VIEWPOINT

Is Chapter 11 The Right Place For A Distressed Homebuilder?

By Scott Y. Stuart

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One of a series of opinion columns by bankruptcy professionals

It seems like the early 1990s all over again. Homebuilders are failing, and home buyers are being left in a state of limbo while banks, lienholders and suppliers all jockey for position, hoping to get a small piece of what once looked like a promising dream for everyone from the builder to the buyer.

Granted, homebuilders today are in large part smarter than in the past. For instance, many homebuilders today have land purchase options, instead of outright land purchases, hedging against potential slowdowns and failures. Notwithstanding, low interest rates and the onslaught of second home buyers had given the building sector an inflated sense of security. It has clearly evaporated.

The real difference between the failed homebuilders of the early 1990s and today, however, is bankruptcy. According to the National Association of Home Builders, during the housing slump of the early 1990's, nearly 15% of home builders went out of business. But bankruptcy was never really considered a viable option at that time -- probably because there was nothing to reorganize, and what could not be restructured outside of a Chapter 11 had no chance in one.

Fast forward to 2007, and there seems to be a rush to the courthouse steps. Kara Homes of New Jersey, Levitt & Sons of Florida and Neumann Homes of Illinois are just a few of the national homebuilders that have journeyed into Chapter 11. Yet no one appears to have a clear vision, upon entry into the process, of how they will emerge, or even if they will be able to exit.

In an industry sector with balance sheets chock full of largely encumbered assets and little free cash (and little prospect of producing any liquidity during a Chapter 11 case), how can a Chapter 11 serve these companies? This question takes on even greater significance when a homebuilder enters a Chapter 11 on adverse terms with its lenders and no ability to independently reorganize without the aid of an entity willing to purchase the homebuilder or to fund a plan. The builders in Chapter 11 proceedings did not appear to have any of that in place at the outset.

When a homebuilder fails, a domino effect ensues: Buyer deposits are left in limbo and are almost certainly lost; sub-contractors stop working; unfinished homes remain in urgent need of attention; and banks are left to decide what they will put in, or sell off to salvage an inevitable loss. Thus, restructuring professionals are left with the tough analysis of whether to wind down a homebuilder or to pressure lenders to hang a little longer with no guarantees of a happy ending.

One of the most challenging issues facing homebuilders today is how to balance the debt often owed to regional banks and the need to complete projects and salvage what can be saved. Banks are sophisticated and know there is risk in every loan and investment, but they often do not want to extend their risk, particularly after a bankruptcy filing. On the other hand, homebuilders know they need to complete projects even on a scaled down basis, but they simply do not have the funds to do it. Even in Chapter 11, while some cash can be squeezed out of lenders to just get by, the larger problem of project completion does not get solved.

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Then, what can bankruptcy do to address any of these issues? It may slow things down, but in the homebuilding world, time is of the essence, and slowing things down may do nothing more then add a layer of issues banks, lienholders, subcontractors and homebuyers cannot afford to sustain. For example, Wachovia Bank, Levitt's largest creditor, recently agreed to provide $10 million in funds to finish 80 homes in Georgia, Florida and South Carolina. Does such a short-term fix on a fractionally small portion of the Levitt empire justify the use of Chapter 11 to survive? These are the basic and general challenges turnaround professionals must assess when recommending and pursuing a course for a distressed homebuilder.

What is clear in most of these situations is that someone needs to step in and finish the work. That party may or may not be the homebuilder. In some cases, banks will take back assets and contract out work to complete projects. In other cases, the homebuilder will simply sell off what it can to an entity capable of completing unfinished projects before too much time passes and the costs to complete actually increase or become insurmountable. Take for example homebuilders such as Centex and Pulte Homes. They're selling houses at bargain prices, downsizing project projections and cutting jobs, not in the context of a Chapter 11, but rather in an effort to avoid Chapter 11 and realistically salvage what they can, even if all parties may feel some pain.

Thus, maybe the more pragmatic and efficient approach to salvaging a failing homebuilder is a strategic turnaround rather than the perceived safe haven of bankruptcy.

Chapter 11 is an important tool when its serves its intended purpose. In the homebuilding industry, even when the long-term result turns out to be good, it really should be a last resort. Using turnaround expertise to create a more pragmatic solution for parties in mutual need of having to get projects completed is probably the best first option.

Homebuilder failures, different from other distressed or failing businesses, present a unique set of issues that may be better addressed as an out-of-court restructuring effort. Hence, while some homebuilders are struggling to survive in Chapter 11, others have opted to make hard choices, face hard realities and attempt to work through a true restructuring without running into Court with no clear vision of what Chapter 11 can or will achieve.

The reality of the homebuilding sector comes down to the art of the deal more so than a traditional Chapter 11 restructuring. Simply put, professionals need to assess if regional banks will play ball or whether builders need to cut expectations, sell off assets and severely downsize to get out from under total paralysis. The choices are often not easy ones to make, but since the goal for all concerned is to get these projects done, particularly where they are well in progress, all parties have a substantial incentive to bring about a consensual result. While this could occur in Chapter 11, it seems that it is better resolved in a negotiated context without the use of a process that may impose more delay, expense and uncertainty than is necessary or productive.

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