Buying and Selling Troubled Real Estate Loans on Uncompleted Projects: Selected Issues

01.22.2009

The number of financial institutions selling troubled real estate loans has increased precipitously in the current economic market. Invariably, these loans are in default, are secured by property whose value is significantly less than the outstanding loan amount, and involve legal and practical issues beyond a normal lending or purchasing transaction. When the underlying property is not yet completed, significant additional issues arise. Because many institutions are under significant pressure to dispose of these troubled assets, loan purchasers often perceive great opportunity to obtain, at bargain prices, assets that will eventually have significant value. But with great opportunity comes great risk. This article is the first in a series that will highlight particular problems that purchasers of troubled loans must address in deciding what price to pay or whether to buy a troubled loan at all. This information is also useful to sellers who are working to position their loans for possible sale.

1. Mechanics' Liens.

In California, the priorities of mechanics' liens relate back to the date that construction of the project commenced. If construction commenced prior to recordation of the deed of trust, mechanics' liens resulting from any work on that project, regardless of when actually done, generally have priority over the lien of the deed of trust. The loan purchaser should obtain a current title report to determine if such mechanics' liens might exist, and should review the lender's title policy to confirm whether it provides insurance against them. The purchaser should also determine whether any material modifications have been made to the loan that could affect the priority of the deed of trust with respect to later occurring work. Certain title endorsements and other assurances may be available depending on the circumstances of the particular project, and particular care must be paid to those assurances in order for the purchaser to make an appropriate evaluation of the risk.

2. Set Aside Letters.

Construction lenders often provide set aside letters in connection with construction loans. A set aside letter requires the lender to set aside construction funds to be used to pay for specified improvements or to discharge a particular obligation. The set aside letter is typically in favor of a city or other governmental agency, but may also be in favor of a surety company. These letters generally provide that, if the specified improvement is not built or other obligation discharged, the funds that were set aside must be advanced under the loan and paid to the city, agency, or surety company. The purchaser of a troubled loan should determine whether any set aside letters have been issued, and if so, whether the purchaser will be required to assume the set aside letter obligations. The preferred approach is to separate the purchase of the loan from the obligations under the set aside letters, which would be retained by the original lender. Set aside letters come in a number of forms, so the language must be examined carefully to determine the exact effect of the set aside letter in question.

3. Subdivision Obligations.

The loan purchaser should determine the extent of any subdivision obligations to complete improvements, pay fees or perform other obligations because those obligations affect the value of the underlying security, and will likely fall on the purchaser after any foreclosure. The purchaser's due diligence should include a review of any subdivision bonds, including whether bonds must be replaced following a foreclosure sale of the property.

4. Public Financing.

The project may be subject to the liens levied by assessment districts, community facilities districts, or other financing districts. Because these liens are prior to the lien of the deed of trust, the loan purchaser should determine the extent and status of these liens, including any delinquent amounts. The purchaser should also explore any opportunities to restructure these public financing arrangements to increase the economic viability of the project.

5. Contractors and Architects.

The loan purchaser should determine whether the loan documents contain proper assignments of construction and architectural contracts. Even if valid assignments were given, the purchaser should evaluate practical issues that may affect its ability to complete the project. For example, are the general contractor and the architect still in business and still involved in the project? Did the contractor agree to continue work if a foreclosure occurs? Can the purchaser continue to use the architectural plans? Similarly, if the contractor and architect have not been paid, they may be unwilling to continue work regardless of the technical requirements of any loan document.

6. Entitlement Status and Assignability of Permits.

The loan purchaser should determine the status of the entitlements for the project, and should determine the expiration date of those entitlements (especially of any tentative map). The purchaser should also review whether any development agreements or other regulatory agreements apply to the project. It is important to evaluate to what extent the necessary permits will apply to the land regardless of any changes in the project's ownership, which will apply only after additional processing with the governmental agency, and which will apply only after additional discretionary action on the part of the governmental agency (which may introduce significant risk in the purchaser's ability to benefit form that permit). Similarly, if the purchaser acquires the project through foreclosure or otherwise, it will be responsible for storm water runoff under the Clean Water Act and related state requirements, including replacing any Notice of Intent pursuant to a General Permit for Storm Water Discharge issued by the State Water Resources Quality Control Board.

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