



GINSBERG
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DISTRESSED REAL ESTATE
Discount Is No Substitute For Diligence

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Something to think about...

Honey, the chances of another plane hitting this house are astronomical.

It's been pre-disastered. We're going to be safe here."

- *T.S. Garp, The World According to Garp (1982)*

DISCOUNT IS NO SUBSTITUTE FOR DILIGENCE

Amidst the bloodshed of stalled and defaulting development projects, a number of our clients view the purchase of discounted debt as a shortcut to buying a (possibly) successful development. In "Garp" terms, the first plane has hit the house. Market failure and risk is already priced into the stalled project (perhaps excessively) and a the troubled project may now be poised to succeed under a new owner. Acquiring a project post-disaster can mean substantial time-savings and cost-savings because construction, permitting, leasing and pre-sales will be in various stages of completion. Moreover, acquiring a troubled project via debt acquisition may allow the purchaser to wipe out certain liens, putting the purchaser in a better position than the original owner/borrower.

However, there are still substantial risks involved when taking over a defaulted project loan. Just as you may wonder whether a used car was ever in a crash or flood, you will want to know the history of the loan and the project before acquiring the debt. There is no lemon law for distressed real estate projects - you have to rely on your own diligence. Lenders make very few representations or promises when debt is sold. Therefore, a loan purchaser must carefully review the entire loan file (yes - the whole file) on top of doing customary real estate diligence. Here are a few additional issues that commonly arise when purchasing a troubled loan:

A. Potential Actions by the Borrower: If a foreclosure is required because the borrower is uncooperative, the borrower might contest the foreclosure by raising affirmative defenses or may raise lender liability claims. An agreement or estoppel from the underlying borrower would ease this concern, but this is often a pipe dream. The borrower is likely to be uncooperative (at least until you offer to release them from recourse). Understanding the borrower's rights, the borrower's current position and the borrower's probable wish list are crucial to any loan purchase.

B. Unit Sales and Declarations: If the project includes (or was to include) for-sale housing, unit purchasers may have contract rights, rights under a recorded declaration or statutory rights such as those in a condominium statute or the Interstate Land Sales Full Disclosure Act. These rights may range from the right of a successor owner to lease units to the obligation of a successor owner to pay association liens. Purchasers should review existing contracts and project documents, but also (when possible) speak to the brokerage community to understand the practical state of pending contracts. Further, a purchaser would be wise to consider the financial status of any mandatory association created to operate the project as this may become a sink-hole of unexpected expense if the association is under-funded or mismanaged.

C. Construction Contracts: While the selling lender probably obtained assignments of third party construction contracts, the developer may have already defaulted under these contracts. Alternatively, these contracts may be with affiliates of the borrower and may need to be terminated as a practical matter. Prudent diligence requires both a review of existing contracts, and a review of whether the price for replacement contracts has increased/decreased since commencement. Depending upon how far construction has progressed, contractors may warrant the most attention because of their lien rights.

D. Property Condition: If a project has stalled, the construction site may have been left in an unsafe condition, leaving any successorowner with unexpected liability. New third party reports are a good idea, but should not be a substitute for the purchaser's walking the project site and questioning contractors and staff, if possible. If units have already been sold, unit owners can be a particularly fruitful (and, possibly, biased) source of information regarding construction status. It is best to verify insurance costs sooner, rather than later.

E. Zoning and Permits: Entitlements, especially if included within a Development Agreement, may have "sunset" provisions which can expire. Additionally, the initial developer may have unwritten agreements with municipalities or neighbors that, regardless of enforceability, may burden or delay a project. It is good practice for a purchaser to reach out to any known interested governmental or neighborhood groups before stepping into an ongoing project. It is particularly helpful to inquire about any bonding issues (requirements, defaults or shortfalls) that may be "off-record" in connection with any project that required municipal approvals.

The above issues are just a few of the concerns that any purchaser of a troubled loan should consider during its due diligence. While there are many benefits to buying a distressed development loan, there are also greater pitfalls. A deep discount helps (but won't eliminate) the risk for the debt buyer. Ginsberg Jacobs attorneys are experienced with both lending and development and can help you assess the downside risk of acquiring the debt on a distressed development project. While we cannot guarantee that a second plane will not hit your house, we can at least look at the radar. ■