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Distressed Real Estate Developments: Opportunities and Traps for Lenders and Investors

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April 17, 2011

Special Bulletin

DEVELOPMENT ISSUES

Recent media reports discuss the impact of the "Great Recession" on unemployment, jobs, and foreclosures of individual residences. But what has not been generally discussed by the media is the enormous number of grandly-envisioned residential subdivisions and planned communities that are currently "moth-balled" or in the hands of lenders as a result of foreclosure of development loans. Indications are that more developments will fail before the economy recovers because many projects are financially "underwater" and no longer eligible for properly underwritten loans, thereby forcing developers to abandon them.

As confidence begins to return to the real estate development market in North Carolina and sellers begin to agree to lower prices, the opportunities related to partially-completed or foreclosed developments will increase. For lenders holding these assets as a matter of necessity, and for opportunistic investors seeking valuable opportunities, the prospect of completing a transaction to sell or acquire the remnants of a development can be very appealing. These real property assets are typically unique and, as a class, are different from any other category of commercial real property.

However, there are several specific matters that should be considered prior to the acquisition of a distressed development, whether that acquisition is by way of foreclosure; deed in lieu of foreclosure; purchase for the purpose of holding the property for bulk resale; or purchase for investment, completion, and resale to end users.

Just What is the Asset?

Any foreclosing lender or potential purchaser should undertake a critical analysis of not only the legal title to the real property, but also the continuing appropriateness of the intended plan of development, the adequacy of the formation of the development pursuant to that plan, and the developer's compliance with the development plan which was intended to add value to the physical property. The asset should be viewed not just as raw land, but as land with a value that either has been enhanced by a development plan imposed upon it or has been burdened by the prior level of non-compliance with that plan by the distressed developer.

For lenders considering foreclosure or a deed in lieu of foreclosure, and for investors considering a purchase, the following goals should be kept in mind:

- Acquiring legal title to the real property that is as close as possible to that to be resold to end users;
- Acquiring possession of an asset with a complete understanding of the steps necessary to correct the

non-complying actions of a failing developer; and,
- Limiting any exposure arising from the developer's prior actions and omissions.

In addition to the evaluation of the legal title to the land component of the asset, a careful consideration should be given to the status of the development rights and the developer's compliance with the plan of development.

What is the Current Status of Compliance with the Development Plan?

Recent experience has shown that compliance with the legally-required development steps of a condominium or planned development is rarely handled with precision by distressed developers. The greater and more prolonged the level of distress suffered by the developer, the more likely it is that releases of property from loans, annexation of additional phases, reservation of necessary future easements, and other development-related actions were not handled correctly. If there are problems, consideration should be given to their impact on the asset's value, including whether the problems can be solved by the potential lender or purchaser acting unilaterally; whether the original developer can solve the problems unilaterally and is willing to do so; and whether other parties whose consent may be necessary for correction of the problem are willing to give their consent, and at what cost.

One additional area that merits consideration in a planned community development is the status of the common elements. It is important to understand what real property has been conveyed to the owners' association if there is one, what real property should be conveyed to the association, the quality of the title to that real property, and the physical condition of any of the improvements situated on that real property.

What Are the Obligations of a Successor Developer for Prior Acts or Omissions of the Original Developer?

Purchasers may be interested in requiring that certain development rights held by the original developer be legally transferred to them in order for them to realize the true value of the asset purchased. Therefore, careful consideration must be given to the status of the development rights (e.g., what was reserved initially, whether any of the rights have expired or been terminated, etc.), who now owns the right to them (e.g., is it the potential seller, multiple parties, or no one), as well as any obligations that might come along with them because of past actions or omissions of the defunct developer. This analysis should include research regarding potential exposure to liability to those who already may have bought lots or units in the development.

Of course, foreclosing lenders or purchasers will want to limit their exposure to liability related to the actions, errors, or omissions of the original developer. Successor liability of subsequent or current owners of development rights is allocated under North Carolina law based on the nature of the development. For example, in a residential condominium, the liability of a successor developer is well described in the North Carolina Condominium Act (Chapter 47C of the North Carolina General Statutes). However, the liability of a successor developer for a planned community is not well described in the North Carolina Planned Community Act (Chapter 47F of the North Carolina General Statutes), and courts have varied in imposing liability on successor developers in planned communities based on the particular facts of the case. A plan to reduce exposure to potential liability as a successor developer is essential for a potential owner of development rights, and must be based on an analysis of the particular facts and circumstances of each transaction.

What Are the Remaining Obligations of a Successor Developer under the Plan of Development?

Another important consideration for potential foreclosing lenders or purchasers is the financial obligations of the developer under the condominium or community documents that will fall upon the potential successor,

particularly if the successor becomes the owner of development rights. Those obligations almost certainly will include liability for general and special assessments levied on the lots or units purchased or foreclosed upon. Depending upon the community documentation, the foreclosing lender or purchaser even may be liable for past assessments the original developer failed to pay, unless community documentation and/or applicable law relieves a foreclosing lender or purchaser of liability for such past assessments.

In some cases, a development right may entitle a successor developer to an exemption from an obligation to pay assessments. Although such an exemption may be appealing on its face, a determination must be made as to whether enjoyment of that exemption would be detrimental to the financial solvency of any owners' association, particularly if the purchaser or foreclosing lender is acquiring a significant inventory that will take some time to sell.

A potential successor developer also may be bound to financial obligations beyond the payment of assessments. The development documentation may require the holder of the development rights to perform promised and once-viable actions that no longer give added value to the development (for example, building and operating a golf course, country club facility, clubhouse, or pool). Such amenities may be very expensive to construct, but demanded by owners of lots or units who bought in reliance on the promise of having them to enjoy.

What is the Financial Health and Status of the Owners' Association?

A foreclosing lender or purchaser will be acquiring real property that either is or is destined to be included in a condominium or planned community. Therefore, the property is likely to be governed by an owners' association. Investigation of the owners' association to determine whether its financial health or status may impose additional burdens on the lender or purchaser is important. A foreclosing lender or potential purchaser should evaluate:

- The fundamental association documents (the declaration, the articles of incorporation, and the bylaws);
- The financial status of the association (the balance sheet, annual budget, and level of bad assessment debt); and,
- The governance of the association (the level of activity of the board and the developer's continued involvement in the board, if any).

A special assessment to make up for the original developer's failure to provide for the financial health of the owners' association may be tolerable for the owner of one lot or unit, but quite burdensome for the owner of 50 or 100 lots or units. The lender or purchaser also should inquire about any disputes or potential disputes among the association, the current members, and/or the original developer. Whether or not there is any real potential liability for a successor developer, these claims can be costly to defend and also have a chilling effect on the resale market. Accordingly, they are pertinent to the lender's or purchaser's evaluation of the development.

What Disclosures Must the Successor Developer Make?

A purchaser of the remnants of a failed development also needs to carefully consider the disclosures that must be provided to end-user purchasers of lots or units. For example, there may be an obligation for the purchaser to provide a Public Offering Statement to purchasers of condominium units. Also, the development may be registered under the federal Interstate Land Sales Full Disclosure Act and under the laws of various states, and there may be an obligation to provide a comprehensive property report to all purchasers. Finally, certain disclosures must be made to all purchasers of residential property in North Carolina, and those disclosures may be more complex or impose a greater burden on a successor developer who is a bulk owner

of lots or units than would be the case with an ordinary resale.

ENVIRONMENTAL ISSUES

Distressed real estate development projects can pose significant environmental issues. In many cases, the developer is no longer complying with the obligations of various environmental permits obtained at the outset of the project, and the relevant owners' association is left without recourse against the developer and without sufficient association funds for making necessary repairs. Lenders ponder whether to foreclose on such properties in the hope of recovering some of their losses – they don't want to be stuck with a distressed property that cannot be sold due to environmental problems or, perhaps even worse, become liable for all or a large share of the cost of repairing the problems.

What are the Obligations of a Successor Developer under a Project's Stormwater Permit?

One of the thorniest environmental issues relates to compliance with stormwater permit requirements. One question is to determine who is responsible for the operation and maintenance of stormwater management facilities (such as swales or ponds) under a stormwater permit. Typically, the permit will have been issued in the developer's name during the permitting phase of a development, and the developer – or "permittee" – remains legally responsible for the operation and maintenance of the facilities until the permit is transferred to another party. However, when a developer walks away from a failed development, the owners' association, particularly one that has not been conveyed the common areas upon which such facilities are located, has little practical ability to successfully correct existing problems or pursue recourse against the developer. If the swales, ponds, or other stormwater management facilities are out of compliance with permit requirements, an owners' association should not automatically assume liability for maintaining the facilities. However, the members of the association may not be able to sell their lots or units at a fair market price until the facilities are constructed or repaired correctly.

From a developer's perspective, an appealing option is to transfer the stormwater permit to the owners' association. However, the North Carolina Department of Environment and Natural Resources ("DENR") will first make sure that the owners' association fully understands the permit obligations, including potentially significant costs, before it will agree to give its required consent to transfer of the permit. DENR also will require that the association be controlled by the residents and not the developer or the developer's successor at the time of the transfer. Generally, DENR requires that at least 50% of the lots or units be owned by end users and that the end users have majority control of the association board. DENR also will require that the stormwater management facilities in the development be in compliance with all regulatory requirements or, if not, that all necessary repairs are made prior to transfer.

How Does One Avoid Acquiring Cleanup Liability?

From a foreclosing lender's or potential purchaser's perspective, it is first and foremost critical that it does not become liable for potentially expensive cleanup of any environmental contamination present on the property or for the repair and maintenance of required facilities after foreclosure or acquisition. While lenders are normally protected from cleanup liability under both federal and state law, the lender must handle the property in a commercially responsible manner and must not attempt to operate the facility itself. In contrast, purchasers are normally liable for property cleanup for any known contamination. A purchaser's liability can be limited by conducting "all appropriate inquiry" into the environmental condition of the property before purchase and qualifying for a "bona fide purchaser" defense. An additional option is to enter into a Brownfields Agreement with the State that includes a covenant not to sue so long as any required land use restrictions are followed.

Just as important, however, is the risk that the lender or purchaser will be unable to sell the property following foreclosure or acquisition due to the property's poor environmental condition. Prior to making a decision to foreclose or purchase, a prudent lender or purchaser should have a qualified consultant conduct a thorough environmental assessment of the property. If the full extent of the contamination or non-compliance with environmental permit requirements cannot be determined accurately by a Phase I Environmental Site Assessment, a lender must weigh the cost of conducting further environmental due diligence (i.e., a Phase II Environmental Site Assessment) and the cost of repair and maintenance of required facilities against the risk that potential buyers will be scared away due to the uncertainty of liability assumed at a subsequent sale.

Should the Lender or Purchaser Dare Talk to Environmental Regulators?

One of the most important things a lender or purchaser can do prior to initiating foreclosure or acquisition is to confer with the appropriate DENR officials about possible remedies for the environmental problems on the property. In the case of erosion and sedimentation issues, DENR and the North Carolina Bankers Association are parties to a 2009 Memorandum of Understanding that calls for negotiated, voluntary remedies for any outstanding issues on development property. Similarly, consultation with agency officials can help a lender or potential purchaser identify what stormwater compliance or contamination issues exist and the potential cost for their correction. Lenders (and potential purchasers, for that matter) should keep in mind that discussing a development's environmental problems with DENR does not expose them to any liability they would not have otherwise. As for a lender, it may be better to delay foreclosure and look for alternative remedies and solutions rather than to find itself holding title to an unmarketable piece of real property which, instead of requiring repair of some of the bottom-line damage flowing from a defaulted loan, actually requires continuing out-of-pocket payments for managing a distressed asset.

CONCLUSION

A distressed or failed real estate development can be a valuable investment, but it also could easily expose a foreclosing lender or purchaser to enough burdens to outweigh its value. A lender that is considering whether or not to take title to collateral as part of its collection efforts with a defaulting borrower should consider carefully all aspects of that collateral before negotiating or making a decision to move forward with foreclosure. Similarly, a significant due diligence period and careful consideration of an acquisition are important for investors in development acreage or bulk homes/lots/units.

For further information regarding the issues described above, please contact Samuel B. Franck or Frank H. Sheffield, Jr.

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