What Benefits / Problems Can Arise?
Consider: problem loans are increasing in your portfolio and REO properties are piling up. Mr. Lux, your high end luxury condominium developer, reports no sales on this residential project for several months. He blames the economy, but an adjacent project is selling some units. The loan is in default and you have reason to believe that: some loan proceeds did not go into the project; and some units may have been discounted and sold to private equity fund investors for cash and are now rented (no proceeds to you of course).

You have asked for updated financials and a business plan for a potential workout, but response has been delayed because Mr. Lux is on a family vacation in the Bahamas on his new yacht.

After you carefully check your loan documents you might want to have counsel file a noticed motion to appoint a receiver and file a notice of default as soon as possible. Given these facts a receiver might be able to preserve and salvage what is left of the project and solicit a broker or auctioneer to sell the remaining units for the benefit of the estate (with court approval of course).

The Receiver will have to show both necessity for the sale as well as necessity for the timing of the sale to obtain a sale order from the court. Evidence that the property is not generating capital and could suffer a substantial deficit in the future may not be adequate to justify an immediate sale of the property; that will require a showing of imminent destruction or material devaluation of the property. By this quick action you may not realize 100% of your loan funded, but you may recapture more funds with a receiver minding the store than with Mr. Lux in charge.

As units are sold off you find that mechanics liens are coming out of the woodwork. Do these liens constitute potential liability to the receivership or to the lender? How may a lender protect its self from lender liability issues while the project is in receivership? Does the lender need to be concerned about these issues? More discussion in part II.

• Cost and Benefit of a Buildout in a Receivership.
Clear points and authorities are required to convince the court that a buildout in a receivership will benefit the receivership estate (and all parties). A Court may not wish to deal with risks implicit in a buildout unless the need is clear. Agreement of all other creditors helps. At a minimum a showing must be made that other creditors will not be prejudiced.

Next, the lender will have to identify a qualified and experienced residential construction receiver to recommend to the court. The appointed receiver may also be a general contractor, or someone who understands and will monitor buildout construction.

The lender should obtain an appraisal, a cost analysis, and study of feasibility and sales absorption to aid in deciding whether to build out with a receiver, or try to obtain court approval to sell the project "as is." Remember that the cost analysis must include the cost of the receivership, which the plaintiff will be responsible for funding in the likely event that the estate does not have sufficient funds to begin with.

Be sure to obtain the receiver's input on what authorities and documentation she/he will need from the developer/borrower, and include this requirement in the receivership order. The order should require turnover of (but not be limited to) the following: (a) all building plans, specifications and cost sheets, plans and cost sheets for onsite and offsite improvements; (b) all information and original contracts pertaining to contractors and subcontractors; (c) all documents concerning contract rights and payments; (d) all documents regarding mechanic's liens (and any litigation filed), (e) all construction contracts and bids; (f) any liens filed against the project; (g) all sign off cards from building inspectors and governmental approvals; (h) all

rights of access and easements; (i) all permits, licenses lease agreements and leasehold interests; (j) all documents and records and accounts pertaining to the homeowners association; (k) all modular units or trailers; (l) all equipment, inventory and supplies;(m) all utilities information and general intangibles; (n) and all records and other documents wherever located.

• Is an Internal Buildout a Reasonable Alternative in a Declining Market?

All right! Your notice of default has run it term, the foreclosure is completed, and the single family, lower end construction project is now titled in "Straightforward Bank." You are ready to go! But you must then decide if it is really worthwhile to build out this single family project in Los Angeles. The number of homes in some stage of foreclosure jumped approximately 57 percent in January 2008 compared to a year earlier; lenders are being forced to take possession of homes they cannot unload. Think about the risk! What about discounting the entire project to appeal to a "foreign investor" or equity fund instead?

If you are faced with making the decision "To build or not to build," be very cautious. Selling at a discount now or at an auction may be a better decision in the long run than laying out the funds to build out the project unless the market / region indicates a reasonable chance of recovery. An internal build out may be reasonable in some markets but not others. Do your research thoroughly before you decide.

What Are the Risks in Allowing the Project to Sit and Deteriorate Pending Completion of the Foreclosure?

The answer to this depends on many factors — the location, type and condition of the project, local market conditions, developer's strength (financial only!), outstanding mechanics liens, current percentage of completion, percentage of vacant land, potential liability issues and environmental issues all must be considered before deciding whether to move forward "in a cautious manner".

Not taking any action may also result in liability, however. If the lender knows of but ignores health, safety and environmental issues detrimental to the general public, if the project is sustaining considerable vandalism and theft, if insurance is non existent or insufficient, and the lender does little to intervene (thinking that lender liability is limited or nonexistent), the lender may be unpleasantly surprised! The potential legal ramifications of inaction in these circumstances will be discussed in Part II.

• What to Do if the Developer Says a Chapter 7 or 11 Bankruptcy Filing Is Imminent?

Filing a notice of default as soon as possible is always a good idea. With luck you may beat the bankruptcy filing. Obtaining appointment of a receiver is problematic at this point, since the bankruptcy judge may or may not allow the receiver to remain in control of assets in the case. The court may prefer appointing a bankruptcy trustee, or (shudder) allow the debtor to remain in possession. In any event, at the end of the 90-day notice period you can seek relief from the automatic stay to proceed with the foreclosure sale.

Whatever the ultimate choice, lenders should deal with the current residential development issues firmly and quickly. There will always be a new issue brewing on the horizon. According to Goldman Sachs analysts, commercial real estate is starting to slide and they project a "prolonged sharp decline." Does this remind any of us of a different time in space?

[Click here for Part II of this article. Ed.]

**** Beverly N. McFarland**, CEO, The Beverly Group, Inc., a nationwide asset management and consulting firm located in Granite Bay, California and the Northern Bay Area. Its principals serve as receivers and trustees in bankruptcy as well. Ms. McFarland is a Founding Director in both the California Receivers Forum and the Sacramento Valley Chapter, past chair of the CRF, a current member of the Bay Area Chapter and an Associate Publisher of Receivership News.*

**** William H. Crispin** is a partner in Crispin & Greenberg, P.L.L.C., a law firm in Washington, D.C. specializing in commercial litigation and telecommunications law and also works with local counsel in various states around the country on receivership issues. Mr. Crispin received an award as one of "Washington's Top Lawyers" in 2007. www.crispinlaw.com.*