

In declining market, residential developments benefit from receivership's protective role

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Last year marked an extraordinary rise in defaults in unfinished housing developments and condominium construction or conversions. Not surprisingly, the rate of defaults continues its steady increase. In many cases, these projects are simply being handed over to lenders by developers who see no solution to their lack of sales. Sales of residential real estate remain sluggish, and as a result, we can expect to see the rate of these defaults escalating through 2009. With this in mind, it is beneficial to examine the related issues and potential problems such loan defaults present for lenders.

Typically, by the time the default has reached the stage for the lender to pursue a foreclosure, the previous funding has been exhausted. Many subcontractors and vendors have not been paid and are no longer working, substantial portions of the project may remain unfinished, and permits and entitlements may be in danger. By this time, if the developer/borrower has decided to walk away, there will most likely be a need for protection of the property — including construction or repair work, maintenance of buildings and personal property, upkeep of “curb appeal” and prevention of deterioration.

Most often, there are myriad reasons why the lender may not want to foreclose, among them homeowner association issues, health and safety concerns, possible future warranty issues, environmental questions and other reasons to avoid coming into title. In these cases, lenders should

seriously consider using a receiver, a neutral party appointed by a state or federal court. A receiver not only shields the lender from liability exposure, but also from “deep pocket syndrome,” which emerges when various interested parties expect the lender to make everyone whole again. The receiver gives the lender impartial third-party control of the asset, and also allows a quick start on assessing current status, determining operating expenses, planning options for optimal recovery and preparing the property for sale through appropriate strategies.

The receiver will apply for and maintain all necessary permits and licenses, verify that documents are being properly recorded, secure approvals, select and monitor vendors and contractors, and, importantly, assure the project moves along carefully and swiftly.

The potential minefield of issues with existing condo and homeowners alone presents complex problems the lender will not want to be directly involved in. A receiver has the additional benefit of direct access to the court and, as an agent of the court, is given wide latitude to guarantee that value of the asset — the lender's security — is maximized.

The Order Appointing Receiver defines the scope of responsibility and authority for the receiver to continue, terminate or complete construction as appropriate (and usually of benefit to the lender). The prudent receiver will review the order carefully prior to appointment. This will help ensure the appropriate points are included — including the

ability to sell property “as is, where is” — and that the Final Order Discharging Receiver will remove any potential further liability of the receivership estate or the lender for claims of construction defects, title issues and other liability.

With distressed real estate assets and related business enterprises, as with hotels, the receiver will restore or create an environment of order and professionalism to project management, operations, accounting and reporting that has deteriorated during the period preceding the loan default.

Limited receivers allow construction to continue

In the case of unfinished housing developments, “limited receiverships” offer an effective way to continue construction with minimal interruption, while also providing reassurance to the lender that the project is under the control of a competent third-party fiduciary. A limited receivership is not a specific legal remedy, but is simply a modified receivership that allows the receiver to take a more limited role as long as certain requirements are met, such as staying within budget and on schedule and using funding only for specified items.

In short, under these circumstances, the lender no longer funds the developer directly, but provides the funds to the receiver, who in turn reviews and approves all of the developer's monetary requests and directly pays all vendors and suppliers. This allows the existing contractor and/or developer to continue their work unhindered, while providing the lender with a third-party watchdog to safeguard

spending.

Usually, this limited receivership is agreed to as part of a forbearance agreement, but with substantially more control built in. In a typical forbearance, the lender has limited or no control over subcontractors and vendors in part to avoid any issues of lender liability. The receiver can remain in place until completion of construction or even until the last unit is sold, depending on the lender's preference, and the lender can continue with the foreclosure in place but merely postponed as appropriate. Since the receiver's aim is to do what is in the best interest of the property, the limited receivership can give the lender all of the benefits of a forbearance agreement — with more control and stability.

Whether its role is more traditional or “limited,” the receiver's ability to immediately begin the process of marketing the property is critical in a period of rapidly declining values — and will ultimately generate higher returns for the lender. The traditional — and lengthy — sequence of default, filing of the notice, waiting the jurisdiction period, conducting the foreclosure, engaging a broker, marketing the asset for a reasonable period and negotiating the sale can be dramatically shortened, which also helps maximize loan recovery.

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