COMMERCIAL OBSERVER

Dealing with Condominium Construction Loan Defaults

BY STUART SAFT OCTOBER 29, 2019 2:55 PM REPRINTS

STUART SAFT. CHRIS MORRIS

There have been numerous reports regarding the softening condominium market resulting from the excess capacity of expensive units (i.e., over $10 million). The softening could lead to developers not meeting their repayment milestones and ultimately to defaults, workouts or foreclosures. Because of the unusual nature of condo construction lending, lenders need to be cognizant of certain issues unique to condo financing.

Condo financing is different from virtually any other kind of lending, particularly in New York State, due to the fact that there are at least four parties with an interest in the expeditious completion of the construction: the borrower, the lender, potential buyers, and the New York State Attorney General (NYAG) — even though only two parties (the borrower and the lender) were signatories to the loan documents. Unlike other forms of construction loans, the two non-signatories with interest in the process (the potential buyers of the units and the NYAG), play a critical role in making certain that the loans are repaid. A lender ignoring the NYAG (in whose jurisdiction condo formation and sales occur) and the effect of their actions on the market could see the value of their collateral diminish.

There are multiple issues to consider in dealing with potential condo loan defaults, but none more pressing than deciding whether to issue a Notice of Default which, in all other forms of financing, is a routine issue. In the event that the borrower has not complied with the terms of the loan documents, sending the notice becomes critically important but, if sent prematurely, could result in a significant adverse impact because of the significance of the Notice of Default to the NYAG. Upon the receipt of the notice by a borrower-sponsor, sales must cease, closing of signed contracts postponed, the sales office closed, marketing curtailed and the offering plan amended to disclose all material factors related to the default. Counterintuitively, halting sales while the sponsor is not performing a loan provision and then commencing sales after the issue is resolved without actually declaring a default can be more expedient.

Accordingly, knowing when to send a Notice of Default, what kind of notice to send, and how to resolve the issue without sending a Notice of Default is important to everyone involved.

It is imperative that the lender review all of the condo documents and the filings with the NYAG before deciding the appropriate action to take. This is due to the potential liability to the sponsor and its impact on the value of the collateral if the offering plan failed to fully and adequately disclose material facts relating to the offering. The lender must also ascertain whether the borrower has performed all of its obligations pursuant to the terms of the offering plan and the NYAG's regulations or the lender (or the successor sponsor) could be obligated to take such actions.

The lender also has to determine whether the building construction or rehabilitation is in accordance with the approved building plans on file with both the New York City Department of Buildings and the NYAG. Finally, the lender should review the executed purchase agreement to become aware of specific promises or deadlines that were made to purchasers that could become an issue for the lender.

Of course, if the lender determines that the borrower did not make adequate disclosures or there are other significant issues the lender or a successor sponsor can have the offering plan amended. Conversely, once the sponsor declares the plan effective and units have already closed, the lenders options are limited although the debt will be reduced with each sale.

If the borrower has acted in accordance with the loan documents and the offering plan, in most default situations it makes sense for the lender to permit the borrower to complete the project and avoid the risk of negative publicity, litigation, or an NYAG investigation. Frequently leaving the borrower in control of the project is the most efficient and effective way of proceeding without increasing the lender's exposure to risk or diminishing the likelihood of loan repayment.

It is important to note that unlike many other states, New York does not impose liability to a lender or successor sponsor for the original sponsor's mistakes. The original sponsor is responsible for their own mistakes — although the successor sponsor may decide to fix the original sponsor's mistakes in order to improve the marketability of the remaining units.

A softening of the real estate market always poses issues for lenders, but there is no reason why the project cannot be completed and the units sold if properly handled, which is an important lesson from prior market softenings.

Stuart Saft is a partner at Holland & Knight.