

Legal and Practical Considerations for Purchasers of "Broken" or Distressed Condominiums

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Across the country, and particularly in the State of Florida, investors are poised to make bulk acquisitions of interests in troubled or "broken" condominium projects. Generally, the assets in question may be uncompleted condominium buildings with outstanding purchase contracts for some or all of the units, or units in a completed building in which a large number of units remain unsold. These acquisitions often take place in one of two forms: (a) assets purchased from struggling developers or banks that have foreclosed or (b) through the purchase of discounted debt from lenders.

While it is anticipated that these transactions will likely offer opportunities to purchasers by virtue of deep discounts over values that existed at the top of the market, financial models for these transactions should account for legal and practical issues that may have a significant impact upon projections. Investors that do not adequately consider these issues may face additional expenses, construction delays, rescinded purchase contracts, regulatory and legal actions, slower sales absorption, unexpected third-party claims, reduced rental rates and, ultimately, failed financial models. This Alert serves as a brief guide to certain key legal and practical issues that investors should consider prior to making investments in troubled or "broken" condominiums.

What Is the Status of Construction and What Are the Investor's Rights Under the Construction Contract (Pre-Closing and Post-Closing) and Other Professional Contracts? As a basic due diligence starting point, investors may want to ascertain the status of the construction contract (even when the building is finished) and contracts of other professionals, the rights and obligations of the investors (if any) as an assignee or successor to the original developer under the contract, and defenses and claims of the contractor and its sureties.

Rights. Potential investors should determine what rights of the original developer under the construction contract will be retained by the investor, including the rights to pursue warranty, defect and punchlist claims and to seek recourse against any construction bonds, letters of credit and insurance policies. A close comparison should be made of an investor's rights under the construction contract against liabilities and obligations that an investor may be potentially incurring for construction defects and warranty claims (including those obligations that may be incurred by virtue of being considered a developer under the Florida Condominium Act or similar statutes in other jurisdictions). Investors should take care to avoid situations in which they may incur significant liabilities for construction defects and warranty claims, but have no recourse against the contractor, its surety and insurers for such claims.

Obligations. Investors should also determine which obligations, if any, of the original owner that the investor will inherit under the construction contract as well as whether the investor will be required to remedy any defaults by the original developer under the construction contract.

Buildings Under Construction. For buildings under construction, investors should also inquire whether:

- The contractor is paying subcontractors and materialmen promptly and whether there are any liens on the project;
- The ability of the investor to continue to obtain draws under an existing construction loan;
- Change orders, change directives and potential cost-overruns exist; and
- The construction schedule is still accurate.

Other Professional and Construction Related Contracts. Similar inquiries should be pursued with respect to architects' contracts and the contracts of other professionals.

Are the Purchase Contracts Valid and What Is the Likelihood That Purchasers Under Contract Will Close? Investors purchasing uncompleted buildings or units subject to purchase contracts may want to make an educated assessment of whether pending, but not closed, purchase contracts will ultimately close. A number of factors should be evaluated when making such an assessment.

Degree of Speculation. In a declining or troubled market, condominiums containing a large percentage of speculators may generally experience a higher closing default rate and a higher rate of purchasers taking legal action in an attempt to recapture deposits than those buildings that have a low percentage of speculators.

Will End Lenders Fund Closings? Some condominium buildings in certain markets are experiencing "blacklisting" in which lenders refuse to provide end loans to purchasers in the building, often without regard to the creditworthiness of the unit purchaser or the percentage of equity contributed. This blacklisting is more likely to occur in projects owned by troubled developers or that have already experienced significant default rates, high rates of foreclosure or in which purchase prices

have fallen dramatically. Blacklisting of a building may result in a domino effect in which existing unit owners default on their mortgages because of the difficulty in reselling them, thereby depressing purchase prices further. In addition to blacklisting, in "declining markets," Private mortgage insurance ("PMI") may not be available and end mortgage lenders may require additional equity.

Additionally, many mortgage lenders will not close on end loans in a building unless 50 percent of the units have already closed. Consequently, closings should be scheduled in such a manner so as to first close on cash sales and on those sales where the respective lender does not have such a requirement. Thus, investors may want to evaluate the number of units that will be purchased with and without mortgage financing.

Do the Condominium Documents Comply with Applicable State Law? Many states, including Florida, regulate the offering of condominium projects developed in their state. Florida, and many other states, require that an extensive prospectus be prepared and delivered to purchasers of residential units. In Florida, the failure to comply with these offering requirements and the requirement to prepare and deliver a prospectus can result in rescission rights on behalf of unit purchasers.

During the course of a project, developers by necessity may make frequent changes to projects (including, without limitation, with respect to the nature and extent of amenities, unit features, the square footage size of units and budgets). Depending on the nature and magnitude of these changes, such changes may entitle purchasers in Florida and other states to rescind their contracts. Thus, potential investors may want to rigorously review offering prospectuses delivered to purchasers for legal compliance as well as for the likelihood of having to make amendments to these documents prior to closing.

How do purchase prices under existing purchase contracts compare to current market prices? Generally speaking, unit purchasers that perceive that they bought at "top of the market" prices tend to have a significantly higher closing default rate than those that believe that their unit price still represents a bargain or something reasonably close to current market value. Correspondingly, unit purchasers that perceive that their unit was purchased at a price close to current market values may be more reluctant to default and relinquish their deposits. Efforts made by a developer to maintain good communication with purchasers prior to closing can also be a significant factor in influencing purchasers to close.

Was the Original Condominium Offering in Compliance with the Interstate Land Sales Act? The federal Interstate Land Sales Act ("ILSA") mandates that all offerings of condominiums in interstate commerce that do not qualify for an exemption be registered with the U.S. Department of Housing and Urban Development ("HUD"). Traditionally, many developers asserted exemptions from registration under ILSA on the basis that their projects qualified for a 99 or less unit exemption or on the basis that the purchase contracts provided that the units would be completed within two years of the date of the first purchase contract. In an atmosphere of heightened litigation, these exemptions have been under attack and, at least for the moment, have significantly eroded. For this reason, developers are more frequently filing registrations with HUD than in prior years. Thus, in the case of bulk purchases of units or the purchases of loans in projects with sales contracts pending, investors may want to evaluate whether ILSA exemptions apply (negating the requirement to register with HUD) or whether existing HUD registrations comply with applicable law. Additionally, ILSA requirements for project registration and the timing of delivery of documents to purchasers are complex and highly technical. Failure to meet ILSA requirements or factual inaccuracies in ILSA registration materials may result in claims by purchasers for rescission or damages, even after closings occur.

Was the Condominium Project Required to Be Registered in States Other Than the State Where the Project Is Located? Several states, including New York, require registration of projects built outside of their state that are sold or marketed to residents of their state. These requirements also include delivery of additional documents to purchasers. For example, a condominium project built outside of New York, but marketed in New York or sold to New York residents, may also be required to comply with the registration and offering requirements of New York, in addition to the laws of the state where the project is actually located. Consequently, investors should determine the state of residency of all purchasers under pending contracts and whether contracts with purchasers not residing in the state where the project is constructed are also subject to additional regulation by the purchaser's state of residency. The failure to follow legal requirements of the state where a purchaser resides have resulted in rescission claims by purchasers and demands by state attorneys general for rescission.

Will the Purchase by the Investor of Units Result in Additional Filing Requirements or Rescission Rights? Will the Bulk Purchaser of Condominium Units be Treated as a Developer? In many states that require that disclosure documents or prospectuses be delivered to purchasers, a bulk purchaser will be required to amend existing filings or make additional filings with the state regulatory body. In Florida, a bulk purchaser of units that offers seven or more units for sale in a one-year period will be considered a "subsequent developer." This treatment generally results in such an investor incurring legal obligations similar to those of the original developer under the Florida Condominium Act with respect to the units so acquired, including the requirements to make filings with the Division of Florida Condominiums, Timeshares, and Mobile Homes and to provide purchasers with the disclosure documents mandated by the Florida Condominium Act.

What Are the Investor's Rights Under the Condominium Documents? As the Declarant under the declaration of condominium, the original developer normally grants itself numerous rights, including retaining control of the board of directors for a period of time, the right to make certain amendments to condominium documents, the right to use common

areas and units as a sales center or sales models and the right to use portions of the project for sales and leasing activities. The terms of the declaration of condominium, applicable law and the structuring of an acquisition transaction may be of significance in determining whether an investor retains such rights, including the right to retain control of the board of directors. The condominium documents should also be examined to determine the rights of the investor to conduct rental programs in acquired units and restrictions on leasing.

Financial Issues

Bankruptcy Issues. If the project or the developer has been or is subject to bankruptcy proceedings, the investor should make appropriate inquiries regarding a variety of issues, as well as agreements and obligations that have been terminated or that the investor may wish to have terminated through the bankruptcy proceeding. Investors should be aware that recent changes to the Florida Condominium Act provide that a developer loses control of the condominium's board of directors upon filing a bankruptcy proceeding or in the event of a receivership proceeding that has not been dismissed within 30 days of its filing. However, the Florida Condominium Act provision requiring change of control of the board upon a bankruptcy filing may be subject to attack in bankruptcy proceedings as an impermissible violation of the automatic stay provisions of the U.S. Bankruptcy Code.

Blacklisting. As noted above, blacklisting of a building may signal any one or more of several problems in the condominium, including: (a) falling purchase prices and resale prices, (b) insufficient closings or high default rates on purchase contracts, (c) problems in collecting assessments, (d) an unduly high percentage of investor owners and (e) an excessively high number of foreclosures.

Assessment Defaults and Assessment Rates. Depending upon the laws of the state in question and the language of the condominium declaration, if a unit is foreclosed upon, condominium assessments incurred but not paid by the owner may result in budget deficiencies and in turn result in increased assessments to other unit owners. For example, Florida law provides that a first mortgagee is responsible only for pre-foreclosure assessments up to the lesser of one percent of the original principal balance of the mortgage or six months of assessments. Thus, those condominiums that have a significant number of foreclosures may experience escalating assessments as the condominium association assesses the remaining unit owners for the unpaid assessments of foreclosed former unit owners. As assessment levels thereby increase, other units may face foreclosure when they are unable to pay increased monthly assessments. Unit owners that were relying upon rental income may be more severely stressed as this situation occurs in an environment that is experiencing declining rents and an increasing surplus of units. A vicious cycle may ensue. Potential bulk purchasers of condominiums may thus attempt to assess the number of current and future foreclosures in a condominium building.

Additionally, the market is increasingly experiencing a discrepancy between the purchase price or market values of units and assessment levels. At the top of the market, assessment levels and amenities were designed to correspond to purchase price of the respective units. It was presumed that purchasers of expensive units could afford higher levels of assessments and amenities. As a result of current market conditions, the market is resetting unit values and prices. However, the market is largely incapable of pushing assessment levels down, since many common expenses (such as insurance, maintenance, reserves and utilities) cannot be dramatically reduced. Thus, assessment levels have not declined by similar relative amounts. This situation has in some cases resulted in assessments being disproportionately large when compared to the reduced purchase prices of units. Prospective end purchasers looking to buy a unit from investors may be able to afford to buy the unit, but they may not be able to afford the assessment level that corresponded to a much higher purchase price.

Accuracy and Sufficiency of Budget. Investors, particularly in the case of incomplete buildings or buildings with little operating history, should make a careful assessment of whether operating or projected budgets are sufficient to pay common and other expenses. Budget projections by some developers have proven to be overly optimistic.

Guaranties and Reserves. Potential investors should also consider the existing obligations of the developer or lender to fund deficiencies in the budget and to guaranty assessments. Additionally, investors should determine whether reserves have been paid or waived and whether amounts reserved (if any) to date are adequate.

Summary

Current market conditions may offer bulk investors in "broken" or distressed condominiums with significant opportunities. However, in order to accurately assess risk and pricing, these investors may want to fully account for the issues discussed above.

For Further Information

If you have any questions about this Alert or would like more information, please contact [Brian L. Belt](#), any other [member](#) of the [Real Estate Practice Group](#) or the attorney in the firm with whom you are regularly in contact.