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August 17, 2009

The Stress of Distressed Assets: Lenders Need to Think Twice About Foreclosing on Partially Completed Residential Developments

Ellen M. Berkowitz
Brady R. McShane

It's undeniable: The United States economy currently faces the worst recession since the Great Depression. Constricted credit markets combined with plummeting real estate values have had a disastrous impact on much of the nation's residential development community.

As reported in an article by Roger Vincent (using market information from Hanley Wood Market Intelligence) in the March 4, 2009, issue of the *Los Angeles Times*, developers in California have abandoned the construction of approximately 250 residential developments with a combined total of 9,389 houses and condominium units, valued at approximately $3.5 billion.

According to that same *Los Angeles Times* article, developers have discontinued sales on 370 new-home developments in California, totaling approximately 30,000 residential units worth around $11.9 billion.

These properties, commonly referred to as "distressed assets," have become a significant liability for the lenders left holding the rights to them in today's depressed economy.

The objective for lenders involved with distressed assets is to preserve whatever value there is in an asset and, ideally, find a way to generate a future return on that investment. Previously obtained entitlements and permits, which require significant time and money to secure, can be in danger of expiring or being terminated by local, state or federal agencies

Newsletter Editors

Roger Grable
Partner
rgrable@manatt.com
714.371.2550

Our Practice

Manatt has a broad background in all areas of real estate practice due to default. Losing existing entitlements and permits potentially can devalue a distressed asset by tens of millions of dollars.

Understanding potential environmental liabilities, development obligations, permit requirements and mitigation measures is critical to effectively evaluate the present and future market value of the asset. By analyzing a number of land-use issues relative to those assets and performing adequate due diligence to understand both the beneficial and potentially negative aspects of the asset, lenders can develop a strategy to obtain their objectives. In other words, they can make the distressed asset a little less distressing.

This article lays out the necessary steps to effectively evaluate land-use issues associated with a distressed asset. Those steps include obtaining a current 1) analysis of project entitlements, including discretionary, administrative and third-party approvals; 2) analysis of remaining on-site and off-site development obligations and applicable mitigation measures; 3) accounting of other operating expenses such as development and impact fees, property taxes and municipal bond assessments, such as community facility and service district assessments; 4) environmental assessment of the project site; and 5) assessment of the political landscape and potential to renegotiate project approvals to reduce development obligations and create a viable project.

Analyzing project entitlements: Obligations, fees and expiration/termination

Project entitlements are local, state or federal government approvals that permit construction of a project in a given location. They can include discretionary approvals, administrative permits and licenses, and other third-party approvals and agreements.

(Discretionary approvals typically are issued by a body of appointed or elected officials who are under no obligation to issue such approvals. Administrative approvals, on the other hand, usually are issued by agency staff and must be approved if the applicant satisfies specified criteria. Third-party approvals and agreements are issued by parties other than the local agency and in most cases are also discretionary in nature.)

These entitlements add considerable value to the property and have often been obtained after a lengthy and complicated political process. At the same time, they can impose a host of development obligations, development and impact fees, and other conditions, requirements and mitigation measures.

Most entitlements are valid only for specified periods of time. They are frequently in danger of expiring or being rescinded by the issuing agency due to default. Preserving them is typically of paramount importance, as is understanding the obligations they impose.

Development obligations, fees and other requirements

Discretionary approvals for a project range from more typical general plan designation and zone changes, design approvals and use permits, to more complex specific plans, development agreements, disposition and development agreements (if the project lies within a redevelopment plan area) and tentative tract maps.

In California, most distressed assets also will have undergone environmental review pursuant to the California Environmental Quality Act (CEQA) in the form of a certified Environmental Impact Report (EIR). CEQA applies to discretionary projects that are proposed to be carried out or approved by a public agency, and mandates that public agencies refrain from approving projects with significant environmental effects if "there are feasible alternatives or mitigation measures" that can substantially lessen or avoid those effects (see Cal. Pub. Res. Code Sec. 21000 *et seq.*).

In evaluating a distressed asset, it is important for the lender to understand what entitlements have been issued, if those entitlements permit development of the project as proposed and whether additional entitlements will be required to permit full build-out of the project. A project that is not fully entitled will be significantly devalued upon divestiture.

Additionally, existing discretionary approvals may impose conditions and/or require mitigation measures, which can include significant development and fee-payment obligations. In the distressed asset context, these obligations usually have not been fulfilled, with significant conditions remaining to be satisfied before a project can be constructed, a final map(s) is recorded and/or certificates of occupancy can be issued.

Furthermore, these obligations are extremely costly and time-consuming, and often go well beyond mitigating the impacts of the project itself.

Common development obligations tied to distressed assets include 1) construction of in-tract and off-tract backbone infrastructure such as roadway improvements, sewers, storm drains, water and dry utilities; 2) dedication of property for roadways, parks and open space, and utility easements; and 3) payment of impact fees for traffic improvements, schools and other public facilities.

Less-typical obligations (but not uncommon to large residential projects approved during the most recent real estate boom) include the imposition of considerable development fees and construction of 1) wastewater-treatment plants and other oversized infrastructure improvements; 2) public facilities such as fire and police stations; 3) community buildings such as libraries, civic centers and activity centers; and 4) affordable housing.

Further, if historically or culturally significant resources are on-site, the developer or successor-owner likely will be obligated to protect, preserve and/or rehabilitate these structures or sites. Additionally, a number of off-tract development obligations require encroachment permits or the purchase of land or easements to secure rights for their construction.

Distressed assets also may be subject to additional contractual obligations pursuant to a development agreement with a government redevelopment agency authority such that the developer or its successor is subject to profit and participation obligations requiring the payment of a certain percentage of its profits to the redevelopment agency when the project comes online and begins to generate revenue.

Administrative and third-party approvals include final subdivision maps, permits for horizontal and vertical construction, and third-party agreements and approvals such as 1) Williamson Act cancellation contracts overseen by the California Department of Conservation (the California Land Conservation Act of 1965, commonly referred to as the Williamson Act, allows landowners within locally designated agricultural preserves to enter into special contracts to restrict their land for agricultural and open space uses in exchange for tax reductions. Upon agency approval, a landowner may cancel a Williamson Act contract by paying substantial fees or exchanging the Williamson Act land for other land of equal or greater value and size. The exchanged property then becomes subject to a permanent agricultural easement); 2) streambed alteration agreements obtained from the California Department of Fish and Game; 3) Clean Water Act Section 404 permits issued by the Army Corps of Engineers for the discharge of dredged and fill material into waters of the United States; 4) Section 401 Water Quality Certification issued by the California Regional Water Quality Control Board; and 5) stormwater and wastewater permits issued by the State Water Resource Control Board and Regional Water Quality Control Boards.

As is the case with discretionary approvals, these approvals and agreements can impose onerous conditions, mitigations and monitoring requirements. Conditions attached to state and federal permits (take permits, 404 permits and 401 permits, for example) often require in-kind mitigation whereby the developer or successor-owner must provide suitable replacement habitat on-site or off-site, pay significant fees, limit construction during defined periods, and monitor and report on certain environmental conditions for a period of time.

It is not only important for a lender to understand the extent of obligations attached to a distressed asset, but also to evaluate the relative state of completion or satisfaction of these obligations-especially if the developer is no longer cooperating with the lender.

The lender should commission a consulting service to evaluate the status of improvements on the site and prepare a report identifying the estimated cost to complete remaining on-site and off-site development obligations. It also is important to engage an appraiser to appraise the value of the project, given the state of completion and current market conditions.

Although municipal bond issuances may have been originally anticipated by the approving agency and developer to finance specified improvements, such options often are no longer viable in the current market.

Expiration or termination of entitlements

Distressed assets often have been "mothballed" or outright abandoned by the developer. If certain conditions are not satisfied during this time of inactivity, entitlements can expire or be rescinded by the issuing agency due to the developer's default.

Reinstating entitlements can be time-consuming and cost-prohibitive for the successor-owner, and there is no guarantee that the issuing agency will not add additional conditions to the entitlement(s) or even reissue them altogether - particularly if the political winds have changed since they were originally granted.

Most large residential projects are governed by development agreements or vesting tentative subdivision maps that help to insulate them from detrimental changes in underlying land-use regulations and increases in impact and development fees.

These vesting tools essentially lock in development rights issued by the local agency, allowing developers to proceed with a project so long as specified conditions are satisfied within the map expiration period or timelines established in the development agreement. However, development agreements and vesting tentative subdivision maps expire, and are subject to termination by the issuing agency if the developer does not comply with their respective terms and conditions.

Transferability and third-party consent

In determining whether to foreclose on a property, it is also important for lenders to understand any limitations on the transferability of existing entitlements, as certain entitlements are more difficult to transfer than others.

Third-party consent and/or notice typically are required for, among other things: subdivision-improvement agreements; acquisition agreements for municipal bonds; and covenants, conditions and restrictions contained in various transactional documents. A lender's failure to comply with applicable consent and notice requirements prior to transfer can potentially unwind a deal in some cases.

Existing development agreements often impose consent or pre-approval requirements prior to the transfer of ownership of the distressed asset to a successor developer or lender. These consent and pre-approval requirements generally are intended to ensure development of the project by setting financial and other standards for acceptable successor developers.

Environmental issues

Distressed assets - especially large master-planned residential developments in undeveloped areas inherit a range of environmental conditions that can negatively impact a property's value. Thus, an evaluation of the potential exposure to environmental liability should be part of any lender's assessment of whether or not to foreclose on a distressed asset.

Properties in California are subject to numerous state and federal environmental liability regulations. These include but are not limited to: the Resource Conservation and Recovery Act; Toxic Substances Control Act; Hazardous Materials laws; Occupational Safety and Health Administration Association regulations; Clean Water Act; Clean Air Act; and tank and materials handlings laws.

The federal Comprehensive Environmental Response, Compensation and

Liability Act (CERCLA) is one of the primary federal laws imposing liability for the remediation of contaminated properties (see 42 U.S.C. Sec. 9601 *et seq.*). CERCLA provides certain defenses and exemptions from liability, including a "secured creditor exemption," that can protect lenders from both pre- and post-foreclosure liability. Lenders must pay careful attention to the requirements for these safe harbors, as they are specific and complex. Accordingly, the lender should immediately seek advice as to the applicable environmental laws.

Additionally, although similar exemptions may exist under federal and state environmental laws, the CERCLA secured creditor exemption does not guarantee protection from liability under those other statutes. Further, the lender should conduct diligence prior to foreclosure to understand the environmental condition of the property.

(CERCLA provides relief from liability for property owners who conduct "all appropriate inquiries" to assess the environmental condition of the property prior to acquisition and meet certain other requirements. Lenders may obtain additional protection from CERCLA liability by conducting "all appropriate inquiries" prior to foreclosure.)

At a minimum, such diligence should include 1) reviewing the EIR prepared for the project pursuant to CEQA; 2) commissioning an updated Phase I environmental site assessment; and 3) potentially commissioning a more detailed and complete assessment of the environmental condition of the property in the form of a Phase II environmental assessment. The lender also should consider obtaining environmental insurance coverage to help reduce the level of risk.

Identifying loan collateral: Updating title reports and ALTA/ACSM surveys

A lender evaluating a distressed asset should also identify the loan collateral and order an updated title report and American Land Title Association (ALTA)/American Congress on Surveying and Mapping (ACSM) survey covering the asset. The lender's counsel should review the title report and survey to identify any significant exceptions.

The existence of mechanic's and other liens and mortgages, delinquent taxes, annual Community Facilities District and other assessments, and covenants with significant development obligations and/or use restrictions are also commonly disclosed on title for distressed assets. Furthermore, the title report and survey will help identify atypical easements and dedications in favor of third parties, encroachments, improvements and utilities within the property.

Surveys can also provide information regarding the flood-zone designation of a property, which a lender may find to have changed for the worse due to the Federal Emergency Management Agency's (FEMA's) ongoing Flood Map Modernization Program.

(FEMA is in the process of updating its flood-hazard maps throughout the country - see www.fema.gov/plan/prevent/fhm/mm_main.shtm.)

As a result of this Flood Map Modernization Program, FEMA has redesignated properties, formerly outside of the flood plain, as lying within flood zones. Such redesignation can result in requirements for existing buildings to obtain flood insurance; significant restrictions imposed on new construction within the flood zone; and requirements that the developer or its successor provide certain additional financing for any testing and/or physical work on, for example, nearby levees necessary to restore accreditation and remove the property from a flood zone. If a property is redesignated as lying within a flood zone, the practical result often is that further development will be almost entirely curtailed and the lots will be unmarketable.

In the event of foreclosure, title to the property will be transferred to the lender subject to the e encumbrance unless they are terminated at or before closing. Further, any unsecured liens will need to be assumed or paid prior to transfer.

Although reviewing the title report and survey is an important step, additional information critical to the valuation of a distressed asset, such as property entitlements and environmental condition, often is not recorded on the title or discernable from a survey.

Litigation searches are also critical to fully understanding the liabilities associated with a distressed asset. Although not disclosed on the title or in entitlements review, litigation is common to distressed assets, can tie up disposition of the property and can seriously impair the asset's value.

Assessing the political landscape: renegotiation of project approvals and development obligations

Lenders should also consider engaging legal counsel to work with the local government agencies regarding the entitlements. Sometimes, the objective will be to extend the existing entitlements so as to enable another developer to build or complete the contemplated project. On other occasions, it may be clear that the project as originally designed is no longer feasible because of changed market conditions or the scope of obligations is too onerous.

For those projects, legal counsel can work with the local government agencies to obtain an agreement for a smaller project that involves less financial investment and fewer development obligations. There may be a desire to change the type of project, such as turning a for-sale condominium project into a for-rent apartment project, or turning a residential project into a commercial one.

Local government agencies may also have negotiated for a number of exactions such as the civic centers and libraries described earlier. While these commitments may have seemed reasonable when times were good, they may today make a project economically infeasible and require the renegotiation of any agreements promising to provide them. Entitlements and agreements may be difficult to change if the political landscape is different and the new elected officials have an entirely different concept in mind for the particular property.

A thorough understanding of the land-use obligation associated with a distressed asset is critical to effectively evaluate the present and future market value of that asset. Basing a decision to foreclose on an incomplete understanding of the implications of the asset's entitlement status, environmental condition and related development obligations can be a disastrous mistake, costing a lender hundred of millions of dollars.

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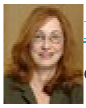Ellen M. Berkowitz Ms. Berkowitz represents clients in all aspects of land and property development. She provides legal, strategic and political advice to help clients maximize the value of their real estate assets.

Brady R. McShane Mr. McShane’s practice focuses on land use, government regulatory, and real estate development matters, where he advises clients on the numerous regulatory, environmental, political and technical issues involved in developing property in California.