

CALIFORNIA COASTAL COMMUNITIES INC

Form 10-Q

November 12, 2010

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2010

OR

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 November 1, 2010 there were 10,995,902 shares of Common Stock, par value \$.05 outstanding

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CALIFORNIA COASTAL COMMUNITIES, INC.

(DEBTOR-IN-POSSESSION)

FORM 10-Q

FOR THE QUARTER ENDED SEPTEMBER 30, 2010

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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 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;
- the potential for additional real estate impairment charges;
- 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;
- the impact of recent accounting pronouncements; and

- stock market valuations.

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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; our dependence on the California market; the 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 debt facilities after we emerge from bankruptcy; 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 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 together with the Risk Factors set forth therein. You should also read the following Consolidated Financial Statements and the related notes.

Forward-looking statements speak only as of the date they are made and 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)

	September 30, 2010	December 31, 2009
ASSETS		
Cash and cash equivalents	\$ 3.0	\$ 8.9
Restricted cash	0.8	0.8
Real estate inventories	225.1	235.4
Other assets, net	2.3	4.8
	\$ 231.2	\$ 249.9
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities not subject to compromise:		
Accounts payable and accrued liabilities	\$ 4.9	\$ 2.9
Model home financing	22.5	22.5
Other liabilities	1.6	0.4
Total liabilities not subject to compromise	29.0	25.8
Liabilities subject to compromise:		
Accounts payable and accrued liabilities	1.1	0.9
Revolving loan	81.7	81.7
Term loan	99.8	99.8
Other liabilities	8.4	8.3

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Total liabilities subject to compromise	191.0	190.7
Commitments and contingencies		
Stockholders' equity:		
Common Stock \$.05 par value; 13,500,000 shares authorized; 10,995,902 shares issued and outstanding	0.5	0.5
Excess Stock \$.05 par value; 13,500,000 shares authorized; no shares outstanding		
Additional paid-in capital	59.6	59.5
Accumulated deficit	(46.3)	(24.0)
Accumulated other comprehensive loss, net	(2.6)	(2.6)
Total stockholders' equity	11.2	33.4
	\$ 231.2	\$ 249.9

See the accompanying notes to Consolidated Financial Statements.

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CALIFORNIA COASTAL COMMUNITIES, INC.

(DEBTOR-IN-POSSESSION)

CONSOLIDATED STATEMENTS OF OPERATIONS

(in millions, except per share amounts)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Revenues:				
Homebuilding	\$ 5.6	\$ 9.6	\$ 16.3	\$ 32.9
Land sales		1.8	1.4	1.8
	5.6	11.4	17.7	34.7
Costs of sales:				
Homebuilding	5.0	8.0	15.0	25.4
Land sales		1.8		1.8
Loss on impairment of real estate inventories	8.0		14.0	3.2
	13.0	9.8	29.0	30.4
Gross operating (loss) profit	(7.4)	1.6	(11.3)	4.3
Selling, general and administrative expenses	1.0	1.1	3.2	3.6
Reorganization costs	2.3		6.0	
Interest expense	0.1		0.1	0.8
Gain on debt restructuring		(4.1)		(24.8)
Other expense, net	1.3	1.1	1.6	1.8
(Loss) income before income taxes	(12.1)	3.5	(22.2)	22.9
Income tax expense	0.1	21.6	0.1	37.1
Net loss	\$ (12.2)	\$ (18.1)	\$ (22.3)	\$ (14.2)
Net loss per common share:				
Basic and diluted	\$ (1.11)	\$ (1.65)	\$ (2.03)	\$ (1.29)
Common equivalent shares:				

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Basic and diluted	11.0	11.0	11.0	11.0
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See the accompanying notes to Consolidated Financial Statements.

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CALIFORNIA COASTAL COMMUNITIES, INC.

(DEBTOR-IN-POSSESSION)

CONSOLIDATED STATEMENTS OF CASH FLOWS

(in millions)

(unaudited)

	Nine Months Ended September 30,	
	2010	2009
Cash flows from operating activities:		
Net loss	\$ (22.3)	\$ (14.2)
Adjustments to reconcile net loss to cash used in operating activities:		
Gain on debt restructuring		(24.8)
Model homes depreciation	0.2	0.2
Deferred taxes	(8.3)	8.9
Deferred tax asset valuation allowance	8.4	28.2
Gains on sales of real estate inventories and land	(2.6)	(7.5)
Loss on impairment of real estate inventories	14.0	3.2
Proceeds from sale of real estate inventories and land, net	17.0	33.6
Increase in real estate inventories	(17.0)	(21.8)
Accrued or prepaid reorganization costs	1.0	
Changes in assets and liabilities:		
Decrease in other assets	1.0	1.3
Increase in accounts payable, accrued and other liabilities	2.7	0.3
Cash (used in) provided by operating activities	(5.9)	7.4
Cash flows from investing activities:		
Change in restricted cash		0.4
Cash provided by investing activities		0.4
Cash flows from financing activities:		
Borrowings of revolving loan		26.5
Repayments of revolving loan		(19.2)
Repayments of term loan		(7.6)
Repayments of other project debt		(5.9)
Deferred financing costs		(0.2)
Cash used in financing activities		(6.4)
Net (decrease) increase in cash and cash equivalents	(5.9)	1.4

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Cash and cash equivalents - beginning of period		8.9		2.3
Cash and cash equivalents - end of period	\$	3.0	\$	3.7
Supplemental disclosures of cash flow information:				
Cash paid or received during the period for income taxes	\$	1.0	\$	0.1
Cash paid during the period for reorganization items		4.4		
Supplemental disclosures of non-cash investing and financing activities:				
Amortization of deferred financing costs capitalized in real estate inventories	\$	1.3	\$	1.7
Decrease in project debt and accrued liabilities due to debt restructuring	\$		\$	32.8

See the accompanying notes to Consolidated Financial Statements.

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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 and the current year's previously issued Quarterly Reports on Form 10-Q. 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 successful in that regard. Unless the Company is successful in executing a bankruptcy reorganization plan, or otherwise 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 provide sufficient liquidity to meet its current debt obligations under the current terms of the existing Revolving Loan agreement and Term Loan agreement as described in Notes 5 and 6, in addition to meeting 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 unless the Company is successful in replacing or restructuring its Revolving Loan and Term Loan debt through confirmation of a plan of reorganization in the Chapter 11 Cases.

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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 Company and the other Debtors described below 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 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

Overview

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

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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 post-petition vendors, 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.

The Company has 13 direct or indirect consolidated subsidiaries that 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 and a hearing on the adequacy of the disclosure statement was held on May 12, 2010. Subsequently, on June 18, 2010, the Company obtained a financing commitment from Luxor Capital Group, LP (Luxor) to provide \$184 million of new debt financing and on July 2, 2010 filed a revised disclosure statement and proposed joint plan of reorganization, which were further revised on July 28, 2010. On August 31, 2010, the Luxor financing commitment expired.

The Company is continuing to negotiate with its lenders to develop a consensual plan of reorganization, however 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 in a manner that is acceptable to the Bankruptcy Court and the creditors and other parties in interest.

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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 nine months ended September 30, 2010, the Company incurred reorganization costs aggregating approximately \$6.0 million and has incurred total reorganization costs of \$7.3 million through such date.

The Company's liquidity and capital resources are significantly affected by the Chapter 11 Cases, which have resulted in various restrictions on its activities, limitations on financing and the requirement of obtaining 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 is currently scheduled to terminate on December 3, 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 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 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 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 Chapter 11 Cases. While the Company generated 31 net sales orders in the first nine months of 2009, it generated only 10 net sales orders at Brightwater during the comparable period of 2010, which the Company believes reflects the negative impact of the Chapter 11 Cases, as well as continued economic uncertainties, high unemployment and a general downturn in the housing market in the middle of 2010.

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 before and after it emerges from bankruptcy. 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 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.

Based on Brightwater sales in 2009 and the first nine months of 2010, unless the Company is successful in executing a plan of reorganization in the Chapter 11 Cases, the Company does not believe that its cash, cash equivalents and future real estate sales proceeds will provide sufficient liquidity to meet its current debt obligations under the current terms of the existing Revolving Loan Agreement and Term Loan Agreement as described in Notes 5 and 6, in addition to its 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 unless the Company is successful in replacing or restructuring its Revolving Loan and Term Loan debt through confirmation of a plan of reorganization in the Chapter 11 Cases, as described above. 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 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.

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Reorganization Costs

Reorganization costs include legal and professional fees incurred in connection with the Chapter 11 Cases. During the three and nine months ended September 30, 2010, the Company incurred \$2.3 million and \$6.0 million, respectively, of reorganization costs and paid approximately \$2.5 million and \$4.4 million, respectively, of such costs. The Company has incurred total reorganization costs of \$7.3 million from October 2009 through September 30, 2010.

Over-the-Counter Market

On April 27, 2010, the Company's common stock commenced trading under the symbol *CALCQ* in the OTCQB marketplace for Over-The-Counter stocks registered on the Securities and Exchange Commission which are current on registration filings. The Company's common stock was delisted from the Nasdaq Stock Market at the open of trading on April 27, 2010 as a result of the Company's inability to emerge from the Chapter 11 process by April 26. 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 15g-9 of the Securities Exchange Act of 1934, as amended, commonly referred to as the penny stock rule.

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 Company currently has an interest in one inactive joint venture in which the Company has a controlling or majority economic interest, and thus is controlled by the Company and is 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

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beginning in the quarter ended 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. See Note 2 for discussion regarding the Chapter 11 Cases.

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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 a plan of reorganization can be completed. 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 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.

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 and nine months ended September 30, 2010, the Company recorded impairment charges of \$8.0 million and \$14.0 million, respectively on the Brightwater project. See Note 4 Real Estate Inventories. During the comparable periods in 2009, the Company recorded zero Brightwater project impairment charges and inland project impairment charges totaling zero and \$3.2 million, respectively.

In making its determination to record Brightwater project impairments, the Company has incorporated various 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, in accordance with ASC 360-10-35, in developing estimated future cash flows for impairment testing for its 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 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.

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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 September 30, 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 September 30, 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.

The following table summarizes the Company's fair value measurements at September 30, 2010 (in millions):

Description	Fair Value Hierarchy	Fair Value	Impairment Charges for the Nine Months Ended September 30, 2010
Real estate inventories	Level 3	\$ 219.4	\$ 14.0

In accordance with ASC 360, real estate inventories with a carrying value of \$233.0 million were determined to be impaired during the three months ended June 30, 2010 and further impaired during the three months ended September 30, 2010, resulting in a year-to-date impairment charge of \$14.0 million which is reflected in cost of sales. The Brightwater inventories were written down to their estimated fair value of \$219.4 million, after net additions of \$400,000 during the three months ended September 30, 2010. See *Impairment of Real Estate Inventories* above and Note 4 Real Estate Inventories.

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.

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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 and nine months ended September 30, 2010, the Company recorded valuation allowance adjustments on deferred tax assets totaling \$5.0 million and \$8.4 million, respectively. During the comparable periods in 2009, the Company recorded valuation allowance adjustments on deferred tax assets totaling \$20.6 million and \$28.2 million, respectively. See Note 9 Income Taxes.

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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 the Company utilizes a portion of its NOLs or certainty increases regarding the Company's use of its NOLs due to projected results of operations and there is objectively verifiable evidence to support the expected 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. In addition, if an ownership change occurs as a result of the Company's emergence from Chapter 11, the utilization of tax net operating losses in the carryforward period is likely to be materially jeopardized.

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 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.

Loss Per Common Share

Loss per common share is accounted for in accordance with ASC 260-10, *Earnings Per Share*. Basic earnings (loss) 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 September 30, 2010, real estate inventories aggregated 279 lots and homes, including 17 model homes, 10 standing inventory homes completed and unsold, three homes completed and in escrow, two homes under construction and in escrow and two inventory homes under construction. Real estate inventories at September 30, 2010 included \$224.5 million recorded for 262 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 being planned for 22 homes 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 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.

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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.

During the second quarter of 2010, a non-Debtor subsidiary of the Company sold a 60-acre parcel of land in Huntington Beach, California which was encumbered by an oil lease and a conservation easement for \$1.4 million.

During the three and nine months ended September 30, 2010, the Company recorded impairment charges of \$8.0 million and \$14.0 million, respectively, with respect to its Brightwater project. During the three and nine months ended September 30, 2009, the Company recorded inland project impairment charges totaling zero and \$3.2 million, respectively.

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 September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Capitalized interest, beginning of period	\$ 40.7	\$ 37.5	\$ 36.8	\$ 37.3
Interest incurred and capitalized	2.9	5.0	9.0	12.2
Charged to cost of sales	(1.2)	(2.9)	(3.4)	(5.7)
Charged to gain on debt restructuring		(2.8)		(7.0)
Capitalized interest, end of period	\$ 42.4	\$ 36.8	\$ 42.4	\$ 36.8

Note 5 Revolving Loan

See Note 2 for a detailed discussion of the status of the Chapter 11 Cases which commenced October 27, 2009. Since that date, the Company has not made any payments of principal on the Revolving Loan or the Term Loan described below in Note 6; however the Company continues to pay interest on the outstanding principal balances at agreed upon non-default interest rates.

As of September 30, 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

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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, and did not repay the loan in full on the June 30, 2010 maturity date resulting in an aggregate of \$81.7 million of principal due and unpaid as of September 30, 2010.

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 and nine months ended September 30, 2010 was \$700,000 and \$2.6 million, respectively, at weighted-average interest rates of 3.56% and 3.53%, respectively. Interest incurred on the Revolving Loan for the three and nine months ended September 30, 2009 was \$1.0 million and \$3.2 million, respectively, at weighted-average interest rates of 3.54% and 3.67%, 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 LIBOR + 3.25% and was current on such interest payments as of September 30, 2010. On July 28, 2010, the Bankruptcy Court approved a settlement agreement between the Debtors, the agent and the existing lenders that provided, among other things, that no default interest will be due.

As of September 30, 2010, the Company has delivered 94 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 14 homes (six Trails, one Sands, five Cliffs and two Breakers) delivered during the nine months ended September 30, 2010. Due to the Chapter 11 Cases, no principal payments were made on the 24 homes delivered during the fourth quarter of 2009 and the first nine months of 2010.

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As of September 30, 2010 and December 31, 2009, approximately zero and \$500,000, respectively, of deferred loan fees and closing costs related to the Revolving Loan are included in other assets and were amortized over the expected 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 30%, regarding which the Company has been notified it is in default.
- 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 minimum liquidity covenant which requires the Company to maintain a minimum cash balance of \$4.0 million at all times.
- A prohibition on dividends.

As of September 30, 2010, the Company's consolidated total liabilities are \$220.0 million, tangible net worth after excluding the 2009 and 2008 inland impairment charges and valuation allowances on deferred tax assets is \$93.2 million and the leverage ratio is 2.36. 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's unrestricted cash balance of \$3.0 million as of September 30, 2010, does not comply with its minimum liquidity requirement of \$4.0 million.

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 was unable to fully repay the Revolving Loan by its current maturity date on June 30, 2010 from cash flow from operations. Through the Chapter 11 reorganization process, the Company is striving to restructure its debt to incorporate payments that will 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 this endeavor.

Note 6 Term Loan

See Note 2 for detailed discussion of the status of the Chapter 11 Cases which commenced October 27, 2009. Since that date, the Company has not made any payments of principal on the Term Loan or the Revolving Loan described above in Note 5; however the Company continues to pay interest on the outstanding principal balances at agreed upon non-default interest rates.

As of September 30, 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, \$15.0 million, \$10.0 million and \$15.0 million due on December 31, 2009, March 31, 2010, June 30, 2010 and September 30, 2010, respectively, resulting in an aggregate of \$49.8 million of principal due and unpaid as of September 30, 2010.

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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 and nine months ended September 30, 2010 was \$1.4 million and \$4.0 million, respectively, at weighted-average interest rates of 4.31% and 4.28%, respectively. Interest incurred on the Term Loan for the three and nine months ended September 30, 2009 was \$1.4 million and \$4.6 million, respectively, at weighted-average interest rates of 4.29% and 4.61%, 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 LIBOR + 4.00% and was current on such interest payments as of September 30, 2010. On July 28, 2010, the Bankruptcy Court approved a settlement agreement between the Debtors, the agent and the existing lenders that provided, among other things, that no default interest will be due.

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 \$1.0 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 24 homes delivered during the fourth quarter of 2009 and first nine months of 2010.

As of September 30, 2010, the Company has delivered 94 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 14 homes (six Trails, two Sands, five Cliffs and one Breakers) delivered during the nine months ended September 30, 2010, and made cumulative mandatory repayments for the Term Loan of \$25.2 million prior to the filing of the Chapter 11 Cases.

As of September 30, 2010 and December 31, 2009, approximately \$1.0 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.

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.
- 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 of 45% as of September 30, 2010 and thereafter, regarding which the Company has been notified it is in default.
- An interest coverage covenant which prohibits the Company's ratio of EBITDA to interest incurred from being less than 2.00 to 1.00.

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- A minimum consolidated tangible net worth covenant of \$80 million, excluding impairment charges for inland projects and valuation allowances on deferred tax assets.
- A minimum liquidity covenant which requires the Company to maintain a minimum cash balance of \$4.0 million at all times.
- A prohibition on dividends.

As of September 30, 2010, the Company's consolidated total liabilities are \$220.0 million, tangible net worth after excluding the 2009 and 2008 inland impairment charges and valuation allowances on deferred tax assets is \$93.2 million and the leverage ratio is 2.36. 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's unrestricted cash balance of \$3.0 million as of September 30, 2010, does not comply with its minimum liquidity requirement of \$4.0 million.

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, June 30, or September 30, 2010. Through the Chapter 11 reorganization process, the Company is striving to restructure its debt to incorporate payments that will 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 this endeavor.

Table of Contents**Note 7 Model Home Financing**

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.

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 allows 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. In connection with the Chapter 11 Cases, the Bankruptcy Court approved the Company's assumption of this lease on September 29, 2010. During the three and nine months ended September 30, 2010, the Company made model home lease payments totaling \$788,000 and \$2.4 million, respectively. 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	\$ 0.8
2011	3.3
Total	\$ 4.1

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

As of September 30, 2010 and December 31, 2009, other liabilities not subject to compromise included contingent indemnity and environmental obligations totaling \$1.6 million, including a reserve for the California Department of Toxic Substances Control matter discussed below.

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As of September 30, 2010 and December 31, 2009, other liabilities subject to compromise were comprised of the following (in millions):

	Subject to Compromise	
	September 30, 2010	December 31, 2009
Accrued pensions and benefits	\$ 5.6	\$ 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)
	\$ 8.4	\$ 8.3

Accrued pensions and benefits includes the accrued benefit liability for the Company's defined benefit retirement plan for which the benefit accrual for all participants was terminated on December 31, 1993. Due to the prohibition on payments for prepetition liabilities in the Company's Chapter 11 Cases, no assets have been contributed to the plan during 2010. Contingent indemnity and environmental obligations primarily reflect (i) 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 and (ii) a reserve recorded during the three months ended September 30, 2010 related to a claim by the California Department of Toxic Substances Control, discussed below.

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.

A trial date in the District Court case has been set for November 16, 2010. After considering the legal costs of continuing to defend itself, HRC has determined that it will allow the DTSC to obtain a default judgment against it. The DTSC has already filed a proof of claim in the Bankruptcy Cases and will presumably assert that the Company should pay the amount of the HRC default judgment under an alter ego theory of liability. The Company believes that defending itself against any prospective liability in the Bankruptcy Cases will be a better allocation of resources and will have a greater likelihood of success than funding HRC to go to trial in the District Court. While the Company does not believe the DTSC has a valid claim based on the merits of its case or under an alter ego theory of liability, since HRC will allow the DTSC to obtain a default judgment against it, applicable accounting rules require the Company to accrue for DTSC's approximately \$1.2 million of claims against HRC during the third quarter of 2010.

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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):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Balance at beginning of period	\$ 1.9	\$ 1.8	\$ 1.9	\$ 1.7
Provision				0.1
Adjustment due to change in estimate				
Payments				
Balance at end of period	\$ 1.9	\$ 1.8	\$ 1.9	\$ 1.8

Note 9 - Income Taxes

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Current taxes	\$	\$	\$	\$
Deferred taxes	(4.9)	1.0	(8.3)	8.9
Valuation allowances on deferred tax assets	5.0	20.6	8.4	28.2
Income tax expense	\$ 0.1	\$ 21.6	\$ 0.1	\$ 37.1

During 2009 and the first nine months 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 for federal alternative minimum tax paid for years prior to 2009 authorized by the November 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 carry backs of the applicable NOL. In June 2010, the Company filed a refund claim for the amount of the tax receivable and received the refund during the third quarter of 2010.

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The federal NOLs available as of September 30, 2010 were approximately \$166 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 \$75 million thereafter.

Internal Revenue Code (the Code) Section 382 generally limits the availability of NOLs if an ownership change occurs. The Code defines an ownership change as a shift of stock ownership of more than 50% generally within a three-year period. If the Company were to experience an ownership change, it would determine if it has an overall net unrealized built-in gain (NUBIG) or overall net unrealized built-in loss (NUBIL). Assuming the Company has a NUBIG, the use of all remaining NOLs would generally be subject to an annual limitation equal to (i) the value of the Company's equity before the ownership change plus the increase in the value of the Company resulting from any debt cancellation through the Chapter 11 Cases, multiplied by the long-term tax-exempt rate (3.86% as of November 2010) plus (ii) built-in gains recognized within five years of the ownership change, subject to an overall limitation of the NUBIG. Assuming the company has a NUBIL, the use of NOLs (and other built-in losses subject to an overall limitation of the NUBIL) would generally be subject to an annual limitation equal to the value of the Company's equity before the ownership change plus the increase in the value of the Company resulting from any debt cancellation through the Chapter 11 Cases, multiplied by the long-term tax-exempt rate (3.86% as of November 2010). If the Company's NUBIG or NUBIL is not greater than the lesser of (a) 15% of the fair market value of its assets or (b) \$10 million, then the NUBIG or NUBIL is deemed to be zero.

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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 44% as of November 1, 2010, as computed in accordance with Section 382. The cumulative shift includes the effect of an approximate 15% ownership shift which occurred in the second quarter of 2010 upon the sale of a large stockholder's position. 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 certainty increases regarding the Company's use of its NOLs or projected results of operations and there is objectively verifiable evidence to support the expected 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. In addition, if an ownership change occurs as a result of the Company's emergence from Chapter 11, the utilization of tax net operating losses in the carryforward period is likely to be materially jeopardized.

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 necessitated 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. Therefore, 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 \$166 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.

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 \$4.8 million at September 30, 2010, \$100,000 would decrease the Company's effective tax rate if recognized. During the quarter ended September 30, 2010, the Company's unrecognized tax benefits decreased by approximately \$100,000 as a result of the expiration of statutes of limitations. The Company expects that its unrecognized tax benefits will decrease by approximately \$1.4 million within 12 months of the reporting date due to statutes of limitation lapses.

The Company recognizes interest expense and penalties related to uncertain tax positions as interest or other expense. As of September 30, 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 2007 through 2009 remain open for Federal purposes for which the Company utilized NOLs generated in 1993 to offset taxable income. The years 2006 through 2009 remain open for California purposes, during which time the Company utilized NOLs generated in 2007.

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.

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Note 10 - Commitments and Contingencies

Real Estate Matters

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 primarily for the Brightwater project. 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 including matters discussed in Note 8 above. 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.

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 September 30, 2010, total stockholders' equity is \$11.2 million, reflecting beginning stockholders' equity of \$33.4 million, net loss of \$22.3 million, and a \$100,000 reduction in unrecognized tax benefits during the nine months ended September 30, 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.

During the nine months ended September 30, 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 the Chapter 11 Cases. The 2009 restricted shares vested at a rate of 25% per quarter during 2009. The Company is currently prohibited from issuing shares due to the Chapter 11 Cases.

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The Company did not grant any options during the nine months ended September 30, 2010 and 2009. Pursuant to ASC 718-10, *Compensation Stock Compensation*, the Company recorded zero and \$53,000 of compensation expense during the nine months ended September 30, 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 nine months ended September 30, 2010 follows:

	Number of Options	Weighted-Average Exercise Price	Weighted-Average Remaining Life
Outstanding, January 1	17,500	\$ 21.58(a)	
Granted		\$	
Exercised		\$	
Outstanding, September 30	17,500	\$ 21.58(a)	5.35 years
Fully vested and exercisable at September 30	17,500	\$ 21.58(a)	5.35 years
Available for future grants at September 30	221,794		

(a) Adjusted for special dividend of \$12.50

As of September 30, 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 5.35 years. All outstanding stock options are fully vested. The aggregate intrinsic value of all outstanding, fully-vested and exercisable stock options at September 30, 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 ASC 718-10. 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.

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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 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 post-petition vendors, 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 we 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.

We have 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 our current operations and have no current material operations.

On March 26, 2010, we filed a proposed disclosure statement and proposed joint plan of reorganization with the Bankruptcy Court and a hearing on the adequacy of the disclosure statement was held on May 12, 2010. Subsequently, on June 18, 2010, we obtained a financing commitment from Luxor Capital Group, LP ("Luxor") to provide \$184 million of new debt financing and on July 2, 2010 filed a revised disclosure statement and proposed joint plan of reorganization, which were further revised on July 28, 2010, with the Bankruptcy Court. On August 31, 2010, the Luxor financing commitment expired.

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We are continuing to negotiate with our lenders to develop a consensual plan of reorganization, however 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 in a manner that is acceptable to the Bankruptcy Court and the creditors and other parties in interest.

We and the other Debtors continue to operate our business as debtors-in-possession. We have incurred and will continue to incur significant costs associated with the reorganization which are expected to significantly affect our results of operations. During the nine months ended September 30, 2010, we incurred reorganization costs aggregating approximately \$6.0 million and have incurred total reorganization costs of \$7.3 million through such date.

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 the requirement of obtaining 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. Our authorization to continue to use cash collateral and to sell homes free and clear of liens is currently scheduled to terminate on December 3, 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 when we 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.

We depend on cash flows generated from operations 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 Chapter 11 Cases. While we generated 31 net sales orders in the first nine months of 2009, we generated only 10 net sales orders at Brightwater during the comparable period of 2010, which we believe reflects the negative impact of the Chapter 11 Cases, as well as the continued economic uncertainties, high unemployment and a general downturn in the housing market in the middle of 2010.

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 or new financings can be obtained in order for us to meet our debt obligations before and after we emerge from bankruptcy. 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 additional financing, and the terms of such financing if it is available. The current housing and mortgage markets also present significant uncertainty as to our 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 to the Consolidated Financial Statements for further discussion.

Based on Brightwater sales in 2009 and the first nine months of 2010, unless we are able to successfully execute a plan of reorganization with respect to the Chapter 11 Cases, we do not believe that our cash, cash equivalents and future real estate sales proceeds will provide sufficient liquidity to meet our current debt obligations under the current terms of the existing Revolving Loan Agreement and Term Loan Agreement as described in Notes 5 and 6 to the Consolidated Financial Statements, in addition to our anticipated operating and project development costs for

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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 unless we are successful in replacing or restructuring our Revolving Loan and Term Loan debt through confirmation of a plan of reorganization in the Chapter 11 Cases. The Consolidated Financial Statements herein do not include any adjustments that might result from the outcome of this uncertainty.

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Over-the-Counter Market

On April 27, 2010 our common stock commenced trading under the symbol `CALCQ` in the OTCQB marketplace for Over-The-Counter stocks registered on the Securities and Exchange Commission which are current on registration filings. Our common stock was suspended from trading on the Nasdaq Stock Market on April 27, 2010 because we had not emerged from the Chapter 11 process by April 26, 2010. Our common stock was officially delisted on June 21, 2010. 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.

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 three 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 three months of 2010, our primary goals will be to:

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- propose a consensual plan of reorganization to restructure our debt obligations which can be confirmed by the Bankruptcy Court as soon as possible, and would enable us to emerge from Chapter 11 bankruptcy in early 2011; 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.

Our total revenues for the three months ended September 30, 2010 and 2009 were \$5.6 million and \$11.4 million, respectively and \$17.7 million and \$34.7 million for the nine months ended September 30, 2010 and 2009 respectively. For the three months ended September 30, 2010 and 2009, we delivered four and 21 homes, respectively. Our total assets as of September 30, 2010 and December 31, 2009 were \$231.2 million and \$249.9 million, respectively, with Brightwater and other nearby properties constituting \$224.5 million (97% of total assets) and \$234.8 million (94% of total assets), respectively. Our homebuilding subsidiary, Hearthsides 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 September 30, 2010, we had \$204.0 million of debt (including the model homes lease) against \$11.2 million of book equity.

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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 and business conduct, audit committee charter and nominating committee charter.

Homebuilding Outlook and Operating Strategy

The housing market downturn that began in 2006 and accelerated when the financial crisis and economic recession began in 2007 has continued through the third quarter of 2010. Specifically, the credit markets and the mortgage industry have experienced a period of unparalleled turmoil and disruption characterized by bankruptcy, declining home prices and restrained demand, low consumer confidence, high unemployment, financial institution failure, consolidation and an unprecedented level of intervention by the United States federal government. This disruption of 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 in relation to the levels of consumer demand, particularly in light of record numbers of foreclosed homes which are being offered at substantially reduced prices. These pressures in the marketplace forced homebuilders to use increased sales incentives and price reductions in an effort to generate sales and reduce inventory levels throughout 2009 and the first nine months of 2010.

Although the National Bureau of Economic Research recently concluded that the national recession that began in December 2007 ended in June 2009, weakness in the homebuilding environment has continued as unemployment remains at very high rates. Economic uncertainty and the lapse of government support incentives for homebuyers continue to hamper the homebuilding industry, despite some modest economic improvements. The main factors driving these conditions have been mounting sales of lender-owned homes acquired through mortgage foreclosures and short sales which has been fueled by increasing mortgage delinquencies, greater voluntary or involuntary mortgage defaults, and the lifting to varying degrees of voluntary lender foreclosure moratoriums; a generally weak economic and employment environment; tightened mortgage credit standards and reduced credit availability; tepid consumer confidence; intense competition for home sales; and the actual or proposed winding down, reduction or reversal of government programs and policies supportive of home ownership. We expect these factors to continue to negatively impact housing markets to varying degrees through the fourth quarter of 2010 and into 2011.

The broader homebuilding industry has experienced a continuously depressed level of new home sales, which we believe was exacerbated by a general hesitation in the national and global markets due to the oil spill in the Gulf of Mexico; uncertainty of the European financial system; and declines in the stock market earlier this 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 12.2% at both the end of the third quarter of 2010 and at the end of the third quarter of 2009, while the unemployment rate in Orange County was 9.6% in September 2010 compared with 9.4% in September 2009. We believe that as long as these high unemployment rates continue, they will be one of the key barriers to commitment to a home-buying decision for our potential customers and will continue to impact the sales pace of the industry as a whole.

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 nine months of 2010 and 2009. We believe the weak demand we are experiencing, particularly for homes over \$1.5 million, reflects the excess supply of higher end homes in the coastal Huntington Beach market, as well as homebuyers' reluctance to make a purchasing decision until they are comfortable that home prices have stabilized. In addition, uncertainties surrounding future economic growth and our continuing

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Chapter 11 Cases have suppressed our home sales. The inventories of resale homes in the Huntington Beach coastal zip codes have been declining, reducing the supply of resale homes with which Brightwater may compete, and the jumbo-mortgage market is showing signs of gradual improvement. However, there can be no assurance that these trends will continue.

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During 2009, the California home-buyer tax credit enacted early in the year boosted demand somewhat; however, the federal stimulus plan did not significantly impact sales at our Brightwater project due to its income and first-time buyer restrictions. As the credits expired, demand declined. 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. As of August 15, 2010, the Franchise Tax Board stopped accepting applications for the first-time buyer credit and as of September 14, 2010, the Franchise Tax Board reported that it is likely that applications for more than \$100 million of the new home credit have been received, although it is still accepting applications.

Our overall outlook remains cautious given the significant negative factors and trends noted above and the uncertainty as to when our served markets may experience a sustained recovery. We continue to believe a meaningful improvement in housing market conditions will require a sustained decrease in unsold homes, price stabilization, reduced mortgage delinquency and foreclosure rates, improved economic activity and employment levels, and the restoration of both consumer and credit market confidence that support a decision to buy a home. We cannot predict when these events may occur. While we have begun to see some positive signs that these negative trends in the overall economy are moderating, 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 and into 2011 as lenders seek to unload their inventory of foreclosed homes. 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 remain reluctant to purchase a Brightwater 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 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 November 2010, the spread has narrowed to approximately .50% to .90%. 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.

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

- continued offering incentives for all of our homes in order to reduce inventory at Brightwater; and
- pursued a proposed joint plan of reorganization for relief under Chapter 11 in the Bankruptcy Court in order to restructure the approximately \$182 million of Brightwater indebtedness under the Revolving Loan and the Term Loan and to pay certain costs of exiting the Chapter 11 process.

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, our results

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for 2010 are 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 consumer 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.

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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;
- 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 nine months of 2010 and 2009, we delivered 14 and 39 (including 21 Brightwater) homes, respectively. As of November 9, 2010, three additional homes have been delivered, bringing year-to-date deliveries to 17 homes, and three additional homes are in escrow, as discussed further under Item 1 Business Our Current and Future Homesites below.

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, prior to our bankruptcy filing that impact appeared 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 once we emerge from bankruptcy.

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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 and 10 net sales orders during the first nine months of 2010. We believe the deceleration in sales pace for the fourth quarter of 2009 and the first nine months of 2010 primarily reflects the negative impact of the Chapter 11 announcement in October 2009. 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 will continue to be challenging throughout the remainder of 2010 and into 2011, as unemployment rates remain elevated, foreclosure activity continues to be significant and consumer confidence continues to be eroded. Although substantially reduced home prices and low consumer mortgage interest rates have improved housing affordability, many potential homebuyers remain tepid about purchasing a home in this uncertain 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.

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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 the fourth quarter of 2010 and in 2011 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, a significant improvement in job growth 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 14 homes (six Trails, two Sands, five Cliffs and one Breakers) during the nine months ended September 30, 2010, compared with 39 deliveries (11 Trails, four Sands, two Cliffs, four Breakers and 18 inland project homes) during the comparable period in 2009. We acquired no single-family residential lots during the nine months ended September 30, 2010 and 2009 and we have no contracts to acquire land or lots.

The following chart describes our current projects, their location and our lot and standing home inventories as of September 30, 2010:

Project	Location	Commenced Sales	Models (b)	Backlog	Standing Inventory	Specs Under Construction	Remaining Lots	Total Lot Inventory
<u>Brightwater in Orange County</u>								
<u>(a):</u>								
The Trails	Huntington Beach	2007	4	2	4		17	27
The Sands	Huntington Beach	2007	4	1	3	1	52	61
The Cliffs	Huntington Beach	2008	4	1	1		89	95
The Breakers	Huntington Beach	2008	5	1	2	1	87	96
<i>Subtotal Orange County</i>			17	5	10	2	245	279
<u>Lancaster:</u>								
Unimproved lots	Lancaster	(c)					73	73
<i>Total All Projects</i>			17	5	10	2	318	352

(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 and leased them back; however, the lease 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 September 30, 2010, we had standing inventory of 10 Brightwater homes. During the nine months ended September 30, 2010, net new orders at Brightwater decreased to 10 homes compared with 31 homes during the comparable period in 2009 due to the negative impact of our Chapter 11 bankruptcy on buyer confidence, the continued weak economic environment, and the absence of sales activity at our inland projects compared with the first nine months of 2009. During the first nine months of 2010 we had no sales of inland homes compared with 17 (excluding the sale of 62 finished lots and four model homes at the Woodhaven project) during the first nine months of 2009. Cancellations as a percentage of new orders were 33.0% during the nine months ended September 30, 2010, compared with approximately 11.1% during the comparable period in 2009 with the higher cancellation rate in the first nine months of 2010 reflecting the negative impacts of the general economy and our continuing Chapter 11 bankruptcy process. Backlog for Brightwater as of September 30, 2010 decreased to five homes compared with 17 homes as of September 30, 2009.

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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.

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 September 30, 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 September 30, 2010, we have delivered an aggregate of 77 homes (excluding the 17 model homes) at Brightwater, including 35, 17, 14, and 11 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.
- 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 (two delivered to date) 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 2015.
- 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 September 30, 2010, approximately 77% 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 \$115 to \$132 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 3% to 18%. Gross margins for the larger homes at The Cliffs and The Breakers are currently expected to approximate 12% to 18%, while gross margins at The Trails and The Sands are currently expected to approximate 3% to 10%. The decrease in expected margins as compared with the prior quarter expectation reflects greater than expected use of outside brokers, particularly in the near term and incentives provided to buyers during our Chapter 11 Cases, partially offset by reduced basis due to valuation reserves.

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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 and nine months ended September 30, 2010 and 2009 were as follows:

Location	Deliveries	
	Three Months Ended September 30, 2010	Nine Months Ended September 30,