



AMERICAN
BANKRUPTCY
INSTITUTE

Concurrent Session:
**The State of Real Estate Industry
and What's Next in Bankruptcies
and Restructurings**

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**THE STATE OF REAL ESTATE INDUSTRY AND WHAT'S
NEXT IN BANKRUPTCIES AND RESTRUCTURINGS**

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Effects of the Credit Crunch on the Homebuilding Industry

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While the wave of bankruptcy filings and closures of mortgage brokers has had a severely negative impact on the nation's economy, the effect of that credit crunch on the homebuilding industry may ultimately have ramifications that will run deeper than the effects felt in the mortgage industry. With very few exceptions, such as San Antonio, Texas, which is currently a very good housing market, the housing industry throughout the United States is in significant trouble.

As reported by one research analyst, we are in the midst of a 20% decline in the sale prices of resale homes. That is the greatest decline since the Great Depression. (www.housingpredictor.com/crisis.html, March 4, 2008).

Throughout California, applications for new building permits are significantly lower than in the prior year. In Sacramento, one of the more troubled areas in California, new building permits were down about 66% from January 2007 to January 2008.

In Los Angeles, in December 2007, 26% of the resale houses that were sold had been purchased at the peak of the market (7/05-12/06) and, of those, 58% were sold at prices below the mortgage amount. In Orange County, 27% of the houses sold in December 2007 were purchased during the peak period and, of those, 63% were sold at prices below the mortgage amount. The figures for San Diego County were 21% purchased during the peak period and 64% sold below the mortgage amount, and for the Inland Empire 35% were purchased during the peak period and 77% sold below the mortgage amount.

It is an astounding statistic that in the Inland Empire, over one-third of the houses sold in December 2007 were purchased during the peak period and over three-fourths of those were sold for a price less than the amount of the mortgage.

Most single-family home developers are sustaining very substantial losses, and to generate cash some of these developers have begun selling houses at 20% discounts, far below the builder's costs. While sales at deep discounts might provide a mechanism to solve short-term cash flow problems, ultimately many of these builders will go out of business if the current trend continues.

The collateral effects of the single-family home malaise are significant. One of the most obvious effects will be the decreased revenue from real estate taxes received by cities and counties.

In November 2007, a report authored by the U.S. Conference of Mayors predicted that the housing recession will reduce property values in 2009 by \$1.2 trillion and slash tax revenue by more than \$6.6 billion. (www.bloomberg.com/apps/news?pid=home, March 24, 2008). Some counties in California have adopted automatic programs to begin reassessment of properties and to reduce the assessed values, and, as a result, real estate tax income, of single family homes in hard hit areas. Tax assessors offices in most counties are overflowing with requests by home owners for reassessment. The long-term effect on schools and other projects funded by real estate taxes of this reassessment and reduction has yet to be felt, but it is almost certain to occur.

In addition, there are added costs to municipalities as a result of houses not being occupied and lawns not being maintained, as well as related expenses that will increase as the number of foreclosures and vacancies increases.

Even non-profit cultural institutions are being adversely affected by the housing crisis. As reported in the Friday, March 21, 2008, issue of the Los Angeles Times, "some of Southern California's major cultural institutions are bleeding because of the sub-prime mortgage crisis, with combined losses of more than \$3,000,000 - and mounting - since February when their seemingly safe and innocuous construction bonds turned into fiscal leeches." (Los Angeles Times, March 21, 2008, Section E, page 1). "Among the non-profits that are scrambling to escape interest payments that have more than doubled are the Los Angeles County Museum of Art, The Orange County Performing Arts Center and the Natural History Museum of Los Angeles County and the Colburn School." (*Id.*)

The interest payments have increased for the non-profits due to fears that as a result of the huge financial losses suffered by the insurers of sub-prime mortgages, those insurers may no longer be financially answerable on their policies insuring repayment of bonds issued by the non-profit institutions. Thus the policies that gave the bonds issued by the non-profit entities their high ratings, and therefore lower interests rates, are no longer being viewed as an absolute source of secondary recovery by the financial community.

Not surprisingly, the mortgage and housing crises are affecting the poor to a disproportionately greater degree than they are the wealthy. Social services departments indicate

that the homeless rates are on the rise, not only from families that lose their own homes, but from renters who have been evicted following foreclosure of their rental unit. (www.msnbc.msn.com/id/22246203/).

Foreclosures also negatively impact the value of other houses in the same neighborhood. According to a study conducted by Georgia Tech Associate Professor Dan Immergluck concerning foreclosures in Chicago in the late 1990s, "each foreclosure on an urban block lowered property values by an average of nearly 1 percent, and about 1.4 percent in low income neighborhoods" (www.msnbc.com/id/23599085/).

While intuitively one might think that a slowing of the sales volume of houses would benefit those in the remodeling industry, as reported in the San Diego Union Tribune on February 24, 2008, that is not the case. Rather, the housing downturn has actually significantly slowed the remodeling market.

The downsizing by builders has significantly added to the number of vacancies in the commercial rental markets in Southern California, and the effect of these layoffs, together with the layoffs being experienced in related trades, such as sub-contractors, has contributed significantly to the number of unemployed people in California. It now appears that the originally published job growth figures for California in 2007 were substantially overstated, (with the job growth for the Inland Empire, Riverside and San Bernardino counties), being revised from an increase of 42,300 jobs added to just 1,100 added in 2007. Projections for 2008 range from minimal job growth to an actual loss in the number of jobs.

An intangible effect of the housing and sub-prime mortgage crises is the effect on consumer confidence that the continued press coverage of these crises creates. According to Federal Reserve Chairman Ben Bernanke, "there is something on the order of 4 cents or 9 cents on the dollar of an effect on consumer spending when home values decline." (www.reuters.com/article/bondsnews/idUSWAT00789620070719, July 19, 2007)

The engine that drives the U.S. economy is consumer spending. A lack of consumer confidence, if it results in significantly decreased consumer spending, will significantly dampen the U.S. economy, further driving down prices of houses and increasing significantly the losses to be suffered from sub-prime and alt A mortgages.

For builders who own raw land inventory or lots in the process of entitlement, or even fully entitled lots, the situation is much more dire. While builders with finished houses can

obtain cash by selling the houses at deep discounts (even if at a loss), the situation is not the same with respect to raw land and lots. Most builders owning raw land inventory or lots are in covenant default with respect to their loans (*i.e.*, they are in breach of provisions in their loan documents, such as having a minimum net worth or debt to equity ratio), which gives lenders the right to cease funding on their loans.

As the housing crisis deepens, and the value of houses, as well as land and lots upon which houses would be built, continues to decline, lenders have been increasingly reluctant to continue funding builders to take lots to full entitlement.

In addition, lenders have begun the process of reappraising the lot projects and, when the appraisals come in significantly lower than the original appraised value of the projects, making a demand upon developers to re-margin their loans so that if a loan was originally made at 70% loan-to-value, the developer would be required to pay down the loan to a point that the loan amount would be 70% of the new appraised value. For most cash strapped developers in this market, funding their projects through entitlement from their own funds, or making re-margin payments, is either not possible, or not advisable.

For public builders, and private builders with substantial cash reserves, there is no realistic alternative to making the re-margin payments and fund the lot projects to entitlement from their own funds. As a result, these demands represent an increasingly large, and unrealistic, cash demand in a declining market.

There are very few buyers for raw land or lots at prices that would make any sense to the developers. While there are billions of dollars in funds which have been assembled to take advantage of the depressed real estate market, to date there have been very few actual purchases of lots.

The perception in the market place is that the value of raw land and lots will continue to decline. Under such circumstances, it makes financial sense for the distressed real estate funds to delay purchasing land or lots. This is so both because the funds will likely be able to purchase the same inventory later at a lower price and because the period of time that they will be required to carry those lots until the market turns and the lots are saleable at a profit will be shorter.

Lot values have decreased to the point that many raw land and entitled lot projects actually have a negative residual value (*i.e.*, the cost to complete the lots is greater than the amount that the lots can be sold for upon completion and entitlement). Based upon the offers

being made in the market place today, lots are being valued at a percentage of the actual dollars which have been spent for improvement and/or entitlement, with no value being attributed to the underlying land.

On the bright side, governmental agencies have recognized the seriousness of the problems in the sub-prime, alt A and homebuilding markets, and are making attempts to mitigate the problems in those markets.

Recent legislation has resulted in an increase in the maximum loan limits for mortgages which can be purchased by Fannie Mae. In addition, the Federal Reserve has recently increased the funds it will make available and broadened the collateral it will accept beyond the highest rated mortgages in order to pump more liquidity into financial markets. The recent decrease in the Federal Funds rate, the assistance from the government in the proposed purchase of Bear Sterns by JP Morgan Chase, and the legislation signed by the President to stimulate the economy by making direct payments to many tax payers from the government all indicate a clear governmental recognition of, and willingness to attempt to mitigate the damages created by, the sub-prime crisis and the housing crisis.

In addition, builders have been seeking from local governmental entities delays in the payment of developmental impact fees. Currently, builders are required to pay those fees at the time building permits are issued. Builders are asking for a delay in the obligation to make those payments until the house is ready to be occupied. The response of governmental entities to such requests, especially when the decrease in real estate tax revenue will squeeze the financial condition of those entities, has yet to be determined.

Two home builders, JMC Homes of Roseville and Lennar Corporation, are offering properties with 30-year fixed-rate mortgages with 4.875%. To put this rate in context, the average rate of 30-year fixed-rate mortgages has not fallen below 5.23% in Freddie Mac's 37-year history.

In addition, KB Homes is selling houses with a guarantee that if either the price of the house, or the interest rate on the loan obtained to purchase the house, falls prior to the closing, the buyer will be entitled to either the lower purchase price or interest rate.

The National Association of Homebuilders has suggested that a tax credit of \$10,000 be given to anyone who purchases a newly built house. While at first the proposal may appear extreme, it is interesting to note that the Tax Reduction Act of 1975 gave people who bought a

new home in that year a tax credit equal to 5% of the purchase price, up to \$2,000. In 1975, the median home price was around \$39,300; it was about \$246,000 in 2007, according to census data. (San Francisco Chronicle, February 28, 2008.)

The Foreclosure Prevention Act of 2008, which has been introduced in the Senate, contains a variety of measures to assist homebuilders and improve the housing market. One of the most significant provisions of the Foreclosure Prevention Act of 2008 would allow homebuilders to get tax refunds by applying losses incurred between 2006 and 2008 to taxes paid on profits for the past five years, instead of the two years allowable under the present law.

The transaction between Lennar Homes and Morgan Stanley which occurred at the end of 2007 was to a large extent a transaction driven by the ability of Lennar to carry back the tax loss created by the transaction to 2005, and to receive a very large refund of taxes paid in 2005. If developers are allowed to carry back losses for five years, the cash benefit to developers from income tax refunds may be substantial.

It is not yet known whether these responses to the housing crisis and the sub-prime mortgage crisis will have a significant effect on affected markets.

While it is impossible in such turbulent financial times to predict the future with regard to either the sub-prime mortgage, Alt A mortgage or home building markets, there are several negative factors that have not yet occurred (or which have occurred but will be continuing) that will negatively impact these markets.

The first of these factors is that the sub-prime and Alt A loans will continue to reset as to interest rates and monthly payments in the months to come.

An estimated 5 million adjustable rate loans will reset by the end of 2009. (www.housingpredictor, March 24, 2009).

The number of U.S. homes that were involved in some stage of foreclosure in 2007 was 79% higher than in the previous year. ([//biz.yahoo.com/ap/080129/foreclosure_rates.html](http://biz.yahoo.com/ap/080129/foreclosure_rates.html).)

In January 2008, monthly foreclosures exceeded the number of monthly home sales in California. 19,821 homes went into foreclosure in January in California representing about \$8 billion in loans. (Mercury News, February 23, 2009).

Nationally, February 2008 "marked the 26th consecutive month with a national year over year increase in foreclosure - related filings." (www.msnbc.msn.com/id/23601813, March 13, 2008).

The sub-prime mortgage crisis and housing crisis have even affected the value of conventionally financed houses. In 2007, the prices of conventionally financed homes in the United States declined for the first time on record. (Toledoblade.com/apps/pbcs.dll/article?aide/20080227/business06/802270384, February 28,2008).

The typical time period in California between the first defaulted payment on a loan and the time the property securing repayment of loan becomes property of the lender is about ten months. Thus, defaults that currently exist, and defaults which can be predicted due to reset interest rates and payments in the months to come, virtually assure a continuing increase in the number of single-family residence foreclosures. As those foreclosure rates continue to rise, and perhaps even accelerate, the negative impact on the housing market, both for resales and for developers attempting to sell new houses, is obvious.

In addition, to date, lenders have primarily attempted to sell houses that have been foreclosed upon at market sales prices. As the number of homes being held by lenders dramatically increases, as it inevitably will over the next six months, and assuming lenders act as they have in the past, lenders will sell houses at greatly reduced prices, thus further depressing sales prices in the single-family home market.

A related but significant additional problem is the consequence of lenders foreclosing upon raw land or lot projects. Lenders typically do not like holding such collateral, and in this market it is very possible that lenders will sell raw land or lot projects at greatly depressed prices. Thus, when the market begins to improve and new construction is commenced, the developers who were able to avoid foreclosure of their raw land and/or lot projects will have a basis in that land, or those lots, that will make it virtually impossible for them to compete with other developers who purchased land or lots from the lenders at greatly reduced prices.

The impact of these two factors (wholesaling of single-family homes and of lot projects by lenders) will most likely have the same effect on real estate values and prices as the action of the RTC in the early 1990s when it sold portfolios of loans and or properties at greatly discounted prices, thus further depressing the real estate market, causing other savings and loans to fail and to repeat the process.

An additional negative factor in this market, which does not bode well for the future prospects for developers, is the fact that the bankruptcy laws, which, since the real estate crisis of the early 1990s, have been subject to legislative changes which do not favor debtors and have

been judicially interpreted recently in ways that are detrimental to debtors, do not seem to provide much protection for developers and/or home builders who are forced to file bankruptcy. Under the relevant provisions of chapter 11 of the Bankruptcy Code, the debtor must either have a substantial equity position to protect the secured creditor, must be able to operate a profit after filing a chapter 11, or must make the regular debt service payments to the lender during the case, in order to remain in a chapter 11 case and prevent the secured lender from foreclosing on its collateral. For many developers and homebuilders with troubled projects, none of these three conditions can be met. In addition, in 2005, the Bankruptcy Code was amended to define "single asset real estate" as follows:

real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental. 11 USC § 101(51B)

Under Bankruptcy Code Section 362(d)(3), a creditor is authorized to seek to obtain relief from the "automatic stay" in any Chapter 11 case filed by a "single asset real estate" debtor unless the Debtor-in-Possession has complied with one of two statutory alternatives within 90 days following the entry of an order for relief. Thus, a creditor will be able to successfully obtain relief from the automatic stay otherwise imposed under Section 362 if the "single asset real estate" debtor fails within such 90-day period to either:

- (i) file "a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time"; or
- (ii) commence *monthly* payments "in an amount equal to interest at the then applicable non-default contract rate of interest on the value of the . . ." secured claim held by the moving party.

The provisions described above were added by the amendments to what is now the Bankruptcy Code enacted into law on October 17, 2005. Although the prior version of the Bankruptcy Code had contained a similar provision impacting "single asset real estate" debtors, the prior statute did not apply if the debts in the case under Title 11 exceeded \$4 million. Under the current Code, the \$4 million "cap" has been eliminated in its entirety.

To the extent that real estate companies have filed chapter 11s, the filing is typically made by the holding company with the purpose of dealing with unsecured debt issues at that level and to protect the proceeds from the projects owned by the developer with a positive value.

For the smaller real estate developer, the individual owning the development company is typically required to sign personal guarantees of the secured loans made to the entities owning the projects. The issue thus becomes one of preserving the individual guarantor's net worth in the face of large deficiencies at the project level which translates into personal liability based on the guarantees. The prospects for the individuals under those circumstances are often bleak.

Fall 2008

Shopping for Liquidity: What's a Retailer to Do?

The Stressed Consumer

Against the backdrop of government leaders warning of possible catastrophic depression-era economic consequences from the spreading subprime mortgage crisis and credit crisis, the confluence of negative factors affecting the American consumer is overwhelming:

- Home values are plunging
- Foreclosures are soaring
- Unemployment is up
- Housing sales are down
- Prices are rising
- Credit is evaporating

Going into the critical Christmas selling season, the International Council of Shopping Centers recently forecast that consumer spending will increase by 1.7 percent, while the National Retail Foundation (NRF) forecast an increase

of 2.2 percent. Both forecasts are significantly below the 4.4 percent increase that the NRF typically reports, making this year one of the slowest growth holiday seasons since 2002.¹

Impact on Retailers

Given the economic conditions, it is no wonder that consumer spending is down and retailers are uneasy. Indications that consumers have cut back on spending are prevalent.

The September 2008 General Merchandise Comp Store Sales Analysis reports shopper traffic trends throughout the country and highlights the decline faced by the retail industry.² September 2008 U.S. shopper traffic declined a total of 14.2 percent from September 2007, with the largest drop of 17.8 percent in

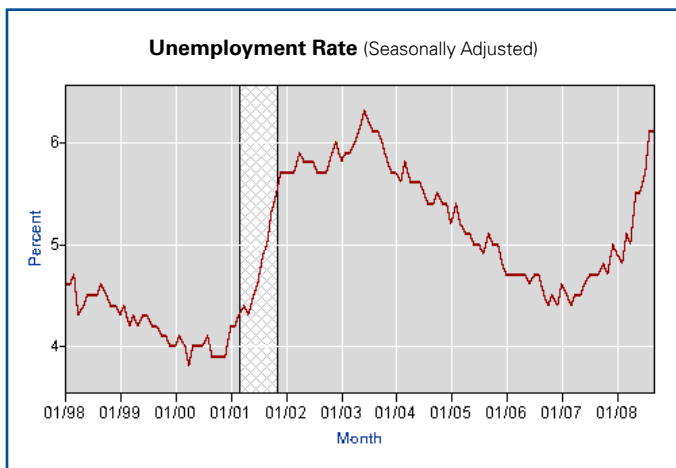
the Northeast (see table on Page 2). These numbers reflect the overall concerns of consumers due to the struggling economy.

The Federal Reserve's October 2008 Beige Report states that economic activity has been slow with decreased consumer spending in retail, auto sales, and tourism. With consumer spending slow, many shoppers have concentrated their purchases on less expensive brands and on necessary items such as food and other staple items.³ Furniture and apparel sales have declined. In September 2008 alone, furniture sales dropped over 2.3 percent, the most since 2003, while apparel and clothing sales have decreased by that same amount, representing the greatest

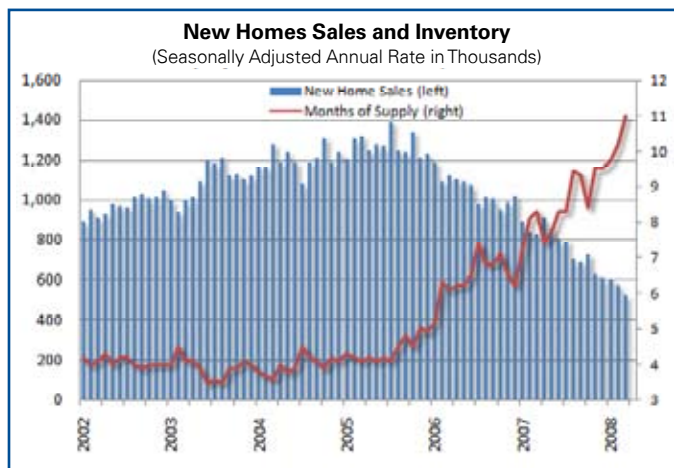
¹ National Retail Foundation and ICSC.

² General Merchandise Comp Store Sales Analysis Report and ShopperTrak, September 2008.

³ Federal Reserve's October 2008 Beige Book.



Source: Seeking Alpha, "Economic Report Summary: Plunging Home Prices and Consumer Confidence," June 29, 2008 (Note: Cross-hatched area represents recession)



Source: U.S. Census Bureau

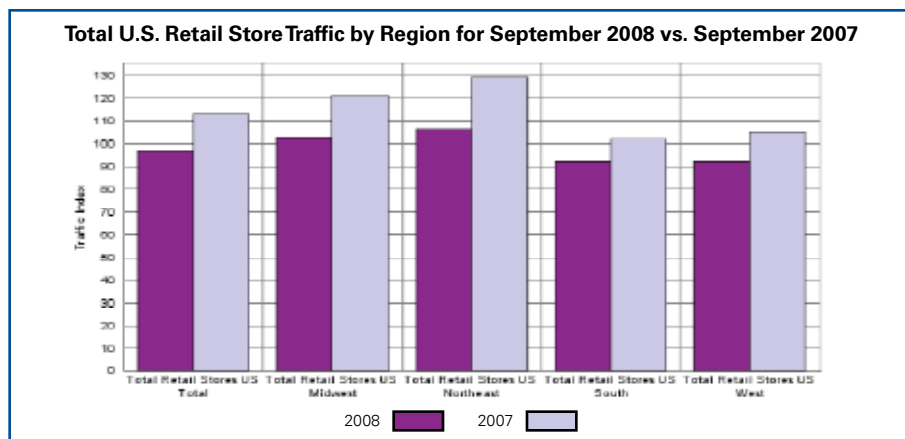
month over month decline this year. Department stores also were negatively affected, as they typically stock more discretionary merchandise. Macy's, J.C. Penney Co., and Nordstrom are just a few of the many retailers that have trimmed their third quarter profit forecasts after sales fell short of expectations.⁴

Although discounters such as Wal-Mart reported positive September sales, they reported that the sale of discretionary items was soft, with electronics and videogames among the weakest categories.⁵ MasterCard also reported that electronics and appliances sales were weak, with reported sales dropping 13.8 percent in September compared to the same period last year.

Increasing Retail Distress

The effect of decreasing customer traffic and sales can be seen in an analysis of the top 35 North American retail companies as determined by sales (see table on Page 3).⁶ Between September 2007 and September 2008:

- The stock price of 27 (77.1 percent) of the 35 retailers declined; 18 by more than 20 percent.⁷
- The debt-to-equity ratio of 23 (65.7 percent) of the 35 retailers increased; 7 by more than 100 percent.⁸
- Comparable store sales decreased in the most recent quarterly filings for 19 (54.3 percent) of the 35 retailers relative to the same 2007 quarter.



Source: September 2008 General Merchandise Comp Store Sales Analysis

The retailers that reported positive comparable store sales growth in 2008 are those categorized as necessity or discount stores (i.e., Walmart, Kroger, Walgreens), emphasizing the consumers' focus on buying necessities rather than discretionary items.

Retailer's Response

It is estimated by the International Council of Shopping Centers that there will be over 5,770 store closings this year, up 25 percent from 2007 (see below). In addition to store closings, expansion plans have also taken a hit. J.C. Penny, Lowe's, Home Depot, and Office Depot are just a few of the retailers that have decided to scale back or delay their expansion plans.⁹ As seen with Linens 'n Things (LNT) and Mervyns, Chapter 11 reorganizations can quickly turn into Chapter 11 liquidations. LNT will be liquidating 371 of its stores¹⁰ and Mervyns will be liquidating 149

stores.¹¹ Moreover, Circuit City has announced that it is actively seeking a buyer, while Talbots has announced that it is cutting expenses and costs by trimming 9 percent of its staff.^{12,13}

Liquidity and Lenders

The liquidity crisis affecting lenders is making it increasingly difficult for retailers to access financing. Any retailer seeking to refinance its credit facility—especially any recent highly leveraged LBOs—will find this environment extremely challenging. First, lenders are protective of their capital and are extremely cautious about new financings. Second, from October 2007 to October 2008, loan rates have increased approximately 175 to 225 basis points. Third, according to Barbara Anderson, Managing Director at National City Retail Finance, updated inventory appraisals in certain discretionary retail segments are increasingly showing depreciating

Store Name	Store Closings/Expansion Plans
Ann Taylor	Closing 117 stores nationwide.
Cache	Planning on closing 20 to 33 stores.
Charming Shoppes	Owner of Lane Bryant and Fashion Bug will close 150 underperforming stores.
Circuit City	Closing 155 stores.
Dell	Closing 140 stores.
Disney Stores	Closing 98 stores.
Eddie Bauer	Closed 27 stores and is planning on closing 2 outlet shops by the end of 2008.
Foot Locker, Inc.	Closing 140 stores.
The Gap Inc.	Opening 100 new stores and closing 115 locations by the end of 2008.
The Home Depot, Inc.	Closing 15 underperforming locations.
Pacific Sunwear	Announced earlier this year it will be closing its 153-store Demo chain.
Talbots	Closing 78 of its children's and men's stores.
Zales and Piercing Pagoda	Announced earlier this year it is closing 105 underperforming stores and kiosks.

Source: *The New York Times*, "Retailing Chains Caught in a Wave of Bankruptcies," April 15, 2008, Money.Aol.Com, "36 Retail Stores Closing Doors," and *The Wall Street Journal*, "Circuit City to Retrench," November 3, 2008.

⁴ *MarketWatch.com*, "Macy's Slashes Profit, Sales Forecasts; Shares Skid," October 10, 2008.

⁵ *The New York Times*, "Gadgets Hit as Nervous Consumers Plan for Lean Holidays," October 15, 2008.

⁶ KPMG Corporate Finance LLC reviewed the Top 35 North American traditional retailers by sales, excluding Internet-based companies and automotive dealerships, and those not reporting comparable sales statistics. Data sourced through *One Source* and company filings.

⁷ Publix Super Markets Inc. is not a publicly traded company.

⁸ Bed Bath & Beyond Inc. and AutoZone, Inc. did not report total debt-to-equity ratios.

⁹ *Capital IQ* and *New York Times*, "Retailing Chains Caught in a Wave of Bankruptcies," April 15, 2008.

¹⁰ *Reuters.com*, "Update 1-Linens 'n Things Store Closings to Begin Friday," October 15, 2008.

¹¹ *Newsday.com*, "Mervyns Says It Will Close all 149 stores; Becomes Latest Retailer to Citing Falling Liquidity," October 17, 2008.

¹² *mysanantonio.com*, "Mervyns, Retailers Trapped in the Middle," October 5, 2008.

¹³ *Directmag.com*, "Talbots to Ax 9 Percent of Workforce to Cut Costs," June 8, 2008.

Store Name	Sales	Stock Performance			Debt to Equity Ratio		
	% Change for Comp Store Sales*	Sept - 07 Stock Price	Sept - 08 Stock Price	% Change in Stock Price	Oct - 07 Total Debt to Equity Ratio	Oct - 08 Total Debt to Equity Ratio	Comparison
Circuit City Stores, Inc.	-13.3%	7.91	0.76	-90.39%	0.00	0.26	+
The Gap Inc.	-10.0%	18.44	17.78	-3.58%	0.00	0.04	+
Office Depot, Inc.	-10.0%	20.62	5.82	-71.77%	0.20	0.28	40.0%
OfficeMax Incorporated	-10.0%	34.27	8.89	-74.06%	0.90	1.31	45.6%
The Home Depot, Inc.	-7.9%	32.44	25.89	-20.19%	0.50	0.63	26.0%
Staples, Inc.	-7.0%	21.49	22.50	4.70%	0.10	0.75	650.0%
Limited Brands, Inc.	-7.0%	22.89	17.32	-24.33%	0.60	1.32	120.0%
Nordstrom, Inc.	-6.0%	46.89	28.82	-38.54%	0.30	2.28	660.0%
Macy's, Inc.	-5.8%	32.32	15.19	-53.00%	0.70	1.06	51.4%
Kohl's Corporation	-5.6%	57.33	46.08	-19.62%	0.20	0.33	65.0%
Lowe's Companies, Inc.	-5.3%	28.02	23.69	-15.45%	0.30	0.30	0.0%
Barnes & Noble, Inc.	-4.7%	35.26	28.08	-20.36%	0.00	0.14	+
J.C. Penney Company, Inc.	-4.3%	63.37	33.34	-47.39%	0.80	0.72	-10.0%
Dillard's, Inc.	-4.0%	21.83	11.80	-45.95%	0.50	0.57	14.0%
The Pantry, Inc.	-2.5%	25.63	21.19	-17.32%	2.50	3.59	43.6%
Supervalu Inc.	-1.3%	39.01	21.70	-44.37%	1.80	1.45	-19.4%
Foot Locker, Inc.	-0.5%	15.33	16.16	5.41%	0.10	0.06	-40.0%
Target Corporation	-0.4%	63.57	49.05	-22.84%	0.60	1.46	143.3%
Bed Bath & Beyond Inc.	-0.1%	34.12	31.41	-7.94%	0.00	0.00	0.0%
Safeway Inc.	0.5%	33.11	23.72	-28.36%	1.00	0.85	-15.0%
AutoZone, Inc.	0.6%	116.14	123.34	6.20%	4.00	4.80	20.0%
Winn-Dixie Stores, Inc.	0.9%	18.72	13.90	-25.75%	0.00	0.03	+
Publix Super Markets Inc.	1.3%	NA	NA	NA	0.00	0.00	0.0%
Rite Aid Corporation	1.6%	4.62	0.84	-81.82%	1.90	4.62	143.2%
Walgreen Company	2.6%	47.24	30.96	-34.46%	0.00	0.11	+
The Great Atlantic & Pacific Tea Company	2.8%	30.46	10.82	-64.48%	0.90	2.68	197.8%
CVS Caremark Corporation	3.1%	39.63	33.66	-15.06%	0.77	0.28	-63.6%
Family Dollar Stores, Inc.	3.6%	26.56	23.70	-10.77%	0.20	0.20	0.0%
The TJX Companies, Inc.	4.0%	29.07	30.52	4.99%	0.40	0.40	0.0%
Best Buy Co., Inc.	4.3%	46.02	37.50	-18.51%	0.10	0.57	470.0%
The Kroger Co.	4.7%	28.52	27.48	-3.65%	1.40	1.48	5.7%
Wal-Mart Stores, Inc.	5.0%	43.65	59.89	37.21%	0.60	0.67	11.7%
Costco Wholesale Corporation	9.0%	61.37	64.93	5.80%	0.00	0.25	+
BJ's Wholesale Club, Inc.	15.5%	33.16	38.86	17.19%	0.00	0.01	+
GameStop Corp.	20.0%	56.35	34.21	-39.29%	0.60	0.26	-56.7%

* Most recent quarterly sales compared to the corresponding quarter in the previous year.

+ Total debt-to-equity increased by an undeterminable number.

Source: One Source, recent company quarterly reportings.

inventory values. As collateral values shrink, borrowers' availability shrinks as well, presenting challenges to both borrowers and lenders. Moreover, depreciated asset values pose a heightened risk to lenders in a liquidation scenario. In Mrs. Anderson's opinion, if the economy doesn't turn around, the real liquidation value test will come after holiday spending season.

Next Steps

Aside from offering customers discounts and promotions, retailers will need to be creative, proactive, and aggressive in exploring all financial and strategic alternatives. The traditional shelter of Chapter 11 may not offer retailers much refuge if inventory values and the availability of new financing continue to decrease. In fact, one lender has noted

that "retailers can no longer raise a new bank group for a DIP financing." KPMG Corporate Finance's professionals have the requisite retail sector and transaction experience to formulate and execute a strategic plan to assist you in navigating your business through this challenging economic environment. Retailers should evaluate one or several paths towards preserving value and creating liquidity.

KPMG Corporate Finance LLC

KPMG Corporate Finance LLC understands the pros and cons of various financial and operational techniques for preserving value and creating liquidity. We can customize an approach to help best meet your needs. KPMG Corporate Finance has significant retail and real estate knowledge and experience gained through deep consumer markets sector knowledge that we leverage across

our diverse product offering. Our Special Situations Advisory Group (SSAG) understands how to develop and execute the appropriate strategies in this difficult economic environment. First, SSAG regularly accesses alternative sources of debt and equity capital. These alternative capital sources are actively lending and investing into this restrictive credit market. Second, SSAG executes strategies to help a company deleverage its balance sheet

through a negotiated debt restructuring; and third, SSAG can effectuate an accelerated M&A process for all or a portion of your business, including noncore assets. Such transactions can quickly (30–90 days) raise cash for your business. Contact one of our seasoned professionals to help you confidentially assess the strategic path that makes sense for your business.

KPMG Corporate Finance provides a full suite of investment banking and advisory services to its domestic and international clients. Our professionals have the experience and depth of knowledge in global M&A to advise clients on restructurings, mergers and acquisitions, sales and divestitures, capital raises, buy-outs, financings, fairness opinions, and other advisory initiatives. In addition, we remain independent of financing sources, helping to ensure that our efforts are objective and aligned with the goals of KPMG's firms' clients. Operating in 51 countries, KPMG's Corporate Finance practice comprises more than 1,800 professionals who are able to meet the needs of KPMG's firms' clients across the globe. In 2007, as a leading financial adviser, KPMG's Corporate Finance practice completed 450 deals totaling US\$27.5 billion, according to Thomson Financial's global M&A league tables.

Retailers should evaluate one or several paths toward preserving value and creating liquidity. These include:

Creating liquidity	Debt restructuring: <ul style="list-style-type: none"> • Negotiate with lenders to explore all opportunities to extend deadlines and increase availability. "Deleveraging" should be your mantra. • Negotiate with landlords to explore all opportunities to restructure leases, including lease terminations, rent reductions, term modifications, size reductions, subleases, and assignments. • Negotiate with trade creditors to explore all opportunities to enhance liquidity by extending terms, consolidating vendor relationships, and considering debt-for-equity swaps.
Capital raise	<ul style="list-style-type: none"> • Confidentially seek financial and strategic partners domestically and internationally. • Confidentially seek alternative financing sources with more patient capital during this market cycle. • Monetize real estate via sale-leasebacks.
Acquisitions or disposals	<ul style="list-style-type: none"> • Confidentially explore opportunities either to sell all or a portion of the business, or to acquire strategically complementary businesses. • Market and dispose of excess owned and leased properties.
Cash management	<ul style="list-style-type: none"> • Implement a third-party analysis of your operations to identify cost rationalization and enhanced cash flow management techniques.

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We welcome the opportunity to meet with you, learn more about your company's objectives, and discuss our people and capabilities.

KPMG Corporate Finance — Objectivity. Insight. Experience.

KPMG Corporate Finance LLC is a leading middle market adviser serving domestic and international clients. We offer a full suite of investment banking and strategic advisory services. Visit us online at www.kpmgcorporatefinance.com.

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Winter 2009

Weathering the Storm

Market Update

The homebuilding environment deteriorated significantly in the second half of 2008. Homebuilder sentiment regarding market conditions dropped to a record low of nine in November, based on an index maintained by the National Association of Home Builders (NAHB) where greater than 50 indicates “positive” sentiment. The tight credit markets, bleak consumer confidence, and rising unemployment rates have kept homebuyers on the sidelines while home foreclosure rates have continued to rise.

Existing home sales dropped 1.6 percent to 4.98 million annualized units in October 2008 as compared with the year earlier period. This represents a drop of 3.1 percent on a monthly basis from September 2008. Regionally, existing home sales in the west rose 37.5 percent in October and declined 9.1 percent, 10.2 percent, and 9.8 percent in the midwest, south, and northeast, respectively, as compared to a year ago.¹

New home sales decreased 40.1 percent to 433,000 annualized units in October 2008 as compared to the year earlier period. This represents a drop of 5.3 percent on a monthly basis from September 2008 and a steep 69 percent decline from the pinnacle rate of 1,389,000 homes in July 2005.²

Inventories of existing homes for sale

for the fourth consecutive month fell 0.9 percent at the end of October 2008 from a month ago to 4.23 million units. The impetus for inventory drop was primarily homebuyers and investors seeking deals among foreclosed properties. The current inventory level represents a 10.2 months supply at the current sales pace as compared to 10 months supply at the end of September 2008.¹

Inventories of new homes for sale fell 8 percent at the end of October 2008 from a month ago to 381,000 units as homebuilders continue to scale back new construction.² Building permits issued in October 2008 for new housing construction fell 4.5 percent from a month ago and 38.8 percent from a year ago, to a seasonally adjusted annual rate of 791,000—the lowest level since the Commerce Department began publishing data in January 1959. The current inventory level represents an 11.1 months supply at the current sales pace as compared to the 10.9 months supply at the end of September 2008.³

The national median price for all existing homes sold in October 2008 was US\$183,300, a decrease of 11.3 percent from a year ago median of US\$206,700. The national median price for all new homes sold in October 2008 was US\$218,000, a decrease of 7 percent from a year ago median of US\$234,300.

The S&P/Case-Schiller Home Price indices, the leading measure of U.S. home prices, reported on October 28, 2008 for the time period up to August 2008 showed record annual decline in home prices in excess of 16 percent. All 20 metropolitan areas measured in the index showed annual declines. The Sun Belt markets were the most impacted—Phoenix and Las Vegas led with annual declines greater than 30 percent followed by Miami, San Francisco, Los Angeles, and San Diego, which experienced annual declines in excess of 25 percent.

Dropping home prices have enticed some homebuyers to commence home purchases. However, the majority of the home purchases have stemmed from the foreclosure market. “Compared to a fairly small share of foreclosures or short sales a year ago [September 2007], distressed sales are currently 35 to 40 percent of transactions. These are pulling the median price down because many are being sold at discounted prices,” explained Lawrence Yun, a chief economist with the National Association of Realtors.⁴

Zillow.com, a Seattle-based firm known for monitoring home values, reported in its third quarter 2008 report that an

¹ National Association of Realtors.

² U.S. Census Bureau.

³ U.S. Census Bureau and the Department of Housing and Urban Development.

⁴ *Housingwire*, “Existing Home Sales Rise 5.5 Percent in September,” October 24, 2008.

estimated one in seven homeowners have negative equity. This statistic doubles to include approximately 28 percent of homeowners if the home purchase was made in the past five years.⁵

Barclays Capital estimates that banks and loan investors owned 826,200 foreclosed homes as of September 1, 2008, an increase of 240 percent from 343,500 a year earlier. Analysts expect that a number of homes that are temporarily off the market due to pending foreclosures and homeowners awaiting stronger demand will hit the market in the next couple of years.⁶ Barclays forecasts the inventory of foreclosed homes will peak at around 1.3 million homes in mid-2010.⁷

While an increase in sales of foreclosed homes reduces inventory, it is not favorable for homebuilders in the near term. Increasing supply of foreclosed homes depresses prices of existing and new homes. As such, homebuilders have to compete with falling home prices resulting in a very somber outlook for the homebuilding community.

Homebuilder Options to Weather the Storm

In the current tumultuous homebuilding environment where home prices

continue to steadily erode, absorption rates continue to slow, and home inventory levels remain high, the homebuilders hoping to weather the storm are looking for decisive government action and cash generation.

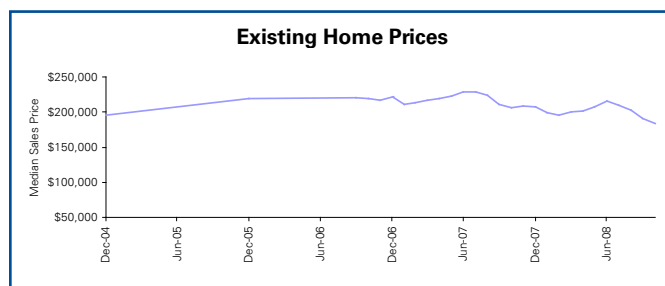
The government has attempted steps, albeit with limited success thus far, to stimulate the homebuilding market. The US\$7,500 tax credit for homebuyers passed at the end of July 2008 was met with antipathy by homebuyers due to the repayment provision. The plan provided for an interest-free loan rather than a tax credit.⁸ The down payment assistance program generated some activity; however, it was met with incredible turmoil in the markets, which offset any real gains. Most recent dialogue has consisted of a 10 percent tax credit of up to US\$22,000 and a temporary interest rate reduction on mortgages, although no such plans have been implemented.

Some in the industry believe a real tax credit, consisting of no repayment provision that applies to all homebuyers, combined with subsidized mortgage rates—a similar strategy to the 1975 housing correction—are needed to stimulate home buying.⁹

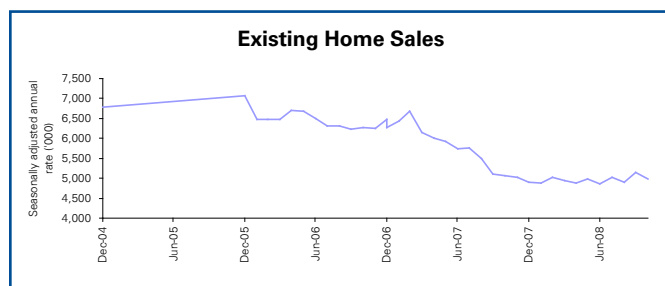
It will take time to deplete excessively high home inventory levels. As the

supply of foreclosed homes continues to hit the market, the prices of new and existing homes will continue to face downward pressure. Prices of new homes were the first to decline at the onset of the housing downturn followed by existing home prices, which needed to catch up and are doing so now as evidenced by an 11.3 percent year over year decline. As prices decrease, homebuyers will likely enter the market. The unsold inventory of homes will likely slowly decline until home prices start to stabilize signaling a bottom in the housing market. The Joint Center for Housing Studies of Harvard University points to a positive long-term trend for household formations; however, recovery will be a function of time.¹⁰

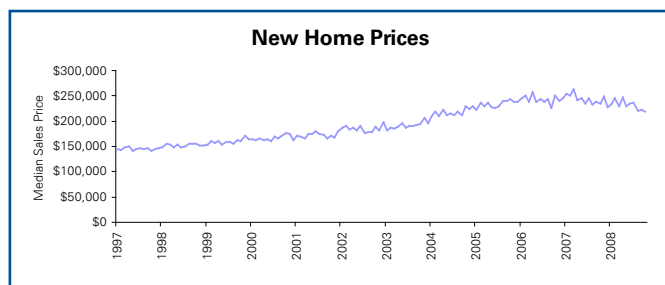
⁵ *The Wall Street Journal*, "One in Seven Homeowners Underwater," September 12, 2008.
⁶ *The Wall Street Journal*, "Bargain Hunters Help Shrink Housing Glut," October 28, 2008.
⁷ *The Wall Street Journal*, "Home Resales Increase 1.4%, Buoyed by Bargain Hunters," October 25, 2008.
⁸ CNN Money, "Beware the \$7,500 tax credit," August 19, 2008.
⁹ Pulte Homes Inc. Q3 2008 Earnings Call Transcript.
¹⁰ The state of the nation's housing 2008.



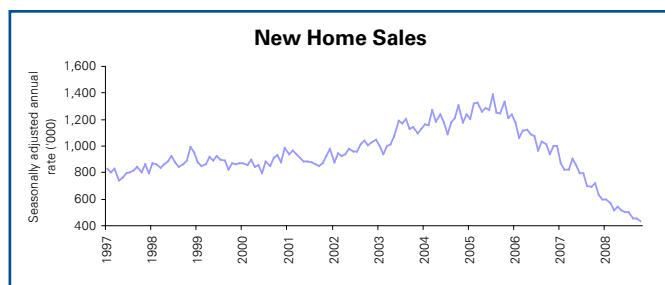
Source: U.S. Census Bureau



Source: National Association of Realtors



Source: U.S. Census Bureau



Source: U.S. Census Bureau

Market Snapshot											
Company	Market Cap ¹	Share Price ¹	52 Week Low	52 Week High	Price % Change 1 Mo	Price % Change 3 Mo	Price % Change 1 Yr	EV ² /Sales	EV ² /EBITDA	EV ² /EBIT	
HOMEBUILDING											
BROOKFIELD HOMES CORP.	126.9	4.74	1.49	18.75	-48.3%	-63.1%	-71.9%	2.0x	NM	NM	
BEAZER HOMES USA INC.	71.0	1.81	1.13	12.40	-42.9%	-74.0%	-78.7%	0.6x	NM	NM	
CENTEX CORPORATION	1,138.7	9.16	4.91	30.29	-25.2%	-43.5%	-56.1%	0.5x	NM	NM	
DR HORTON INC.	2,175.5	6.87	3.79	17.95	-6.9%	-44.9%	-42.6%	0.7x	258.4x	NM	
HOVNANIAN ENTERPRISES INC.	168.1	2.19	1.70	13.50	-49.0%	-69.3%	-71.0%	0.6x	NM	NM	
KB HOME	902.5	11.63	6.90	28.99	-30.3%	-44.1%	-44.3%	0.4x	42.2x	57.3x	
LENNAR CORP.	1,141.6	7.11	3.42	22.73	-8.1%	-45.9%	-55.1%	0.5x	NM	NM	
MDC HOLDINGS INC.	1,443.0	31.00	20.89	48.62	-7.8%	-25.2%	-12.4%	0.6x	5.5x	5.8x	
M/I HOMES, INC.	147.8	10.54	5.13	26.00	-22.6%	-41.2%	5.1%	0.6x	NM	NM	
MERITAGE HOMES CORPORATION	380.6	12.40	5.10	29.49	-9.7%	-47.1%	-9.3%	0.5x	NM	NM	
NVR INC.	2,368.4	434.25	316.82	679.37	-11.4%	-27.4%	-11.7%	0.4x	3.3x	3.4x	
ORLEANS HOMEBUILDERS INC.	39.6	2.10	1.27	6.65	-31.6%	-57.1%	-58.3%	0.9x	NM	NM	
PULTE HOMES INC.	2,742.2	10.65	6.49	23.24	-4.4%	-26.6%	4.2%	0.7x	15.2x	19.8x	
RYLAND GROUP INC.	725.0	16.97	9.95	37.85	-9.7%	-26.8%	-26.2%	0.5x	8.6x	12.4x	
STANDARD PACIFIC CORP.	194.0	1.93	1.22	6.85	-32.0%	-39.7%	-44.2%	0.5x	NM	NM	
TOLL BROTHERS INC.	3,166.5	19.93	13.55	28.00	-13.8%	-19.9%	-3.6%	1.1x	19.8x	23.1x	
WCI COMMUNITIES INC.	56.5	1.00	0.32	3.41	-6.6%	-50.9%	-54.4%	0.0x	NM	NM	
Homebuilding Mean								0.6x	15.2x	16.1x	
BUILDING PRODUCTS COMPANIES											
AXIS-SHIELD PLC ³	230.6	4.66	3.44	5.13	-2.3%	-20.7%	-13.5%	2.1x	19.7x	45.5x	
AMERICAN WOODMARK CORP.	230.6	16.43	13.50	32.42	-11.4%	-30.9%	-15.2%	0.4x	10.8x	NM	
BEACON ROOFING SUPPLY INC.	523.6	11.82	6.70	18.74	-13.6%	-27.4%	28.3%	0.5x	8.3x	12.4x	
BLACK & DECKER CORP.	2,550.3	42.44	35.54	84.76	-16.2%	-32.9%	-48.7%	0.6x	6.2x	8.0x	
CARLISLE COMPANIES INC.	1,295.1	21.23	18.00	40.72	-8.7%	-34.5%	-46.7%	0.6x	5.0x	6.3x	
CEMEX S.A.B. DE C.V. ³	5,404.0	6.95	4.10	32.61	-8.1%	-65.3%	-74.8%	0.9x	4.5x	7.7x	
COOPER INDUSTRIES LTD.	4,183.8	24.14	22.07	55.76	-22.0%	-49.3%	-51.9%	0.8x	4.7x	5.4x	
THE DIXIE GROUP, INC.	38.2	3.02	3.00	10.32	-26.3%	-60.3%	-66.4%	0.4x	5.6x	12.9x	
DREW INDUSTRIES INC.	302.2	14.06	10.50	32.25	16.2%	-12.3%	-48.5%	0.5x	5.0x	6.9x	
FORTUNE BRANDS INC.	5,666.5	37.80	32.83	78.05	-0.9%	-35.7%	-50.7%	1.4x	7.0x	8.4x	
THE HOME DEPOT, INC.	39,251.5	23.11	17.05	31.08	-2.0%	-14.8%	-19.1%	0.7x	6.8x	9.3x	
HUTTIG BUILDING PRODUCTS INC.	14.9	0.69	0.69	4.78	-37.7%	-68.1%	-81.9%	0.1x	NM	NM	
INTERFACE INC.	349.5	5.54	3.63	18.27	-21.4%	-57.9%	-68.2%	0.5x	3.7x	4.3x	
JAMES HARDIE INDUSTRIES NV ³	1,068.9	2.48	2.09	4.61	-11.9%	-38.3%	-55.6%	1.1x	12.9x	26.0x	
LAFARGE SA	10,690.3	54.76	40.72	161.46	-16.2%	-54.9%	-65.8%	1.5x	6.1x	7.9x	
LOUISIANA-PACIFIC CORP.	238.6	2.31	1.62	16.41	-51.9%	-76.3%	-85.0%	0.4x	NM	NM	
LOWE'S COMPANIES INC.	30,281.0	20.66	15.76	28.49	-4.8%	-16.2%	-15.4%	0.7x	6.0x	8.3x	
MAKITA CORP. ³	2,732.5	19.41	14.54	61.49	9.1%	-26.1%	-56.3%	0.5x	2.3x	2.6x	
MARTIN MARIETTA MATERIALS INC.	3,630.5	87.64	63.24	142.71	11.8%	-22.4%	-34.9%	2.3x	9.7x	14.4x	
MASCO CORP.	3,447.8	9.58	7.44	25.00	-5.6%	-49.7%	-57.2%	0.6x	6.4x	8.4x	
MOHAWK INDUSTRIES INC.	2,103.0	30.74	26.09	83.70	-36.5%	-55.5%	-61.8%	0.6x	4.7x	7.2x	
OWENS CORNING	2,044.8	15.95	11.32	28.58	1.4%	-34.1%	-27.5%	0.7x	6.6x	14.7x	
PPG INDUSTRIES INC.	7,212.1	43.92	38.52	72.21	-11.4%	-30.1%	-36.0%	0.7x	5.5x	7.5x	
RPM INTERNATIONAL INC.	1,543.3	11.99	10.83	25.19	-15.6%	-44.5%	-37.1%	0.6x	5.0x	6.2x	
SHERWIN-WILLIAMS CO.	6,889.0	58.93	44.51	65.00	3.5%	0.6%	-6.2%	1.0x	7.3x	8.7x	
SNAP-ON INC.	2,070.7	36.05	30.37	62.21	-2.4%	-36.8%	-26.2%	0.8x	5.1x	6.1x	
STANLEY WORKS	2,504.9	31.79	26.24	52.88	-2.9%	-33.7%	-39.0%	0.8x	5.5x	7.3x	
TREX CO. INC.	207.7	13.56	5.34	21.73	-16.9%	-26.9%	96.8%	0.9x	8.5x	30.9x	
UNIVERSAL FOREST PRODUCTS INC.	401.2	21.03	15.90	38.39	-11.1%	-36.0%	-26.5%	0.2x	8.4x	35.0x	
USG CORP.	937.0	9.45	5.66	40.25	-36.2%	-66.0%	-74.2%	0.5x	93.4x	NM	
VALSPAR CORP.	1,957.9	19.62	14.57	24.95	-4.1%	-17.1%	-13.0%	0.8x	7.5x	9.5x	
VILMORIN CLAUSE & CIE SA ³	1,265.6	94.54	83.09	169.82	-2.6%	-38.2%	-38.6%	1.6x	7.0x	12.0x	
VULCAN MATERIALS COMPANY	6,606.6	59.98	40.56	100.25	10.5%	-19.9%	-32.5%	2.7x	11.8x	20.7x	
WEYERHAEUSER CO.	7,948.7	37.62	28.94	78.00	-1.6%	-32.2%	-48.6%	0.7x	10.4x	45.3x	
WOLSELEY PLC ³	3,076.4	4.65	4.41	11.62	-15.0%	-42.7%	-67.5%	0.3x	5.2x	8.6x	
Building Products Companies Mean								0.7x	6.4x	8.4x	

¹ Market Capitalization amounts are in millions, based on closing Share Prices as of November 30, 2008

² Enterprise Value (EV) equals Market Capitalization plus Debt, Preferred Equity, and Minority Interest, minus Cash and Cash Equivalents; For Homebuilding companies, Enterprise Value excludes debt related to the company's mortgage finance division

³ Market Capitalization and Share Prices are based in foreign exchange listed securities and converted to US\$

Source: Capital IQ and company filings

Recent Select Transactions for the Homebuilding and Building Products Industries											
Date	Company	Event	Security Type	Transaction Value (\$ million)	Cash Balance (\$ million)						
					9/30/2006	9/30/2007	9/30/2008				
10/30/08	MDC Holdings Inc.	10/30/08 – Shelf Registration	Common Stock; Corporate Debt (Nonconvertible); Preferred Stock (Nonconvertible)	1,000.00	132.84	729.48	1,160.87				
9/19/08	K.Hovnanian Enterprises, Inc.	9/19/08 – Public Offering	Corporate Debt (Nonconvertible)	594.52	N/A	N/A	N/A				
8/22/08	Meritage Homes Corp.	8/22/08 – Shelf Registration (a) 5/29/08 – Shelf Registration (b)	Common Stock; Corporate Debt (Nonconvertible); Preferred Stock (Nonconvertible); Warrants (a) Common Stock (b)	350.00 (a) 15.51 (b)	75.44	45.30	119.03				
8/19/08	Standard Pacific Corp.	8/19/08 – Shelf Registration (a) 8/4/08 – Public Offering (b) 5/26/08 – Private Placement (c)	Common Stock (a) Common Stock (b) Convertible Preferred (c)	58.68 (a) 152.50 (b) 381.25 (c)	5.23	5.09	711.95				
8/4/08	M/I Homes, Inc.	8/4/08 – Shelf Registration	Common Stock; Corporate Debt (Nonconvertible); Preferred Stock (Nonconvertible); Warrants	250.00	2.71	2.49	4.34				
7/18/08	Centex Corp.	7/18/08 – Shelf Registration	Common Stock	49.04	42.68	81.48	1,260.60				
6/9/08	Walter Industries Inc.	6/9/08 – Public Offering	Common Stock	254.10	160.64	23.16	31.19				
5/16/08	Hovnanian Enterprises Inc.	5/16/08 – Private Placement	Corporate Debt (Nonconvertible)	600.00	36.79	19.63	677.21				
5/16/08	Pulte Homes Inc.	5/16/08 – Shelf Registration	Common Stock	72.25	94.63	101.79	1,173.89				

Source: Capital IQ, company filings

On the road to recovery, homebuilders need to explore every option to generate cash. The combination of lowering costs, managing inventory, restructuring debt payments and land commitments, and raising funding are crucial to cash preservation and cash generation. Companies need to maximize efficiencies in all aspects of their business, from how they deliver material to construction sites, to how long it takes to build a home. Many homebuilders are taking aggressive steps to sell homes in order to decrease inventory. Additionally, restructuring debt and land commitments to delay maturities combined with fund-raising are essential to a strong balance sheet. Pulte Homes is targeting a cash reserve of US\$1.8 billion by the end of 2008 and has ensured it has no significant debt coming due until 2011.¹¹ Standard Pacific recently conducted a US\$153 million rights offering.¹² Its cash balance of US\$712 million on September 30, 2008 is up 140 times from the same time a year ago. Homebuilders are keeping a keen eye on their cash balances, which are up significantly from prior years. The table on Page 3 highlights some of the recent steps taken by companies to bolster their balance sheet.

KPMG Corporate Finance

KPMG Corporate Finance is a full service, independent, middle-market investment

bank with deep experience in the homebuilding sector. KPMG Corporate Finance also has extensive experience in special situations and real estate disposition to make it a trusted adviser in this sector. We can advise and assist in the execution of transactions that seek to maximize value for homebuilding and building products companies and improve the likelihood of preserving equity in any project. Through our vast global network and contacts with specialty capital providers in the homebuilding sector, we (comprising the

professionals formerly with Keen Realty, LLC) are able to provide your company with financial restructuring options and access to needed liquidity. Our real estate and special situations advisory bankers welcome the opportunity to meet with you on a confidential basis to learn more about how we might assist you to explore all of the strategic alternatives available in the market today.

¹¹ Pulte Homes Inc. Q3 2008 Earnings Call Transcript.

¹² Standard Pacific Corp. Q3 2008 Earnings Call Transcript.

Companies should evaluate one or several paths toward preserving value and creating liquidity. These include:	
Creating liquidity	Debt restructuring: <ul style="list-style-type: none"> • Negotiate with lenders to explore all opportunities to extend deadlines and increase availability. "Deleveraging" should be your mantra. • Negotiate with landlords to explore all opportunities to restructure leases, including lease terminations, rent reductions, term modifications, size reductions, subleases, and assignments. • Negotiate with trade creditors to explore all opportunities to enhance liquidity by extending terms, consolidating vendor relationships, and considering debt-for-equity swaps.
Capital raise	<ul style="list-style-type: none"> • Confidentially seek financial and strategic partners domestically and internationally. • Confidentially seek alternative financing sources with more patient capital during this market cycle. • Monetize real estate via sale-leasebacks.
Acquisitions or disposals	<ul style="list-style-type: none"> • Confidentially explore opportunities either to sell all or a portion of the business, or to acquire strategically complementary businesses. • Market and dispose of excess owned and leased properties.
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The New Age of Real Estate Loan Defaults

By: Gregg Loubier and Joshua del Castillo of Allen Matkins

I. Introduction

When the music stopped for the global credit markets in late 2007, the value of many mortgage-related assets plummeted. The damage caused by the mortgage credit downturn of 2007 and 2008 has yet to be fully understood, but it is clear that certain mortgage lenders, investment banks, hedge funds, bond insurers, and other holders of affected assets are already suffering huge losses. The effects of the downturn extend far beyond its origins in the United States subprime residential mortgage sector. The contraction and shifting of credit availability for the purchase and refinancing of real estate has created a "credit crunch" that slows the pace of real estate activity. Securitizing mortgage lenders have been especially hard-hit as the market for bonds backed by mortgages has contracted, thus slowing the pace of mortgage origination for securitization. Poor credit decisions relating to existing commercial and residential assets and the contraction of credit availability are adversely affecting economic "fundamentals" such as employment and consumer spending, which tends to depress real estate values. After years of prosperity, it appears that we are entering a "down cycle" in real estate.

Many real estate law practitioners worked during earlier real estate downturns, representing clients hurt by the downturn and clients that profited from others' misfortunes. Today, seasoned real estate lawyers are resuming and expanding their practices in loan defaults and remedies, workouts and foreclosures, and bankruptcy, along with newer real estate lawyers who have never worked in a deteriorating real estate market environment.

Real estate lawyers will produce many articles and give many speeches in 2008 about real estate loan defaults. This article discusses several issues that arise in defaulted commercial real estate loans - notice of default, enforcement of nonrecourse carve-out guaranties, prepayment restrictions, late charges, and the finality of foreclosure - and illustrates the issues by reviewing an important recent court decision on each topic. The authors hope that this article will provide a springboard that introduces, or reintroduces, the reader to the law of real estate finance in this new age of real estate loan defaults.

II. Commencing Nonjudicial Foreclosure by Notice of Default

The filing of a notice of default under a deed of trust with power of sale is often the lender's first exercise of a default remedy after a borrower's loan default. The form and required contents of the notice of default are specified by statute. CC §§ 2924, 2924c. The contents of the notice of default must comply strictly with the statutory requirements, which are intended to protect the borrower from a wrongful or unfair loss of the property. A trustee sale based on a statutorily deficient notice of default may be invalidated.

Under §2924(a)(1), the power of sale under a deed of trust "shall not be exercised" until a notice of default is recorded "identifying the . . . deed of trust . . . [and containing a] statement that a breach of the obligation . . . has occurred . . . setting forth the nature of each breach actually known to the beneficiary" The notice of default informs the borrower of the existence and nature of the default so that the borrower has an opportunity to pay the obligation, or cure the default and reinstate the obligation. Section 2924c grants to a borrower, or any beneficiary under a subordinate deed of trust, the right to reinstate the defaulted obligation by paying all defaulted amounts and the lender's enforcement costs and expenses. After recording the notice of default, the lender must wait 3 months before publishing a notice of sale. §2924(a)(2). Reinstatement may be made until 5 business days before the foreclosure sale date stated on the recorded notice of sale. §2924c(e).

The case of *Anolik v EMC Mortgage Corp.* (2005) 128 CA4th 1581 (2005), 28 CR3d 759, illustrates how lenders must take care in analyzing and handling existing defaults and preparing the notice of default, and how an attempted foreclosure based on an erroneous notice of default may be subject to attack.

Plaintiff Anolik bought a home in 1998 with a mortgage loan secured by a deed of trust in favor of defendant EMC. After Anolik's default, EMC recorded a notice of default on July 6, 2000. Anolik sued EMC, seeking to enjoin the pending foreclosure sale and a declaration that the notice of default was void. EMC prevailed at trial, but the appeals court reversed.

The events that ultimately invalidated EMC's notice of default began long before the notice of default was filed. Civil Code 52924 requires that a notice of default must set forth at least one accurate statement of a breach that is sufficiently substantial to warrant the remedy of foreclosure. The court of appeal ultimately found that EMC's notice of default failed to state even one default that existed at the time the notice was filed.

The court determined at the outset that the portion of EMC's notice of default that described a general, nonspecific default for failure to pay late charges, advances, assessments, and attorneys' fees, "if any," did not state a specific breach and, therefore, failed to meet the statutory standard.

EMC's notice of default also asserted that Anolik was in default for failure to make all payments due in March, April, May, June, and July 2000. In October and December 1999, EMC had paid property tax bills that Anolik failed to pay as required before delinquency. Instead of demanding reimbursement of the tax advances as permitted under the deed of trust, EMC "forced" an impound account on Anolik starting in December 1999 and thereafter attempted to collect higher monthly payments, including additional amounts monthly to recover the tax advances and to pay future tax payments. Anolik continued making payments but never paid the increased monthly payment amount. The court found that EMC had no right under the loan documents to impose an impound account on Anolik and, therefore, Anolik could not be in default for failure to make the increased payments due in March, April, May, or June 2000.

Anolik did not make the July 2000 payment, but the court ruled that this failure was not a "sufficiently substantial breach" at the time the notice of default was filed on July 6, 2000. Thus, according to the appellate court analysis, Anolik was not in default for failure to pay any of the identified monthly installments at the time the notice of default was filed.

EMC argued further that, even if the stated defaults did not exist, Anolik was nonetheless in default when the notice was filed because Anolik had never paid the installment due in December 1998. The court rejected the argument since the notice of default did not give notice of that particular payment default. In sum, the court ultimately held that the notice of default was defective because it failed to accurately identify a default existing at the time the notice was filed.

The *Anolik* case stands as a cautionary tale for lenders and their counsel, and reminds borrowers' counsel that a lender's nonjudicial foreclosure may be attacked by seeking to invalidate the notice that commences the foreclosure process. A notice of default is often prepared under pressure to quickly commence foreclosure. Gathering and organizing the necessary information about the defaults, the accelerated loan balance, and the correct reinstatement amount can be more time-consuming and burdensome than expected. If an error in

the notice is discovered later, a corrected notice may be recorded, but the 3-month waiting period and the period for reinstatement will have to start over.

III. Enforcement of Nonrecourse Carve-Out Guaranties

Nonrecourse commercial real estate loans often contain "carve-outs" to the recourse limitations providing that the borrower will be liable to the lender for "bad acts" such as fraud, misappropriation of rents, transfer or encumbrance of the collateral without the lender's consent, waste, and bankruptcy of the borrower. Some carve-outs create liability to the extent of any damage suffered by the lender as the result of the bad act. Other carve-outs will trigger full recourse liability for the entire principal balance of the loan. The lender may also require that a "warm body" guarantor execute in favor of the lender a guaranty of the borrower's nonrecourse carve-out liabilities. In securitized real estate loans, the list of bad acts includes the borrower's failure to maintain itself as a single-purpose bankruptcy-remote entity as required in the loan documents. The nonrecourse carve-out guaranty is a critical source of credit support because the single-purpose borrower by definition has no assets other than the mortgaged collateral to support payment and performance of its loan obligations and recourse liabilities.

The case of *Blue Hills Office Park LLC v. J.P. Morgan Chase Bank* (D Mass 2007) 477 F Supp 2d 366 was a "high stakes, winner-takes-all, quintessentially complex commercial case" decided by a federal district court in Massachusetts that produced the first published decision enforcing a nonrecourse carve-out guaranty of a securitized loan. In 1999, Credit Suisse First Boston Mortgage Securities Corp. made a loan to Blue Hills Office Park, LLC for \$33 million that was secured by a mortgage on the borrower's Blue Hills Office Park. The borrower was a newly formed single-purpose bankruptcy-remote entity. The loan was nonrecourse subject to full recourse liability carve-outs for failure to maintain the borrower's status as a single-purpose entity, and for transfer of any part of the mortgaged property without the lender's consent. The loan also contained other limited recourse carve-outs. Two principals of the borrower guaranteed the loan under a guaranty with the same nonrecourse carve-outs found in the loan documents. The loan was securitized after closing.

At the time of loan closing, the Blue Hills Office Park was 100-percent occupied by tenant Boston Equiserv Limited Partnership, whose lease was set to expire in 5 years. Blue Hills learned that Equiserv intended to vacate the property at the end of the lease term so that it could purchase and relocate to an adjacent property. Equiserv's obligation to buy the new property was

conditioned on the seller having obtained a special permit to construct a new parking garage. In an attempt to keep Equiserv as its tenant on the property, after the special permit was issued, Blue Hills appealed the issuance of the special permit on the grounds that the new garage would block sight lines and views and diminish the value of Blue Hills' property.

Shortly thereafter, however, Blue Hills settled with the owner of the adjacent property. Under the settlement, Blue Hills received a payment of \$2 million and waived all further rights of appeal. The settlement assured that Equiserv would buy the adjacent property and relocate, leaving Blue Hills Office Park vacant.

Blue Hills never told its lender about the settlement, the waiver of appeal rights, or the settlement payment. The borrower's \$2 million settlement payment was wired directly to a client account at Blue Hills' law firm in the name of a member of Blue Hills controlled by the guarantors. Later, the money was split between the guarantors.

After Equiserv vacated, Blue Hills defaulted on the loan. The lender foreclosed and an affiliate of the lender made the high bid and took the property at the foreclosure sale, resulting in a \$10.77 million deficiency. The property was later sold to a third party. After the foreclosure sale, the lender learned about the settlement payment from a real estate broker.

In early 2005, the borrower filed a lender liability claim against the lender, and the lender counterclaimed against Blue Hills and the guarantors for full recourse liability for the deficiency. The court rejected all of the borrower's claims against the lender. On its counterclaims, the lender asserted that the borrower and guarantors were liable for the deficiency because of the borrower's bad acts:

- The transfer of the settlement payment and the waiver of the zoning appeal rights; and
- The failure to maintain the borrower's status as a single-purpose entity.

The borrower argued that the restrictions on transfer of the mortgaged property referred only to transfers of the real estate. The court decided that the language of the loan documents suggested the opposite, and the \$2 million settlement and the borrower's rights to the zoning appeal constituted a part of the mortgaged property. The court reasoned that, in a nonrecourse loan, the lender looks entirely to the mortgaged property for security; to protect only the real property would be unreasonable and impractical. 477 F Supp 2d at 378. The court held that the transfer of the payment and waiver of the appeal rights without the lender's consent violated the

restrictions against transfers of the mortgaged property, and the guarantors were liable for the full amount of the deficiency. 477 F Supp 2d at 382.

The court further determined that the borrower failed to maintain its status as a single-purpose entity by

- Commingling the \$2 million settlement with the funds of another entity; and
- Violating its obligation to maintain an independent director that participated in the borrower's affairs as required under the loan documents.

The court said that it was not persuaded that the borrower and guarantors intended to defraud the lender. Instead, the borrower conducted its business under the erroneous impression that the settlement was not part of the mortgaged property. The borrower and the guarantors had been counseled by their attorneys throughout the events that resulted in the settlement of the zoning appeal and transfer of the \$2 million settlement. The court suggested that the guarantors either received bad advice or failed to heed their attorneys' warnings. Without judging what happened between attorney and client, the court expressed its:

regret over the time, money, and resources that necessarily have been expended to correct this faulty settlement structure. Lawyers must remember that, in the very essence, they are their client's teachers - teachers of the law and how the law is most likely to be applied to the evidence available . . . Here one is left with the indelible impression that positions were taken and structures arranged with a view to salvaging something from a general wreck that would inevitably be "worked out" rather than scrutinized by the full processes of careful trial and adjudication.

477 F Supp 2d at 384.

IV. Restrictions on Real Estate Loan Prepayment

Under common law rules, a lender is not obligated to accept prepayment of a note unless the note is prepayable by its terms. Real estate loan documents customarily address the circumstances under which a borrower may prepay a loan. Prepayment restrictions vary. Commonly, prepayment is prohibited altogether during an initial period, followed by a period during which the loan may be prepaid together with a prepayment premium, with a short open prepayment period during the several months prior to maturity. A prepayment premium may be expressed simply as a percentage of the amount being prepaid. More likely, the note will provide

a "yield maintenance" formula that attempts to compensate the lender for the loss of interest income as the result of early payment.

A typical yield maintenance formula provides for payment of the greater of:

- A fixed percentage (such as one percent) of the principal balance being paid; or
- An amount equal to the difference between:
 - The remaining principal and interest payments on the loan (including any balloon payment at maturity), discounted to present value based on an index derived from U.S. Treasury obligations; and
 - The amount of principal being prepaid.

To the extent the index for discounting to present value is lower than the note rate, the yield maintenance formula will produce a higher amount due. Yield maintenance formulas that apply an index based on a U.S. Treasury obligation (a so-called "Treasury-flat" formula) are often criticized because the index, which is almost always less than the note rate, may inflate the yield maintenance premium.

Under California law, prepayment premiums are treated as an alternative performance under the contract rather than as liquidated damages; however, an excessive prepayment premium may be unenforceable. See *Lazzareschi Inv. Co. v. San Francisco Fed. Sav. & Loan Ass'n* (1972) 22 CA3d 303, 99 CR 417.

The case of *River East Plaza, LLC v. Variable Annuity Life Co.* (ND Ill 2006) 2006 WL 2787483 captured the attention of many lenders and their counsel after the Illinois district court disallowed the imposition of a Treasury-flat prepayment penalty against a commercial borrower.

In 1999, River East Plaza, LLC, borrowed \$12.7 million from Variable Annuity Life Insurance Company at a fixed rate for 20 years, secured by a mortgage on the borrower's commercial property. On prepayment, the promissory note provided for payment of a prepayment premium equal to the greater of (i) one percent of the principal prepaid or (ii) the difference between the discounted present value of the remaining principal and interest payments and the principal prepaid. Approximately 3 years later, the borrower elected to pay off the loan so that it could sell the property to the tenant. When the borrower requested a pay-off amount from the lender, the lender calculated the prepayment fee at \$4,713,000, which was around 38 percent of the principal balance. (The amount of the fee was later reduced to approximately

\$3.9 million to correct a calculation error.) After the lender denied the borrower's request for a waiver of the prepayment fee, the borrower paid the loan in full, including a payment of the prepayment premium under protest, and sued the lender to recover what the borrower characterized as an unreasonable prepayment penalty.

In the Illinois district court, the borrower argued that the prepayment provision should be analyzed as a liquidated damages clause. The lender argued that the clause was a contractual, bargained-for form of alternative performance. In its decision, the district court applied a liquidated damages analysis to determine the "reasonableness" of the prepayment fee. The court resolved to uphold the prepayment premium only if it appeared to be a reasonable, agreed-upon estimate of the lender's potential damages from prepayment, *calculated at the time of contracting*, under circumstances where actual damages would have been difficult to fix. The court held that the prepayment premium was not reasonable at the time of contracting because it did not bear any relationship to the actual damages sustained by the lender as a result of prepayment. The court said that a reasonable prepayment premium instead would equal the present value of the interest unpaid due to early principal payment, assuming the lender invested the prepaid principal in an investment comparable to the prepaid loans, and not a present value calculated based on the Treasury-flat formula. The court invalidated the yield maintenance amount as a penalty but allowed the lender to recover the alternative one-percent fee.

In the lender's appeal to the Seventh Circuit Court of Appeals, *River East Plaza, LLC v. Variable Annuity Life Co.* (7th Cir 2007) 498 F3d 718, the court began from the position that Illinois courts will not enforce penalty clauses. If the sole purpose of the clause is to secure performance, then the clause is a penalty. To distinguish between a penalty and a permissible contractual alternative form of performance, it is necessary to evaluate the relative values of the alternatives presented to the borrower under the circumstances. The court reasoned that River East would have paid an additional \$13 million in interest through maturity, but instead paid \$3.9 million for the privilege of prepayment. By that analysis, the fee hardly appeared to be a penalty. The borrower had bargained for the right to prepay and, on exercise of that right and payment of the premium, was released from a larger long-term payment obligation. In overturning the district court decision, the court emphasized that "a contrary result would have broad implications for both lenders and borrowers of mortgage-secured loans . . . and might

inadvertently effect a wide-ranging alteration of the law of real estate financing." 498 F3d at 725.

V. Enforcement of Late Fees

Almost all institutional promissory notes contain a clause permitting the lender to collect a late charge if payment under the note is not made when due. Since the California Supreme Court decision in *Garrett v. Coast & S. Fed. Sav. & Loan Ass 'n* (1973) 9 C3d 731 (1973), 108 CR 845 (Garrett), late charges must comply with liquidated damages requirements. Civil Code §1671 now provides that a liquidated damages provision such as a late charge is valid unless the party seeking to invalidate the provision establishes that the provision was unreasonable under the circumstances existing at the time the contract was made. CC §1671(b).

The recent court of appeal case, *Poseidon Dev., Inc. v Woodland Lane Estates, LLC* (2007) 152 CA4th 1106, 62 CR3d 59, reported in 30 CEB RPLR 154 (Sept. 2007) (see also Bernhardt, *Later Thoughts on Late Charges*, 30 CEB RPLR 140 (Sept. 2007)), illustrates one appellate court's reaction to a lender's attempt to collect a large late fee on a late balloon payment.

In 2004, plaintiff Poseidon Development made a one-year, interest-only loan to Woodland Lane Estates, LLC, for \$770,000. The promissory note provided that, if an "installment" was not paid when due, the borrower would pay the lender a late charge equal to 10 percent of the overdue amount to compensate the lender for the administrative expense incurred due to the late payment. Woodland paid all of its interest installments on time, but failed to pay the \$770,000 balloon payment at maturity. After Poseidon commenced foreclosure proceedings, Woodland eventually paid the loan but refused to pay a late charge of \$77,000.

Poseidon brought a breach of contract action against Woodland seeking damages and recovery of the \$77,000 late charge for the missed balloon payment. Poseidon argued that the balloon payment constituted an "installment" subject to late charge if not paid when due. The trial court disagreed. The court of appeal reversed the trial court decision on procedural grounds; however, the court of appeal also held that Poseidon was not entitled to collect the late charge on the balloon payment.

First, although the loan documents used the words "installment" and "payment" interchangeably, the language of the note suggested that the final payment on maturity was not an installment to which the late charge should apply. Second, if the late charge provision were to

apply to the balloon payment, then the late charge would be considered unreasonable liquidated damages because the damages bore no relationship to the actual damages contemplated at the time the loan was made. The late charge was intended to compensate Poseidon for administrative expenses, and the parties could not have reasonably contemplated at the time the loan was made that Poseidon would suffer \$77,000 in administrative expense if the balloon payment were not paid on time.

The *Poseidon* case suggests that more careful drafting of the note and late charge provision could have clarified an intent to apply the late charge to the balloon payment. However, it is not clear that more attention to detail could save a late charge under a liquidated damages analysis if calculated as a percentage of the entire principal balance. See *Garrett, supra*. The better practice may be to apply the late charge to regular installment payments and attempt to collect default interest on the past due balloon payment until paid, although it is not clear whether default interest charged on the entire principal balance could survive scrutiny under CC §1671(b) and the *Garrett* case.

VI. Finality of Judicial Foreclosure Sale

A recent case illustrates how combining a traffic jam with the strict rules on the finality of judicial foreclosure sales can have disastrous results for the lender. In *Amalgamated Bank v. Superior Court* (2007) 149 CA4th 1003, 57 CR3d 686, reported in 30 CEB RPLR 161 (Sept. 2007), the lender, as cotrustee for Pension Trust Fund for Operating Engineers (PTF), held a security interest in property owned by the borrower, Winncrest Homes (Winncrest), to secure a loan by PTF to Winncrest. When Winncrest ceased making payments on the loan, PTF brought a judicial foreclosure action against Winncrest and obtained a judgment allowing the property to be sold at a sheriff's sale subject to right of redemption.

The sale was set to begin in Sacramento at 10:00 a.m. on the appointed day. A third party bidder named Bruce Palmbaum arrived to bid on the property with ample available funds. The property was worth around \$6.5 million, and Palmbaum intended to make a \$6 million opening bid. The sheriff commenced the sale at 10:00 a.m., and Palmbaum made a \$2000 opening bid. No other bidders were present, not even the beneficiary, because PTF's designated bidders had gotten stuck in traffic on the way from the Bay Area to the sale in Sacramento, arriving after 10:00 a.m. When the sheriff confirmed the sale to Palmbaum for \$2000, PTF objected, but the officer stated that the sale was closed; PTF's collateral was gone.

PTF filed an action to set aside the foreclosure sale, cancel the sheriff's deed, and restrain Palmbaum from disposing of the property. It was in that context that the court reviewed whether the foreclosure sale should be set aside.

Under CCP §701.680, a sheriff's sale in judicial foreclosure is "absolute" and "may not be set aside for any reason" except for irregularities when the purchaser is the judgment creditor and the judgment creditor brings the motion to set aside within 90 days of the sale. In this case, the property was sold to a third party; therefore, PTF had no right under §701.680 to set aside the sale for irregularity. The court concluded that "[t]here is simply no room in the statutory scheme for a judgment creditor (for whose benefit the foreclosure sale was held in the first place) to deprive a third party purchaser at a judicial foreclosure sale of his interest in the property by bringing an action to set aside the sale." 149 CA4th at 1018. The court apparently gave no consideration to the fact that the property had sold for a nominal price well below the actual value of the property.

VII. Conclusion

The current downturn in real estate will provide real estate lawyers with new and varied opportunities to counsel clients on how to manage problems and pursue opportunities in an uncertain real estate market. The cases reviewed in this article illustrate how several important issues of real estate finance law arise and may be resolved in the context of a distressed real estate investment.