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Protecting Condominium Construction Lenders When Developers Default

By Stuart M. Saft*

This article examines the best practices for a lender to proceed prior to and during a default by the developer of a mixed-use condominium.

A softening real estate market is problematic for all construction lenders, but particularly for lenders financing the development of condominiums, which entail a great deal of risk as a result of the nature of a condominium and the government's involvement in the process of creating, selling and, sometimes, operating condominiums. A lender acting pursuant to its loan documents to enforce its rights could unintentionally become involved in either a state investigation or disputes with unit owners or purchasers. Moreover, seemingly minor transgressions could result in the developer's inability to close units, that were subject to executed purchase agreements which, the lender assumed, would provide the funds to repay the loan.

This article examines the best practices for a lender to proceed prior to and during a default by the developer of a mixed-use condominium.

PRE-NOTICE OF DEFAULT NOTICE DUE DILIGENCE

Due diligence prior to declaring an event of default is critically important in order for the lender to fully appreciate any exposure that it might have. The reason condominium construction financing requires a heightened review by the lender is because of the fact that the units themselves could be considered by regulators as a security and, as such, are subject to local, state and federal securities and consumer protection laws. There is also a risk of litigation by lawyers bringing lawsuits against developers by purchasers or contract vendees and attempting to involve the construction lender, who is frequently the only available deep pocket involved in the condominium development process. The review must include an analysis of:

- The offering material;

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- The condominium's declaration, bylaws, and other formation and governing documents;
- The state condominium act and, if applicable, the securities laws of the state in which the condominium is located and the state where the units were sold;
- Federal securities and consumer protection laws, which could impact sales;
- The executed purchase and sale or other agreement for the units (collectively, the purchase agreement);
- Sales and marketing materials that were used in the sale of the units; and
- The borrower/developer's compliance with the loan covenants in developing the property and the closing of any units.

One of the construction lender's largest concerns must always be that, upon completion of the condominium's construction, the units are marketable and that the condominium's common elements and units are in conformance with the law, regulations and offering documents, as well as the traditional lender concerns relating to compliance with local municipal codes, and construction practices and procedures. Unlike the financing of other forms of real estate, condominium construction financing necessitates that the units can and will be salable and are actually sold in order for the construction loan to be repaid or for the lender to be able to litigate its position to a developer or another lender. Even if the construction has been completed, a certificate of occupancy issued and the declaration of condominium, which forms the condominium, is recorded, it does not necessarily mean that the loan can or will be repaid. However, satisfaction of each of the foregoing steps is an essential precursor to repayment.

The specific documents that need to be reviewed include: the declaration of condominium; bylaws and tax maps/floor plans; the certificate of incorporation in those jurisdictions that require one; the offering plan/prospectus or other documents (the public offering statement or "POS") filed with the state or other agency that has jurisdiction over the sale of condominium units; filings under the Interstate Land Sales Full Disclosure Act ("ILSA"), if required; the applicability of the federal Condominium and Cooperative Abuse Relief Act; as well as compliance with the local or state procedures for forming the condominium and selling the units. It is imperative that the condominium formation requirements are met because, if the condominium is not legally formed and operating, then the units that are subject to purchase agreements cannot or could not have closed and provide the funds to repay the loan.

It is also essential that, if the first closing has already occurred, the lender must be certain, that a valid and legal condominium was established. This necessitates a complete familiarity with the laws of the state in which the condominium is located as well as the laws of the state in which sales were made. It is important to note that every state has its own, unique condominium law and, although many states follow the Uniform Condominium Act or the Uniform Common Interest Ownership Act, there are variances that must be considered. In the case of condominiums, one size does not fit all.

In this regard, it is important to note that condominiums are creatures of state statute and cannot exist unless they are in compliance with state law. Many states also permit the issuance of a title insurance endorsement providing affirmative insurance that the declaration will create a valid and legal condominium. While this endorsement cannot be issued at the closing of the construction loan because the declaration will not be recorded and the condominium formed by that time, some title insurance companies will agree to issue a letter committing to issue the endorsement upon the future recordation of the declaration of condominium.

The lender must also make certain that the condominium will function in a way that will not have an adverse impact on the developer, any owner of unsold units and the lender because, the lender may be required to obtain the ownership of the unsold units or sell its position to a third party, who will become the owner of the unsold units. This concern also has to include the lender's ability to benefit from any special developer rights and limit the adverse impact of being liable for the developer's actions or failure to act in developing the property. This review must ascertain that:

- There is nothing that would render the title to the units unmarketable;
- The documents cannot be amended in a way that is adverse to the lender's interest without the lender's approval;
- There is no limitation on the sale, lease or financing of the unsold units;
- The condominium's board of managers, cannot interfere in the marketing, sale or use of the units; and
- Easements or other restrictions on the sale of units cannot be created that will have an adverse effect on the units.

In addition, since Fannie Mae and Freddie Mac have developed specific regulations relating to condominiums, the review of the governing documents must ensure that the current Fannie Mae and Freddie Mac regulations are not violated and, that any future requirements can be easily incorporated into the governing documents. Finding a problem in the foregoing review would necessitate having the problem eliminated prior to, or as part of, any workout or restructuring.

OPERATION OF THE CONDOMINIUM

The lender should also be concerned about:

- The proper operation of the condominium;
- The manner in which the operating costs are allocated;
- The decision-making process for electing and operating a board;
- Special developer rights and control;
- Limitations on the board increasing the common charges and assessments, particularly on the unsold units;
- The process for making repairs, replacements, improvements, additions and alterations to the units and the common elements;
- The basis for the allocation of the percentage interests in the common elements;
- Existing lawsuits by purchasers;
- Enforcement actions by regulators;
- Incomplete sales;
- Existing unit owner defaults;
- Issues with the construction including building, fire or health code violations; and,
- Most importantly, whether the cost of operating the condominium and the unit common charges are consistent with the projections contained in the offering material.

The reason for this concern is that any of the foregoing issues could result in a significant increase in the common charges and assessments and, therefore, the costs of the condominium, which could become a burden on the lender or its successor, and because there is an inverse ratio between the amount of the common charges and assessments and the value of the units, higher costs will result in a lower value for the units.

Moreover, the lender has to be concerned over the use of casualty insurance proceeds and condemnation awards because, once the declaration is filed and the lender's lien is on the individual units and not the common elements or the entire property, the provisions contained within the loan documents will no longer be relevant. For example, what if the governing documents provided that, in the event of a casualty, the condominium would be restored unless all of the unit owners elected to terminate the condominium and distribute the insurance proceeds to the unit owners?

However, if there was a fire after only 10 units closed in a 300-unit complex, any one of the initial 10 unit owners could refuse to elect to terminate the condominium, in which event the construction lender would be forced to wait until the condominium is restored before receiving proceeds to be used to repay the loan since the declaration and not the loan documents, would govern the decision to reconstruct the project. In order to avoid such a problem, the documents should provide a mechanism for making certain that the lender's interests are protected without creating an impediment to sales. The lender also has to determine whether the building is being built in accordance with the approved building plans on file with the local municipality.

PURCHASE AGREEMENTS

The purchase agreements for the units are extremely important documents since they are the basis pursuant to which the loan will be repaid. The primary concern in reviewing the purchase agreements are to determine whether the purchaser is obligated to close and whether the developer is obligated to meet certain conditions prior to the closing, which the lender might not be able to meet.

However, the lender will also not want to be forced to close if there is the likelihood that there will not be a sufficient number of sales. The lender would not want to proceed with dividing the property into units and common elements and then find out that, because of the insufficiency of sales or a changing market or economy, only a *de minimis* number of the units are sold resulting in the lender finding itself in a *de facto* "partnership" with the owners of a minority of the units, who have a different agenda than the lender.

Of course, the purchase agreement cannot provide that the closings do not have to occur if the lender does not want to close, but if no closings have occurred the lender might be able to cancel the purchase agreements and sell the entire building. The lender should also make certain that the purchase agreements will be enforceable under state and federal law and that the purchasers do not have any rights to rescind their contracts, which could permit them to terminate the contracts without a forfeiture of their deposits.

The lender should also be concerned that the developer is not obligated to close by a certain date specified in individual contracts and, if so, whether the date can be met. The lender should also determine if one or more units have to be completed in a manner that would be difficult or impossible to achieve by an outside closing date. Of paramount importance are any rights that the purchaser may have to terminate the purchase agreement and receive a refund of its deposit and any limitations on the deposit being paid to the lender after a default, including complying with regulatory requirements.

The understanding of state law becomes particularly important in reviewing the purchase agreements because of issues such as:

(a) Lien priority;

(b) Whether the lender's lien is subordinate to, or subordinated by, the deed to purchasers and/or their purchase agreements; or

(c) Whether the sponsor can use part or all of the deposit in the development of the condominium and, if so, under what circumstances.

An additional issue is a situation where the deposits are payable in installments in which event the lender should make certain that the mechanism and the result of the payment or failure to pay is clearly defined.

If the project has not been completed, the lender should determine if the purchase agreements permit the developer to make changes and modifications to the plans and specifications for the project if necessitated by governmental requirements or changes in circumstances, as long as the purchaser is not materially and adversely affected. The developer should also have the right to substitute materials, change floor plans and make other changes as are deemed necessary during construction that are not material to a unit even if the unit is subject to the purchase agreement. The purchase agreement must be flexible enough to reflect the reality of large construction projects and the inevitable changes and modifications that will occur during such processes.

In addition, the purchase agreement should provide which party obtains the interest that accrues on the deposit and the conditions for its release. The purchase agreement should also indicate whether deposits have to be retained in escrow or can or were used by the developer or the conditions for the release of such deposits, the sponsor's counsel or title insurer will be the escrow agent, that the escrow requirements are consistent with local law and, that the purchaser's rights with regard to the escrowed funds are limited unless the sponsor is in default.

THE OFFERING MATERIALS

The relationship between the developer and the condominium association and its unit owners is largely dependent on the statute and regulations issued by the regulators in the state in which the condominium is located (and, in some instances, the state where sales are made) and the terms and conditions contained within the POS. Although the POS cannot contradict the provisions contained within the local condominium law, and the federal and state securities laws that relate to the offering of securities, in general, and purchase agreements, in particular, the POS may contain specific limitations on the obligations of the developer and the unit owners.

Moreover, many states provide the developer with special rights and limitations on those rights in order to:

(1) Permit the expeditious completion of the residential development;

(2) Provide the unit owners with the ability to control their destiny;

(3) Make certain that the developer fulfills its obligations under the law and the POS; and

(4) Provide comfort to the construction lenders.

Since purchasers would be able to rescind their purchase agreements and have their deposits returned for material misstatements or omissions in the POS or otherwise claim that they were damaged if relevant information became unavailable after the closing, the lender will want to be certain that the state's offering requirements are satisfied.

Lenders must keep the special developer's rights and obligations in mind when determining how to deal with a default. It should be noted that pursuant to state law, developers are frequently obligated to:

- Complete construction of the condominium and turn it over to the purchasers in good condition;
- Provide all of the amenities that are promised;
- Satisfy any financial obligations that arise as a result of the developer's acquisition, development or sale of the units including removal of the developer's financing as well as any other liens on the sold unit; and
- Turn over control of the condominium association to the unit owners.

As is obvious from the foregoing discussion, the special rights, described below, which are granted to developers are extremely valuable to the lender, who has the right to make certain they are preserved in order to protect its loan.

The issues that have arisen in the past regarding special developer control have created complex problems for lenders, which are rarely easy to resolve. Among the problems faced by lenders are:

- The developer's inability to sell enough units and at a high enough price to complete construction and satisfy the construction loans;

- Lack of unit purchasers or purchasers who are not willing or able to pay the minimum purchase price necessary to enable the developer to satisfy its obligations to its lenders and other creditors;
- Faulty construction causing the developer to be sued; or
- The developer and the lender have done their jobs but, as result of the changing economy, the market disappears.

In each of these instances regardless of whether the developer has done anything wrong, the burden of resolving the issue may fall on the lender. As a result, the lender could inherit problems with the unsold units.

Special developer rights include the right to control certain aspects of the condominium in order to facilitate the developer's completion of the property. These special rights frequently include the right to complete construction, the right to initially control the board, the right to expand the condominium (if the condominium was supposed to be expandable and the law permits expandable condominiums) and the right to enter into certain other agreements. The special developer rights are sometimes assignable and frequently expire if not utilized within a certain period of time or when certain sales thresholds have been met.

Likewise, local law may place obligations on the developer requiring it to provide purchasers with disclosure documents in a certain form, maintain the association's records, release construction mortgages prior to the conveyance of completed units, and complete construction in accordance with local building codes and zoning requirements. Local law could also give the unit owners the ability to bring actions against the developer for violating any of the foregoing provisions.

One of the considerations for both lenders and potential purchasers of the developer's interests (and the attendant special developer rights) are concerns about the liability that flows with the special developer rights, which frequently results in the lender foregoing foreclosing its loan in order to avoid potential liability.

The lender or a potential assignee may not want to have liability for construction problems, failure to maintain the property, failure to maintain the appropriate reserves, issues regarding the condominium's financing or lack of funds. In some jurisdictions the special developer rights become attached to the unsold units, while in other states the purchaser has to assume the special developer rights in order to be bound by them. It is imperative that the lender understand the potential risk attendant to special developer rights.

However, regardless of what the law provides, the existing unit owners frequently, consider both the lender acquiring its collateral and the purchaser of the unsold units as a successor developer and someone obligated to solve the condominium's problems. Unfortunately, both the governing documents and state law may not provide the developer or its successor with the ability to make decisions.

The other question that needs to be understood is whether a successor developer is able to continue selling units or rent them until the market improves. Some POSs contain specific provisions with regard to the ability of the developer or successor developer to lease rather than sell units. The developer can continue selling units, but if the units cannot be sold for a price that equals or exceeds the debt on the unit, the lender is certainly not going to favor a sale that results in a loss.

An additional problem for the lender, who takes over a project, is attempting to alter the marketing strategy or construction plans in order to appeal to potential purchasers whose attitude toward the property needs to be changed in order for there to be a successful marketing campaign. The problem is that the developer is committed to developing the property in a certain way to comply with the POS and the governing documents, thereby making it difficult for the developer or its lender to change its position after the initial units are sold. A successor developer or lender will frequently believe that changing the project increases the likelihood of sales, but this is not necessarily fast or doable.

Another idea for a lender or the successor developer is to decrease or increase the number of units, which changes the percentage interest in the units for the owners of the existing units. Although existing unit owners are in favor of unit sales, they may not be prepared to have their own assessments increased nor have the amenities that they purchased reduced.

In addition, the unit owners may not be in favor of a change in the common elements with the intention of increasing the number of units so that the sales prices can be less per unit and still allow the successor sponsor to make a profit on its investment while the existing unit owners lose the benefit of the value that they thought they originally negotiated. As a result of these conflicts, several states, in particular New York, have extensive regulatory frameworks that provide the regulator with involvement in all condominium offerings.

POTENTIAL LENDER LIABILITY

Lenders who finance condominium projects may be responsible for taking over operations of the property in the event that the developer defaults on the loan. In some states, by taking over a troubled project, the lender risks becoming a special developer for the condominium. If the original developer reserved special developer rights in the governing documents, and the lender exercises those rights because the rights are necessary to complete the condominium (i.e., the right to finish construction, operate a sales office on site and sell units without board approval), the lender could be exposing itself to developer liability.

Liability may arise from implied or express warranties for defects in construction of the project. In many instances, the risk of special developer liability can be limited in drafting the property transfer documents or by structuring bankruptcy remote single purpose entities to take ownership of a troubled project.

However, it may be impossible to prevent some special developer liability from accruing if active management of the development process is required in order for the lender to realize the full economic benefit of the project. In such cases, the risks associated with special developer liability must be fully understood in order for the lender or its successor to determine if its interest would be better served by selling its position to a third party, who will execute on the sponsor.

In addition, the lender could expose itself to liability by having representatives sit on the condominium's board of managers or actively participating in decision-making. There is also a potential conflict of interest in deciding on such things as:

- Assessments;
- Acceptance of the condition of common elements which may not be in the condition required by the POS;
- Interfering with a unit owner's right to have a property inspection made at the time of the turnover;
- Failing to properly maintain the common elements; or
- Failing to make certain that there has been adequate disclosure of all material facts for fear that it will have an adverse impact on sales of units.

Both the Uniform Condominium Act and the Uniform Common Interest Owners Act as well as some state laws permit a foreclosing lender to acquire certain special developer rights by election, such as the right to construct or expand the condominium, the right to enter into contracts, the right to sell units without board approval and the right to control the board. In these instances, the lender may have three options to choose from.

First, the lender may choose to acquire all of the special developer rights in exchange for the assumption of all of the obligations except for any misrepresentations, breaches of warranty or breaches of fiduciary duty by the sponsor.

Second, the lender may choose to acquire certain special developer rights relating to maintaining models, sales offices, signs and advertisements in which event the lender's liability is limited to acts arising out of amending or issuing the POS and operating a sales office.

Third, the lender may choose to acquire special developer rights for the sole purpose of transferring the rights to another entity, in which case, the lender assumes minimal liability limited to its own acts and omissions.

Courts in states that have addressed the issue generally come to the conclusion that a lender cannot be held liable if it does nothing. When courts have imposed liability on a lender, it is because of the lender's control over the sponsor or control over the condominium development. Under the instrumentality theory, a lender who deviates from the typical creditor-debtor relationship by exercising substantial control over the sponsor is liable to unit owners. Under the assumption theory, a foreclosing lender who takes over the responsibilities of the sponsor and completes construction is liable to unit owners.

NOTICES OF DEFAULT AND FORECLOSURE

Condominium construction financing is different from virtually any other kind of lending, particularly in states with strong consumer protection laws, because of the fact that there are at least four parties having an interest in the expeditious completion of the construction, although only two parties (the borrower and the lender) sign the loan documents. Unlike other forms of construction loans, the two non-signatories with an interest in the process are the potential buyers of the units and the regulators, under whose jurisdiction condominium formation and sales occurs. A lender ignoring the regulators 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 loan defaults in condominium construction loans, but none are 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, the sending of a Notice of Default 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 regulators. Upon the receipt of a Notice of Default by a borrower-sponsor sales must cease and the offering plan amended to disclose all material factors related to the default. Conversely, 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 a more expedient way of proceeding.

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

CONCLUSION

A clothing chain once advertised that “an educated consumer is our best customer” and no where is that truer then when dealing with condominium construction loan defaults.