

CALIFORNIA COASTAL COMMUNITIES INC

Form 10-Q

May 13, 2010

[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

**x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the quarterly period ended March 31, 2010**

**OR**

**o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the transition period from                      to**

**Commission file number: 0-17189**

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# CALIFORNIA COASTAL COMMUNITIES, INC.

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**02-0426634**  
(I.R.S. Employer Identification No.)

**6 Executive Circle, Suite 250**  
**Irvine, California**  
(Address of principal executive offices)

**92614**  
(Zip Code)

Registrant's telephone number, including area code: **(949) 250-7700**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES ☒ NO ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ☐ No ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐  
(Do not check if a smaller reporting company)

Smaller reporting company ☒

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ☐ NO ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

As of May 13, 2010 there were 10,995,902 shares of Common Stock, par value \$.05 outstanding



Table of Contents

**CALIFORNIA COASTAL COMMUNITIES, INC.**

**(DEBTOR-IN-POSSESSION)**

**FORM 10-Q**

**FOR THE QUARTER ENDED MARCH 31, 2010**

**INDEX**

|                                                              |                                                                                                       |    |
|--------------------------------------------------------------|-------------------------------------------------------------------------------------------------------|----|
| <u>Cautionary Statement About Forward-Looking Statements</u> |                                                                                                       | 3  |
| <u>Part I -</u>                                              | <u>Financial Information:</u>                                                                         | 5  |
|                                                              | <u>Item 1.</u>                                                                                        | 5  |
|                                                              | <u>Consolidated Financial Statements</u>                                                              |    |
|                                                              | <u>Consolidated Balance Sheets - March 31, 2010 (unaudited) and December 31, 2009</u>                 | 5  |
|                                                              | <u>Consolidated Statements of Operations - Three Months Ended March 31, 2010 and 2009 (unaudited)</u> | 6  |
|                                                              | <u>Consolidated Statements of Cash Flows -Three Months Ended March 31, 2010 and 2009 (unaudited)</u>  | 7  |
|                                                              | <u>Notes to Consolidated Financial Statements</u>                                                     | 8  |
|                                                              | <u>Item 2.</u>                                                                                        | 23 |
|                                                              | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>          |    |
|                                                              | <u>Item 3.</u>                                                                                        | 37 |
|                                                              | <u>Quantitative and Qualitative Disclosures About Market Risk</u>                                     |    |
|                                                              | <u>Item 4.</u>                                                                                        | 38 |
|                                                              | <u>Controls and Procedures</u>                                                                        |    |
| <u>Part II -</u>                                             | <u>Other Information:</u>                                                                             | 38 |
|                                                              | <u>Item 1.</u>                                                                                        | 38 |
|                                                              | <u>Legal Proceedings</u>                                                                              |    |
|                                                              | <u>Item 6.</u>                                                                                        | 38 |
|                                                              | <u>Exhibits</u>                                                                                       |    |
| <u>SIGNATURE</u>                                             |                                                                                                       | 39 |



Table of Contents

**CAUTIONARY STATEMENT ABOUT FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Exchange Act of 1933 and Section 21E of the Securities Exchange Act of 1934 that relate to future events or our future financial performance. In addition, other statements we may make from time to time, such as press releases, oral statements made by our officials and other reports that we file with the Securities and Exchange Commission may also contain such forward-looking statements. Undue reliance should not be placed on these statements which involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expects, plans, anticipate, believes, estimates, predicts, potential, continue, or the negative of such terms or other comparable terminology.

These forward-looking statements include, but are not limited to:

- the impact, effect and eventual result of the Chapter 11 Cases in restructuring our debt obligations under the Revolving Loan and Term Loan;
- our and the other Debtors' ability to remain as a debtors-in-possession during the pendency of the Chapter 11 Cases;
- our ability to create stockholder value;
- our compliance with future debt covenants and actions we may take with respect thereto;
- economic changes nationally or in local markets, including changes in consumer confidence, volatility of mortgage interest rates and inflation;
- continued or increased downturn in the homebuilding industry;
- statements about our strategies, plans, objectives, goals, expectations and intentions;

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- information relating to anticipated operating results, financial resources, changes in revenues, changes in profitability, interest expense, growth and expansion;
- the impact of demographic trends and supply constraints on the demand for and supply of housing;
- housing market conditions in the geographic markets in which we operate;
- the number and types of homes and number of acres of land that we may develop and sell;
- our ability to deliver homes from backlog;
- the timing and outcomes of regulatory approval processes or administrative proceedings, which may result in delays in land entitlement, development, construction, or the opening of new communities;
- our ability to secure materials and subcontractors;
- our ability to produce the liquidity and capital necessary to service our debt, fund operations, expand and take advantage of future opportunities if current market conditions persist;
- our cost of and ability to access additional capital;
- our ability to realize the value of our net operating loss carry forwards;
- our ability to continue relationships with current or future partners;
- the effectiveness and adequacy of our disclosure and internal controls;

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### Table of Contents

- the impact of recent accounting pronouncements; and
- stock market valuations.

Any or all of the forward-looking statements included in this report and in any other reports or public statements made by us may turn out to be inaccurate. This can occur as a result of incorrect assumptions or as a consequence of known or unknown risks and uncertainties. These risks and uncertainties include the unpredictability of the Chapter 11 bankruptcy process; competitive environment in which we operate; local, regional and national economic conditions; the effects of the current national credit market crisis, inflation and the recession; our ability to comply with the covenants and amortization schedules contained in our Revolving and Term Loan agreements; the demand for homes; adverse market conditions that could result in additional inventory impairments, including an oversupply of unsold homes, declining home prices, and increased foreclosure and short sale activity; declines in consumer confidence; increases in competition; fluctuations in interest rates and the availability of mortgage financing; mortgage foreclosure rates; the availability and cost of land for future growth; the availability of capital, including access under our existing credit facilities; uncertainties and fluctuations in capital and securities markets; changes in tax laws and their interpretation; legal proceedings; the ability of customers to finance the purchase of homes or sell existing homes; the availability and cost of labor and materials; the amount of our debt and the impact of restrictive covenants in our loan agreements; adverse weather conditions; domestic and international political events; geopolitical risks and the uncertainties created by terrorist attacks; the effects of governmental regulation, including regulations concerning development of land, the home building industry, sales and customer financing processes, and the environment; and other risks discussed in our filings with the Securities and Exchange Commission. Many factors mentioned in this report or in other reports or public statements made by us, such as government regulation and the competitive environment, will be important in determining our future performance. Consequently, actual results may differ materially from those that might be anticipated from our forward-looking statements. You should not place undue reliance on any of these forward-looking statements because they are based on current expectations or beliefs regarding future events or circumstances, which involve known and unknown risks, uncertainties and other factors which may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by these forward-looking statements.

Although we believe that our strategies, plans, objectives, goals, expectations and intentions reflected in, or suggested by these forward-looking statements are reasonable given current information available to us, we can give no assurance that any of them will be achieved. Forward-looking statements speak only as of the date they are made. We undertake no obligation to publicly update any forward-looking statements, whether as a result of new information, future events or otherwise. However, any further disclosures made on related subjects in our subsequent reports on Forms 10-K, 10-Q and 8-K should be consulted.

These forward-looking statements should be considered in light of the information included in this report and our other filings with the Securities and Exchange Commission, including, without limitation, the Risk Factors and the description of trends and other factors in Management's Discussion and Analysis of Financial Condition and Results of Operations, set forth in this Form 10-Q and in our Form 10-K for the year ended December 31, 2009. You should also read the following Consolidated Financial Statements and the related notes.

We assume no, and hereby disclaim any, obligation to update any of the foregoing or any other forward-looking statements, whether as a result of new information, future events, changed circumstances or any other reason after the date of this Form 10-Q. We nonetheless reserve the right to make such updates from time to time by press release, periodic report or other method of public disclosure without the need for specific reference to this Form 10-Q or any other report filed by us. No such update shall be deemed to indicate that other statements not addressed by such update remain correct or create an obligation to provide any other updates.



Table of Contents

**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

CALIFORNIA COASTAL COMMUNITIES, INC.

(DEBTOR-IN-POSSESSION)

**CONSOLIDATED BALANCE SHEETS**

(unaudited)

(in millions)

|                                             | March 31,<br>2010 | December 31,<br>2009 |
|---------------------------------------------|-------------------|----------------------|
| <b>ASSETS</b>                               |                   |                      |
| Cash and cash equivalents                   | \$ 4.7            | \$ 8.9               |
| Restricted cash                             | 0.8               | 0.8                  |
| Real estate inventories                     | 239.2             | 235.4                |
| Other assets, net                           | 4.3               | 4.8                  |
|                                             | \$ 249.0          | \$ 249.9             |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b> |                   |                      |
| Liabilities not subject to compromise:      |                   |                      |
| Accounts payable and accrued liabilities    | \$ 4.3            | \$ 2.9               |
| Model home financing                        | 22.5              | 22.5                 |
| Other liabilities                           | 0.4               | 0.4                  |
| Total liabilities not subject to compromise | 27.2              | 25.8                 |
| Liabilities subject to compromise:          |                   |                      |
| Accounts payable and accrued liabilities    | 1.0               | 0.9                  |
| Revolving loan                              | 81.7              | 81.7                 |
| Term loan                                   | 99.8              | 99.8                 |
| Other liabilities                           | 8.3               | 8.3                  |

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|                                                                                                                                   |          |          |
|-----------------------------------------------------------------------------------------------------------------------------------|----------|----------|
| Total liabilities subject to compromise                                                                                           | 190.8    | 190.7    |
| Commitments and contingencies                                                                                                     |          |          |
| Stockholders' equity:                                                                                                             |          |          |
| Common Stock \$.05 par value; 13,500,000 shares authorized; 10,995,902 and 10,995,902 shares issued and outstanding, respectively | 0.5      | 0.5      |
| Excess Stock \$.05 par value; 13,500,000 shares authorized; no shares outstanding                                                 |          |          |
| Additional paid-in capital                                                                                                        | 59.5     | 59.5     |
| Accumulated deficit                                                                                                               | (26.4)   | (24.0)   |
| Accumulated other comprehensive loss, net                                                                                         | (2.6)    | (2.6)    |
| Total stockholders' equity                                                                                                        | 31.0     | 33.4     |
|                                                                                                                                   | \$ 249.0 | \$ 249.9 |

See the accompanying notes to Consolidated Financial Statements.

Table of Contents

CALIFORNIA COASTAL COMMUNITIES, INC.

(DEBTOR-IN-POSSESSION)

CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per share amounts)

(unaudited)

|                                               | <b>Three Months Ended</b> |                  |
|-----------------------------------------------|---------------------------|------------------|
|                                               | <b>2010</b>               | <b>March 31,</b> |
|                                               |                           | <b>2009</b>      |
| Revenues:                                     |                           |                  |
| Homebuilding                                  | \$ 3.0                    | \$ 12.8          |
| Costs of sales:                               |                           |                  |
| Homebuilding                                  | 2.6                       | 8.8              |
| Loss on impairment of real estate inventories |                           | 3.2              |
|                                               | 2.6                       | 12.0             |
| Gross operating profit                        | 0.4                       | 0.8              |
| Selling, general and administrative expenses  | 1.4                       | 1.5              |
| Reorganization costs                          | 1.3                       |                  |
| Interest expense                              |                           | 0.7              |
| Gain on debt restructuring                    |                           | (20.7)           |
| Other expense, net                            | 0.1                       | 0.4              |
| (Loss) income before income taxes             | (2.4)                     | 18.9             |
| Income tax expense                            |                           | 7.7              |
| Net (loss) income                             | \$ (2.4)                  | \$ 11.2          |
| Net (loss) earnings per common share:         |                           |                  |
| Basic and diluted                             | \$ (0.22)                 | \$ 1.02          |
| Common equivalent shares:                     |                           |                  |
| Basic and diluted                             | 11.0                      | 11.0             |

See the accompanying notes to Consolidated Financial Statements.

Table of Contents

## CALIFORNIA COASTAL COMMUNITIES, INC.

(DEBTOR-IN-POSSESSION)

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(unaudited)

|                                                                         | <b>Three Months Ended<br/>March 31,</b> |             |
|-------------------------------------------------------------------------|-----------------------------------------|-------------|
|                                                                         | <b>2010</b>                             | <b>2009</b> |
| Cash flows from operating activities:                                   |                                         |             |
| Net (loss) income                                                       | \$ (2.4)                                | \$ 11.2     |
| Adjustments to reconcile net loss to cash used in operating activities: |                                         |             |
| Gain on debt restructuring                                              |                                         | (20.7)      |
| Model homes depreciation                                                | 0.1                                     | 0.1         |
| Deferred taxes                                                          | (1.0)                                   | 7.7         |
| Deferred tax asset valuation allowance                                  | 1.0                                     |             |
| Gains on sales of real estate inventories                               | (0.4)                                   | (4.0)       |
| Loss on impairment of real estate inventories                           |                                         | 3.2         |
| Proceeds from sale of real estate inventories, net                      | 2.8                                     | 12.5        |
| Investments in real estate inventories                                  | (5.8)                                   | (7.6)       |
| Non-cash reorganization items                                           | 0.6                                     |             |
| Changes in assets and liabilities:                                      |                                         |             |
| Decrease in other assets                                                | 0.1                                     | 1.2         |
| Increase in accounts payable, accrued and other liabilities             | 0.8                                     | 1.9         |
| Cash (used in) provided by operating activities                         | (4.2)                                   | 5.5         |
| Cash flows from financing activities:                                   |                                         |             |
| Borrowings of revolving loan                                            |                                         | 13.2        |
| Repayments of revolving loan                                            |                                         | (10.1)      |
| Repayments of term loan                                                 |                                         | (1.8)       |
| Repayments of other project debt                                        |                                         | (0.5)       |
| Deferred financing costs                                                |                                         | (0.2)       |
| Cash provided by financing activities                                   |                                         | 0.6         |
| Net (decrease) increase in cash and cash equivalents                    | (4.2)                                   | 6.1         |
| Cash and cash equivalents - beginning of period                         | 8.9                                     | 2.3         |
| Cash and cash equivalents - end of period                               | \$ 4.7                                  | \$ 8.4      |

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### Supplemental disclosures of cash flow information:

|                                                      |    |     |    |     |
|------------------------------------------------------|----|-----|----|-----|
| Cash paid during the period for income taxes         | \$ |     | \$ | 0.1 |
| Cash paid during the period for reorganization items |    | 0.7 |    |     |

### Supplemental disclosures of non-cash investing and financing activities:

|                                                                                 |    |     |    |      |
|---------------------------------------------------------------------------------|----|-----|----|------|
| Amortization of deferred financing costs capitalized in real estate inventories | \$ | 0.5 | \$ | 0.6  |
| Decrease in project debt and accrued liabilities due to debt restructuring      | \$ |     | \$ | 28.7 |

See the accompanying notes to Consolidated Financial Statements.

Table of Contents

CALIFORNIA COASTAL COMMUNITIES, INC.

(DEBTOR-IN-POSSESSION)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

**Note 1 - Basis of Presentation**

The accompanying Consolidated Financial Statements have been prepared by California Coastal Communities, Inc. and its consolidated subsidiaries (the "Company"), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The Company believes that these unaudited Consolidated Financial Statements reflect all material adjustments (consisting only of normal recurring adjustments) and disclosures necessary for the fair presentation of the results of operations and statements of financial position when read in conjunction with the Consolidated Financial Statements and Notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. Intercompany accounts and transactions have been eliminated.

The results for interim periods are not necessarily indicative of the results to be expected for the full year. This report contains forward-looking statements. Readers are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties that actual events or results may differ materially from those described herein as a result of various factors, including without limitation, the factors discussed generally in this report.

*Going Concern and Financial Reporting in Reorganization*

While the Company is striving to restructure its senior secured revolving credit agreement ("Revolving Loan") and senior secured term loan agreement ("Term Loan") debt through the Chapter 11 reorganization process described below in Note 2, there can be no assurance that the Company will be able to successfully execute such plan. In the event that the Company is not successful in that regard, substantial doubt would exist as to its ability to continue as a going concern. The accompanying Consolidated Financial Statements have been prepared assuming that the Company will continue as a going concern and contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. As a result of the Chapter 11 reorganization process described below, the realization of assets and the satisfaction of liabilities are subject to uncertainty. While operating as debtors-in-possession under Chapter 11, the Debtors may sell or otherwise dispose of or liquidate assets or settle liabilities, subject to the approval of the Bankruptcy Court or as otherwise permitted in the ordinary course of business, in amounts other than those reflected in the accompanying Consolidated Financial Statements. Further, a plan of reorganization could materially change the amounts and classifications of assets and liabilities in the historical consolidated financial statements. The accompanying Consolidated Financial Statements do not include any direct adjustments related to the recoverability and classification of assets or the amounts

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and classification of liabilities or any other adjustments that might be necessary should the Company be unable to continue as a going concern or as a consequence of the Chapter 11 Cases.

### **Note 2 Chapter 11 Proceedings and Plans of Management**

On October 27, 2009, the Company and certain of its direct and indirect wholly-owned subsidiaries (collectively with the Company, the Debtors ) filed voluntary petitions (the Chapter 11 Petitions ) for relief under chapter 11 of title 11 ( Chapter 11 ) of the United States Code (the Bankruptcy Code ) in the United States Bankruptcy Court for the Central District of California (the Bankruptcy Court ). The Chapter 11 Petitions are being jointly administered under the caption *In re California Coastal Communities, Inc.*, Case No. 09-21712-TA (the Chapter 11 Cases ). The Debtors continue to operate their businesses and manage their properties as debtors-in-possession under the jurisdiction of the Bankruptcy Court and in accordance with the applicable provisions of the Bankruptcy Code and orders of the Bankruptcy Court. The Debtors have obtained the Bankruptcy Court s approval to, among other things, continue to pay critical vendors with lien rights, sell homes free and clear of all liens on an interim basis, use cash collateral on an interim basis, honor homeowner warranties, meet payroll obligations and provide employee benefits. There can be no assurance that the Company and the other Debtors will be able to successfully develop, execute, confirm and consummate one or more plans of reorganization with respect to the Chapter 11 Cases that are acceptable to the Bankruptcy Court and the creditors and other parties in interest, or continue to operate as debtors-in-possession until the Chapter 11 Cases have been fully adjudicated.

Table of Contents

The Company has 13 direct or indirect consolidated subsidiaries which are not guarantors of the \$81.7 million Revolving Loan or the \$99.8 million Term Loan and are not Debtors in the Chapter 11 Cases. These subsidiaries are former owners of businesses unrelated to the Company's current operations and have no current material operations.

*Plans of Management*

On March 26, 2010, the Company filed a proposed disclosure statement and proposed joint plan of reorganization with the Bankruptcy Court, neither of which has been approved by the Bankruptcy Court. The proposed joint plan provides for the extension of the Revolving Loan and the Term Loan to enable the Company to complete construction and sale of the homes at its Brightwater project. Throughout the Chapter 11 reorganization process the Company has tried and will continue to try to work with the various members of its lending syndicate to determine whether a consensual restructuring of the Revolving Loan and the Term Loan can be accomplished. However, a majority of the Company's lenders are opposed to the plan as filed, and there can be no assurance that the Company and the other Debtors will be able to successfully confirm, consummate and execute a plan of reorganization with respect to the Chapter 11 Cases that is acceptable to the Bankruptcy Court and the creditors and other parties in interest. A court hearing on the adequacy of the disclosure statement was held on May 12, 2010. The Company expects the Court to enter an order approving the disclosure statement containing certain revisions. The Court scheduled a valuation hearing for July 15, 2010 and a plan confirmation hearing for July 28, 2010.

The Company and the other Debtors continue to operate their business as debtors-in-possession. The Company has incurred and will continue to incur significant costs associated with the reorganization which are expected to significantly affect the Company's results of operations. During the three months ended March 31, 2010, the Company incurred reorganization costs aggregating approximately \$1.3 million and has incurred total reorganization costs of \$2.6 million through such date.

The Company has maintained business operations through the reorganization process. The Company's liquidity and capital resources, however, are significantly affected by the Chapter 11 Cases, which have resulted in various restrictions on its activities, limitations on financing and a need to obtain Bankruptcy Court approval for various matters. In particular, the Debtors are not permitted to make any payments on pre-petition liabilities without prior Bankruptcy Court approval. However, the Debtors have been granted relief in order to continue wage and salary payments and other employment benefits to employees as well as other related pre-petition obligations; to continue to construct and sell homes; and to pay certain pre-petition trade claims held by critical vendors with lien rights. The Company's authorization to continue to use cash collateral and to sell homes free and clear of liens with the consent of the lending syndicate is currently scheduled to terminate on June 30, 2010.

Under the priority schedule established by the Bankruptcy Code, certain post-petition and pre-petition liabilities need to be satisfied before general unsecured creditors and equity holders are entitled to receive any distribution. At this time, it is not possible to predict with certainty the effect of the Chapter 11 Cases on the Company's business or various creditors, or when the Company will emerge from these proceedings. Future results will depend upon the confirmation and successful implementation of a plan of reorganization. The continuation of the Chapter 11 Cases, particularly if a plan of reorganization is not timely confirmed, could further adversely affect the Company's operations.

The Company depends on cash flows generated from operations and available borrowing capacity to fund its Brightwater development, and to meet its debt service and working capital requirements. However, the Company's ability to continue to generate sufficient cash flows has been and will continue to be adversely affected by continued difficulties in the homebuilding industry, continued weakness in the California economy, and negative publicity and prospective homebuyer concerns related to the bankruptcy. While the Company generated 31 net sales orders in the first nine months of 2009, it generated only two net sales orders at Brightwater during the fourth quarter of 2009, which the Company believes

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reflects the negative impact of the Chapter 11 Cases, as well as the seasonal slowdown in sales. Thus far in 2010, the pace of sales has continued to be slow, with only six net sales generated through May 10, 2010 compared with seven net sales during the comparable period of 2009.

Due to cash requirements for on-going home construction and scheduled debt amortization, the Company's ability to meet future loan repayment requirements will depend on the confirmation of a plan of reorganization by the Bankruptcy Court. Based on Brightwater sales in 2009 and the first quarter of 2010, the current pace of home sales is not expected to generate sufficient cash flow to meet the Company's currently scheduled loan repayments for the Revolving Loan and Term Loan as described in greater detail in Notes 5 and 6.

Table of Contents

Continuing negative conditions in the housing and credit markets give rise to uncertainty as to the Company's present and future ability to meet its projected home sale closings and whether modified or new financings can be obtained in order for the Company to meet its debt obligations. There can be no assurance that the Company will be successful in any of these endeavors. While the national credit markets appear to be improving, there is limited availability of financing for small businesses which presents significant uncertainty as to the ability of the Company to secure replacement financing, if needed, and the terms of such financing if it is available. The current housing and mortgage markets also present significant uncertainty as to the Company's ability to achieve sufficient positive cash flow from operations required to satisfy its debt obligations and meet financial covenant requirements. See Notes 5 and 6 for further discussion.

While the Company is striving to restructure its Revolving Loan and Term Loan debt through the Chapter 11 Cases, unless the Company is successful in amending and extending the terms of the Revolving Loan and Term Loan agreements, the Company does not believe that its cash, cash equivalents and future real estate sales proceeds will be sufficient to meet its debt obligations or to meet anticipated operating and project development costs for Brightwater, and general and administrative expenses during the next 12 months. These factors raise substantial doubt about the Company's ability to continue as a going concern. The Consolidated Financial Statements herein do not include any adjustments that might result from the outcome of this uncertainty.

*Liabilities Subject to Compromise*

Liabilities subject to compromise refers to pre-petition obligations which may be impacted by the Chapter 11 Cases. These amounts represent the Company's current estimate of known or potential pre-petition obligations to be resolved in connection with the Chapter 11 Cases. Differences between estimated liabilities and the claims filed or to be filed will be investigated and resolved in connection with the claims resolution process. The Company continues to evaluate these liabilities throughout the continuation of the Chapter 11 Cases and adjusts amounts as necessary. Such adjustments may be material. Due to the expected number of creditors, the claims resolution process may take considerable time to complete. Accordingly, the ultimate number and amount of allowed claims is not presently known.

*Reorganization Costs*

Reorganization costs include legal and professional fees incurred in connection with the Chapter 11 Cases. During the three months ended March 31, 2010, the Company incurred \$1.3 million of reorganization costs and paid approximately \$700,000 of such costs. The Company has incurred total reorganization costs of \$2.6 million from October 2009 through March 31, 2010.

*Nasdaq Delisting*

The Company's common stock is currently trading over-the-counter in the recently created OTCQB marketplace under the trading symbol CALCQ. The trading of the Company's common stock in the over-the-counter market rather than on Nasdaq may negatively impact the trading price and the levels of liquidity available to its stockholders. In addition, securities that trade over-the-counter are not eligible for margin loans and will make the Company's common stock subject to the provisions of Rule 15c-9 of the Securities Exchange Act of 1934, as amended, commonly referred to as the penny stock rule.

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On October 28, 2009, the Company received a letter from Nasdaq notifying it that it had determined to delist the Company's common stock from trading as a result of the commencement of the Chapter 11 Cases. The Company appealed the Nasdaq determination on December 3, 2009 and, on December 29, 2009, the Nasdaq Hearings Panel granted the Company's request to remain listed, subject to certain conditions, including (1) providing periodic updates as to the status of the Brightwater credit facilities restructuring efforts; and (2) emerging from the Chapter 11 process no later than April 26, 2010. On April 9, 2010, the Company received a delisting determination notice from the Nasdaq Hearings Panel informing the Company that its common stock would be delisted from the Nasdaq Stock Market as a result of the Company's inability to emerge from the Chapter 11 process by the April 26 deadline. The Nasdaq Listings and Hearings Review Council subsequently denied the Company's request to review the Nasdaq Hearings Panel's determination and its common stock was delisted at the open of trading on April 27, 2010 when it commenced trading in the OTCQB marketplace.

The Company has filed an application with Nasdaq seeking the relisting of its securities on The Nasdaq Stock Market following the Company's emergence from the Chapter 11 process. In that regard, all companies, whether listed on Nasdaq or not, are required to satisfy the initial listing requirements upon emergence from a Chapter 11 process to qualify for listing. While the Company presently plans to take all necessary steps to ensure its compliance with the applicable requirements, there can be no assurance as to whether or when the Company's common stock will be relisted on Nasdaq.

Table of Contents

**Note 3 - Significant Accounting Policies**

*Basis of Consolidation*

The accompanying Consolidated Financial Statements include the accounts of the Company and all majority-owned and controlled subsidiaries and joint ventures. Certain of the Company's wholly-owned subsidiaries are members in joint ventures which were involved in the development and sale of a residential project and residential loan production. The financial statements of joint ventures in which the Company has a controlling or majority economic interest (and thus are controlled by the Company) are consolidated with the Company's financial statements. The Company's investments in unconsolidated joint ventures are accounted for using the equity method when the Company does not have voting or economic control of the venture operations, as further described in Note 5 to the Consolidated Financial Statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009. All significant intercompany accounts and transactions have been eliminated in consolidation.

*Consequences of Chapter 11 Cases*

Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) 852-10-45, *Reorganizations Other Presentation Matters*, which is applicable to companies in Chapter 11, generally does not change the manner in which financial statements are prepared. However, it does require that the financial statements for periods subsequent to the filing of the Chapter 11 Cases distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business. Amounts that can be directly associated with the reorganization and restructuring of the business must be reported separately as reorganization items in the statements of operations beginning in the quarter ending December 31, 2009. The balance sheet must distinguish pre-petition liabilities subject to compromise from both those pre-petition liabilities that are not subject to compromise and from post-petition liabilities. Liabilities that may be affected by a plan of reorganization must be reported at the amounts expected to be allowed, even if they may be settled for lesser amounts. In addition, cash provided or used by reorganization items must be disclosed separately in the statement of cash flows. The Company applied ASC 852-10-45 effective on October 27, 2009 and is segregating those items as outlined above for all reporting periods subsequent to such date.

*Subsequent Events*

In the preparation of this Quarterly Report on Form 10-Q, the Company evaluated events for accounting treatment and disclosure that occurred after the balance sheet date but before the financial statements were issued or were available to be issued.

*Reinstatement of 5% Ownership Limitation*

On May 13, 2010, the Company reinstated a ban on acquisitions of additional shares of its common stock, under certain circumstances, in order to preserve the tax benefits of the Company's \$164 million of net operating loss ( NOL ) carryovers. See Note 9 for additional discussion.

*Cash Flows and Debt Compliance*

Negative conditions in the current housing and credit markets give rise to uncertainty as to the Company's present and future ability to meet its projected home sale closings and whether new or modified financings can be obtained, if needed. The Company, like many other homebuilders, is constantly evaluating potential alternatives regarding its capital structure including, but not limited to, various strategies for restructuring its debt and raising additional capital. There can be no assurance that the Company will be successful in any of these endeavors. The limited credit availability for small businesses presents uncertainty as to the ability of the Company to secure additional financing, if needed, and the terms of such financing if it is available, and as to the ability of the Company to achieve positive cash flow from operations required to satisfy its obligations. See Notes 5 and 6 below for further discussion.

Table of Contents

*Real Estate*

Real estate inventories primarily consist of homes available for sale, homes under construction and lots under development and are carried at the lower of cost or fair value less costs to sell. The estimation process involved in the determination of fair value is inherently uncertain because it requires estimates as to future events and market conditions. Such estimation process assumes the Company's ability to complete development and dispose of its real estate properties in the ordinary course of business based on management's present plans and intentions. Economic, market, and environmental conditions will affect management's development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. Accordingly, the ultimate values of the Company's real estate properties depend upon future economic and market conditions, and the availability of financing.

The cost of sales of multi-unit projects is computed using the relative sales value method. Interest and other carrying costs are capitalized to real estate projects during their development and construction period.

*Impairment of Long-Lived Assets*

The Company assesses the impairment of real estate inventories and other long-lived assets in accordance with ASC 360-10-35, *Impairment or Disposal of Long-Lived Assets*, which requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment is evaluated by comparing an asset's carrying value to the undiscounted estimated cash flows expected from the asset's operations and eventual disposition. If the sum of the undiscounted estimated future cash flows is less than the carrying value of the asset, an impairment loss is recognized based on the fair value of the asset. If impairment occurs, the fair value of an asset is deemed to be the amount a willing buyer would pay a willing seller for such asset in a current transaction. Additionally, as appropriate, the Company identifies alternative courses of action to recover the carrying value of its long-lived assets and evaluates all likely alternatives under a probability-weighted approach as described in ASC 360-10-35.

During the three months ended March 31, 2010 and 2009, the Company recorded inland project impairment charges totaling zero and \$3.2 million, respectively. See Note 4 Real Estate Inventories.

In accordance with ASC 360-10-35, in developing estimated future cash flows for impairment testing for its real estate inventories, the Company has incorporated its own market assumptions including those regarding home prices, sales pace, sales and marketing costs, infrastructure and home-building costs, and financing costs regarding real estate inventories. The Company's assumptions are based, in part, on general economic conditions, the current state of the homebuilding industry, expectations about the short- and long-term outlook for the housing market, and competition from other homebuilders in the areas in which the Company builds and sells homes. These assumptions can significantly affect the Company's estimates of future cash flows. For those communities deemed to be impaired, the Company determines fair value based on discounted estimated future cash flows using estimated absorption rates for each community.

The estimation process involved in the determination of value is inherently uncertain since it requires estimates as to future events and market conditions. Such estimation process assumes the Company's ability to complete development and disposition of its real estate properties in the ordinary course of business based on management's present plans and intentions. Economic and market conditions may affect management's

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development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. Accordingly, the amount ultimately realized from such project may differ materially from current estimates and the project's carrying value.

### *Fair Value of Financial Instruments*

The Company adopted ASC 820-10 *Fair Value Measurements and Disclosures*, as it applies to financial assets and liabilities measured at fair value on a recurring basis on January 1, 2008 and as it applies to non-financial assets and liabilities on January 1, 2009. The carrying amounts of the Company's financial instruments including cash and cash equivalents, restricted cash, accounts payable and accrued liabilities, model home financing, and other liabilities approximate their respective fair values because of the relatively short period of time between origination of the instruments and their expected realization. Due to the Chapter 11 Cases and current default status of the Company's Revolving Loan and Term Loan, the carrying amounts of the debt may not approximate fair value as of March 31, 2010. Accordingly, the fair value of debt that is included in liabilities subject to compromise in the Company's consolidated balance sheets cannot be reasonably determined as of March 31, 2010, as the timing and amounts to be paid are subject to confirmation by the Bankruptcy Court. The Company has been notified that purchase/sale transactions involving the Revolving Loan and Term Loan have occurred between certain members of the loan syndicates and other financial or investment institutions. However, it is not practicable for the Company to determine the fair value of the Revolving Loan and Term Loan as the transactions are occurring in a private market.

Table of Contents

*Income Taxes*

The Company accounts for income taxes on the liability method, in accordance with ASC 740-10, *Income Taxes*. Deferred income taxes are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect in the years in which these differences are expected to reverse. The liability method requires an evaluation of the probability of being able to realize the future benefits indicated by deferred tax assets. A valuation allowance is established against a deferred tax asset if, based on the available evidence, it is more likely than not that such asset will not be realized. The realization of a deferred tax asset ultimately depends on the existence of sufficient taxable income in either the carryback or carryforward periods under tax law. The Company evaluates on a quarterly basis, whether a valuation allowance should be established based on its determination of whether it is more likely than not that some portion or all of the deferred tax assets will be realized. In the Company's assessment, appropriate consideration is given to all positive and negative evidence related to the realization of the deferred tax assets. This assessment considers, among other matters, the nature, frequency and magnitude of current and cumulative income and losses, forecasts of future profitability, the duration of statutory carryback or carryforward periods, the Company's experience with operating loss and tax credit carryforwards not expiring unused, and tax planning alternatives.

The Company's assessment of the need for a valuation allowance on its deferred tax assets includes assessing the likely future tax consequences of events that have been recognized in the Company's Consolidated Financial Statements or tax returns. The Company bases its estimate of deferred tax assets and liabilities on current tax laws and rates and, in certain cases, on business plans and other expectations about future outcomes. Changes in existing tax laws or rates could affect the Company's actual tax results and its future business results may affect the amount of the Company's deferred tax liabilities or the valuation of its deferred tax assets over time.

During the three months ended March 31, 2010 and 2009, the Company recorded valuation allowances on deferred tax assets totaling \$1.0 million and zero, respectively. See Note 9 *Income Taxes*.

Due to uncertainties in the estimation process, particularly with respect to changes in facts and circumstances in future reporting periods (carryforward period assumptions), it is reasonably possible that actual results could differ from the estimates used in the Company's historical analyses. The Company's assumptions require significant judgment because the residential homebuilding industry is cyclical and is highly sensitive to changes in economic conditions. The Company's current assessment of the need for a valuation allowance is primarily dependent upon utilization of tax net operating losses in the carryforward period and its future projected taxable income. The Chapter 11 filing constitutes significant negative evidence under ASC 740-10 as it represents uncertainties related to future projected taxable income. Additionally, there are critical uncertainties as to whether the Company will be able to continue selling homes at its Brightwater project using currently projected sales prices and absorption rates in light of the continuing deterioration in the housing and credit markets. If certainty increases regarding the Company's projected results of operations and there is objectively verifiable evidence to support the realization of a portion of its deferred tax assets, an adjustment to the Company's valuation allowance may be recorded to reflect greater expected utilization.

*Homebuilding Revenues and Cost of Sales*

The Company's homebuilding operation generates revenues from the sale of homes to homebuyers. The majority of these homes are designed to appeal to move-up homebuyers and are generally offered for sale in advance of their construction. Sales contracts are usually subject to certain contingencies such as the buyer's ability to qualify for financing. Revenue from the sale of homes is recognized at the close of escrow when title passes to the buyer and the earnings process is complete. As a result, the Company's revenue recognition process does not involve significant judgments or estimates. However, the Company does rely on certain estimates to determine the related construction costs and resulting gross margins associated with revenues recognized. The cost of sales is recorded based upon total estimated costs within a subdivision and allocated

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using the relative sales value method. The Company's construction costs are comprised of direct and allocated costs, including estimated costs for future warranties and indemnities. The Company's estimates are based on historical results, adjusted for current factors.

Table of Contents

*Earnings Per Common Share*

Earnings per common share is accounted for in accordance with ASC 260-10, *Earnings Per Share*. Basic earnings per common share is computed using the weighted-average number of common shares outstanding for the period. Diluted earnings per common share is computed using the weighted-average number of common shares outstanding and the dilutive effect of potential common shares outstanding.

*New Accounting Pronouncements*

In January 2010, the FASB issued Accounting Standards Update (ASU) No. 2010-06 (ASU 2010-06), *Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements*, which requires new disclosures and clarifications of existing disclosures for recurring and nonrecurring fair value measurements. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009. The adoption of ASU 2010-06 during the first quarter of 2010 did not have a material effect on our Consolidated Financial Statements.

**Note 4 Real Estate Inventories**

Real estate inventories primarily consist of homes under construction and lots under development at Brightwater along with a five-acre project being planned for 22 homes, in Huntington Beach in coastal Orange County and one inland community in Lancaster in Los Angeles county planned for 73 homes. As of March 31, 2010, real estate inventories aggregated 364 lots and homes, including 17 model homes, six standing inventory homes completed and unsold, three homes completed and in escrow, and nine homes under construction and in escrow. Real estate inventories at March 31, 2010 included \$238.6 million recorded for 274 lots and homes under development and 17 model homes held under a financing lease at the Brightwater community as well as a five-acre project outside the Brightwater community, which are located on a mesa north of the Bolsa Chica wetlands in Huntington Beach, California. The additional recorded value in real estate inventories reflects the fair value of 73 lots at the Company's subsidiary's inland project in Lancaster, California. The Company capitalizes carrying costs including interest and property taxes, as well as direct construction costs, to real estate inventories during the development and construction period.

The Brightwater planned community offers a broad mix of home choices, averaging 2,860 square feet and ranging in size from 1,710 square feet to 4,339 square feet. The community also has 37 acres of open space and conservation area. With 356 homes permitted on 68 acres, the resulting low-density plan equates to approximately five homes per acre, consistent and compatible with the neighboring Huntington Beach communities. The Company began selling and delivering homes at The Trails and The Sands in 2007. Sales of the larger two products, The Cliffs and The Breakers, began in February 2008 and the Company began delivering homes at The Cliffs and The Breakers neighborhoods during the third quarter of 2008.

The Company recorded impairment charges totaling zero and \$3.2 million during the three months ended March 31, 2010 and 2009, respectively.

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As required by ASC 360-10-35, should market conditions deteriorate in the future or other events occur that indicate the carrying amount of the Company's real estate inventories may not be recoverable, the Company will reevaluate the expected cash flows from each project to determine whether any additional impairment exists at any point in time.

Capitalized interest is allocated to real estate inventories when incurred and charged to cost of sales when the related property is delivered. Changes in capitalized interest follow (in millions):

|                                           |    | Three Months Ended<br>March 31, |         |
|-------------------------------------------|----|---------------------------------|---------|
|                                           |    | 2010                            | 2009    |
| Capitalized interest, beginning of period | \$ | 36.8                            | \$ 37.3 |
| Interest incurred and capitalized         |    | 3.0                             | 4.0     |
| Charged to cost of sales                  |    | (0.6)                           | (1.4)   |
| Charged to gain on debt restructuring     |    |                                 | (4.2)   |
| Capitalized interest, end of period       | \$ | 39.2                            | \$ 35.7 |

Table of Contents

**Note 5 Revolving Loan**

See Note 2 for a detailed discussion of the status of the Chapter 11 Cases which commenced October 27, 2009.

As of March 31, 2010 and December 31, 2009, \$81.7 million was outstanding for both periods under the Revolving Loan. The Company did not pay \$1.7 million of principal due on September 30, 2009, and received a notice of event of default from the agent for the lending syndicate on October 1, 2009. In addition, the Company did not pay an additional \$10.0 million due on December 31, 2009 and \$10.0 million due on March 31, 2010, resulting in an aggregate of \$21.7 million of principal due and unpaid as of March 31, 2010. A major stockholder of the Company currently holds approximately 16% of the Revolving Loan.

Interest on the facility is calculated on the average outstanding daily balance and is paid monthly. Interest incurred on the Revolving Loan for the three months ended March 31, 2010 and 2009 was \$900,000 and \$1.2 million, respectively, at weighted-average interest rates of 3.50% and 3.80%, respectively. Following the Company's \$1.7 million principal payment default, effective October 1, 2009, interest began to accrue at the default rate specified in the loan; however, under the terms of the Bankruptcy Court's cash collateral order, the Company continued paying interest at the non-default rate of 3.50% and was current on such interest payments as of March 31, 2010.

As of March 31, 2010, the Company has delivered 82 homes at Brightwater since inception of the project, including the 17 model homes included in the sale-leaseback transaction completed on December 31, 2008 and two homes (one Cliffs and one Breakers) delivered during the three months ended March 31, 2010. Due to the Chapter 11 Cases, no principal payments were made on the 12 homes delivered during the fourth quarter of 2009 and the first quarter of 2010.

As of March 31, 2010 and December 31, 2009, approximately \$300,000 and \$500,000, respectively, of deferred loan fees and closing costs related to the Revolving Loan are included in other assets and amortized over the life of the loan. Amortization of these costs is included in the capitalization of interest allocated to real estate inventories and charged to cost of sales when the related homes are delivered.

Under the Revolving Loan, the Company is required to comply with a number of covenants, including the following financial covenants which the Company considers to be the most restrictive of all of the debt covenants:

- A leverage covenant that prohibits the Company's ratio of consolidated total liabilities to consolidated tangible net worth from exceeding a maximum ratio of 2.5 to 1.0. The calculation of the covenant excludes impairment charges related to inland projects and valuation allowances on deferred tax assets.
- A loan-to-value ratio, which prohibits the Company's ratio of Revolving Loan debt outstanding to borrowing base value from exceeding a maximum ratio, regarding which the Company has been notified it is in default:

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| Reporting Period                          | Maximum<br>Loan-to-Value<br>Ratio |
|-------------------------------------------|-----------------------------------|
| September 30, 2009 through March 30, 2010 | 35%                               |
| March 31, 2010 and thereafter             | 30%                               |

- A minimum consolidated tangible net worth covenant of \$80 million, excluding impairment charges for the Hearthside Lane and Las Colinas projects and valuation allowances on deferred tax assets.
- A prohibition on dividends.

As of March 31, 2010, the Company's consolidated total liabilities are \$218.0 million, tangible net worth after excluding the 2009 and 2008 inland impairment charges and valuation allowances on deferred tax assets is \$105.4 million and the leverage ratio is 2.07. The Company is in compliance with the leverage and net worth covenants. However, the Company was notified on September 28, 2009 that it is not in compliance with the loan-to-value ratio covenant of the Revolving Loan based on an appraisal obtained in August 2009 by the agent for the Revolving Loan and Term Loan. In addition, the Company is not in compliance with the minimum sales covenant which requires that the sum of the cumulative number of homes delivered as of March 31, 2010 plus 50% of the number of homes in escrow at March 31, 2010 equal or exceed 96. As of March 31, 2010, the Company had delivered 82 homes and had 12 homes in escrow for minimum sales of 88. Under the proposed Chapter 11 plan of reorganization, these covenants would be eliminated.

Table of Contents

While the sales pace at Brightwater was close to expectations at the beginning of 2009, the mix of sales was heavily weighted towards smaller homes which are generating less liquidity than the larger homes. The Company did not meet its mandatory principal repayments due on September 30, 2009, December 31, 2009, or March 31, 2010 and does not expect to be able to fully re-pay the Revolving Loan by its current maturity date on June 30, 2010 from cash flow from operations. The Company is striving to restructure the Revolving Loan and Term Loan through the Chapter 11 reorganization process to extend the maturity dates of the loans and defer scheduled amortization payments in order to accommodate the expected sales pace of the Brightwater project and provide sufficient liquidity to fund continued home construction. There can be no assurance that the Company will be successful in any of these endeavors. While the national credit markets appear to be improving, there is limited availability of financing for small businesses, which presents significant uncertainty as to the ability of the Company to secure additional financing, and the terms of such financing if available. The current housing and jumbo mortgage markets also present uncertainty as to the ability of the Company to achieve sufficient positive cash flow from operations required to satisfy its debt obligations.

**Note 6 Term Loan**

See Note 2 for detailed discussion of the status of the Chapter 11 Cases which commenced October 27, 2009.

As of March 31, 2010 and December 31, 2009, \$99.8 million was outstanding for both periods under the Term Loan. The Company did not pay \$9.8 million due on December 31, 2009 and \$15.0 million due on March 31, 2010, resulting in an aggregate of \$24.8 million of principal due and unpaid as of March 31, 2010. A major stockholder of the Company currently holds approximately 19% of the Term Loan.

Interest on the facility is calculated on the average outstanding daily balance and is paid monthly. Interest incurred on the Term Loan for the three months ended March 31, 2010 and 2009 was \$1.3 million and \$1.7 million, respectively, at weighted-average interest rates of 4.25% and 5.07%, respectively. Following the Company's \$1.7 million principal payment default on the Revolving Loan, effective October 1, 2009, interest under the Term Loan began to accrue at the default rate specified in the loan; however, under the terms of the Bankruptcy Court's cash collateral order, the Company continued paying interest at the non-default rate of 4.25% and was current on such interest payments as of March 31, 2010.

The Term Loan is subject to mandatory repayments and commitment reductions based on 60% of the \$600,000 release price on the first 70 units closed at the Brightwater project, and 60% of the \$1 million release price per unit thereafter. As of September 30, 2009, the Company had delivered 70 homes. These mandatory repayments are applicable to the commitment reductions. However, due to the Chapter 11 Cases, no principal payments were made on the additional 12 homes delivered during the fourth quarter of 2009 and first quarter of 2010.

As of March 31, 2010, the Company has delivered 82 homes at Brightwater since inception of the project, including the 17 model homes included in the sale-leaseback transaction completed on December 31, 2008 and two homes (one Cliffs and one Breakers) delivered during the three months ended March 31, 2010, and made cumulative mandatory repayments for the Term Loan of \$25.2 million.

As of March 31, 2010 and December 31, 2009, approximately \$1.6 million and \$1.9 million, respectively, of deferred loan fees and closing costs related to the Term Loan are included in other assets and amortized over the life of the loan. Amortization of these costs is included in the capitalization of interest allocated to real estate inventories, and charged to cost of sales when the related homes are delivered.

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Under the Term Loan, the Company is required to comply with a number of covenants, including the following financial covenants which the Company considers to be the most restrictive of all of the debt covenants:

- A leverage covenant that prohibits the Company's ratio of consolidated total liabilities to consolidated tangible net worth from exceeding a maximum ratio of 2.50 to 1.0. The calculation of the covenant excludes impairment charges related to inland projects and valuation allowances on deferred tax assets.

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## Table of Contents

- A loan-to-value ratio, which prohibits the Company's ratio of Term Loan debt outstanding to borrowing base value from exceeding a maximum ratio, regarding which the Company has been notified it is in default:

| Reporting Period                          | Maximum<br>Loan-to-Value<br>Ratio |
|-------------------------------------------|-----------------------------------|
| March 31, 2010 through September 29, 2010 | 60%                               |
| September 30, 2010 and thereafter         | 45%                               |

- An interest coverage covenant which prohibits the Company's ratio of EBITDA to interest incurred from being less than 2.00 to 1.00.
- A minimum consolidated tangible net worth covenant of \$80 million, excluding impairment charges for inland projects and valuation allowances on deferred tax assets.
- A prohibition on dividends.

As of March 31, 2010, the Company's consolidated total liabilities are \$218.0 million, tangible net worth after excluding the 2009 and 2008 inland impairment charges and valuation allowances on deferred tax assets is \$105.4 million and the leverage ratio is 2.07. The Company is in compliance with the aforementioned covenants except for the loan-to-value and interest coverage covenants. The Company was notified on September 28, 2009 that it is not in compliance with the loan-to-value ratio covenant of the Term Loan based on an August 2009 appraisal obtained by the agent for the Revolving Loan and Term Loan. In addition, the Company is not in compliance with the minimum sales covenant which requires that the sum of the cumulative number of homes delivered as of March 31, 2010 plus 50% of the number of homes in escrow at March 31, 2010 equal or exceed 96. As of March 31, 2010, the Company had delivered 82 homes and had 12 homes in escrow for minimum sales of 88. Under the proposed Chapter 11 plan of reorganization, these covenants would be eliminated.

While the sales pace at Brightwater was close to expectations at the beginning of 2009, the mix of sales was heavily weighted towards smaller homes which are generating less liquidity than the larger homes. Therefore, the Company did not make the mandatory repayments due on December 31, 2009 or March 31, 2010. The Company is striving to restructure the Revolving Loan and Term Loan through the Chapter 11 reorganization process to extend the maturity dates of the loans and defer scheduled amortization payments in order to accommodate the expected sales pace of the Brightwater project and provide sufficient liquidity to fund continued home construction. There can be no assurance that the Company will be successful in any of these endeavors. While the national credit markets appear to be improving, there is limited availability of financing for small business, which presents uncertainty as to the ability of the Company to secure additional financing, and the terms of such financing, if available. The current housing and mortgage markets also present uncertainty as to the ability of the Company to achieve sufficient positive cash flow from operations required to satisfy its debt obligations.

## Note 7 Model Home Financing

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On December 31, 2008, the Company entered into a sale-leaseback transaction for 17 model homes at its Brightwater project with an unrelated third party investor for \$25.0 million, consisting of \$22.5 million cash, \$2.0 million deferred and payable in two years provided there has not been a significant decrease in the value of the model homes, and \$500,000 payable for conversion of the model homes for sale to homebuyers upon termination of the lease agreement. The Company has an option to repurchase the model homes after at least 90% of the homes of the respective model type have sold, but no earlier than January 1, 2011. If the Company does not repurchase the models, after the lessor receives a 16% internal rate of return, the Company is entitled to receive 75% of any profit resulting from the sale of the models at the end of the lease. Due to the Company's repurchase option and profit participation which constitute continuing interest, and in accordance with ASC 840-40, *Sale-Leaseback Transactions*, the Company accounted for the transaction as a financing transaction rather than as a sale and recorded model home financing debt of \$22.5 million.

The Company utilized \$10.2 million of the model home financing proceeds to make mandatory repayments under the Revolving Loan and Term Loan, thereby reducing the payments that would have been due in 2009. The Company used an additional \$10.7 million of the proceeds to reduce the balance outstanding under the revolving credit agreement. See Notes 5 and 6 for additional discussion.

Table of Contents

In connection with the sale-leaseback transaction, the Company agreed to assign the first \$500,000 of proceeds from sales commissions resulting from the eventual resale of the model homes, or additional purchase price received, to its partner in the Oxnard joint venture, which is an affiliate of the investor who purchased the model homes. The \$500,000 payment represents additional capital contributions that become payable upon the dissolution of the joint venture.

The model home lease allowed the Company to utilize the 17 model homes for continued customer display for a term of three years expiring December 31, 2011, with two renewal options for one year each. As required by the lease agreement, the Company prepaid six months of rent totaling \$1.6 million on December 31, 2008. During the three months ended March 31, 2010, the Company made model home lease payments totaling \$788,000. Monthly lease payments of \$262,500 per month are due through December 2010, and \$279,167 per month in 2011. The future minimum lease payments under the terms of the related lease agreement are as follows (in millions):

| Year  | Amount |
|-------|--------|
| 2010  | \$ 2.4 |
| 2011  | 3.3    |
| Total | \$ 5.7 |

**Note 8 - Other Liabilities (Not Subject to Compromise and Subject to Compromise)**

As of March 31, 2010 and December 31, 2009, other liabilities not subject to compromise included contingent indemnity and environmental obligations totaling \$400,000.

As of March 31, 2010 and December 31, 2009, other liabilities subject to compromise were comprised of the following (in millions):

|                                                    | Subject to Compromise |                      |
|----------------------------------------------------|-----------------------|----------------------|
|                                                    | March 31,<br>2010     | December 31,<br>2009 |
| Accrued pensions and benefits                      | \$ 5.5                | \$ 5.5               |
| Home warranty reserves                             | 1.9                   | 1.9                  |
| Contingent indemnity and environmental obligations | 0.7                   | 0.7                  |
| Capital contribution due to joint venture          | 0.5                   | 0.5                  |
| Unamortized discount                               | (0.3)                 | (0.3)                |
|                                                    | \$ 8.3                | \$ 8.3               |

Contingent indemnity and environmental obligations primarily reflect reserves before related discount (recorded pursuant to Fresh-Start Reporting in 1997) for contingent indemnity obligations for businesses disposed of by former affiliates and unrelated to the Company's current operations.

*Home Warranty Reserve*

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The Company provides a home warranty reserve to reflect its contingent obligation for product liability. The Company generally records a provision as homes are delivered, based upon historical and industry experience, for the items listed in the homeowner warranty manual, which does not include items that are covered by manufacturers' warranties or items that are not installed by the Company's employees or contractors. The home warranty reserve activity is presented below (in millions):

|                                      | <b>Three Months Ended<br/>March 31,</b> |     |             |     |
|--------------------------------------|-----------------------------------------|-----|-------------|-----|
|                                      | <b>2010</b>                             |     | <b>2009</b> |     |
| Balance at beginning of period       | \$                                      | 1.9 | \$          | 1.7 |
| Provision                            |                                         |     |             |     |
| Adjustment due to change in estimate |                                         |     |             |     |
| Payments                             |                                         |     |             |     |
| Balance at end of period             | \$                                      | 1.9 | \$          | 1.7 |

Table of Contents**Note 9 - Income Taxes**

The following is a summary of the tax expense (benefit):

|                                             | Three Months Ended<br>March 31, |        |
|---------------------------------------------|---------------------------------|--------|
|                                             | 2010                            | 2009   |
| Current taxes                               | \$                              | \$     |
| Deferred taxes                              | 1.0                             | 7.7    |
| Valuation allowances on deferred tax assets | (1.0)                           |        |
| Income tax expense (benefit)                | \$                              | \$ 7.7 |

During 2009 and the first quarter of 2010, the Company recorded valuation allowances for the entire amount of its net deferred tax assets due to uncertainties regarding the resolution of the Chapter 11 Cases filed October 27, 2009. The Chapter 11 filing constitutes significant negative evidence under ASC 740-10 as it represents uncertainties related to future projected taxable income. At this time, the Company is unable to conclude that it is more likely than not that the Company would be able to generate sufficient projected taxable income in future years in order to utilize its NOLs except to offset existing net deferred tax liabilities. The Company monitors the availability of real estate for development at economically viable prices, market conditions and other objectively verifiable economic factors affecting the Company's operations, as well as other positive and negative factors, as it assesses valuation allowances against its deferred tax assets.

During the fourth quarter of 2009, the Company recorded a \$950,000 tax receivable related to the November 6, 2009 passage of the Worker, Homeownership and Business Assistance Act of 2009 which allows businesses with NOLs for 2008 and 2009 to carry back losses for up to five years and suspends the 90% limitation on the use of any alternative tax NOL deduction attributable to carrybacks of the applicable NOL. The Company expects to file a refund claim for federal alternative minimum tax paid for years prior to 2009 and anticipates receiving the refund during 2010.

The federal NOLs available as of March 31, 2010 were approximately \$164 million. The amount of federal NOLs which expire if not utilized is \$49 million in 2010, \$42 million in 2011, zero in 2012, 2013 and 2014, and \$73 million thereafter.

The Internal Revenue Code (the "Code") generally limits the availability of NOLs if an ownership change occurs within any three-year period under Section 382. If the Company were to experience an ownership change of more than 50%, the use of all remaining NOLs would generally be subject to an annual limitation equal to the value of the Company's equity before the ownership change, multiplied by the long-term tax-exempt rate (4.03% as of May 2010) plus (ii) recognized built-in-gains, defined as those gains recognized within five years of the ownership change subject to an overall limitation of the net unrealized built-in gains existing as of the ownership change date. The Company estimates that after giving effect to various transactions by stockholders who hold a 5% or greater interest in the Company, it has experienced a three-year cumulative ownership shift of approximately 29% as of May 10, 2010, as computed in accordance with Section 382. While the Company's net deferred tax assets are currently fully reserved due to the uncertainty of the timing and amount of future taxable income, if the Company generates taxable income in future periods, reversal of all or a portion of the valuation allowance could have a significant positive impact on net income in the period that it becomes more likely than not that the deferred tax assets will be utilized. In the event of an ownership change, the Company's use of the NOLs may be limited and not fully available for realization.

On May 13, 2010, the Company reinstated a ban on acquisitions of additional shares of its common stock, under certain circumstances, in order to preserve the tax benefits of the Company's \$164 million of NOLs. In accordance with provisions of the Company's charter documents, unless the Company has previously consented in writing (i) no stockholder may acquire shares in an amount that would cause the stockholder to own 5% or more of the common stock; and (ii) no current 5% or greater stockholder may acquire any additional shares of common stock.

In September 2006, the Company's Board of Directors suspended enforcement of the Company's charter documents that restrict stockholders from acquiring more than 5% of the outstanding shares of common stock. At that time, the Board determined that such restrictions were not required to preserve the tax benefits of the Company's NOLs. However, transactions by holders of over 5% of the Company's common stock during the past three years necessitates the reinstatement of this control in order to ensure that the 50% change in ownership threshold is not exceeded which, under IRS rules, would severely limit the Company's use of its NOLs.

Table of Contents

All acquisitions of the Company's common stock in violation of its charter prohibitions are null and void, and the Company is empowered to effectively reverse the effect of any such acquisitions. The Company's Board of Directors may, but is not required to, entertain requests for permission to exceed the limitations on stock acquisitions under circumstances it determines are not likely to jeopardize the Company's ability to preserve and use its NOLs.

*Uncertain Tax Positions*

The Company adopted the provisions of ASC 740-10 as it applies to uncertain tax positions on January 1, 2007. As a result of the implementation, during the first quarter of 2007, the Company recorded a \$5.1 million decrease in deferred tax assets for unrecognized tax benefits, which was offset by an increase in deferred tax assets of \$1.8 million for assets re-evaluated as recognizable. The net change in deferred tax assets of \$3.3 million was recorded as a cumulative effect of a change in accounting principle and resulted in a decrease to the January 1, 2007 retained earnings balance of \$200,000 and a decrease to the additional paid in capital balance of \$3.1 million related to fresh-start accounting pursuant to a 1997 pre-packaged bankruptcy.

Of the Company's unrecognized tax benefits of \$4.9 million at March 31, 2010, \$100,000 would decrease the Company's effective tax rate if recognized. The Company expects that its unrecognized tax benefits will decrease by approximately \$1.5 million within twelve months of the reporting date due to statute of limitations lapses.

The Company recognizes interest expense and penalties related to uncertain tax positions as interest or other expense. As of March 31, 2010, the Company has not recorded any interest or penalties related to unrecognized tax benefits, due to the substantial NOLs available.

Certain tax year filings remain open to Federal and California examination, which are the Company's only tax jurisdictions. The years 2006 through 2009 and the years 2005 through 2009 remain open for Federal and California purposes, respectively, for which the Company utilized NOLs generated between 1990 and 1993 to offset taxable income. If uncertainties resulting in valuation allowances can be favorably resolved, the Company expects to utilize Federal NOLs generated in 1995 through 1997 and in 1999, 2006, 2007 and 2009 in future years. In addition, the Company would expect to utilize California NOL generated in 2007 and 2009 in future years.

Pursuant to ASC 718-740, *Stock Compensation Income Taxes*, the Company has elected to recognize stock option deductions on the tax law ordering method, which maximizes the realization of the stock option deductions in the current year. While the Company realized the majority of its 2006 stock option deductions, approximately \$400,000 of unrealized tax benefits related to stock option deductions are not reflected in the Consolidated Financial Statements. Upon realization of the tax benefits, the Company would increase its additional paid-in capital.

**Note 10 - Commitments and Contingencies**

*Real Estate Matters*

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The Company has outstanding performance and surety bonds, for the benefit of city and county jurisdictions, related principally to its obligations for site improvements and fees at various projects as of March 31, 2010. At this time, the Company does not believe that a material amount of any currently outstanding performance or surety bonds will be called. The Company believes that all work required to be completed at this time under the bonding agreements has been completed and, therefore, draws upon these bonds, if any, will not have a material effect on the Company's financial position, results of operations or cash flows.

### *Legal Proceedings*

### *Other Litigation*

There are various lawsuits and claims pending against the Company and certain subsidiaries. In the opinion of the Company's management, ultimate liability, if any, will not have a material adverse effect on the Company's financial condition or results of operations.

Table of Contents

*California Department of Toxic Substances Control*

In October 2006, the California Department of Toxic Substances Control ( DTSC ) filed a civil complaint against the Company's Hearthside Residential Corp. subsidiary ( HRC ) in the Federal District Court for the Southern Division of the Central District of California. The DTSC's complaint requests that HRC pay for approximately \$1.0 million of costs incurred by the DTSC, together with interest on that amount, primarily in connection with the oversight and remediation of PCB contamination found on residential properties never owned by HRC adjacent to a 43-acre site where HRC completed the removal of PCB contaminated soil during September 2005. HRC's remediation process was approved by the DTSC in December 2005 when it issued a final acceptance of the remediation work. The complaint also seeks an order for HRC to pay any future costs which may be incurred in connection with further remediation, together with court costs and attorney's fees.

Since May 2004, HRC has received invoices from DTSC seeking reimbursement for these costs; however, HRC contends, based upon advice of counsel, that it is not responsible for such costs because neither HRC nor any affiliate ever developed or built the neighboring residential properties, neither HRC nor any affiliate generated the contamination, the contamination did not emanate from the 43-acre site that HRC remediated, and, even if the contamination did emanate from the 43-acre site, it did not do so while HRC owned the site. Furthermore, HRC has also disputed such charges due to the fact that DTSC improperly submitted its bill. The Company's subsidiary is vigorously defending itself in this matter. Therefore, the Company has not accrued for any of DTSC's approximately \$1.0 million of claims related to these residential properties.

Prior to the commencement of the trial that was scheduled for December 2, 2008, the District Court ruled that HRC can be held liable as a current owner of the site under applicable law. HRC applied to have that ruling certified for appeal. In March 2009, the District Court granted permission to hear HRC's appeal and the appellate process commenced. Oral arguments are currently scheduled to be heard on June 9, 2010. HRC currently expects that it could take two to four months to complete the appellate process. There can be no assurance that HRC will receive a favorable ruling that it is not deemed to be a current owner of the site. Once the appellate process is complete, the parties will return to the District Court within 30 to 60 days to commence a trial.

*Corporate Indemnification Matters*

The Company and its former affiliates have, through a variety of transactions effected since 1986, disposed of several assets and businesses, many of which are unrelated to the Company's current operations. By operation of law or contractual indemnity provisions, the Company may have retained liabilities relating to certain of these assets and businesses. There is generally no maximum obligation or amount of indemnity provided for such liabilities. A portion of such liabilities is supported by insurance or by indemnities from certain of the Company's previously affiliated companies. The Company believes its consolidated balance sheet reflects adequate reserves for these matters.

**Note 11 Stockholders' Equity**

As of March 31, 2010, total stockholders' equity is \$31.0 million, reflecting beginning stockholders' equity of \$33.4 million and net loss of \$2.4 million during the three months ended March 31, 2010.

**Note 12 Stock Plan**

*1993 Stock Option/Stock Issuance Plan*

The 1993 Stock Option/Stock Issuance Plan ( 1993 Plan ) was approved at the 1994 Annual Meeting of Stockholders, reserving 7.5 million shares each of Series A Preferred Stock and Class A Common Stock for issuance to officers, key employees and consultants of the Company and its subsidiaries and the non-employee members of the Board of Directors (the Board ). On April 28, 1997, in connection with the Recapitalization, a new class of Common Stock replaced the Series A Preferred Stock and Class A Common Stock, and the Compensation Committee of the Board authorized the grant of stock options for 759,984 shares, equivalent at that time to 6% of the Company s fully diluted equity, for certain directors and officers. At the May 2004 and June 2006 stockholder meetings, the stockholders of the Company authorized an additional 150,000 and 250,000 stock options, respectively, for the 1993 Plan, resulting in total authorized grants of 1,159,984.

Table of Contents

During the three months ended March 31, 2010 and 2009, the Company issued a total of zero and 125,000 shares, respectively, of its common stock to three independent directors under the Director Fee Program, which is a component of the 1993 Plan. The Company is currently prohibited from issuing shares due to its bankruptcy proceedings. The 2009 restricted shares vested at a rate of 25% per quarter during 2009.

The Company did not grant any options during the three months ended March 31, 2010 and 2009. Pursuant to ASC 718-10, *Compensation Stock Compensation*, the Company recorded zero and \$18,000 of compensation expense during the three months ended March 31, 2010 and 2009, respectively, which is reflected in additional paid-in capital.

A summary of the status of the Company's 1993 plan for the three months ended March 31, 2010 follows:

|                                          | Number of<br>Options | Weighted-Average<br>Exercise<br>Price | Weighted-Average<br>Remaining<br>Life |
|------------------------------------------|----------------------|---------------------------------------|---------------------------------------|
| Outstanding, January 1                   | 17,500               | \$ 21.58(a)                           |                                       |
| Granted                                  |                      | \$                                    |                                       |
| Exercised                                |                      | \$                                    |                                       |
| Outstanding, March 31                    | 17,500               | \$ 21.58(a)                           | 5.85 years                            |
| Fully vested and exercisable at March 31 | 17,500               | \$ 21.58(a)                           | 5.85 years                            |
| Available for future grants at March 31  | 221,794              |                                       |                                       |

(a) Adjusted for special dividend of \$12.50

As of March 31, 2010, there were 17,500 options outstanding with a weighted-average exercise price of \$21.58 (ranging from \$13.35 to \$25.99) and a weighted-average remaining life of 5.85 years. All outstanding stock options are fully vested. The aggregate intrinsic value of all outstanding, fully-vested and exercisable stock options at March 31, 2010 was zero.

The Company estimates the fair value of its stock options using the Black-Scholes option pricing model (the Option Model). The Option Model requires the use of subjective and complex assumptions, including the option's expected term and the estimated future price volatility of the underlying stock, which determine the fair value of the share-based awards. The Company's estimate of expected term is determined based on the weighted-average period of time that options granted are expected to be outstanding considering current vesting schedules and the historical exercise patterns of the existing option plan. The expected volatility assumption used in the Option Model is based on historical volatility on traded options on the Company's stock in accordance with guidance provided in SFAS 123(R) and SAB 107. The risk-free interest rate used in the Option Model is based on the yield of U.S. Treasuries with a maturity closest to the expected term of the Company's stock options.

Table of Contents

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

This item contains forward-looking statements that involve risks and uncertainties as set forth in "Cautionary Statements About Forward-Looking Statements" at the beginning of this Quarterly Report on Form 10-Q. Actual results may differ materially from those indicated in the forward-looking statements set forth below. Factors that may cause such a difference include, but are not limited to, those discussed in "Item 1A. Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2009.

**Status of Chapter 11 Cases**

On October 27, 2009, California Coastal Communities, Inc. ( "we" ) and certain of our direct and indirect wholly-owned subsidiaries (collectively with us, the "Debtors" ) filed voluntary petitions (the "Chapter 11 Petitions" ) for relief under chapter 11 of title 11 ( "Chapter 11" ) of the United States Code (the "Bankruptcy Code" ) in the United States Bankruptcy Court for the Central District of California (the "Bankruptcy Court" ). The Chapter 11 Petitions are being jointly administered under the caption *In re California Coastal Communities, Inc.*, Case No. 09-21712-TA (the "Chapter 11 Cases" ). The sole purpose of the Chapter 11 Cases is to restructure the debt obligations under our senior secured revolving credit agreement ( "Revolving Loan" ) and our senior secured term loan ( "Term Loan" ) for which KeyBank National Association ( "KeyBank" ) originally served as the agent to the lending syndicates. On February 26, 2010, KeyBank notified us and the lenders of their resignation as agent. Effective April 6, 2010, Wilmington Trust, FSB agreed to serve as agent for the syndicates. As of March 31, 2010, \$81.7 million in principal amount was outstanding on the Revolving Loan and \$99.8 million in principal amount was outstanding on the Term Loan. A major stockholder of the Company currently holds approximately 16% of the Revolving Loan and 19% of the Term Loan.

We and the other Debtors continue to operate our businesses and manage our properties as "debtors-in-possession" under the jurisdiction of the Bankruptcy Court and in accordance with the applicable provisions of the Bankruptcy Code and orders of the Bankruptcy Court. We have obtained the Bankruptcy Court's approval to, among other things, continue to pay critical vendors with lien rights, sell homes free and clear of all liens on an interim basis, use cash collateral on an interim basis, honor homeowner warranties, meet payroll obligations and provide employee benefits. If the value of the Debtors' assets and operations become materially impaired, our ability to continue as debtors-in-possession and to operate our business in the present mode could be jeopardized. During the three months ended March 31, 2010, we incurred costs totaling \$1.3 million associated with the reorganization and have incurred total reorganization costs of \$2.6 million through such date. We will continue to incur significant costs associated with the reorganization which are expected to adversely affect the results of our business operations.

On March 26, 2010, we filed a proposed disclosure statement and proposed joint plan of reorganization with the Bankruptcy Court, neither of which has been approved by the Bankruptcy Court. The proposed joint plan provides for the extension of the Revolving Loan and the Term Loan to enable us to complete construction and sale of the homes at our Brightwater project. Throughout the Chapter 11 reorganization process we have tried to work with the various members of our lending syndicate to determine whether a consensual restructuring of the Revolving Loan and the Term Loan can be accomplished. However, a majority of our lenders are opposed to our plan and there can be no assurance that we and the other Debtors will be able to successfully confirm, consummate and execute a plan of reorganization with respect to the Chapter 11 Cases that is acceptable to the Bankruptcy Court and the creditors and other parties in interest. A court hearing on the adequacy of the disclosure statement was held on May 12, 2010. We expect the Court to enter an order approving the disclosure statement containing certain revisions. The Court has scheduled a valuation hearing for July 15, 2010 and a plan confirmation hearing for July 28, 2010.

We have maintained business operations through the reorganization process. Our liquidity and capital resources, however, are significantly affected by the Chapter 11 Cases, which have resulted in various restrictions on our activities, limitations on financing and a need to obtain

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Bankruptcy Court approval for various matters. In particular, we and the other Debtors are not permitted to make any payments on pre-petition liabilities without prior Bankruptcy Court approval. While the Bankruptcy Court has consistently approved all of our requests to continue wage and salary payments and other employment benefits to employees, as well as other related pre-petition obligations, to continue to construct and sell homes, and to pay certain pre-petition trade claims held by critical vendors with lien rights; there can be no assurance that our future requests will be approved. Our authorization to continue to use cash collateral and sell homes free and clear of liens with the consent of our lending syndicate is currently scheduled to terminate on June 30, 2010.

Under the priority schedule established by the Bankruptcy Code, certain post-petition and pre-petition liabilities need to be satisfied before general unsecured creditors and equity holders are entitled to receive any distribution. At this time, it is not possible to predict with certainty the effect of the Chapter 11 Cases on our business or various creditors, or when we and the other Debtors will emerge from these proceedings. Future results will depend upon the confirmation and successful implementation of a plan of reorganization. The continuation of the Chapter 11 Cases, particularly if a plan of reorganization is not timely confirmed, could further adversely affect our operations.

Table of Contents

We depend on cash flows generated from operations and available borrowing capacity to fund our Brightwater development, and to meet our debt service and working capital requirements. However, our ability to continue to generate sufficient cash flows has been and will continue to be adversely affected by continued difficulties in the homebuilding industry, continued weakness in the California economy and negative publicity and prospective homebuyer concerns related to the bankruptcy. During the first three months of 2010, we generated five net sales orders at Brightwater, which is equal to net sales orders generated in the comparable period of 2009, and started construction of a limited number of speculative homes which are in greater demand in today's market than contract homes that are constructed over a five to seven month period.

Due to cash requirements for ongoing home construction and debt amortization, our ability to meet future loan repayment requirements will depend on the results of the Chapter 11 Cases, as well as continued home sales at our Brightwater project. Our goal is to restructure debt payments based on our current expectations for future sales over the next four years. The inventories of resale homes in the Huntington Beach coastal zip codes have been declining, which reduces the supply of resale homes with which Brightwater may compete.

Continuing negative conditions in the housing and credit markets give rise to uncertainty as to our present and future ability to meet our projected home sale closings and whether modified financings can be obtained in order for us to meet our debt obligations. There can be no assurance that we will be successful in any of these endeavors. While the national credit markets appear to be improving, there is limited availability of financing for small businesses which presents significant uncertainty as to our ability to secure replacement financing and the terms of such financing if it is available. The current housing and jumbo mortgage markets also present significant uncertainty as to our ability to achieve sufficient positive cash flow from operations required to satisfy our debt obligations and meet financial covenant requirements.

While we are striving to restructure our debt through the Chapter 11 Cases, unless we are successful in amending and extending the terms of the Revolving Loan and Term Loan agreements, we do not believe that our cash, cash equivalents and future real estate sales proceeds will be sufficient to meet our debt obligations as currently structured or to meet anticipated operating and project development costs for Brightwater, and general and administrative expenses during the next 12 months. These factors raise substantial doubt about our ability to continue as a going concern. Our Consolidated Financial Statements set forth above do not include any adjustments that might result from the outcome of this uncertainty.

*Nasdaq Delisting*

Our common stock is currently trading over-the-counter in the recently created OTCQB marketplace under the trading symbol CALCQ. The trading of our common stock in the over-the-counter market rather than on Nasdaq may negatively impact the trading price and the levels of liquidity available to our stockholders. In addition, securities that trade over-the-counter are not eligible for margin loans and will make our common stock subject to the provisions of Rule 15c-9 of the Securities Exchange Act of 1934, as amended, commonly referred to as the penny stock rule.

On October 28, 2009, we received a letter from Nasdaq notifying us that it had determined to delist our common stock from trading as a result of our commencement of the Chapter 11 Cases. We appealed the Nasdaq determination on December 3, 2009 and, on December 29, 2009, the Nasdaq Hearings Panel granted our request to remain listed, subject to certain conditions, including (1) providing periodic updates as to the status of the Brightwater credit facilities restructuring efforts; and (2) emerging from the Chapter 11 process no later than April 26, 2010. On April 9, 2010, we received a delisting determination notice from the Nasdaq Hearings Panel informing us that our common stock would be delisted from the Nasdaq Stock Market as a result of our inability to emerge from the Chapter 11 process by the April 26 deadline. The Nasdaq Listings and Hearings Review Council subsequently denied our request to review the Nasdaq Hearings Panel's determination and our common

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stock was delisted at the open of trading on April 27, 2010 when it commenced trading in the OTCQB marketplace.

We have filed an application with Nasdaq seeking the relisting of our securities on The Nasdaq Stock Market following our emergence from the Chapter 11 process. In that regard, all companies, whether listed on Nasdaq or not, are required to satisfy the initial listing requirements upon emergence from a Chapter 11 process to qualify for listing. While we presently plan to take all necessary steps to ensure our compliance with the applicable requirements, there can be no assurance as to whether or when our common stock will be relisted on Nasdaq.

Table of Contents

**Overview of California Coastal Communities, Inc. and Recent Industry Events.**

We are a residential land development and homebuilding company with properties owned or controlled primarily in Orange County, California and also in Lancaster in Los Angeles county. Our primary asset is a 356-home luxury coastal community known as Brightwater in Huntington Beach, California. Our principal activities include:

- obtaining zoning and other entitlements for land we own or for third parties under consulting agreements;
- improving the land for residential development; and
- designing, constructing and selling single-family homes in Southern California.

Once our residential land is entitled, we may build homes, sell unimproved land to other developers or homebuilders, sell improved land to homebuilders, or participate in joint ventures with other developers, investors or homebuilders to finance and construct infrastructure and homes. The majority of our homes are designed to appeal to move-up homebuyers and are generally offered for sale in advance of their construction.

In view of the continuing significant economic downturn in the housing market, during the remaining nine months of 2010 our new home construction will be limited to our 356-home Brightwater project located on the Bolsa Chica mesa in Huntington Beach, California.

During the remaining nine months of 2010, our primary goals will be to:

- have our plan of reorganization to restructure our obligations under the Term Loan and the Revolving Loan confirmed by the Bankruptcy Court as soon as possible, which would enable us to emerge from Chapter 11 bankruptcy during 2010; and
- continue constructing, selling and delivering homes at Brightwater.

There can be no assurance that we will accomplish, in whole or in part, all or any of these strategic goals or any other strategic goals or opportunities that we may pursue.

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Our total revenues for the three months ended March 31, 2010 and 2009 were \$3.0 million and \$12.8 million, respectively. For the three months ended March 31, 2010 and 2009, we delivered two and seven homes, respectively. Our total assets as of March 31, 2010 and December 31, 2009 were \$249.0 million and \$249.9 million, respectively, with Brightwater and other nearby properties constituting \$238.6 million (96% of total assets) and \$234.8 million (94% of total assets), respectively. Our homebuilding subsidiary, Hearthside Homes, Inc., has delivered over 2,300 homes to families throughout Southern California since its formation in 1994.

Prior to obtaining the Coastal Development Permit for our Brightwater project in December 2005, we historically maintained a minimal amount of leverage. In September 2006, we obtained \$225 million of debt financing, as described in Notes 5 and 6 to the Consolidated Financial Statements, which provided \$100 million for Brightwater construction and \$125 million to fund a \$12.50 per share special dividend paid to our stockholders in September 2006. As of March 31, 2010, we had \$204.0 million of debt against \$31.0 million of book equity.

We were formed in 1988 and our executive offices are located at 6 Executive Circle, Suite 250, Irvine, California 92614. Our website address is <http://www.californiacoastalcommunities.com> and our telephone number is (949) 250-7700. Through our website we make available our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to these reports filed or furnished pursuant to Section 13(d) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after they are filed with, or furnished to, the Securities and Exchange Commission. Copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to these reports are available free of charge upon request. In addition, at our website: <http://www.californiacoastalcommunities.com>, we post copies of our Securities and Exchange Commission filings and press releases, as well as current versions of our code of ethics, audit committee charter and nominating committee charter.

Table of Contents

**Homebuilding Outlook and Operating Strategy**

The financial crisis and economic recession that worsened in 2008 and exacerbated the existing downturn in the homebuilding market persisted throughout 2009 and has continued through the first quarter of 2010. Specifically, the credit markets and the mortgage industry experienced a period of unparalleled turmoil and disruption characterized by bankruptcy, financial institution failure, consolidation and an unprecedented level of intervention by the United States federal government. This disruption on the credit markets has made it more difficult for homebuyers to obtain acceptable financing, particularly for jumbo-mortgages. In addition, the supply of new and resale homes in the marketplace remained excessive for the levels of consumer demand, particularly given the supply of foreclosed homes offered at substantially reduced prices. These pressures in the marketplace resulted in the use of increased sales incentives and price reductions in an effort to generate sales and reduce inventory levels by us and our competitors throughout 2009 and the first quarter of 2010. While there have been signs of improvement in the economy and financial markets during the first quarter of 2010, weakness in the homebuilding environment continued as unemployment remains at very high rates, and is expected to continue throughout the year.

Concern about the state of the economy and the job market continues to negatively affect consumer confidence, as unemployment rates continued to rise throughout 2009 in almost all of the metropolitan areas tracked by the U.S. Department of Labor. The unemployment rate in California was 13.0% at the end of the first quarter of 2010 compared with 11.2% at the end of the first quarter of 2009, while the unemployment rate in Orange County was 10.1% in March 2010 compared with 8.5% in March 2009. These adverse conditions have now persisted to varying degrees since the beginning of 2006 and their impact is reflected in our results for the first quarters of 2010 and 2009. We believe that the weak demand we are experiencing, particularly for homes over \$1.5 million, reflects the excess supply of higher end homes in the Huntington Beach market as well as homebuyers' reluctance to make a purchasing decision until they are comfortable that home price declines are near bottom, that economic conditions have stabilized and that our company will successfully emerge from Chapter 11. However, the inventories of resale homes in the Huntington Beach coastal zip codes have been declining, which reduces the supply of resale homes with which Brightwater may compete, and the jumbo-mortgage market is showing signs of gradual improvement. There can be no assurance that these trends will continue.

During 2009, the California home-buyer tax credit enacted early in the year (which did not contain income or first-time buyer restrictions and was limited to new homes) appears to have boosted demand somewhat; however, the federal stimulus plan has not had much impact on sales at our Brightwater project due to its income and first-time buyer restrictions. As of August 31, 2009, all of the \$100 million in California tax credits had been issued. On March 25, 2010, an additional \$200 million of funding was approved by the State of California which will provide up to a \$10,000 credit to first-time homebuyers or those purchasing a newly built home starting May 1, 2010.

While we have begun to see some positive signs that these negative trends in the overall economy are moderating, such as rising stock markets and fewer new unemployment claims, it remains uncertain when the housing market or the broader economy will experience a meaningful recovery. We anticipate that the overhang of bank-owned homes will continue to bloat the market throughout 2010 as lenders seek to unload their inventory of foreclosed homes. We believe the current conditions may improve during 2010; however there can be no assurance in that regard. In addition, we expect that market conditions will remain challenging and we expect that our operations may sustain periodic losses until the homebuilding industry and economy, as a whole, demonstrate a sustained rebound. Further, until we are able to restructure our Revolving Loan and Term Loan debt through the Chapter 11 Cases, prospective buyers may be reluctant to purchase a home and we may continue to experience slower sales.

We maintain relationships with various mortgage providers and, with few exceptions, the mortgage providers that furnish our customers with mortgages continue to issue new commitments. Our buyers generally have been able to obtain adequate financing but the number of potential home buyers that can qualify under the tightened lending standards has diminished. The availability of certain mortgage financing products continues to be constrained due to increased scrutiny of once commonly-used mortgage products such as sub-prime, Alt-A, and other non-prime

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mortgage products. Further, throughout 2009, the interest rates on jumbo mortgages were significantly greater than interest rates on conforming mortgages, with spreads approximating 1% compared with historical spreads in the range of only .25% to .35%. As of April 2010, the spread has narrowed to approximately .50% to .80%. Mortgage market liquidity issues and more stringent underwriting criteria have impeded some of our home buyers from closing escrow, while others have found it more difficult to sell their existing homes as their buyers face the problem of obtaining a mortgage. Because we cannot predict the short-and long-term liquidity of the credit markets, we continue to caution that, with the uncertainties in these markets, the pace of home sales could remain depressed or slow further until these markets improve.

Table of Contents

In response to the ongoing crisis in the housing market and national credit markets, during the first three months of 2010 we:

- continued offering incentives for all of our homes in order to reduce inventory at Brightwater; and
- filed a proposed disclosure statement and proposed joint plan of reorganization for relief under Chapter 11 in the Bankruptcy Court in order to restructure approximately \$182 million of indebtedness related to our Brightwater project.

We expect to continue operations at only the four Brightwater communities until we see reasonable signs of a housing market recovery. If market conditions decline further, we may need to take additional charges for inventory impairments in future quarters. In addition, we expect that our results for 2010 will be adversely affected by the costs of restructuring our debt through the Chapter 11 Cases. Our results could also be adversely affected if general economic conditions do not improve further or deteriorate, if consumer confidence remains weak or declines further, if job losses continue or accelerate, if foreclosures or distressed sales increase, or if consumer mortgage lending becomes less available or more expensive, any or all of which would further diminish the prospects for a recovery in housing markets.

We believe that stability in the credit and capital markets and an eventual renewal of confidence in the national economy will play a major role in any turnaround in the homebuilding and mortgage lending industries. We also believe that a meaningful improvement in housing market conditions will require the restoration of consumer and credit market confidence that will support a decision to buy a home, which will in turn require a sustained decrease in inventory levels, price stabilization and reduced foreclosure rates.

As the housing market downturn persists, we will continue to adjust and reevaluate our operating strategy in an effort to reduce standing inventories while monitoring our margins and liquidity. Recognizing the challenges presented by the downturn in the homebuilding market, our current operating strategy includes:

- continuing to adjust our cost structure to today's market conditions by controlling our headcount and overhead and rebidding subcontracts and materials in line with reduced demand;
- exercising tight control over cash flows;
- changing sales and marketing efforts to generate additional traffic;
- offering incentives and price reductions to reduce standing inventories and achieve acceptable levels of sales volume and cash flow;

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- continuing to limit construction starts to align product available for sale with sales activity; and
- seeking to balance our short-term goal of selling homes in a depressed market and our long-term goal of maximizing the value of our communities.

During the first three months of 2010 and 2009, we delivered two and seven homes, respectively. As of May 10, 2010, six additional homes have been delivered, bringing year-to-date deliveries to eight homes, and seven additional homes are in escrow, as discussed further under Item 1 Business--Our Current and Future Homesites above.

Despite the challenges of the current California homebuilding market, we believe the potential for our Brightwater project remains high. Brightwater has not been immune to the effects of the unstable mortgage and housing markets; however, that impact appears less severe than the weakness we have seen in our inland markets. We believe that the reduced impact is a result of Brightwater's superior coastal location, the extremely limited supply of new homes on the coast of Southern California and the absence of significant competition from other homebuilders in the Huntington Beach market due to the lack of available land for the development of new single family detached homes. We believe that Brightwater is in a location that is difficult to replace and in a market where approvals are increasingly difficult to achieve. We also believe that Brightwater has substantial embedded value that should not be sacrificed under current depressed market conditions but, rather, should be realized over time. Finally, we believe that Brightwater's demographics remain strong due to the continuing regulation-induced constraints on lot supplies and the significant number of affluent households along the coast of Southern California. Therefore, we remain optimistic about continuing sales at Brightwater.

Table of Contents

While we generated 31 net sales orders in the first nine months of 2009, we generated only two net sales orders at Brightwater during the fourth quarter of 2009. We believe the deceleration in sales pace for the fourth quarter of 2009 primarily reflects the negative impact of the Chapter 11 announcement in October 2009. Our pace of sales since December 31, 2009 remained slow, with only five net sales generated through March 31, 2010. We anticipate that sales pace will continue to be negatively impacted until we successfully implement a Chapter 11 plan of reorganization.

We expect that market conditions may continue to be challenging throughout 2010, as unemployment rates remain elevated, foreclosure activity continues to be significant and consumer confidence continues to be eroded. Although substantially reduced home prices and relatively low consumer mortgage interest rates have improved housing affordability, many potential homebuyers remain tepid about purchasing a home in this unstable economic environment. This demand-side dynamic, in conjunction with a high level of foreclosures, is sustaining the oversupply of unsold new and existing homes and competitive pricing pressures that have generated the extremely challenging conditions our industry has experienced since the beginning of 2006.

While it is difficult to predict when a housing market and economic recovery will occur, we believe we have responded with the right strategies to the current and expected near-term housing market environment. We continue to evaluate additional operating and financing strategies to position ourselves for future opportunities. Longer term, we believe favorable demographics and population growth in southern California and a continuing desire for home ownership will drive demand for new homes in our markets, which will allow us to capitalize on the recovery in those markets when it occurs.

In the ordinary course of doing business, we must make estimates and judgments that affect decisions on how we operate and on the reported amounts of assets, liabilities, revenues and expenses. These estimates include, but are not limited to, those related to impairment of assets; capitalization of costs to inventory; cost of sales including estimates for financing, warranty, and other costs; and income taxes. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. On an ongoing basis, we evaluate and adjust our estimates based on the information then currently available. Actual results may differ from these estimates, assumptions and conditions.

Finally, our operating results during 2010 could be adversely affected if housing, credit market, or general economic conditions deteriorate, if job losses accelerate, if consumer mortgage lending becomes less available or more expensive, or if consumer confidence continues to fall, any or all of which would further diminish the prospects for a recovery in the housing market. We believe that there will not be a meaningful improvement in the housing market until there is a sustained decrease in inventory levels, price stabilization, reduced foreclosure rates, greater availability of jumbo-mortgage financing, and the restoration of consumer confidence that can support a decision to buy a home.

**Our Current and Future Homesites**

Our homebuilding operations include active projects in the Huntington Beach area of Southern California. We delivered two homes (one Cliffs and one Breakers) during the three months ended March 31, 2010, compared with seven deliveries (one Sands, one Cliffs, three Breakers and two inland projects homes) during the comparable period in 2009. We acquired no single-family residential lots during the three months ended March 31, 2010 and 2009 and we have no contracts to acquire land or lots.



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## Table of Contents

The following chart describes our current projects, their location and our lot and standing home inventories as of March 31, 2010:

| Project                             | Location         | Commenced Sales | Models (b) | Backlog | Standing Inventory | Specs Under Construction | Remaining Lots | Total Lot Inventory |
|-------------------------------------|------------------|-----------------|------------|---------|--------------------|--------------------------|----------------|---------------------|
| <b>Brightwater in Orange County</b> |                  |                 |            |         |                    |                          |                |                     |
| <b>(a):</b>                         |                  |                 |            |         |                    |                          |                |                     |
| The Trails                          | Huntington Beach | 2007            | 4          | 5       | 1                  | 3                        | 20             | 33                  |
| The Sands                           | Huntington Beach | 2007            | 4          | 1       | 2                  | 3                        | 53             | 63                  |
| The Cliffs                          | Huntington Beach | 2008            | 4          | 5       | 1                  |                          | 89             | 99                  |
| The Breakers                        | Huntington Beach | 2008            | 5          | 1       | 2                  | 1                        | 87             | 96                  |
| <i>Subtotal Orange County</i>       |                  |                 | 17         | 12      | 6                  | 7                        | 249            | 291                 |
| <b>Lancaster:</b>                   |                  |                 |            |         |                    |                          |                |                     |
| Unimproved lots                     | Lancaster        | (c)             |            |         |                    |                          | 73             | 73                  |
| <i>Total All Projects</i>           |                  |                 | 17         | 12      | 6                  | 7                        | 322            | 364                 |

(a) Land acquired in 1970; commenced construction in 2006.

(b) We sold our 17 Brightwater models to an independent third-party investor on December 31, 2008; however, the transaction is accounted for as a financing and therefore those homes are included in our home inventories.

(c) To be determined subject to market conditions.

As of March 31, 2010, we had standing inventory of six Brightwater homes. During the three months ended March 31, 2010, net new orders decreased to five homes compared with seven homes during the comparable period in 2009 due to the absence of sales activity at our inland projects compared with the first quarter 2009. Cancellations as a percentage of new orders were 38% during the three months ended March 31, 2010, compared with approximately 30% during the comparable period in 2009. Backlog as of March 31, 2010 increased to 12 homes compared with eight homes as of March 31, 2009, reflecting five more Brightwater homes in escrow as of March 31, 2010, including four more of the larger Cliffs and Breakers homes.

### *Brightwater at Bolsa Chica*

Brightwater is our coastal Orange County residential community, located on 105 acres of the Bolsa Chica mesa in the City of Huntington Beach, approximately 35 miles south of downtown Los Angeles. Brightwater was annexed into the City of Huntington Beach in 2008. Brightwater offers a broad mix of home choices averaging 2,860 square feet and ranging in size from 1,710 square feet to 4,339 square feet. Located near Pacific Coast Highway and overlooking the Pacific Ocean, Huntington Harbor and the restored 1,300-acre Bolsa Chica Wetlands, 63 of the 356 homes at Brightwater will have unobstructed ocean and/or wetlands views.

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Brightwater is the largest property in our portfolio and, along with other nearby properties (including a five-acre parcel in the process of entitlement), comprises substantially all of our real estate inventories as of March 31, 2010. This project is located on one of the last large undeveloped coastal properties in Southern California. Brightwater is bordered on the north and east by residential development in the City of Huntington Beach and Huntington Harbor, to the south by open space and the 1,300-acre Bolsa Chica wetlands, and to the west by 120 acres of publicly-owned conservation land and open space on the lower bench of the Bolsa Chica mesa, Pacific Coast Highway, Bolsa Chica State Beach, and the Pacific Ocean. Brightwater also has 37 acres of open space and conservation area.

We completed construction of eight model homes at The Trails and The Sands neighborhoods in July 2007, held a grand opening in August 2007 and delivered the first nine homes in December 2007. During January 2008, we completed construction of nine additional model homes for The Cliffs and The Breakers and in February 2008 began selling homes to buyers who previously registered on our priority list. We held a grand opening for these neighborhoods in March 2008. These homes are larger than The Trails and The Sands, ranging from 2,724 to 4,339 square feet. We began delivering homes at The Cliffs and The Breakers during the third quarter of 2008. As of March 31, 2010, we have delivered an aggregate of 65 homes (excluding the 17 model homes) at Brightwater, including 29, 16, 10, and 10 homes at The Trails, The Sands, The Cliffs, and The Breakers, respectively.

Key facts and assumptions regarding the Brightwater development project include the following:

- Brightwater is expected to consist of 356 homes, including 106 homes at The Breakers, 109 homes at The Cliffs, 79 homes at The Sands and 62 homes at The Trails.

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### Table of Contents

- There are 63 homes at Brightwater which will have unobstructed views of the Pacific Ocean and/or the Bolsa Chica wetlands, including 36 homes at The Breakers (five delivered to date), 25 homes at The Cliffs and two homes at The Sands.
- Build-out of production homes, which is subject to market conditions, is currently expected to take approximately five years and be completed in 2014.
- Costs to improve the lots from their raw condition to finished lots, including County permits, City annexation fees and school fees, approximate \$200,000 per lot. As of March 31, 2010, approximately 76% of these lot improvement costs have already been incurred.
- The direct costs (excluding indirect costs such as supervision, overhead, sales and marketing, warranty, insurance, etc.) of building homes at Brightwater are currently expected to range from approximately \$125 to \$140 per square foot.
- Indirect costs are expected to approximate 3% of sales revenues.
- Based on current sales price and cost projections, the various Brightwater products are currently expected to generate gross margins of approximately 5% to 22% due to our low carrying value in Brightwater. Gross margins for the larger homes at The Cliffs and The Breakers are currently expected to approximate 12% to 22%, while gross margins at The Trails and The Sands are currently expected to approximate 5% to 14%. The decrease in expected margins reflects expected increases in interest rates in connection with restructuring our debt, price reductions required to be competitive under current market conditions, additional incentives to sell standing inventory and greater use of third-party real estate brokers.

The estimation process involved in the determination of value is inherently uncertain because it requires estimates as to future events and market conditions. This estimation process assumes our ability to complete development and disposition of our real estate inventories in the ordinary course of business based on management's present plans and intentions. Economic, market, and environmental conditions may affect our development and marketing plans. The development of Brightwater depends upon various factors. Accordingly, the amount ultimately realized from the Brightwater project may differ materially from our current estimates and the project's carrying value.

Deliveries for the three months ended March 31, 2010 and 2009 were as follows:

|                    |                  | Deliveries<br>March 31, |      |
|--------------------|------------------|-------------------------|------|
| Location           |                  | 2010                    | 2009 |
| <b>Brightwater</b> |                  |                         |      |
| The Sands          | Huntington Beach |                         | 1    |
| The Cliffs         | Huntington Beach | 1                       | 1    |

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|                                |                  |   |   |
|--------------------------------|------------------|---|---|
| The Breakers                   | Huntington Beach | 1 | 3 |
|                                |                  | 2 | 5 |
|                                |                  |   |   |
| <u>Inland Empire/Lancaster</u> |                  |   |   |
| Completed Projects             | Various          |   | 2 |
|                                |                  | 2 | 7 |

*Huntington Beach.* We completed construction of the first eight model homes for The Trails and The Sands products which range from 1,710 to 2,160 square feet during July 2007 and opened for sales in August 2007. We completed construction of nine model homes for The Cliffs and The Breakers in January 2008 and began selling homes in February 2008. We delivered nine homes at an average price of \$1.2 million, or \$609 per square foot during 2007 and 23 homes during 2008, at an average price of \$1.4 million, or approximately \$564 per square foot. We delivered 31 homes at an average price of \$1.2 million (including three Breakers view homes averaging \$3.2 million), or approximately \$539 per square foot, during the year ended December 31, 2009. During the three months ended March 31, 2010, we delivered two homes at an average price of \$1.5 million, or approximately \$430 per square foot. As of May 10, 2010, seven Brightwater homes (including two homes with wetland and ocean views) are in escrow at an average price of \$1.5 million, or approximately \$542 per square foot, and 15 additional homes are completed or under construction and have been released for sale.

Table of Contents

*The Trails and The Sands*

We did not deliver any homes at The Trails and The Sands during the three months ended March 31, 2010. During the comparable period of 2009 we delivered one Sands home and generated \$1.1 million in revenue and gross operating margins of 26.4%. We delivered an additional four Trails homes during May 2010 at an average price of \$853,000. Homes at The Trails and The Sands are presently being offered at prices ranging from \$810,000 to \$1.0 million. As of May 10, 2010, three homes are in escrow at The Trails and The Sands, six homes are completed and unsold, and five homes are under construction and unsold.

*The Cliffs and The Breakers*

We delivered two and four homes at The Cliffs and The Breakers during the three months ended March 31, 2010 and 2009, respectively, and generated revenue of \$3.0 million and \$11.1 million, respectively, and gross operating margins of 12.1% and 33.0%, respectively. Three of the four homes delivered during the first quarter of 2009 were view homes with an average sales price of \$3.2 million. The decrease in margins reflects the absence of view premiums for the two homes delivered during the first quarter of 2010, expected increases in interest rates in connection with restructuring our debt, price reductions required to be competitive under current market conditions, and greater use of third-party real estate brokers. We delivered an additional two Cliffs homes during April and May 2010 at an average price of \$1.3 million. Homes at The Cliffs and The Breakers are presently being offered at prices ranging from \$1.3 million to \$3.2 million for 2,724 to 4,339 square foot homes. As of May 10, 2010, four homes are in escrow at The Cliffs and The Breakers, three homes are completed and unsold, and one home is under construction and unsold.

*The Ridge*

We are pursuing entitlement for 22 homes averaging 3,500 square feet in the City of Huntington Beach near our existing Brightwater project. Entitlement of these lots is subject to approval by the City of Huntington Beach and the California Coastal Commission, and is currently expected to take two to three years. On April 27, 2010 the City of Huntington Beach Planning Commission approved The Ridge project and it is currently expected to be presented to the City Council for their approval in July 2010.

*Lancaster.* In April 2005, we acquired 73 unentitled lots in the City of Lancaster in northern Los Angeles County through a subsidiary of Hearthside Homes, Inc. We have deferred the construction start for this 73-unit project, which has no recorded loan, until sales activity in this market improves significantly. The tentative map for this project is prepared, but we have delayed filing for approval in order to defer the entitlement fees required to be paid at the time of filing.

**Critical Accounting Policies and Estimates**

In the preparation of the Consolidated Financial Statements, we applied accounting principles generally accepted in the United States of America. The application of generally accepted accounting principles may require management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying results. Listed below are those policies and estimates that we believe are

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critical and require the use of complex judgment in their application. In particular, our critical accounting policies and estimates include the evaluation of the impairment of long-lived assets and the evaluation of the probability of being able to realize the future benefits indicated by our significant federal tax net operating losses, as discussed further in Notes 3, 4 and 9 to the Consolidated Financial Statements.

### *Basis of Consolidation*

Our Consolidated Financial Statements include our accounts and all of our majority-owned and controlled subsidiaries and joint ventures. Certain of our wholly-owned subsidiaries are members in joint ventures involved in the development and sale of residential projects and residential loan production. The financial statements of joint ventures in which we generally have a controlling or majority economic interest (and thus are controlled by us) are consolidated with our financial statements. Our investments in unconsolidated joint ventures are accounted for using the equity method when we do not have voting or economic control of the venture operations. All significant intercompany accounts and transactions have been eliminated in consolidation.

Table of Contents

*Impairment of Long-Lived Assets*

We recorded inland project impairment charges totaling zero and \$3.2 million during the three months ended March 31, 2010 and 2009, respectively.

We assess the impairment of real estate inventories and other long-lived assets in accordance with ASC 360-10-35 which requires that long-lived assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Impairment is evaluated by comparing an asset's carrying value to the undiscounted estimated cash flows expected from the asset's operations and eventual disposition. If the sum of the undiscounted estimated future cash flows is less than the carrying value of the asset, an impairment loss is recognized based on the fair value of the asset. If impairment occurs, the fair value of an asset is deemed to be the amount a willing buyer would pay a willing seller for such asset in a current transaction. Additionally, as appropriate, we identify alternative courses of action to recover the carrying value of our long-lived assets and evaluate all likely alternatives under a probability-weighted approach as described in ASC 360-10-35.

In accordance with ASC 360-10-35, in developing estimated future cash flows for impairment testing for our real estate inventories, we incorporated our own market assumptions including those regarding home prices, sales pace, sales and marketing costs, infrastructure and home-building costs, and financing costs regarding real estate inventories. Our assumptions are based, in part, on general economic conditions, the current state of the homebuilding industry, expectations about the short- and long-term outlook for the housing market, and competition from other homebuilders in the areas in which we build and sell homes. These assumptions can significantly affect our estimates of future cash flows. As required by ASC 360-10-35, should market conditions deteriorate in the future or other events occur that indicate the carrying amount of our real estate inventories may not be recoverable, we will reevaluate the expected cash flows from each project to determine whether any additional impairment exists at any point in time. For those communities deemed to be impaired, we determine fair value based on discounted estimated future cash flows using estimated absorption rates for each community.

We evaluated our Brightwater project for impairment as of December 31, 2009, and determined that no impairment was indicated based on our projection of the project's future cash flows, including projected revenues, costs and gross margin. We based our assumptions on our evaluation of projected prices while reflecting current marketing efforts, review of competitive home sales, characteristics of the Huntington Beach housing market, and current construction costs. Our relatively lower book basis in Brightwater of \$233.5 million as of March 31, 2010, is due in part to a fair value adjustment recorded in September 1997 under Fresh Start accounting. Since 1997, we have recorded no impairment charges for Brightwater, primarily due to the long holding period and significant increases in home prices since 1997, before the current challenging conditions and price depreciation of the past two years.

The most critical factors in our Brightwater analysis are projected home prices and direct construction costs, as they are affected by market factors such as home sale competition, the availability of financing for home purchases and competition for direct construction goods and services. Since opening for sales at Brightwater in August 2007, we have reduced prices and offered sales incentives in response to the recent difficult conditions in the housing market. We have reflected these price reductions in our projections which reduced average future projected gross margins for the project from approximately 30%-40% in 2007 to 6%-33% as of December 2009 and 5%-22% as of March 2010. The decrease in expected margins also reflects greater expected use of third-party real estate brokers, particularly in the near-term, and expected increases in interest rates in connection with restructuring our debt.

Home prices and direct construction costs are the most critical factors in our impairment analysis and we estimate that a 1% change in home prices or direct construction costs would change gross margin by approximately .75% and .25%, respectively. Due to their subjective and

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interrelated nature, we cannot meaningfully quantify the impact of potential changes for all of the factors considered in our impairment analysis. While there is risk that additional price reductions may be necessary, it appears unlikely that any future price reductions or direct construction cost increases would result in erosion of the entire positive cash flow that we are currently projecting and result in an impairment charge for this project. However, there can be no assurance in that regard because economic and housing market conditions may continue to worsen or other events beyond our control may occur which could result in a change in our assumptions.

In our analysis, we noted that the Brightwater project in Huntington Beach is in a mature housing market with very limited new home construction and a low supply of comparable resale homes with views or competitive features. Further, Huntington Beach has consistently outperformed other coastal Orange County cities with average market times of four months compared with seven to eight months in neighboring coastal cities. Notably, since August 2009, supply at the \$1.0 million to \$1.5 million level has declined from nine months to five months as of May 2010. During the same time period, supply has declined from 21 months to 16 months at the \$2.0 million and above level. In January 2009, the City of

Table of Contents

Huntington Beach's credit rating was raised, reflecting the city's built-out nature and expected economic resilience of the city's households. Huntington Beach is in coastal Orange County which is the subject of two widely respected annual economic forecasts which expect an increase in median home prices in 2010 and an increase in demand due to improved affordability. Therefore, market data support our assumption that our Brightwater project in Huntington Beach will fare better than most surrounding Orange County communities and significantly better than projects in inland areas, resulting in reasonable expectations of price increases in future years given the limited supply of new homes along the coast of Southern California.

In our impairment analysis of the Brightwater project, we also consider projected construction and related costs and the availability of mortgage financing for our potential homebuyers. While mortgage financing for our homes is still challenging, 30-year jumbo mortgage rates have decreased from a national average high of 8.4% in October 2008 to approximately 5.75% currently and lenders are beginning to relax down payment requirements which were as high as 30% for jumbo loans in the Fall of 2009. With the conforming loan maximum in Orange County continuing at \$729,750, a significant portion of our potential homebuyers are able to finance a substantial portion of their home purchase at historically low mortgage rates approximating 5.0%.

The estimation process involved in the determination of value is inherently uncertain since it requires estimates as to future events and market conditions. Such estimation process assumes the Company's ability to complete development and disposition of its real estate properties in the ordinary course of business based on management's present plans and intentions. Economic and market conditions may affect management's development and marketing plans. In addition, the implementation of such development and marketing plans could be affected by the availability of future financing for development and construction activities. Accordingly, the amount ultimately realized from such project may differ materially from current estimates and the project's carrying value.

We believe that the accounting for the impairment of long-lived assets is a critical accounting policy because the valuation analysis involves a number of assumptions that may differ from actual results and the impact of recognizing impairment losses has been material to our Consolidated Financial Statements. The critical assumptions in our evaluation of potential impairment of real estate inventories included projected sales prices, anticipated sales pace within each community, and applicable discount rates, any of which could change materially as economic conditions change.

*Income Taxes*

We account for income taxes on the liability method, in accordance with ASC 740-10, *Income Taxes*. Deferred income taxes are determined based on the difference between the financial statement and tax bases of assets and liabilities, using enacted tax rates in effect in the years in which these differences are expected to reverse. The liability method requires an evaluation of the probability of being able to realize the future benefits indicated by deferred tax assets. A valuation allowance is established against a deferred tax asset if, based on the available evidence, it is more likely than not that such asset will not be realized. The realization of a deferred tax asset ultimately depends on the existence of sufficient taxable income in either the carryback or carryforward periods under tax law. We evaluate on a quarterly basis, whether a valuation allowance should be established based on our determination of whether it is more likely than not that some portion or all of the deferred tax assets will be realized. In our assessment, appropriate consideration is given to all positive and negative evidence related to the realization of the deferred tax assets. This assessment considers, among other matters, the nature, frequency and magnitude of current and cumulative income and losses, forecasts of future profitability, the duration of statutory carryback or carryforward periods, our experience with operating loss and tax credit carryforwards not expiring unused, and tax planning alternatives.

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Our assessment of the need for a valuation allowance on our deferred tax assets includes assessing the likely future tax consequences of events that have been recognized in our Consolidated Financial Statements or tax returns. We base our estimate of deferred tax assets and liabilities on current tax laws and rates and, in certain cases, on business plans and other expectations about future outcomes. Changes in existing tax laws or rates could affect our actual tax results and our future business results may affect the amount of our deferred tax liabilities or the valuation of our deferred tax assets over time.

On October 27, 2009, we filed Chapter 11 Petitions in the Bankruptcy Court. Due to uncertainties regarding the resolution of our Chapter 11 Cases and our ability to utilize our NOLs in the future, during 2009 we recorded a valuation allowance for the remaining amount of our net deferred tax assets. We recorded an additional valuation allowance of \$1.0 million during the first quarter of 2010 related to deferred tax assets generated during the quarter.

Table of Contents

Due to uncertainties in the estimation process, particularly with respect to changes in facts and circumstances in future reporting periods (carryforward period assumptions), it is reasonably possible that actual results could differ from the estimates used in our historical analyses. Our assumptions require significant judgment because the residential homebuilding industry is cyclical and is highly sensitive to changes in economic conditions. Our current assessment of the need for a valuation allowance is primarily dependent upon utilization of tax net operating losses in the carryforward period and our future projected income. If our results of operations are more or less than projected and there is objectively verifiable evidence to support the realization of a different amount of our deferred tax assets, an adjustment to our valuation allowance may be required to reflect greater expected utilization.

We remain subject to the general rules of Section 382 of the Internal Revenue Code, which limit the availability of net operating losses if an ownership change occurs. If we were to experience another ownership change, the amount of net operating losses available would generally be limited to an annual amount equal to (i) the value of our equity immediately before the ownership change, multiplied by the long-term tax-exempt rate (4.03% as of May 2010) plus (ii) recognized built-in-gains, defined as those gains recognized within five years of the ownership change subject to an overall limitation of the net unrealized built-in gains existing as of the ownership change date. We estimate that after giving effect to various transactions by stockholders who hold a 5% or greater interest in the company, we have experienced a three-year cumulative ownership shift of approximately 29% as of May 10, 2010, as computed in accordance with Section 382. In the event of an ownership change, our use of our NOLs may be limited.

On May 13, 2010, we reinstated a ban on acquisitions of additional shares of our Common Stock, under certain circumstances, in order to preserve the tax benefits of our \$164 million of NOLs. In accordance with provisions of our charter documents, unless we have previously consented in writing (i) no stockholder may acquire shares in an amount that would cause the stockholder to own 5% or more of the common stock; and (ii) no current 5% or greater stockholder may acquire any additional shares of common stock.

All acquisitions of our common stock in violation of our charter prohibitions are null and void, and we are empowered to effectively reverse the effect of any such acquisitions. Our Board of Directors may, but is not required to, entertain requests for permission to exceed the limitations on stock acquisitions under circumstances it determines are not likely to jeopardize our ability to preserve and use our NOLs.

*Homebuilding Revenues and Cost of Sales*

Our homebuilding operation generates revenues from the sale of homes to homebuyers. The majority of these homes are designed to appeal to move-up homebuyers and are generally offered for sale in advance of their construction. Sales contracts are usually subject to certain contingencies such as the buyer's ability to qualify for financing. Revenue from the sale of homes is recognized at the close of escrow when title passes to the buyer and the earnings process is complete. As a result, our revenue recognition process does not involve significant judgments or estimates. However, we do rely on certain estimates to determine the related construction costs and resulting gross margins associated with revenues recognized. The cost of sales is recorded based upon total estimated costs within a subdivision and allocated using the relative sales value method. Our construction costs are comprised of direct and allocated costs, including estimated costs for future warranties and indemnities. Our estimates are based on historical results, adjusted for current factors.

*Litigation Reserves*

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We and certain of our subsidiaries have been named as defendants in various cases arising in the normal course of business and regarding assets and businesses disposed of by us or our former affiliates. See Notes 8 and 10 to our Consolidated Financial Statements beginning on page 5. We have reserved for costs expected to be incurred with respect to these cases based upon information provided by our legal counsel. There can be no assurance that total litigation costs actually incurred will not exceed the amount of such reserve.

### **Recent Accounting Pronouncements**

See discussion regarding New Accounting Pronouncements in Note 3 to the Consolidated Financial Statements.

### **Results of Operations**

After filing the Chapter 11 Cases, we are required to periodically file various documents with, and provide certain information to the Bankruptcy Court, including statements of financial affairs, schedules of assets and liabilities, and monthly operating reports in forms prescribed by Chapter 11, as well as certain financial information on an unconsolidated basis. Such materials will be prepared according to requirements of Chapter 11. While we believe that these documents and reports provide then-current information required under Chapter 11, they are prepared only for the Debtors and, therefore, certain

## Table of Contents

operational entities are excluded. In addition, they are prepared in a format different from that used in our Consolidated Financial Statements filed under the securities laws and they are unaudited. Accordingly, we believe that the substance and format do not allow meaningful comparison with our regular publicly-disclosed Consolidated Financial Statements. Moreover, the materials filed with the Bankruptcy Court are not prepared for the purpose of providing a basis for an investment decision relating to our securities, or for comparison with other financial information filed with the SEC.

The following tables set forth key operating and financial data for our homebuilding operations for the three months ended March 31, 2010 and 2009.

### **Backlog as of March 31**

| Homes in Backlog |      |        | Value (\$ in millions) |        |        | Average Selling Price (\$ in thousands) |          |        |
|------------------|------|--------|------------------------|--------|--------|-----------------------------------------|----------|--------|
| 2010             | 2009 | Change | 2010                   | 2009   | Change | 2010                                    | 2009     | Change |
| 12               | 8    | 50.0%  | \$ 15.8                | \$ 9.1 | 73.6%  | \$ 1,319                                | \$ 1,134 | 16.3%  |

### **Homes Delivered Three Months Ended March 31**

| Homes Delivered |      |         | Value (\$ in millions) |         |         | Average Selling Price (\$ in thousands) |          |         |
|-----------------|------|---------|------------------------|---------|---------|-----------------------------------------|----------|---------|
| 2010            | 2009 | Change  | 2010                   | 2009    | Change  | 2010                                    | 2009     | Change  |
| 2               | 7    | (71.4)% | \$ 3.0                 | \$ 12.8 | (76.6)% | \$ 1,500                                | \$ 1,829 | (18.0)% |

### *Three Months Ended March 31, 2010 Compared with the Three Months Ended March 31, 2009*

We reported revenues of \$3.0 million and gross operating profit of \$400,000 for the first quarter of 2010, compared with \$12.8 million in revenues and gross operating profit of \$800,000 for the first quarter of 2009. Revenues in the current period reflect deliveries of two Brightwater homes. The comparable period of the prior year reflects deliveries of seven homes, including five homes at Brightwater and two inland homes. Gross operating profit for the first quarter of 2009 includes a non-cash impairment charge of \$3.2 million, reflecting a fair value write-down for an inland project in Beaumont which was disposed on September 30, 2009.

We generated \$3.6 million less in gross operating profit before impairment charges from home sales as a result of delivering only two homes at Brightwater which generated a 12.1% gross margin, compared with five Brightwater deliveries which generated a 32.2% gross margin during the comparable period in 2009. The decrease in gross margin reflects the fact that three of the five Brightwater homes delivered during the first quarter of 2009 included view premiums, compared with none in the first quarter of 2010. In addition, the decrease in gross margin during the first quarter of 2010 reflects expected increases in interest rates in connection with restructuring our debt as well as sales price reductions offered in response to the continuing difficult conditions in the housing market and greater use of third-party brokers.

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Reorganization costs of \$1.3 million during the first quarter of 2010 reflect legal and professional fees and other costs associated with the Chapter 11 bankruptcy proceedings.

The \$700,000 decrease in interest expense compared with the first quarter of 2009 primarily reflects the absence of various inland projects which were sold or disposed in 2009 for which we are no longer incurring period costs.

### *Payments Under Contractual Obligations*

Our purchase contracts which are made in the normal course of our homebuilding business for land acquisition and construction subcontracts are generally cancelable at will. Other contractual obligations including our tax liabilities, accrued benefit liability for a frozen retirement plan and other accrued pensions, home warranty reserves and contingent indemnity and environmental obligations are estimated based on various factors. Payments are not due as of a given date, but rather are dependent upon the incurrence of professional services, the lives of annuitants and other factors. The estimation process involved in the determination of carrying values of these obligations is inherently uncertain since it requires estimates as to future events and contingencies. We have provided additional disclosure below in Part II Item 1 Legal Proceedings, and in Note 10 to our Consolidated Financial Statements above.

Table of Contents**Liquidity and Capital Resources**

On September 28, 2009, we received a notice of an event of default from the agent to the lending syndicate with respect to the loan-to-value covenant of the Revolving Loan that would give rise to the right to accelerate the indebtedness under the Revolving Loan and Term Loan. In addition, on October 1, 2009, we received a notice of an event of default with respect to our nonpayment of approximately \$1.7 million of principal that was due on September 30, 2009 under the terms of the Revolving Loan that would also give rise to the right to accelerate the indebtedness under the Revolving Loan and Term Loan. As of March 31, 2010, \$81.7 million and \$99.8 million of principal was outstanding under the Revolving Loan and Term Loan, respectively.

The filing of the Chapter 11 Petitions on October 27, 2009, also constituted events of default under the Revolving Loan and the Term Loan that can trigger acceleration of the indebtedness. However, the filing of the Chapter 11 Petitions automatically stayed those actions against us and the other Debtors. Under the terms of Bankruptcy Court orders, we have continued to pay interest on the outstanding principal balance at pre-default interest rates.

While we are striving to restructure our debt through the Chapter 11 Cases, unless we are successful in amending and extending the terms of the Revolving Loan and Term Loan agreements, we do not believe that our cash, cash equivalents and future real estate sales proceeds will be sufficient to meet our debt obligations or to meet anticipated operating and project development costs for Brightwater, and general and administrative expenses during the next 12 months. These factors raise substantial doubt about our ability to continue as a going concern. The Consolidated Financial Statements herein do not include any adjustments that might result from the outcome of this uncertainty.

Year-over-year changes in the principal components of our liquidity and capital resources are as follows (in millions, except percentages):

| <b>Three Months Ended</b>                       |             |       |             |     |
|-------------------------------------------------|-------------|-------|-------------|-----|
| <b>March 31,</b>                                |             |       |             |     |
|                                                 | <b>2010</b> |       | <b>2009</b> |     |
| Cash and cash equivalents                       | \$          | 4.7   | \$          | 8.4 |
| Cash (used in) provided by operating activities |             | (4.2) |             | 5.5 |
| Cash provided by financing activities           |             |       |             | 0.6 |

The principal assets in our portfolio are residential lots which must be held over an extended period of time in order to be developed to a condition that, in management's opinion, will ultimately maximize our return. Consequently, we require significant capital to finance our real estate development and homebuilding operations. Historically, sources of capital have included loan facilities secured by specific projects and available internal funds. Our unrestricted cash and cash equivalents as of March 31, 2010 aggregated \$4.7 million, the use of which is subject to the Bankruptcy Court's interim cash collateral order.

Since the filing of the Chapter 11 Cases we have only been paying interest under the Term and Revolving Loans as we continue to seek approval of our plan of reorganization to change principal payment schedules and to extend maturities.

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*March 31, 2010 Compared with December 31, 2009*

Cash used in operating activities of \$4.2 million for the first quarter of 2010 primarily reflects investments in Brightwater of \$5.8 million, general and administrative costs of \$1.4 million and restructuring costs of \$1.3 million, which were partially offset by net proceeds from sales of \$2.8 million and the increase in accounts payable and accrued liabilities discussed below.

The \$1.5 million increase in accounts payable and accrued liabilities primarily reflects an increase of \$700,000 for accrued reorganization costs, and increases in accrued amounts for other professional fees and Brightwater project construction.

### **Off Balance Sheet Financing**

In the ordinary course of business, we may enter into land option contracts in order to procure land for the construction of homes. The use of such option agreements allows us to reduce the risks associated with land ownership and development; reduce our financial commitments, including interest and other carrying costs; and minimize land inventories. Under such land option contracts, we will fund a specified option deposit or earnest money deposit in consideration for the right to purchase land in the future, usually at a predetermined price. Our liability is generally limited to forfeiture of the nonrefundable deposits, letters of credit and other nonrefundable amounts incurred. As of March 31, 2010, we have no land option deposits and no third party guarantees.

Table of Contents

We also may acquire land and conduct residential construction activities through participation in joint ventures in which we hold less than a controlling interest. Through joint ventures, we reduce and share our risk and also reduce the amount invested in land, while increasing our access to potential future home sites. The use of joint ventures also, in some instances, enables us to acquire land which we might not otherwise obtain or access on as favorable terms, without the participation of a strategic partner. While we view the use of unconsolidated joint ventures as beneficial to our homebuilding activities, we do not view them as essential to those activities.

Under the requirements of ASC 810, *Consolidation* ( ASC 810 ), certain of our land option contracts may create a variable interest for us, with the land seller being identified as a VIE. In compliance with ASC 810, we analyze our land option contracts and other contractual arrangements and consider whether we should consolidate the fair value of certain VIEs from which we are purchasing land under option contracts. As of March 31, 2010, we had no deposits with VIEs.

**Impact of Inflation, Changing Prices and Economic Conditions**

Real estate and residential housing prices are affected by a number of factors, including but not limited to uncertainty by potential homebuyers in the stability of the United States and global economy, inflation or deflation, interest rate changes, competition and the supply of new and existing homes to be purchased. Uncertainty in the stability of the national economy and significant volatility in the banking system and financial markets can, and has, caused potential homebuyers to refrain from committing to make significant purchases, including the purchase of new homes. In the event the volatility in the banking system and financial markets continues to remain high and the national economy does not stabilize in the near term, our ability to sell new homes to potential homebuyers can be impacted negatively.

The long-term impact of inflation may affect us through increased costs for land, land development, construction and overhead, as well as in increased sales prices of our homes. Our land acquisition costs are generally fixed, therefore, increases or decreases in the sales prices of homes will affect our profits. The sales price of each of our homes is fixed at the time a buyer enters into a contract to acquire a home. Therefore, if we sell our homes before we begin construction, any inflation of costs in excess of those anticipated may result in lower gross margins, unless these increased costs are recovered through higher sales prices.

Also, deflation can cause the market value of our land and constructed homes to decline which could negatively impact our results of operations. If interest rates increase, construction and financing costs, as well as the cost of borrowings, could also increase, which can result in lower gross margins on home sales. Increases in home mortgage interest rates make it more difficult for our customers to qualify for home mortgage loans, potentially decreasing home sales revenue. Increases in interest rates also may affect adversely the volume of mortgage loan originations. Increases in competition and the supply of unsold new and existing homes have had an adverse effect on our ability to generate new home orders and maintain home orders in backlog, and have had a significant negative impact on our results of operations and gross margins on home sales in our inland markets.

Interest rates, the length of time that land remains in inventory and the proportion of inventory that is financed affect our interest costs. If we are unable to raise sales prices enough to compensate for higher costs, or if mortgage interest rates increase significantly, affecting prospective buyers' ability to adequately finance home purchases, our revenues, gross margins and net income would be adversely affected. Increases in sales prices, whether the result of inflation or demand, may affect the ability of prospective buyers to afford new homes.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

We utilize variable rate debt financing for acquisition, development and construction of homes. The interest rates on our debt approximate the current rates available for secured real estate financing with similar terms and maturities, and as a result, their carrying amounts approximate fair value. While changes in interest rates generally may not impact the fair market value of the debt instrument, they do affect our earnings and cash flows. Holding our variable rate debt balance constant as of March 31, 2010, each one point percentage increase in interest rates would result in an increase in variable rate interest incurred for the next 12 months of approximately \$1.8 million.

Table of Contents

We are exposed to market risks related to fluctuations in interest rates on our outstanding variable rate debt. We do not utilize swaps, forward or option contracts on interest rates, or other types of derivative financial instruments. We do not enter into or hold derivatives for trading or speculative purposes.

You should be aware that many of the statements contained in this section are forward looking and should be read in conjunction with our disclosures under the heading "Forward-Looking Statements."

**Item 4. Controls and Procedures**

*Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures*

Our chief executive officer and chief financial officer, with the assistance of management, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report (the "Evaluation Date"). Based on that evaluation, our chief executive officer and chief financial officer concluded that, as of the Evaluation Date, our disclosure controls and procedures were effective to ensure that information required to be disclosed in our reports under the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to management, including our chief executive officer and chief financial officer, as appropriate to allow timely decisions regarding required disclosure.

However, no matter how well a control system is conceived and operated, it can provide only reasonable, not absolute, assurance that the objectives of the control system are met. In addition, the design of a control system must reflect the fact that there are resource constraints and the benefits of controls must be considered relative to costs. Therefore, no cost-effective control system and no evaluation of controls can provide absolute assurance that all control issues and instances of misstatements due to error or fraud, if any, within our company have been detected.

*Changes in Internal Controls*

There have been no changes in our internal control over financial reporting during the three months ended March 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings.**

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See Notes 8 and 10 to the Consolidated Financial Statements above, and Item 1 - Business - Corporate Indemnification Matters and Item 3 - Legal Proceedings in our Annual Report on Form 10-K for the year ended December 31, 2009.

### Item 6. Exhibits.

- 10.05 California Coastal Communities, Inc. 401(k) Plan and Trust Agreement dated effective April 30, 2010.
- 31.1 Section 302 Certificate of Raymond J. Pacini, Chief Executive Officer of California Coastal Communities, Inc.
- 31.2 Section 302 Certificate of Sandra G. Sciutto, Chief Financial Officer of California Coastal Communities, Inc.
- 32.1 Section 906 Certificate of Raymond J. Pacini, Chief Executive Officer and Sandra G. Sciutto, Chief Financial Officer of California Coastal Communities, Inc.\*

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\* These certifications are being furnished solely to accompany this report pursuant to 18 U.S.C. Section 1350, and are not being filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and are not to be incorporated by reference into any filing of the Company, whether made before or after the date hereof, regardless of any general incorporation language in such filing.

Table of Contents

**SIGNATURE**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: May 13, 2010

CALIFORNIA COASTAL COMMUNITIES, INC.

By:

*/s/ Sandra G. Sciutto*  
SANDRA G. SCIUTTO  
Senior Vice President and  
Chief Financial Officer