Concerns For Lenders On Florida Condominium Projects: New Triggers For Turnover And Some Considerations On Successor Developer Liabilities

Robert S. Freedman, Richard C. Linquanti and Robert M. Quinn

The authors review the issues for lenders to consider with regard to a failed or distressed condominium asset and the issues pertaining to a developer's bankruptcy or the appointment of a receiver.

As part of the continuing economic recession and the ongoing slide in the Florida real estate market, the Florida condominium industry is especially in tremendous turmoil. New buyers are few, inventory is high, and contract purchasers are not able to close or, more often, are seeking to avoid closing and to receive a return of their deposits. This results in developers being unable to meet their obligations to the lenders, which leads to lenders having to declare a default and make various determinations as to how to proceed with a crippled project. This situation is playing out in virtually all types of condominium projects (all types of structures, and both new construction and conversions) and the spiraling effect is mind-boggling. Lenders are no longer only lenders able to assess their future costs and liability exposures from the perspective of their loan documents; they are now potentially involuntary developers who must face the muddle of issues arising from real estate development documents, restrictive covenants, condominium associations and state regulation. Successor developer liability lurks just below the surface, and certain actions (or nonactions) can bring those liabilities to the forefront.

Robert S. Freedman is a member of the Real Estate & Finance Practice Group and chair of the Community, Condominium and Resort Development Group of Carlton Fields, P.A. Richard C. Linquanti is a member of the firm's Real Estate & Finance and Corporate, Securities & Tax Practice Groups. Robert M. Quinn is a member of the firm's Business Litigation and Trade Regulation, Real Property Litigation, and Bankruptcy and Creditors Rights Practice Groups. The authors, who all are shareholders in the firm's Tampa office, can be reached at rfreedman@carltonfields.com, rlinquanti@carltonfields.com and rquinn@carltonfields.com, respectively.

New Triggers

Recent changes to the law amplify the need for specific and detailed scrutiny of the situation. Effective October 1, 2008, the Florida legislature amended the Florida Condominium Act (Chapter 718, Florida Statutes) to include two new events that are deemed to immediately trigger "turnover" of control of a condominium association (where the non-developer unit owners are

@DOMINO/VENUS/PAMPHLET02/ATTORNEY/REFJ/FREEDMAN SESS: 1 COMP: 02/09/09 PG. POS: 1

entitled to elect a majority of the members of the board of directors). The new triggers are when a bankruptcy petition is filed by the developer and when a state court receiver is appointed for the developer and is not discharged within 30 days of the original appointment.

The new provisions pertaining to the bankruptcy petition filing may not be valid because it seems to violate Section 541(c)(1)(B) of the federal Bankruptcy Code. Nonetheless, this is on the books until someone successfully challenges it. The appointment of a state court receiver is outside the Bankruptcy Code and therefore is less likely to face validity issues as a turnover event.

Lenders frequently have sought the appointment of a receiver of property to take over the developer's interest in a failed condominium project incident to the commencement of foreclosure proceedings in order to protect their collateral (both from the standpoint of the sales and marketing of condominium units and the operation and maintenance of the condominium property through the condominium association). Since the new provision speaks to the appointment of a receiver "for the developer" rather than for the property, there may be a planning opportunity. But in any case, as a result of the new law lenders now must decide whether the benefits of obtaining a receiver outweigh the risks and consequences of causing control of the condominium association to be turned over to the independent condominium unit owners.

It is important to note that this summary addresses the "developer" under the Florida Condominium Act, not the "developer" under the condominium documents. There is naturally a certain amount of overlap between these two concepts, but it is possible, and frequently it is desirable, not to be the developer for at least part of the Florida Condominium Act while maintaining the rights of the developer under the condominium documents. Even when the term "developer" is used in the Florida Condominium Act, it does not always have the same meaning across the various statutory provisions. One example is that one may become the developer under the statutory definition of one who markets for sale or lease seven or more condominium units in a 12 month period, but not be responsible to a prior unit purchaser as a developer for statutory warranties and latent construction defects. Proper pre-foreclosure planning is essential to minimize the potential for developer liabilities while maximizing the availability and usability of developer rights.

Developer Control

Under the Florida Condominium Act, a developer is entitled to appoint at least a majority of the members of the board of directors of a condominium association until an event of "turnover" occurs. Among other things, this gives the developer control over the association's budget, rules and regulations, management and services contracts and other general operations matters. Once there is an event of turnover, the developer is no longer permitted to elect a majority of the directors, even if the developer owns a majority of the condominium units.

Turnover also has other consequences for the developer. Once an event of turnover has occurred, it cannot be reversed. The developer must cause an independent audit to be performed of the association's finances and must pay for the costs of the audit, it may be required to convey any promised amenities to the association which were not previously included as common elements, and it must deliver to the association bank accounts and other funds and a long list of documents and books and records. There may also be rights contained in the condominium documents which cease upon turnover, rights which the lender typically may desire to preserve and can utilize following the foreclosure (or otherwise transfer the rights to a bulk purchaser). On the other hand, when turnover happens prior to or as a direct result of a foreclosure, the borrower, not the lender, is the party that is legally and financially responsible for the turnover process and liabilities. However, since the borrower is probably insolvent and the lender needs to protect the value of its collateral by not having a dysfunctional condominium association, the fact that the lender is not legally responsible may be of little comfort.

Turnover Event

Before the lender decides whether or not it is concerned about triggering turnover with the appointment of a receiver, it should determine if a turnover event has already occurred. One of the less understood events is when the original developer fails to continue to market condominium units for sale or lease in the ordinary course of business. That circumstance triggers turnover immediately, whether or not the developer, the lender or the unit owners realized it at the time of occurrence. Under favorable conditions, the lender would work with the developer before foreclosure to secure the continuation of marketing efforts in good faith, however minimal those efforts may be. If the developer shuts down all marketing efforts pending foreclosure, the appointment of a receiver will not be an issue because turnover will have occurred already.

Turnover is not necessarily entirely to the foreclosing lender's disadvantage. For example, prior to turnover—

- collected reserves may not be spent by the association for purposes other than repair and maintenance,
- working capital contributions cannot be utilized as long as the developer is deficit funding the budget (which is often tied to an event of turnover),
- transportation services, insurance for directors

@DOMINO/VENUS/PAMPHLET02/ATTORNEY/REFJ/FREEDMAN SESS: 1 COMP: 02/09/09 PG. POS: 2

and officers, road maintenance and operation expenses, in-house communications, and security services may only be included as common expenses if provided in the condominium documents, and

- the failure of the association to maintain certain levels of insurance is presumed to be a breach of fiduciary responsibility by the developer-appointed members of the board of directors.

The effect of turnover having occurred may be more apparent than real. When a lender takes title through foreclosure and begins to market condominium units for sale or lease in the ordinary course of business, it becomes a developer under the Florida Condominium Act in its own right (and not as the legal successor to the original developer, meaning there are various liabilities that are automatically assumed under statute). Under regulations issued by the Division of Florida Condominiums, Timeshares and Mobile Homes, so long as the "new" developer markets units for sale, it is once again entitled to vote its units to elect a majority of the members of the association's board of directors (even though turnover has occurred). The validity of the regulation might be challenged, but that has not happened yet to our knowledge.

This explanation only scratches the surface of the complex planning faced by a foreclosing lender. For example, if the lender-owner markets units for lease but does not market them for sale in the ordinary course of business, it is a "developer," but the regulation does not give it the right to vote its units to elect a majority of the association's board (although a pending regulation at the Division limits this restriction to leases longer than five years). On the other hand, if the lender does not market the units for sale or for lease, but holds them passively until it can arrange for a bulk purchaser (finding a bulk buyer is defined to not constitute selling in the ordinary course of business), such lender is not a developer and may vote its units as any other owner. Proper planning is very fact-specific and time sensitive, so it is critical for the lender to obtain as much information from the developer as possible concerning the project, sales contracts and closings, construction liens, consumer complaints, association finances, budgets and meetings, and the like. No single foreclosure and monetization strategy fits all situations.

Conclusion

In conclusion, there are a myriad of issues to be analyzed and considered with regard to a failed or distressed condominium asset and issues pertaining to a developer's bankruptcy or the appointment of a receiver, and it is important for a lender to consult with experienced counsel well-versed on these issues prior to making a firm determination on a course of action. The situation would seem likely to get worse before it gets better, and wise and measured decisions will help to minimize, as much as possible, exposure for a lender.