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The Legal Corner

Workouts with Homebuilders

By Michael Santoro & Josh Gluck
Kaye Scholer LLP

Here we go again! Less than ten years after the rise and fall of the tech stock bubble, the economy is now facing the reversal and potential collapse of real property values. As yet, there is no sign that we have reached the bottom of the real estate market, and the steady stream of bad news shows few signs of letting up in what is now being called the worst housing economy since the Depression.

Foreclosure rates are at two-decade highs and things are getting worse amid increasing trouble in the credit markets. No doubt homebuilders were the first to suffer in this market reverse and many are now beating a hasty retreat. The National Association of Home Builders/Wells Fargo Housing Market Index, where 50 is an even market, read 19 in December for the third month in a row -- the lowest score since the index started in 1985. With record inventory for sale, thousands of new residential units financed during the building boom are coming online only now, and as buyers are nowhere to be seen, 2008 will be a challenging year.

The end of good times has been abrupt for many developers and the lenders that financed them. How did this happen so quickly? Amid the real estate frenzy from 2002 to early 2007, lenders often loaned far too much money based on overblown land values, which were hiked, we are slowly learning, by a combination of easy credit, widespread speculation and a financial mania not unlike that surrounding internet stocks less than a decade ago. Developers and investors came out of the woodwork to put money into undeveloped land, finished lots and completed homes as quickly as they were offered for sale, sending prices for all into the stratosphere, and the lenders went along for the ride. Then came the subprime debacle and resulting credit crunch. The consequence was that the availability of easy financing vanished and the sales market for completed projects virtually ground to a halt, leaving homebuilders with limited exit strategies.

The first wave of loan defaults hit developers holding raw land and partially developed projects, and both lenders and large homebuilders have taken astounding write-downs. In both northern and southern California, discounts of 30-60% off of boom prices are now commonplace, with the Central Valley, Sacramento and the Inland Empire being particularly hard hit. Loan interest reserves are depleting quickly, and as absorption (i.e. sales) rates decline to historic lows, developers are missing payments and failing to keep covenants in their loan documents. As loans to developers mature, sources of refinancing have virtually disappeared. Developers holding raw land or partially complete projects are finding that the market for development and construction loans is dead, and are often forced to take drastic measures such as selling the property for cents on the dollar or giving up large chunks of equity for small investments by vultures.

Compounding these problems, if the lender has not been paid, chances are someone else has not been paid either. If a property in foreclosure is riddled with mechanics' liens and stop notices - claims by unpaid contractors who've worked on the project - the value of the lender's collateral may be seriously compromised, and a workout will be much more difficult if not impossible. During the heyday, construction on a project often started before the closing of the construction loan, and this is now complicating the ability to work out problem loans. In such instances, mechanics' liens take priority over the lender's deed of trust. When closing the loan, lenders routinely looked to title companies to insure against mechanics' liens, and as a result the title company often obtained an indemnity from the borrower or other deep pocket. If the indemnitor has now gone belly-up, those indemnities are worthless to the title company. As they face increasing claims from lenders, the once friendly title companies are now looking for ways to avoid paying claims on their policies, setting the stage for legal wrangling with lenders.

So now what? Developers who wish to remain participants in good standing in the industry should be working closely with their lenders to come up with a reasonable, collaborative workout plan to make it over the hump. Although in the past, many lenders have taken a hard-line stance against delinquent borrowers, as default rates rise and lenders are coming under increasing strains to stem losses, many may be willing to cut deals to avoid becoming land barons by foreclosure, especially with those borrowers who are honest, cooperative and make full disclosure about the state of their projects and their accounts.

Some lenders are recognizing that if they foreclose, they will have to sell the property at a deep discount or hire a developer to complete the project, and that working with the existing developer who knows the property may be the best way to maximize returns. Loan terms can be extended, interest partially or fully deferred, curtailments and payments reduced or deferred and covenants loosened. A lender may be more disposed to make a deal if a borrower or guarantor is willing to pay some or all of accrued interest, taxes and insurance, maintain the property until the market improves, and/or handle mechanics' liens claims. In some circumstances, borrowers have been extracting fees from lenders to assist in the disposition or ongoing maintenance of the property, giving the developer assistance to pay overhead until the market turns. In addition, some lenders are showing increased willingness to accept short pays on loans if property is sold in lieu of foreclosure.

In a challenging market, workouts may benefit both the lender and the borrower, and it is best for both to have solid plans in place before the dropping of the other shoe - the commercial real estate market.

Michael Santoro *is a partner in the Real Estate Department of Kaye Scholer LLP's Los Angeles office, where his areas of practice include real estate, commercial law and bankruptcy, with an emphasis on workouts and debt and equity financing, representing investment banks, financial institutions, insurance companies, developers, investors and borrowers. Mr. Santoro can be reached at* ***310.778.1095*** *or* ***msantoro@kayescholer.com.***

Josh Gluck *is an associate in the Real Estate Department of Kaye Scholer LLP's Los Angeles office, where he assists in the representation of clients in various real estate industry matters, including investment banks, financial institutions, developers, investors and joint ventures. Mr. Gluck can be reached at* ***310.788.1093*** *or* ***jgluck@kayescholer.com.***

KAYE SCHOLER LLP • **1999 Avenue of the Stars, Suite 1700 • Los Angeles, CA 90067**