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Land Use for the Lender: Due Diligence and Problem Solving

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LAND USE FOR THE LENDER:
DUE DILIGENCE AND PROBLEM SOLVING

I. Overview of Entitlements' Importance to Mortgage Collateral

The importance of "entitlements" to real property collateral for a mortgage loan is paramount. Entitlements is a broadly inclusive term, describing the public and private rights, limitations and approvals for use of real property. Although often used in the context of purely public land use law regulation and related approvals, many entitlements emanate from private land use law.

Examples of Entitlement Areas:

Public:
- Platting
- Zoning
- Setbacks
- Traffic/Parking/Loading
- Signage
- Landscape/Trees
- Grandfathering/Vested rights
- Use specific regulations
    - Sexually oriented businesses (SOB)
    - Pawn Shops
    - Bars
    - Entertainment venues
    - Other "NIMBY" (**N**ot **I**n **M**y **B**ack**Y**ard) uses

Private:
- Restrictive covenants (aka Deed Restrictions, Declarations, Reciprocal Easement Agreements [REA], etc.)
- Easements
- Long term ground leases
- Condominium declarations
- Timeshares

Real estate collateral without a legal right to use/develop/operate it for its economic "highest and best use," will have diminished value. Mortgage loans are underwritten based upon appraisals, which typically *assume* the ability to use/develop/operate the collateral for its highest and best use (or the use stated in the appraisal).

Without appropriate entitlements, the collateral may be restricted in that use or even prohibited, and the consequences for the borrower and lender would be dramatic. Without necessary entitlements, borrowers may be more likely to default. If the collateral was previously foreclosed by the lender, then the lender's reasonable expectation for

recovery will be diminished. Even if the lender has the patience to hold the collateral and seek necessary entitlements, new appraisals will be required. Based upon the *current* entitled use, the value of the collateral on the books of the lender is negatively affected. An assumption in an appraisal of different entitlements than currently exist is an extraordinary assumption which will require explanation in order to support the appraised valuation.

Real Life Examples:

- City Opposed Development – A loan is made for a new mixed use project located in a small un-zoned city. The borrower handled its affairs poorly, defaulted after commencing development and, ultimately, the lender became owner of the collateral. By that time, the development cycle was maturing and a denser version of the project was required to be viable. The city became concerned and commenced preparation of a zoning ordinance, with a focus on the small commercial area of the city. The draft zoning ordinance would significantly impede the proposed project. Despite negotiations with the city for changes to accommodate the proposed project, the city passed the new zoning ordinance prohibiting a major component of the proposed project. The lender file a plat to vest the proposed project under the Texas vested rights statute (discussed later). Further negotiation with the city was unsuccessful. Ultimately, the dispute led to the lender suing the city, which litigation is ongoing. No developer is willing to purchase the property until entitlements are confirmed.
- Market Changes and City Rescinds Zoning Changes – A land developer assembled land for a mixed use project in a small zoned city. The developer negotiated with the Mayor and achieved support of rezoning to support a market supported density, as a matter of right (i.e., no discretionary review and approval). An economic down-cycle delayed the project. A building developer purchased land to develop the first building in the project, which was designed and underwritten based on existing zoning. The building was pre-leased to the level required by the construction lender. The details of the project and tenants were provided to the city and became public knowledge. Numerous meetings with the city reviewed development issues in preparation for the submission of construction plans and commencement of construction. At the last meeting, which included the land developer, the Mayor took the developers aside and disclosed that due to "citizen pushback," the city had, without notifying the developers, reversed the prior zoning changes enacted for the benefit of the project. Instead, the city implemented a Planned Development ordinance which would require detailed, site specific review and approval. These changes delayed the proposed building, and adversely impacted the marketability of the remaining land in the overall project.
- Density Down-zoning – A residential lot developer options land in a zoned city and meets with the city to confirm density and requirements for a moderately priced single family residential subdivisions. The city confirmed current zoning and requirements for the project. Surreptitiously, the city downzones the property, reducing density. The developer sued, seeking

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Title search: Land Use for the Lender: Due Diligence and Problem Solving

Also available as part of the eCourse
Commercial and Construction Loan Processes

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