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## Construction Risk Management

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# Back to the Future: Non-Performing Construction and Development Loan Workouts

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This is not necessarily about now.

This is about a day in the future. One in which we experience the next significant economic downturn. The one that starts with some big, unexpected, pivotal 'Black-Swan' event that precipitates an economic crisis (like the 2008 failure of Lehman Brothers, Bear Stearns, et al). In good times, it's all about managing profitability. In a steep downturn, it is all about damage control. Since economic downturns are typically sudden, it usually takes time to recalibrate to the new harsh economic reality. Better to be prepared, have a plan, and know your options.

We are now in the longest recorded economic growth cycle in U.S. history: fourteen years and counting. As much as we would like to believe it, deep down we know that there is no new paradigm of perpetual economic growth. Economies are made up of people making investment decisions who, over time, are generally 'hard-wired' to act in a way that generates pendulum-swinging financial excesses and extremes. Like all economic cycles, this one will inevitably end. So it's business as usual right up until the end.

When the next recession does rear its ugly head, it is helpful to recognize, acknowledge and prepare for the issues and challenges that will have to be addressed to deal effectively with non-performing loans.

There are four main components to construction and development loan workouts:

1) recognition and write-down of the impaired loan
2) workout negotiations, including debt and equity restructuring
3) pre-foreclosure project preservation, completion, or sale; and
4) post-foreclosure project preservation, completion, or sale

In a significant economic downturn, time is your enemy. Once it is clear you will have a large number of non-performing loans, accepting the new reality and understanding the challenges ahead will allow you to quickly and efficiently get on with the business of mitigating losses, recalibrating your expectations, and turning things around.

This is written primarily from the perspective of California state and federal law. Although most states generally track California law, each state is different – Texas in particular. As a result, this is only intended to be a general overview of key issues, alternatives, and strategies involved in the workout of non-performing construction and development loans.

## The Write-Down

While you might have a difficult time accepting it, you usually know when things have gone south long before you formally recognize a loan as impaired and take the write-down.

Since your borrower, the developer, is typically still communicating with you and at least superficially cooperative at this point, this is the time to review your loan documents (and their enforcement provisions), disbursement and inspection records, and borrower bank accounts securing the loan to make sure they're complete and current. These documents and records rarely look the way you expect or want them to be, so be prepared. When a receiver is appointed, the receiver is usually in the position of having to reconstruct the property-related loan records, which consumes both time and money. Being prepared and on top of your loan portfolios will create efficiencies in a downturn and allow the receiver to immediately focus on mitigating losses, rather than first having to decipher incomplete loan records.

You will need to designate the loan as impaired and recognize projected loan losses before you can start meaningful action to solve the problem (i.e. workout negotiations, increasing the loan balance, suspending loan advances, or taking other more drastic action like selling the loan or moving for the appointment of a receiver).

Most lenders prefer to bundle as many loan write-downs as possible at year-end. Delaying the write-down also delays your ability to take clear and decisive action. It's not easy. In my thirty years of experience with distressed construction loans, I have never come across a lender that didn't agonize over booking a loan write-down.

Unfortunately, write-down delays result in unnecessary loan losses. For example, we were engaged to sell a sizeable construction loan for a partially-completed condominium project for a lender early in the calendar year. Everyone realized fairly quickly in the marketing process that the price the lender was seeking for the loan was too high to meet the market, but the lender wouldn't reduce the sale price for months because they didn't want to book the write-down until the end of the year.

The outcome was that just two weeks before year-end, the loan price was marked down drastically, subject to closing before year-end. The loan did sell, but only at a significantly greater discount than necessary because of the long delay to lower the price and the requirement for a very quick year-end all-cash close. This is a common occurrence that is easily avoided. We know that lenders are understandably reluctant to recognize losses until the very last moment and want to match the sale of the loan to the recognition of losses, but that delay is costly. Seasoned buyers of distressed loans are well aware of this and wait for those year-end bargains. Ironically, any loan recovery in excess of the write-down is then booked as profit, further distorting the true distress of the written-down loan.

In deep recessions, things get worse before they get better, so the sooner you act, the more likely you'll have a successful outcome and recover more money.

### Workout Negotiations

In the absence of outright fraud or abandonment of the project by the developer, it is better to do what's necessary to support the borrower to promptly complete and sell the project. Most developers lose interest and walk away from a development project once they've concluded they no longer have any equity. Worse, once a borrower becomes an adversary, everything becomes a costly and time-consuming battle, slowing down the workout and exponentially increasing the costs of doing so.

Even though the loan may require the borrower to cover shortfalls and include personal completion guarantees, it is better to find a way to carry the developer across the finish line as quickly as possible than it is to compel them to perform or cooperate against their will. Sometimes you can't, but it's almost always better if you can. Consult with your legal counsel regarding any written communications (including email) with the borrower and the use of an appropriate forbearance agreement.

The developer is in the best position to get the project completed, and a completed project is significantly more valuable and easier to sell than a partially completed one. In a serious economic downturn, markets tend to deteriorate and languish until they've bottomed out. More and more distressed properties come to market and prices continue to decline.

For example, we took over a large, nearly completed townhome project as receiver to complete miscellaneous interior work, some site improvements, and finalize DRE sale approvals necessary prior to selling the townhomes. The lender had stopped making advances to the developer when it realized the project was worth less than the loan. However, the developer would not finish the project without further advances from the lender, so work stopped while the bank tried to force the borrower to perform. Finally, the lender was left with few options and sought our appointment as receiver. Of necessity, the process of completing and selling the project by a receiver on a bulk basis took months longer than had the lender simply funded the borrower to complete the project and sell the units. The lender would have undoubtedly recovered more proceeds in a much shorter period but for its failure to work with the developer.

If you can't promptly find a workable way for the developer to complete and sell the project, then the next step is to use personal guarantees and the move to appoint a receiver to motivate the borrower to cooperate with the remaining available strategies:

1) restructuring the borrower's debt and equity
2) borrower sale of the property
3) lender sale of the loan
4) borrower agreement to keep the property safe and secure while the lender completes the foreclosure, or
5) borrower cooperation with the appointment of a receiver

Often, simply initiating the process of appointing a receiver is sufficient to motivate a borrower to cooperate.

If the borrower will not quickly agree to complete and/or sell the project on terms acceptable to the lender, then it is important to immediately move on to the next step in

your pre-foreclosure strategy. In work outs, time is not your friend and things do not magically get better with time.

## Pre-Foreclosure

It is important to remember that a lender can't control, manage, or operate a property prior to completing the foreclosure. Doing so runs the risk that the lender's loan proceeds are deemed by the court as having been converted to passive equity and may constitute a violation of the very complex one-action rule. So a lender's remaining pre-foreclosure alternatives are limited to:

1) selling the non-performing loan
2) standing by until the foreclosure is complete, or
3) obtaining the appointment of a receiver to protect, complete, and/or sell the project

A receiver cannot control or sell the loan itself, as it is the underlying agreement between the lender and the borrower. However, the lender can sell its loan, and market it directly or through a broker or auction platform. Although the sale of a non-performing construction loan yields the lowest sale proceeds, it is often the fastest and most cost-effective way to get a non-performing loan off the books. The buyer of the loan is taking on an incomplete project, the risk of borrower bankruptcy, and must complete the loan foreclosure process – which typically results in a very steep discount and substantially greater loan losses.

Most lenders do not want to foreclose on an incomplete construction project – particularly apartment, condominium, or tract housing projects – in order to avoid taking on liability for construction defects or environmental contamination. In California, construction defects liability continues for ten years from completion and environmental liability *is perpetual*. In this case, the exit strategies are limited to the appointment of a receiver or sale of the loan.

A receiver can get to work right away and generally insulates the lender from the liability associated with the completion, operation, and sale of the project, as the lender will not take possession or control of the project (avoiding lender liability issues by having the property in 'legal custody').

A receiver can also be given the authority to negotiate and settle mechanics liens or sell the project free and clear of junior liens (but not stop notices). Since there is typically no income generated by an incomplete construction project, the lender will need to fund the receivership through protective advances or the receiver must borrow funds from a third party with a super-priority lien using receivers' certificates in order to do so. The lender will need to be comfortable making prompt funding decisions so the receiver can proceed ahead without unnecessary delays.

The specter of borrower and guarantor bankruptcy exists until the property is sold or foreclosed. To reduce the risk of borrower bankruptcy, a receiver can be appointed to take control of the borrower entity (rather than just the property) with a receivership order that gives the receiver the sole right to file a bankruptcy action for the entity. If a receiver is in already place when the borrower files for bankruptcy, generally the bankruptcy court will allow the receiver to remain in place as custodian during the pendency of the bankruptcy.

More broadly, with an experienced receiver and the proper receivership orders, a receiver can quickly and efficiently step into the shoes of the developer to secure the property, perform due diligence, amend public agency approvals and development agreements, complete construction, remediate environmental issues, and market and sell the property free and clear of liens. In the case of condominiums or tract housing, the receiver can either sell the units 'wholesale' on bulk basis or for full 'retail' market value to individual buyers. In the case of environmental issues, the receiver can also sell the property unremediated pursuant to court order absolving the receiver and lender of environmental liability.

A lender has the option to file the receivership action in either state or federal court, subject to jurisdictional considerations. The decision as to which court to file in is very specific to the location and details of the underlying litigation, an issue that should be discussed with the lender's legal counsel.

While a lender cannot 'direct' or 'control' a receiver, as a receiver is legally an officer of the court, a lender can indirectly guide the scope of the work through the court's orders, as well as through the disbursement of funds to the receiver. For example, a court will often agree to require that the receiver only take certain actions with the prior written consent of the lender. In addition, if the receivership order allows the receiver to borrow from the lender, the lender can often de facto control the scope of the receiver's work by its willingness to advance funds to the receiver for that work. It is important that the lender's counsel have extensive and specific experience in crafting the receivership order and proposing a receiver that has equally specific and extensive experience with the completion and sale of distressed development projects.

It's also worth noting that courts have very broad discretion

over the receivership orders they issue, and appellate courts are usually reluctant to second-guess lower courts on receivership matters. So, as a general matter, always ask for the receivership orders you want. The worst the judge can do is say no.

## Judicial Foreclosure

In many states, to have a receiver appointed, the lender will need to file a judicial foreclosure action. In states with so-called one-action laws – where a lender can either foreclose or sue the borrower for any losses – a judicial foreclosure and appointment of a receiver is also necessary if the lender wants to both foreclose and recover any additional monetary damages or deficiencies. While judicial foreclosure may sound good, it is usually not. It can be defeated by borrower bankruptcy, can take a very long time to complete, and requires a very costly process to establish the 'fair value' of the foreclosed property. And in California, the borrower retains the right to repurchase the property for up to year after it is foreclosed, leaving the property in receivership limbo for a year after the judicial foreclosure is completed. In thirty years, I have only seen two judicial foreclosures litigated through to completion, and no one was happy with the outcome in either case, so proceed with caution. In most cases, a better outcome is achieved when the court allows the receiver to sell the property.

## Post-Foreclosure

Once the lender has completed the non-judicial foreclosure of the project, it is free to complete, operate and sell it, since the lender is also now the fee owner of the property. However, the lender is now both responsible and liable for the project and, as mentioned above, any environmental liability is in perpetuity.

In order to further limit the liability associated with the ownership of construction projects, some lenders elect to create a separate wholly-owned legal entity in which to foreclose distressed properties. At the very least, this provides some 'political distance' between the lender and the property.

Post-foreclosure, the key issue for lenders beyond basic liability management is to have the staff and decision-making structure in place to make efficient construction and development decisions necessary to complete and sell a distressed project. These decisions involve public agency approvals, design, capital allocation, insurance, risk management and asset pricing that are not typically part of a lender's business culture or training.

Developers calibrate risk to maximize financial opportunity. Lenders minimize liability, seeking to move as much risk to the borrower as possible. Lender staff are, at best, discouraged from taking risk and often penalized for it, while their developer borrowers are rewarded for taking risk. The two are fundamentally different cultures and business models.

## Conclusion

It is always better to be prepared than caught off guard when the economy turns, as it inevitably will. Time is not your friend in a recession. Markets can deteriorate for years.

Understanding the general issues and consulting with experts on potential strategies and alternative approaches to distressed construction and development loans will allow you to have a plan in place so, when the time comes, you can promptly and methodically resolve them. The sooner you can execute your strategy, the lower your cost and the greater your recovery of loan proceeds will be.▪