Commentary

Risk Management Assessment and Its New Role

by Robert Smylie

Two years into the real estate market meltdown and what have we learned? That bankers and investors are taking great risks in acquiring partially completed, completed, and partially sold subdivision projects. Apparently, risk management assessment has not been a priority in acquiring failed subdivision projects, whether by foreclosure, purchase of notes or property, which results in significant exposure to litigation. Appropriate risk management assessment includes assessing, planning, and creation of mechanisms to limit potential claims. Bankers and investors must become educated to the risks that developers have faced. Traditional legal protections afforded lenders are limited in scope and bulk sale and note purchasers should be weary of lender protections under existing law, as a myriad of complex issues may give rise to new theories of liability. Decisions from arbitrators and courts indicate the great consideration given to equitable arguments, rather than law and facts, placing even more significance on effective risk management assessment. Common considerations are discussed below; however the actual array of issues is extensive and beyond the scope of this article.

Construction. Proper assessment of the quality of existing construction and scope of needed remaining work is critical. So often it's what cannot be seen that creates significant problems. The terms of construction contract(s), including indemnity, insurance, and bonding provisions, and the effects of performing construction with new contractors should be reviewed, as well as design and architectural plans. Issues arising from poor design may not become apparent until the sales process. Significant issues for subdivision projects are the effects of completion delays, lack of sufficient funds and/or deterioration from extended exposure. Deficient construction issues may be latent, but should be mitigated when possible to reduce future litigation.

Insurance. Risk management assessment includes insurance review, including: existing coverage; parties covered; coverage for completion; and any coverage compromise/voiding by developer actions. It is common to find limited coverage or no insurance at all. If an assessment determines that the policy is deficient in scope or sufficiency, new policies and/or supplemental policies should be acquired.

Entitlements. Entitlements should be reviewed for current status, compliance and nature of pending conditions and possible project redesign to accommodate more viable options for the current marketplace. Projects are often subject to costly conditions of approval such as on/off-site improvements, affordable housing, and conditions for which bonds are issued. Failure to take such obligations/costs into consideration affects the bottom line. There may also be on-going conditions, which bind successor owners and which require disclosure to purchasers.

Project Documents. Project documents, though reviewed by the California Department of Real Estate ("DRE"), may contain conflicting provisions and/or provisions unsuitable for successor owners. For instance, a developer may follow the pre-litigation dispute resolution procedures set forth in California's construction statutes ("SB800") or opt-out of SB800's onerous timelines and requirements. A developer's choice to be bound by SB800 is extremely difficult for lenders, bulk sale and note purchasers to comply with as it is unlikely that they can produce the documents required by SB800. Opting-out of SB800, if possible, may be prudent for a successor owner; previously closed homes will complicate the issue.

Delayed projects complicate handling of project documents. If material changes are needed, DRE approval is required, often leading to delays in retail sales. Successor owners may have disclosure obligations to retail purchasers, such as subsidizing assessments, maintaining certain joint use facilities and obligations to build-out improvements.

Operation and Management of Project. This is a complicated issue in "broken" condominium projects where there are sold and unsold units. A review of operating expenses, reserves delinquencies, management and possible special assessments is necessary, as all affect unsold units sales. A source of funding, often the lender or new buyer, will need to be created to remedy any significant delinquencies. Surety bonds may be available to cover the delinquent assessments, provided the successor owner is cautioned that collecting on such bonds may void an existing Public Report and/or create a future obligation to guarantee assessments in the future.

Also, successor owners should understand their rights to participate and/or control the Board of Directors of a HOA. This includes understanding fiduciary obligations to the HOA, which if not adhered to, may give rise to multiple liabilities.

Receiverships. Receiverships have grown significantly as projects continue to fail. Many lenders choose to engage neutral court-appointed receivers to manage distressed assets. The receiver's actions are taken pursuant to court approval and the lender can be protected from liability for activity within the receivership estate because lenders do not become owners. However, appointing a receiver may be costly depending on the circumstances of the property.

Single Purpose Entities ("SPE"). Placing assets into a SPE is an option for lenders seeking to sell the failed assets directly. This is advisable only for lenders with the experience to complete failed projects. Lenders choosing this route must maintain all legal requirements of separation with the SPE, as the failure to do so may create exposure to construction defect and other lawsuits. Potential benefits of an SPE for disposition are greater control over the property and possibly greater recovery on the loan. However, it is not risk free.

Conclusion. Lenders, note purchasers and bulk sale purchasers implement a risk management assessment system that properly evaluates and creates mechanisms to limit the risks of "ownership." Without such a system, liabilities may arise and diminish any opportunities for success, result in protracted litigation and possible liability.

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