The New Age of Condominium Workouts – Perspectives from All Angles and the Tremendous Potential for Disaster

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I. **BACKGROUND**. In many metropolitan areas, the condominium boom is now giving way to a growing backlog of unsold units. The developer, the unit owners and the condominium association are finding that they are long-term bedfellows, and that their interests are not necessarily aligned on such issues as construction defects and rental of unsold units. The developer's lenders are getting nervous as buyers abandon their purchase agreements and the interest reserve steadily diminishes. The contractor and design professionals are seeking payment for changes, delays and additional work. This paper will explore the differing interests, legal positions and leverage of the parties, and how these play out in the areas of condominium workouts, foreclosures, bankruptcies and bulk sales.

II. **A NOT SO HYPOTHETICAL SCENARIO**. Rising 44 floors above Biscayne Bay is Platinum, a condominium advertised throughout Europe and the Americas as the ultimate luxury experience. The glass, marble and steel monolith has 540 residential units, an 800-space garage, and extensive – and expensive - recreational and spa amenities. Recently, Platinum has floundered on the rocky reefs of a market challenged by oversupply, declining values, and shrinking demand. Buyers have vanished but for the vultures.

During the frenzy of 2003 - 2004, the developer had 350 units under contract. After construction started, it signed up purchase agreements for an additional 150 units. However, there has been a significant "melt." As of October, 2007, the situation was as follows:

- 230 units had closed,
- 50 buyers were in various stages of litigation (with a laundry list of alleged defaults and purported misrepresentations by the developer's sales staff),
- another 70 buyers were demanding a refund of their deposits, claiming they were entitled to rescind their contracts because of material changes in the offering statement,
- another 100 buyers were in default, but had not yet claimed that the developer is in default and could walk away from their contracts, and
- a group of investor/speculators with contracts on 50 units had approached the developer and offered to buy the unsold units if there was a substantial reduction in the purchase price. The group had suggested a reduction of 25% from their 2003 pre-construction "friends and family" original purchase prices. They had also conditioned the offer on an amendment to condominium documents removing all restrictions on rentals and pets.

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The developer of Platinum is Platinum LLC, a special purpose entity. Its parent company is an experienced residential condominium developer, whose principals Fred Finance and Bob Builder are widely known and respected for their ability to deliver a financially successful project on time and on budget. The developer's crack sales and marketing team had no problem achieving 65% presales prior to the commencement of construction in June, 2004. With few exceptions, buyers paid deposits of 20% of the unit purchase price. With the consent of the lenders, the developer used the portion of the deposits in excess of 10% of the purchase price for construction purposes. The remaining deposits are held in escrow with a national title company.

Developer's counsel had submitted the required extensive documentation to the Florida condominium regulatory agency. Because the developer anticipated a four year period for pre-sales and construction, it had taken the additional precaution of complying with the Interstate Land Sales Full Disclosure Act by filing a Property Report and Statement of Record with the Department of Housing and Urban Development ("HUD").

The developer had financed the $275,000,000 tab for land acquisition, sales, marketing, architecture and engineering and construction with a construction loan of $195,000,000 from a consortium of three lenders. The loan was non-recourse except for the "bad boy" carve-outs, environmental matters and construction cost overruns, which were guaranteed by the principals. The developer procured a mezzanine loan of $40,000,000, secured by an assignment of the members' interests in the developer and a very soft second mortgage. A group of offshore investors, who had scored stellar returns on other projects developed by the principals, funded $40,000,000 in equity.

Currently, 400 units are completed and have received temporary certificates of occupancy ("CO"). The general contractor, Qualified Condominium Constructors ("GC"), and its subcontractors are building out the interiors in the unfinished units, completing the common areas and amenities, and beginning work on the extensive landscaping. However, there are a substantial number of unresolved claims and they have threatened to stop work imminently.

The developer chose Innovation Design Studio ("IDS") as its architect. The agreement with IDS provides that the architect retains the ownership and copyright of the plans and specifications created or provided by it. It also includes a disclaimer for mold and other claims involving water intrusion, an arbitration clause with a non-joinder provision, a limitation of liability to the amount of IDS' insurance coverage (which is a project policy of $1,000,000), and a requirement that the architect be covered by any indemnity given by GC. The developer was obligated to add to the declaration of condominium a covenant not to sue or initiate any proceedings against the architect more than two years after the date of the CO. The architect selected the structural and MEP engineers, who had worked with IDS on many previous jobs. The civil engineer, although new to the team, was experienced. Although IDS selected each engineer, the developer contracted separately with each of them, and each of those agreements limited claims for consequential damages to the amount of the respective engineer's fee.

The developer and GC signed a cost-plus contract with a guaranteed maximum price (GMP). They had worked together on four previous jobs of similar size over the past 12 years. The GC agreement states that there are no third-party beneficiaries to the contract and that the developer may not assign any warranties or claims arising from the GC agreement to the lenders, condominium association or unit owners. It further requires the developer to indemnify GC for any third party actions, and to give GC notice and an opportunity to cure as a

precondition to any claim. Finally, it provides mandatory arbitration and a limited one-year warranty as the developer's sole remedy against GC. Because of their excellent past history, and to save costs, the developer and lenders agreed with GC that only the primary subs should be bonded. Construction commenced in May, 2004, and proceeded with a minimum of disruptions until 2005, when the project was struck by two hurricanes and severe cost increases for concrete and drywall. GC, subs and various consultants have combined outstanding claims of $12,000,000 for damages arising from delays, changes ordered by the developer and unforeseen conditions.

The developer has received a series of complaints regarding water intrusion around the windows and inadequate cooling in the hallways. Recently, the developer's project supervisor has observed delaminating of the layers of glass in the hurricane-impact windows and doors. The glazing subcontractor indicates that the manufacturer of the windows blames defective resin from China and improper installation by a separate sub-subcontractor. Both subs are threatening to declare bankruptcy if the problem is determined to be pervasive.

As a result of the closings, the loan balance has been reduced by $95,000,000; however, the interest reserve will expire in December, 2007.

Platinum is operated by a condominium association with a board of administration consisting of three directors, two of whom were appointed by the developer. As required by Florida law, the unit owners other than the developer are entitled to elect one–third of the directors on the board as soon as 15% of the units are sold. A non-developer unit owner who has repeatedly clashed with the developer was elected to the board.

Operating costs of the association had skyrocketed since the estimated operating budget was prepared in 2003, primarily due to increases in casualty insurance, utilities and costs for additional employees to handle building start-up and move-ins. The developer chose not to increase assessments to avoid hurting sales and triggering rescission claims from recalcitrant buyers. Instead, it had been subsidizing the shortfall in addition to paying assessments on its units. To preserve its dwindling resources, the developer stopped paying the subsidy and its assessments three months ago; at that time, the developer owed the association $700,000; the assessments on the unsold inventory are $175,000 per month and the subsidy is an additional $50,000 per month.

The new non-developer director has demanded that the developer pay assessments. He has also presented the developer with a list of demands on behalf of the unit owners in residence. He insisted that the association:

- hire independent counsel and appoint a new manager who owes its allegiance to the association and not to the developer.
- prepare a realistic budget
- conduct regular meetings of the board and members
- deliver the following reports and information to the board: an accounts receivable aging report for assessments, an accounts payable report, an analysis justifying reserve/replacement/deferred maintenance schedule, ledger and expense records documenting association expenses; and the association's warranty correction notices to the developer, contractors, etc. for incorrect work
- file liens against the units of the delinquent owners, including the developer's units.

He also demanded that the developer furnish the following information to the association immediately:

- a timetable for completing construction
- a timetable for turning over control of the association
- warranties from manufacturers, contractors and subcontractors, including the window manufacturer
- inventory of the association's personal property, including high-end weight room and video theatre equipment that was promised, but not installed
- job description for the full-time association receptionist, who is on first name basis with the developer, but is "never there."
- cable television/data/alarm and management contracts and bidding/negotiation materials
- opinions from counsel relied upon by association directors
- all bills and communications to and from association counsel
- proof of the contractor and sub-contractor employees' immigration/work status
- permits for environmental, water and sewer-related work
- roster of unit owners, including mailing labels

III. THE WORKOUT SCENARIO.

A. **Lender Considerations.** Lenders facing a loan default situation in connection with a loan to finance condominium construction or conversion projects will conduct the following analysis.

1. Preliminary financial analysis when the loan goes into default or on watch.

a. Determine project value as completed in light of the current market conditions.

b. Carefully reassess the project budget and amounts necessary to complete, paying particular attention to soft-cost adjustments required to account for the true time required to absorb the unsold units.

c. Carefully assess realistic sales prices, and determine if sale of units is the best exit strategy for the project; review alternative exit strategies.

d. Evaluate the performance, financial strength and commitment of the developer/sponsor to determine whether it is doing a good job under the current circumstances and whether it is best to continue with or change the developer/sponsor for the project.

e. Review guarantees executed by the developer/sponsor to assess leverage to negotiate various settlement options or exit strategies.

f. Assess the various parties to the lender group, their profiles and capabilities and where each tranche is in relation to project value as of the time of analysis and as completed.

g. Evaluate current state of project. Review title updates and construction inspection reports, update appraisal, update litigation search on borrower and guarantors, and update UCC searches.

2. Ascertain the philosophy and objectives of each lender in a distress situation.

a. Does the lender have the capability, experience and fortitude to go through a workout, restructuring or foreclosure of the loan?

b. In a multitranche or syndicated loan, what is the likely behavior of others in the lending group? Will they be very aggressive or cooperative with the other lenders? Review the intercreditor or participation agreements to clearly understand intercreditor rights and responsibilities.

c. If the loan is in a securitization, assess the role, responsibilities and temperament of the servicer and special servicer. If a syndication, assess the role, responsibilities and temperament of the lead lender/agent.

3. Evaluate Options.

a. Depending on the result of the analyses and factors described above, evaluate the options available and develop an action plan.

b. If a subordinate mezzanine lender is holding a loan that is "out of the money," determine whether it is best to write down the position to market value and hold on to see whether any value can be salvaged, or to sell at a significant discount to a party more suited to deal with distressed real estate.

c. If a subordinate mezzanine lender's position is not completely "out of the money" and if they are the junior position in the debt stack, determine whether it is best to sell the loan at perhaps a small or no discount to par to a better suited party, or to be prepared to take an activist role with the project, the borrower and the other parties in the lending group.

d. An activist strategy will often involve negotiating a standstill or forbearance agreement between the junior-most lender and the senior lenders/servicer and other agreements with the borrower/guarantors. The lenders' leverage with the guarantors is based upon their financial exposure, capabilities and ability to complete the project successfully. These are critical factors in determining both strategy and objectives with the borrower/guarantors.

e. If the loan is to be sold off as an exit strategy, determine how best to market the loan and what the realistic value and upside must be for a distressed loan buyer.

f. If the loan is out of the money, analyze the risk/reward of buying a more senior position to protect the investment, how much more needs to be invested and what the return is likely to be on new money invested as well as the likely outcome with respect to the original investment.

g. What are the lenders' capabilities to take on an activist role in a workout for a development project? Do they have the right people to oversee the project or is outsourcing needed?

h. Should a new party be brought in to take over the responsibilities of the developer, and how will such a change affect the liabilities of the obligors under the guarantees, assuming they are financially viable.

i. Consider making changes in various key positions in the development of the project if parties are not performing, and what costs, if any, may be involved in making any changes, such as construction manager, selling agent, marketing agents, etc.

4. Succeeding to Developer Liabilities. In the event of a foreclosure or deed in lieu the foreclosing lender will need to evaluate which developer's liabilities it will inherit if it takes over the project. Assuming there's still the liquidity in the market, the senior lender would likely not actually foreclose and complete the project; thus, successor liability for the lender is more of a theoretical issue. However, any lender contemplating a takeover of the project (or of the ownership interests in the borrower) will want to analyze which developer liabilities it can avoid and to quantify the cost of those it cannot. If the exit strategy includes a "bulk sale" of units to one or more groups, then the scope of the successor developer's liabilities will affect what the buyer will pay.

a. Will the lender inherit any of the developer's liabilities? If so, which ones and to whom? Are the developer's liabilities primary or secondary? These may include the following:

(i) Construction warranties. Verify whether the developer has any contractual, common law or statutory construction warranties. Has the developer disclaimed them to the extent possible? If the developer has given construction warranties, is it receiving ones of comparable scope and duration from the contractors, subcontractors? Do the general contractor's and subcontractors' performance bonds cover their respective warranties if they are not contractual? Is the lender an obligee under the bonds?

(ii) Buyer deposits. If the buyers' interests are not extinguished in the foreclosure action, what is the liability for repayment of deposits if buyers rescind their purchase agreements and the full amount of the deposits is not in escrow?

(iii) Liabilities to the general contractor and subcontractors. What amounts are owed to the general contractor, subcontractors and design professionals for completion of the project, including common areas? Evaluate and qualify outstanding claims for delays and cost overruns.

(iv) Payment of assessments on developer owned units. Is the developer obligated to pay assessments on its units? Has the developer guaranteed the assessments? Is the developer obligated to subsidize the shortfall between the association's operating costs and the assessments?

(v) Official records of the condominium association. Is the developer-controlled association maintaining official records?

(a) Will the lender be able to obtain from the developer the necessary documentation that has to be provided to the association at turnover? See the checklist at end of this paper for typical documents and items to be delivered by the developer to condominium association.

(b) Is the developer required to deliver to the condominium association, "as built" plans or record drawings? Is the developer assuring that the contractor and subcontractors are documenting the changes? Will these be available to the lender and at what cost?

(vi) Compliance with regulatory reporting requirements.

b. If a lender takes over the project, determine whether or not it can avoid becoming a successor developer. For example, if the lender sells the inventory of units in a single transaction, will it avoid developer liability? Did the lender receive an assignment of developer's rights as part of the loan documentation? If not, are there other means of asserting or obtaining developer rights, such as a statutory provision or case on point?

c. If the lender becomes a developer,

(i) Will it be entitled to control the condominium association and exercise the developer's rights and reservations?

(ii) What regulatory filings must be made before it is entitled to sell units?

5. General Comments/Observations

a. These days, some projects are significantly under water, so a portion of the loan will not be recovered. Other projects are still viable and may need more liquidity to cover carrying costs over a longer sell-out period, but sell-out values may still justify holding the loan and funding/restructuring to accommodate the additional carrying costs. Still others may have conversion to another use (i.e. condos to rental apartments, condos to hotels, etc.) and may require more capital or other changes to effectuate the changes of use.

b. The dynamics between the various lenders in the lending group can be an important factor in the outcome of a distressed loan situation. Some lenders are militant and aggressive, and want to exercise remedies immediately; others are reticent to do so for fear of litigation or souring the relationship with their borrower. Servicers and special servicers add another dynamic to the equation; some are easier to manage and may vary widely in competence and experience in a workout situation.

c. The posture of the borrower and guarantors is critical to the strategy and outcome of a loan default scenario. Borrowers can be cooperative due to relationship and reputational considerations, concern over recourse obligations, or for other reasons. Borrowers can also be intransigent and hostile, threatening certain actions that may be detrimental to the project and the lending group's interests in order to gain leverage or reduce their guaranty exposure. Proper "bankruptcy proofing" in loan structuring should reduce some of that leverage. Borrowers may also continue to believe in the viability of the project and thus be willing to infuse more capital or provide other undertakings in order to sustain the project and protect their equity investment. Finally, the capabilities, focus, commitment and financial wherewithal of the borrower/guarantor must be considered carefully in determining the ongoing role of the developer/sponsor in a workout situation.

B. **Developer Considerations.** Below are some of the considerations for a developer with a troubled condominium project facing default on its loan. The developer is juggling the demands of multiple parties: the lenders, contractors, buyers, condominium

associations, other owner associations and unit owners. A part of the juggling act is the fiduciary duty owed to the owners by the developer-appointed directors. The developer's need to placate each constituency gives it a greater degree of leverage than it would otherwise have, while at the same time leaving it open to risk for actions taken (or not taken) and then determined to not have been in the best interests of the constituents.

1. Generally, the developer should conduct the same financial analysis as the lenders.

a. Determine project value as completed, given the current market conditions.

b. Reassess the project budget and amounts necessary to complete, paying particular attention to added soft costs required to carry the project during the time required to absorb the unsold units, especially:

(i) Additional interest costs

(ii) Cost overruns

(iii) Discounts

(iv) Sales incentives to buyers and real estate brokers

(v) Additional marketing costs

(vi) Unresolved delay claims from the contractor, subcontractors and design professionals

(vii) Additional operating costs (association assessments, taxes for developer owned units)

(viii) Subsidies to the condominium association

(ix) Additional attorneys' fees and costs for

(a) conducting risk-analysis on viability of any existing contracts to purchaser and problematic provisions in condominium documents

(b) defending buyer litigation

(c) negotiating or litigating with lenders

(d) negotiating or litigating construction defect and other claims with contractors, subcontractors, condominium association and unit owners

c. Carefully evaluate sales prices, and determine if individual sale of units is the best exit strategy for the project rather than one or more bulk sales at a significant discount.

d. Evaluate the competition (current unsold inventory, inventory coming on line during next 1-2 years, absorption rates in current environment).

e. Evaluate practical and legal enforceability of outstanding purchase agreements.

f. Carefully analyze whether there are any legal defects in the form of purchase agreement which could render it void or voidable, such as unenforceable default provisions.

g. Does the project comply with the Interstate Land Sales Full Disclosure Act ("ILSFDA") or fall into one of the full or partial exemptions or has it failed to qualify for one or more exemptions? 15 U.S.C. § 1702. *See* Stubblefield, Jo Anne P., "The Not So Simple Life: Interstate Land Sales Issues in Condominium and Mixed-Use Developments," *The ACREL Papers* (Mar, 2005); Gaillard, W. Foster, and Sklar, William, "Knowing a Little More about a 'Lot' - The Interstate Land Sales Full Disclosure Act," *The ACREL Papers*, (Oct, 2003); Sklar, William P., and Dolce, Jennifer L., "The Interstate Land Sales Full Disclosure Act's Two Year Completion Exemption from the Condominium Developer's Perspective," *Fla. B.J.* (Feb. 1999); Lisman, Carl H., "Understanding the Interstate Land Sales Full Disclosure Act," *The Practical Real Estate Lawyer* (Jan. 1997).

(i) If the developer filed a Statement of Record with HUD, determine whether:

(a) Is the Statement of Record (including the Property Report) accurate? Has the developer made any material changes which necessitated or required an amendment to the filing?

(b) Has the HUD filing been updated for general information about the project and its related areas? Is any update required?

(c) Has each buyer received a copy of the Property Report? Does the developer have a copy of the receipt for the Property Report signed by the buyer and seller in its files?

(d) Does the purchase agreement comply with the ILSFDA requirements?

(1) Does it provide that in the event of a buyer default, the buyer receives a return of all deposit monies in excess of 15% of the total purchase price?

(2) Does it provide that the developer must give the buyer a 20-day cure period in the event of a default?

(3) Does it provide for a seven-day rescission period (may actually be lengthened under state law)?

(4) Does it include the conspicuous statement allowing the buyer a two-year rescission period if no Property Report was delivered prior to execution of the contract?

(ii) Many condominium developers attempt to avoid complying with the requirements of ILSFDA by taking advantage of either the "completed lot exemption," 15 U.S.C. §1702(a)(2), which is a complete exemption, or the "99 lot exemption," 15 U.S.C.

§1702(b)(1), which is a partial exemption. Often, a developer may use a combination of these exemptions.

(iii) If the developer utilized the "completed lot exemption" under ILSFDA, determine whether purchase agreements comply with the requirements for taking advantage of the exemption:

(a) Unconditional promise to complete unit within two years from date buyer signs the purchase agreement (not the effective date!), except that the completion date may be extended by acts recognized as constituting justification for legal impossibility under the laws of the state where the project is located (force majeure exception). The contract cannot be merely state an estimated completion date. Courts have held that even if the unit is completed within the two-year period, if the contract does not contain the unconditional obligation, then the contract is not exempt from the ILSFDA.

(b) Buyer's remedies cannot be limited.

(1) The purchase agreement cannot limit buyer's remedies to the return of the deposit plus interest. The purchase agreement must also give buyer the right of specific performance. *Markowitz v. Northeast Land Co.*, 906 F.2d 100 (3d Cir. 1990).

(2) In Florida, the courts have imposed a higher standard - the purchaser's remedies cannot be limited to rescission. The buyer must be able to affirm the contract and seek damages. *Dorchester Development, Inc. v. Burke*, 439 So.2d 1032 (Fla. 3d DCA 1983). The Florida Supreme Court has ruled that in order to be exempt from the ILSFDA, the contract must unconditionally obligate the developer to complete construction within two years and must not limit buyer's right to specific performance or damages. *Samara Development Corp. v. Marlow*, 556 So.2d 1092 (Fla. 1990).

(c) Any presale contingency is limited to 180 days from the date the <u>first</u> buyer of a Unit signs a purchase agreement.

(iv) If the developer utilized the "99 lot exemption," determine whether the purchase agreements comply with the requirements necessary to take advantage of the exemption. The "99 lot exemption" is a "partial" statutory exemption under ILSFDA that relieves the developer from the registration and disclosure requirements, but not from the "anti-fraud" prohibitions against the use of unlawful and misleading sale practices in 15 U.S.C. § 1703(a)(2). One of the "anti-fraud" provisions prohibits the developer from representing that roads, sewers, water, gas or electric service, or recreational amenities will be provided or completed by the developer without stipulating in the purchase agreement that such services or amenities will be provided or completed. The regulations governing 15 U.S.C. §1703(a)(2)(D) provide that the developer has a contractual obligation to specifically include a stipulation in the purchase agreement to provide or complete certain facilities whenever the developer represents that such facilities will be provided. 24 CFR §1715.15.

(v) The other "anti-fraud" provisions make it unlawful for any developer to:

(a) employ any device, scheme, or artifice to defraud;

(b) obtain money or property by means of any untrue statement of a material fact or any omission to stated material fact necessary in order to make the statements made not misleading; or

(c) engage in any transaction, practice or course of business which operates or would operate as a fraud or deceit on a buyer.

(vi) The developer's counsel must be aware of the current trends in case law on ILSFDA claims by aggressive purchaser's attorneys. Numerous and various (sometimes wild) claims are made by counsel, and the developer must understand the nature of the claim and appreciate the fact that the claim may be upheld by a court (as bizarre as the claim may seem to be). The developer must also be certain to make modifications in response to new court interpretations of ILSFDA. For example, the ruling in *Mayersdorf v. Paramount Boynton, LLC*, 910 So.2d 887 (Fla. 4th DCA. 2005), where the court held that the 99 lot exemption does not require that the seller give the purchaser a 20 day right to cure in the event of a default and that there is no limitation on the seller keeping all of the purchaser's deposit as liquidated damages in the event of a default, remains valid law. However, recent trial court decisions in *Pugliese v. Pukka Development, Inc.*, 2007 WL 4165395 (S.D. Fla. 2007), *Meridian Ventures, LLC v. One North Ocean, LLC*, 2007 WL 4414816 (S.D. Fla. 2007), and *Trotta v. Lighthouse Point Land Company, LLC*, Case No. 07-80269-CIV-HURLEY/HOPKINS (S.D. Fla.) (S.D. Fla. 2008), possibly evidence a trend to interpret the 99 lot exemption to require the same contract protections for a purchaser as would exist for a HUD-registered project. While these cases are not the official law of the land, they need to be given due consideration and analysis and possible modification to the contract provisions.

h. Evaluate whether the developer has complied with state laws, especially those regulating condominiums, common interest ownership communities, disclosure, and real estate sales practices.

(a) Has the developer filed all necessary documentation required with any state or local condominium or land use regulatory agency? Is the developer required to update the filings periodically? If so, is the developer required to deliver the updates to the regulatory filings to the buyers? When and with what types of disclosures?

(b) Has each buyer received a copy of all documents required to be delivered to the buyer? Does the developer have in its files a copy of the receipt for the documents signed by the buyer?

(c) Does state law give the buyer any rescission rights for failure to receive the documents?

(d) Is the developer required to amend or update periodically any disclosure to the buyer? If so, does state law give the buyer any rescission rights for any amendment which materially alters or modifies the documents in a manner adverse to the buyer? Are there any material changes in the documents, and how is materiality determined?

i. Evaluate the developer's compliance with the purchase agreements. For example, did the developer promise completion by a set date, and if so, has the date been met? If not, is the reason one which is recognized as constituting justification for legal impossibility under the laws of the state or an act of God? If there is justification for an

extension of time, how much additional time is recognized under state law as reasonable? Examine seller's default clause and determine what risks and potential claims are associated.

j. Review outstanding purchase agreements critically. Evaluate the likelihood of the buyer closing.

(i) Evaluate each buyer's compliance with the purchase agreement. For example, were deposits paid in a timely manner? Is there a financing contingency? Has the buyer presented a comfort letter or soft commitment from any lender? Examine the buyer default clause.

(ii) Is the purchase price at or below market?

(iii) Determine the amount of the buyer's deposit at risk. How much of the deposit is the seller entitled to retain if buyer defaults (regardless of what is in the contract)? Is the deposit so minimal that a buyer's financial loss is insignificant if he/she walks away?

(a) Under ILSFDA, what is the buyer's liability if he/she defaults cannot exceed 15% of the total purchase price (seller has right to retain all deposits up to 15% of the purchase price)?

(b) If the purchase agreement provides for liquidated damages, are there any limits on liquidated damages under state law?

(iv) What is buyer's financial condition and creditworthiness? Does the buyer have the income and financial resources to obtain a mortgage and to fund the cash to close?

(v) Did the buyer intend to occupy the unit as a primary residence or vacation home, or is the buyer an investor or speculator?

(vi) Does the buyer hold one or multiple contracts?

(vii) Does the buyer have rescission rights if the developer makes material changes to the offering?

(viii) Did the buyer receive all required documents and disclosures? Does seller have receipts for the documents signed by the buyer?

(ix) Did the buyer purchase upgrades? If so, are the monies nonrefundable?

2. As Borrower / Guarantor

a. Does the developer have the financial resources, stamina and willingness to continue?

b. Is additional collateral available? If so, is it sufficient to motivate the lenders to extend the loan term and advance additional funds? Is the project viable enough to risk encumbering other assets which could be used for another project when the market improves?

c. How much additional investment would have to be raised to sustain the project until the anticipated turn around? In order to raise additional funds, how much would the developer and its investors have to give up?

d. Is there sufficient equity in the project to justify devoting additional resources and time to the project?

e. Can the developer retain his sales and management staff to continue the needed efforts to market and maintain the project?

f. To what extent are the principals/guarantors willing to risk their personal capital and/or holdings?

3. As Developer

a. Carefully evaluate the developer's rights and liability under the GMP owner contractor agreement and any other direct agreements with contractors. If the developer has claims against the contractor, subcontractors or design professionals, evaluate various methods of resolving the claims. Has the developer given notice of its claims?

b. Analyze each of the delay damage claims from the contractor and subcontractors. Are the claims valid and documented? Was the developer notified in a timely manner to allow mitigation? Are the delays concurrent?

c. Is the general contractor bonded? Are the subcontractors bonded? Do the bonds cover statutory or common law warranties that may be broader in scope than contractual one? Has the surety been made aware of the construction difficulties at the project?

d. Analyze claims for additional services from the design professionals. Are the claims valid and documented? Did the developer request the additional services?

e. Carefully evaluate the developer's rights and liability under the owner architect agreement and any other direct agreements with design professionals, such as civil engineers, structural engineers, landscape architects, interior designers. If the developer has claims against any of the design professionals, evaluate the likelihood of collection. Has the developer given notice of its claims? Does the developer have a copy of the professional liability insurance of each professional? What are the coverage limits and what other known claims are pending against the architect, engineer or designer?

f. What rights has the developer reserved in the condominium documents and are these rights assignable? Has the developer reserved the following rights?

(i) Right to amend the declaration of condominium and other condominium documents until turnover (or even thereafter if connected to amendments to comply with law or lending requirements).

(ii) Right to use the common elements and unsold units for selling, leasing, management, development and/or construction purposes, including the following: placing signage in the common elements (e.g. at entrances, in lobbies, corridors and other common areas) for sales, rentals, and directions; operating sales or rental offices, models;

holding special events in recreation areas; limiting access to certain common elements for short periods of time if connected to sales or promotional activities

(iii) Right to have guests, invitees stay overnight in units and use recreation areas (a developer exception to transient occupancy prohibitions)

(iv) Right to use visitor parking or parking spaces that have not yet been assigned to unit owners as limited common elements

(v) Right to sell or rent units without association approval

(vi) Right to assign or sell rights to use limited common elements, such as parking spaces, storage areas, docks, cabanas, etc., and retain revenue generated from the sale or assignment

(vii) Right to grant and relocate easements over the condominium property

(viii) Right to place telephones and other telecommunications devices and equipment within the common elements for the developer's sales purposes

(ix) Right to place telecommunications devices on the roof for the benefit of third parties (e.g., cell phone provider) and to retain revenue generated from the use right. The developer may have reserved easement rights or made the roof a commercial unit, depending upon jurisdiction and structure.

C. **Considerations for General Contractor and Subcontractors**

1. The parties constructing the condominium. The interests of the parties responsible for building a condominium project -- general contractors and subcontractors -- may not always be aligned, particularly vis-à-vis the two parties, where the obligations of the general contractor often flow down to subcontractors. On the other hand, if the general contractor protects itself from claims of third parties and others, that protection should shield subcontractors, as well. Moreover, in most circumstances (unless the subcontractor is a sole source provider or has significant bargaining power for another reason), subcontractors have limited abilities to affect the outcome of a project, other than by stopping or threatening to stop work. This is because they are not in privity with the developer, owner or lender, and only first tier subcontractors are in privity with the general contractor. Therefore, while unique problems facing only subcontractors will be noted from time to time, most of the discussions will focus on issues facing the general contractor. (Note that the terms "general contractor" and "contractor" include construction managers that undertake construction obligations or otherwise are "at risk" for elements of the project.)

2. Considerations at the start of the project -- analysis of the project documents. A survival guide for general contractors necessarily begins before the project is troubled. Once the project is failing, it often is too late, or at least very difficult, to protect the contractor's interests in any meaningful way. Therefore, this segment focuses on contractually based strategies that the general contractor may undertake when it is approached to work on the project. The risk management strategies described below likely will not be available on many, or even most, projects. In addition, some of them may not be enforceable under the applicable jurisdiction's relevant statutes and common law. However, they are intended to showcase the broad range of options available to contractors and subcontractors and to alert

the parties to a condominium project to some of the requests they may receive. To the extent that the general contractor is successful in negotiating for the provisions discussed below, it will have much greater leverage in a loan workout setting (notwithstanding its lien priority) and more limited liability for construction defect and other third party claims.

a. Questions concerning the condominium declaration and other documents affecting unit owners. If the contractor is fortunate enough to be brought into the project before the declaration of condominium has been finalized, it will have considerably more ability to affect its fate by including one or more of the provisions suggested below. (Because defect claims often are brought against the developer of the project, as well, some of these recommendations protect the developer in addition to the contractor.)

(i) Prior to closing the purchase of a unit, is the buyer required to inspect the unit and sign a "certificate of satisfaction"?

(ii) To the fullest extent permitted by law, is there a disclaimer of any implied warranties of habitability, merchantability or fitness for a particular purpose and any other implied or express warranties? (Note that many statutes governing common interest ownership projects only permit disclaimers of warranties that are clearly identified, described and circumscribed. There also often are requirements that the disclaimers appear in specific fonts and otherwise indicate that any waivers of rights are understood by the applicable parties.)

(iii) Is a disclaimer of liability for high risk and difficult to control issues, such as termite damage, mold and water intrusion?

(iv) Is a limited warranty, such as a one year repair period, the exclusive warranty? If there is a limited warranty period, shortly before its expiration, the contractor, developer, architect and other relevant parties should inspect the project together with representatives of the condominium association to agree upon and document whether there are any defects or work in need of repair.

(v) Are the developer, unit owners and association required to provide a detailed written notice of any defects as a precondition to any repair obligation or claim? Is the notice given to all potentially affected parties, including contractors and relevant subcontractors? Are all of the affected entities afforded the right to inspect and test (accompanied by experts and counsel), as and when needed, and to make records, including by photographing and/or videotaping such? (Note that many jurisdictions have "right to cure" laws, which mandate notice and an opportunity to repair defects within certain periods of time. See Section III.C.4.k.(iii) below.) Where preferable, do the purchase agreements and condominium documents provide that applicable right to cure laws take precedence over any conflicting laws or agreements? When permitted and desirable, is the applicable right to cure act the exclusive remedy for the unit owners and condominium association?

(vi) Is the right to sue limited to the condominium association (as opposed to individual unit owners)? In addition to stating this restriction, do the purchase agreements, declaration of condominium and any other relevant documents include an affirmative covenant by the individual unit owners not to sue the contractor? Are the unit owners and condominium association required to pay the contractor's and subcontractors' legal fees and other costs if they violate any applicable protective measures in the condominium documents.

(vii) Does the declaration of condominium provide that the condominium association may sue the contractor only if authorized by a vote of a super majority of the unit owners and supported by a certification of merit from an expert? Must all expert and inspection reports and other information gathered by or on behalf of the unit owners and/or association be given to the contractor and relevant subcontractors? Must all notices, claims, etc. be kept confidential except as required by law or necessary for prosecution of or response to claims?

(viii) Do the condominium documents limit the time within which claims may be instituted? Depending upon the jurisdiction, it may be possible, by agreement, to shorten statutes of limitation or, in effect, create statutes of repose.

(ix) If more comprehensive limitations cannot be achieved, at a minimum, do the purchase agreements and condominium documents disclaim the contractor's liability for consequential damages or for other specified, significant economic losses?

(x) Is the association required to fund adequate maintenance reserves and undertake periodic inspections and maintenance programs recommended by the contractor or manufacturers? Is the association required to have maintenance contracts in place before the project is completed? The contractor may want to undertake the maintenance obligations (for a fee) during any period that claims can be brought. Do the condominium documents require that anyone maintaining or repairing the project be licensed, insured and competent to do so?

(xi) Is the contractor afforded full access rights (without obligations) to inspect, document and test the project from time to time after completion of construction (regardless of the entity performing the maintenance obligations)?

(xii) Is the association or developer, on behalf of the association, required and able to obtain insurance to cover any defects and repairs, including pollution liability and other comprehensive coverages that may be needed during and after construction is completed? (Note: In some jurisdictions, insurance to cover such defects and repairs is not available or is prohibitively expensive, in which case the cost as reflected in the assessments or in the cost of the units would be an impediment to sales.) Whatever insurance is carried, is the policyholder required to provide the general contractor with copies of the policies and notices of any modification, termination or failure to renew the insurance? Does the insurance include waivers of subrogation and is the general contractor an additional insured in the applicable insurance policies?

(xiii) If desired, are the unit owners and association required to mediate and/or use other alternative dispute resolution procedures as a precondition to litigation? Should prevailing parties be entitled to their legal fees and other costs? Should the parties agree to an interest rate?

(xiv) In jurisdictions that retain joint and several liability among co-defendants, do the documents require that fault must be apportioned and damages recovered only for the proportional fault of the party?

(xv) Do the condominium documents provide that the relevant provisions dealing with construction matters and liability of the contractor cannot be amended without advance notice to and consent of the contractor, or, at a minimum, may only be amended by a super majority of the unit owners? Are amendments prohibited to the extent they

impair vested or other rights relied upon by the contractor in undertaking the project? Do the documents require that the contractor receive copies of all proposed modifications sufficiently in advance of, and be given an opportunity to attend, meetings where amendments will be proposed or discussed?

b. Questions concerning the agreement between the general contractor and developer (owner contractor agreement). The purpose of this section is not to raise every contractual issue benefiting a general contractor. It is intended only to highlight those provisions particularly relevant to condominium projects or those which are most noteworthy in limiting the contractor's liability for construction defect claims.

(i) Does the owner contractor agreement disclaim any third party beneficiary status under the contract and (to the extent permitted by law) prohibit the assignment of any warranties or claims to anyone, including the condominium association, unit owners and lenders without the consent of the contractor?

(ii) Is the developer required to give the contractor timely notice and copies of all claims received by the developer or of which the developer becomes aware?

(iii) Has the contractor received an assignment of unit owners' deposits or other security in addition to its lien rights as long as there are any outstanding obligations to the contractor? Any assignment of deposits is typically subordinated to the rights of the purchasers and lenders but such can be a negotiating or other useful tool nonetheless.

(iv) Did the contractor receive any guarantee of payment from the developer's parent, a letter of credit and/or other assurances of the developer's ability to pay at commencement of the project? Does the contractor have a right to further financial assurances from time to time if and as the project costs increase? If it has the right to do so, the contractor should not underestimate the value of demanding financial information and satisfactory evidence of funds before agreeing to change orders or undertaking new work.

(v) Does the contractor have the right to stop work if an application for payment remains unpaid for more than a specified number of days after payment becomes due? Has the contractor included a sufficient contractual interest rate on late payments?

(vi) Have the "no damages for delay" and other clauses favorable to the developer or limiting the general contractor's rights to recover for its losses been deleted from the contact?

(vii) If the contractor has assumed liabilities, does the owner contractor agreement define and limit, and if appropriate, liquidate them? For example, does the agreement limit the extent of the contractor's liability to repairing defective work within a defined time period, or cap liability to the contractor's fee, a number allocable to the contractor's profit, or to available insurance coverage?

(viii) Does the agreement require that the declaration of condominium contain the provisions described in Section III.C.2.a above? Does the owner contractor agreement include the developer's indemnification and obligation to defend the contractor for any claims or losses arising out of failure to include the requisite provisions in the declaration or arising from a breach of any of those provisions?

(ix) If the contractor prefers such, is participation in mediation or other alternative dispute resolution procedures a precondition to filing any litigation?

(x) Does the owner contractor agreement require adequate administration of the contract by the architect? Does it require the developer to engage an inspecting engineer that will provide a certification to the developer, contractor, association and unit owners upon completion of construction? (The architect also will want any certifications to run to it.)

(xi) Does the contractor have a right to receive complete design documents before commencement of construction and prompt clarification of conflicts and ambiguities in the construction plans and specifications? Has the contractor expressly disclaimed any obligations for or liability from professional design activities?

(xii) Does the contract exclude the architect from any indemnities that the contractor may provide? Is there a covenant not to sue the contractor in the owner architect agreement?

(xiii) Is "substantial completion" defined in a way that permits release of the final retainage upon completion of the essential elements of the project? For example, can withheld amounts be released before all common area amenities are completed?

(xiv) If the construction contract has a guaranteed maximum price, does it include sufficient construction contingencies that the contractor may use, in its discretion, during construction, as well as for repairs after substantial completion and during any repair periods? Has the contractor confirmed that all contingencies are fully funded?

(xv) Is the insurance coverage for the project and contractor adequate? Do the insurance policies covering the project include sufficient "tails" (i.e., coverage after completion), through the end of the longer of any repair or warranty obligations and applicable statute of limitation periods, if possible? Do the policies include waivers of subrogation and is the general contractor added as an additional insured under the appropriate policies. Do all parties benefiting from insurance coverage receive copies of the policies and notices of any modification, termination or failure to renew the insurance?

(xvi) Is the developer required to give the association and unit owners a list of the names and notice addresses of the contractor and subcontractors within a specified period after the close of sale, if necessary to fulfill any notice obligations? Has the contractor provided the developer with this information?

(xvii) If preferable, does the applicable right to cure act (see Section III.D.4.k.(iii) below) take precedence over any conflicting acts or agreements? If permitted and desirable, does the applicable right to cure act serve as the exclusive remedy of the unit owners and condominium association?

(xviii) Does the contractor want the prevailing party in a dispute to be entitled to its legal fees and other costs?

c. Agreement between contractor and subcontractors. The contractor will want any obligations it has to the developer to flow down to subcontractors. Whether or to what extent this happens will depend upon the relative bargaining power of the parties.

(i) Do the subcontracts limit the contractor's obligation to pay, to the extent permitted by law, by including "pay if paid" clauses, or if such are not enforceable, through "pay when paid" clauses? Of course, subcontractors will want to delete or limit any condition to payment other than satisfactory performance of the work.

(ii) Are there payment bonds for the benefit of the contractor and subcontractors in the event the developer is unable to meet its payment obligations?

(iii) Do contractors and subcontractors have appropriate insurance coverages, including professional liability and/or design build insurance coverage for any design functions that may be part of the work (for example, the subcontractor designing an HVAC system or curtain wall)? Have the parties received adequate assurances as to the insurance coverages for the project and other parties?

d. Loan documents.

(i) Has the contractor signed a consent to an assignment of the owner contractor agreement or any certifications or agreed to provide any warranties? Is the lender is obligated to pay the contractor in full for work performed before and after an event of default by the borrower?

(ii) In the event of an assignment of the owner contractor agreement to the lender (or other third party), is the contractor obligated to continue work if the outstanding obligations, and those going forward, are not being met?

3. Other considerations at the beginning of the project. Residential condominium projects have been the subject of much litigation from disgruntled owners. This trend can only be expected to increase because of, among other things, the downturn of the secondary market and the resultant impact on the inability to complete, sell and re-sell units. Before agreeing to construct a residential condominium, there are certain practical matters that a contractor or subcontractor should consider.

a. Evaluate the developer.

(i) Look for developers with significant experience in residential condominium projects.

(ii) Avoid developers with a history of claims or financial problems.

(iii) Review the development entity, which may be a SPE created for the project, and determine whether there are any payment opportunities potentially available to the contractor. Do not assume that just because the entity is an SPE or a corporate or other protective form such as an LLC that there is no way to recover from a member or other individual principal. *See Blue Hills Office Park v. J.P. Morgan Chase Bank*, 477 F.Supp. 366 (D. Mass. 2007) (holding that the members of the LLC were jointly and severally liable for the full value of the otherwise non-recourse loan where the independent director was not sufficiently active).

b. Review the project's financing.

(i) Confirm that the project's budget contains appropriate contingencies and is sufficient to cover all of the project's costs.

(ii) Verify that the developer has procured sufficient funds through debt or equity to cover the entire project budget.

(iii) Verify that all sources of funds for the project costs are stable and that those providing funds are contractually committed to do so.

c. Avoid high risk types of condominium projects.

(i) Some projects, such as those for first time residential condominium buyers or condominium conversions or renovations, are more likely to generate claims than other types of projects.

(ii) Make sure the project design is of high quality and complete. Design build or fast track projects without adequate supervision may generate more defects, and therefore, more claims. Residential owners often are more sensitive than commercial parties to "defective" work or to work that is less than perfect.

(iii) Be wary of projects calling for extensive "value engineering."

d. Evaluate the other project participants. Determine whether the architect and all other significant consultants are experienced and otherwise qualified.

e. Confirm that sufficient insurance protecting the project and its participants is or will be in place during and after construction.

4. Considerations during the troubled project. The contractor and subcontractors may not realize a project is failing unless they have not been paid or defective work claims are threatened or made. Once they become aware of problems, they must critically evaluate their compliance under their respective agreements and realistically quantify their potential exposure.

a. How far ahead of payment is the construction? Are payments in compliance with contract terms, and is the contractor observing the provisions of the agreement with the developer? How much is held in retainage? Be familiar with contractual terms and understand that contract terms may also be implied by statute or common law. Unfortunately, it is not unusual for general contractors and subcontractors to eschew lawyers and to take steps to become aware of their respective express and implied obligations and rights only after a claim is asserted or they have not been paid for a significant period of time.

b. What notices are required in order to exercise rights under any guaranty, letter of credit or escrow fund? Has the contractor fulfilled notice requirements under applicable agreements and statutes? Whether required or not, has the contractor alerted the lenders that the developer is not paying? (Subcontractors also may want to alert the lenders, and developers, if the contractor fails to pay them when due.) Does the contractor have statutory or common law rights to loan funds held or even previously distributed by the lender? For example, some jurisdictions impose constructive trusts or other restrictions on funds, which may result in a lender being obligated to pay a contractor or subcontractor directly for work performed but for which payment was not received, despite the lender having previously

disbursed funds to the developer for such payments. For reasons discussed in Section III.A. above, mezzanine or other junior lenders may be particularly inclined to make payments to keep a project moving.

c. Does the contractor have updated copies of the project's insurance policies, bonds and all other relevant documents? Review such to determine sources of funds that may be available to pay the contractor and subcontractors or to respond to claims, as well as to identify other rights and obligations. *See e.g.*, *Lamar Homes, Inc. v. Mid-Continental Casualty Co.*, No. 05-0832 (Tx. S.Ct. August 31, 2007) (allegations of unintended construction defects may constitute an "accident" or "occurrence" under the CGL policy and trigger duty to defend defective work claim) and *U.S. Fire Ins. Co. v. J.S.U.B.*, 2007 W.L. 4440232 Fla. S.Ct. (faulty soil preparation causing structural wall and foundation damage constituted "occurrence" and CGL policy therefore provided coverage to repair property damage). *But c.f., Auto-Owner's Inc., Co v. Pozzi*, 2007 WL 4440389 Fla. S.Ct. (defective installation of windows constituted "occurrence" but defective work itself did not constitute property damage, thereby relieving insurance company from liability for cost of repair). Have proper notices of losses or claims been given in a timely manner? The failure to notify surety company at first hint of potential claim may void rights under the bond. *See* unrecorded slip opinion, *Methuen Construction Co. v. Often Co.*, No. 04-1207-G (Mass. Sup.Ct. 9/1/06). Terms of bonds are often strictly construed. See *J. C. Gibson Plastering Co., Inc. v. XL Specialty Ins. Co., et al.*, 521 F.Supp. 2d 1326 (M.D. Fla. 2007); but see *Dooley & Mack Constructors, Inc. v. Developers Surety & Indemnity Co.*, 2007 WL 3274333 (Fla. App. 3 Dist.) (terms of subcontract incorporated in bond permitted general contractor first to declare subcontractor in breach and to finish its work before notifying surety and asserting claim under bond).

d. f the lender or other third party attempts to assume rights under the owner contractor agreement, does the contractor have the contractual right to refuse to work or to relinquish the jobsite unless and until past and current obligations are paid and, if applicable, adequate assurances are received for full and timely payments going forward? Lenders or others may want access to "as built" plans and other project records. The contractor and subcontractors have significant leverage if they can threaten to withhold or refuse to deliver project documents and permits. This also may provide an opportunity to revise existing, unfavorable contract terms. For example, perhaps retainage can be released more quickly and/or progress payments made more frequently.

e. Have the contractor and subcontractors complied with the applicable lien laws and other statutes that may protect contractors or subcontractors or provide rights to be paid timely and in full? Many jurisdictions have "right to pay," "prompt payment," or similar statutes, mandating payment of contractors and subcontractors within specified periods of time. The contractor and subcontractors may be entitled to interest, attorneys' fees and other damages if the developer or lender fails to comply with the provisions of these acts.

f. Has the contractor demanded compliance with alternative dispute and other relevant provisions? The contractor should keep a record of whether and when it receives notices and information from others, as well as its compliance with material contract terms.

g. Are there any claims which may be asserted against other project participants for defective work, improper design, failure to supervise or coordinate work, etc.? Were there multiple contractors engaged by various parties so it is difficult to determine responsibility? Has the architect, developer, lender and/or any other third party interfered with

the work? Was evidence destroyed or impaired by the tests or activities of other parties (a defense in litigation known as "spoliation of evidence")? Although lack of privity may prevent claims against third parties with whom one does not have a contract, such as architects and other design professionals, that defense is eroding in both tort and contract actions.

h. Has the general contractor complied with the terms of its subcontracts and enforced and asserted available claims against subcontractors? Have the subcontractors complied with and enforced the terms of their respective agreements with the general contractor and asserted available claims against the contractor, other subcontractors, suppliers and lower tier subcontractors? Are the parties property licensed? Note that unlicensed entities may work for free. MV Erectors, Inc. v. Niederhauser Ornamental Metalworks Co., Inc., (Calif. S.Ct. 7/14/05). While the contrary result was found in Sammarone v. Bovino, 395 N.J. Super. 132 (2007) (individual with history of engaging unlicensed brokers in order to avoid paying for services may not use lack of a license as a defense against payment), that case likely is limited to its extreme facts.

i. What defenses does the contractor have to any claims being asserted? For example, claims for economic loss arising in a contract action, as opposed to personal injury or property damage claims, are not recoverable against the contractors and subcontractors in many jurisdictions. Force majeure may be a defense to certain claims and may be the basis of affirmative claims for extra compensation by the contractor and subcontractors. Have the developer and unit owners complied with maintenance manuals and warranty documentation? These materials are important not only to protect the asset but they may establish the proper standard of care and serve as a basis for a negligent misuse defense to defect claims.

j. Analyze the impact of any threats of bankruptcy. Determine whether it is an appropriate negotiating tactic or a necessary outcome.

k. Review applicable statutes to determine the possible defenses, claims and exposure under each.

(i) Acts governing the creation of condominiums. A number of jurisdictions have enacted versions of the Uniform Common Interest Ownership Act and other statutory schemes governing the creation of condominiums, planned communities and projects with common ownership interests. These acts may contain express and implied warranties, limitations on disclaimers, notice obligations, statutes of limitation and other restrictions, obligations and rights. A recent California case interpreting that state's condominium act, held that a tolling agreement entered into between the developer and a homeowner's association bound the contractor despite the contractor not being a party to the agreement or having any notice of it. *Landale-Cameron Court, Inc. v. Ahonen*, 155 Cal. App. 4th 1401, 66 Cal. Rptr. 3d 776 (2007). The court therefore permitted the homeowners' association to bring an action against a contractor for a leaking roof after the applicable statute of limitations had expired. It is essential to understand what statutory scheme applies, whether it modifies any contract terms and to comply with ~~any~~all applicable requirements. These statutes also may provide significant negotiating opportunities. For example, liens may have to be disclosed or removed before a unit may be transferred or the existence of a lien may trigger rescission rights or damages. The potential of these outcomes understandably gets a developer's or lender's attention. Uniform acts also may provide limitations on unit owners or serve as a defense to claims, such as where they prohibit unit owners from altering or impairing the structural integrity of a unit.

(ii) Interstate Land Sales Full Disclosure Act. Contractors should understand whether ILSFDA has an impact on project resources or the parties' obligations. (See Section III.B.1.g above).

(iii) Residential "right to cure" acts. A number of states give contractors (and in more limited cases, design professionals) rights to remedy defective construction before unit owners or associations may sue. These acts may provide substantial protections for general contractors and subcontractors on a condominium project. Some of the provisions that appear in these so-called right to cure laws are:

(a) Comprehensive coverage of many types of claims, including defects in materials, products or other components, failure to construct in accordance with plans, construction not in a workmanlike manner or failing to meet acceptable standards or applicable codes.

(b) Before proceedings may be initiated, there must be specific notice of the defect claimed within a specified period of discovery of the problem. Super majority votes or approval of every affected unit owner may be required before they may bring an action. At least one jurisdiction requires the full board of the condominium association to confer in good faith (and in person) with the contractor to attempt to resolve the claim before further proceedings may be brought.

(c) The contractor may have multiple options in responding to the notice, including offering to inspect the alleged defective work, settling or disputing the claim. After inspection, options may include offering to repair all or part of the allegedly defective work, offering to settle without repair, offering to buy back affected units or refusing to repair or settle. The contractor generally is permitted to inspect the project and may have a right to have its lawyer present, to videotape inspections and to engage in testing of the project. Typically, the potentially affected subcontractors are given notice and the opportunity to attend any inspection. In the event of testing by unit owners, the owner may be required to use licensed individuals and to provide the contractor with notice and an opportunity to observe. Some right to cure acts provide procedures for destructive testing in order to preserve evidence and the project.

(d) Some acts limit recovery to reasonable costs of repair, actual direct damages, or reduction in value. Others provide interest on recovery amounts, costs of loss of use, and attorneys' fees and costs to prevailing parties.

(e) An unreasonable rejection of a settlement offer or an offer to repair may prevent the rejecting party from recovering an amount exceeding the offer or the reasonable cost to repair defects attributable to the contractor's fault.

(f) Statutorily provided defenses to claims include compliance with codes, unforeseeable acts or acts of God, nature or third parties, owner's failure to mitigate or prevent damages or to follow the contractor's or manufacturer's recommendations, failure to properly maintain the project, damage caused by misuse, alteration or third parties, defects disclosed or otherwise accepted before purchase, and damage caused by insects, rot and mold.

(g) The act may prohibit claims for certain types of damages such as economic loss or consequential damages and provide attorneys' fees and costs for frivolous claims or those brought in contravention of the terms of the act.

(h) Mediation may be a mandatory precondition to litigation. Other acts require arbitration in all cases or where the damages at issue are less than a specified amount.

(i) At least two states apparently are concerned with the possibility of fraudulently induced claims because they prohibit a person from providing anything of value to a unit owner, association or property manager, etc. to encourage that person to file a claim.

(iv) Prompt payment acts. Many jurisdictions have enacted statutes that mandate payments to contractors and subcontractors within specified time periods, and limit the circumstances under which payments may be withheld, among other things. Failure to comply with these provisions may obligate the non-complying party to pay interest on unpaid sums and legal fees and other costs Given that these acts may imply contract terms and modify negotiated agreements, it is critical to be familiar with all applicable provisions.

(v) Lien laws. In most jurisdictions, statutory or common law provides contractors and subcontractors (of varying tiers) with the ability to place liens upon projects if they are not paid in accordance with their respective contract terms. Compliance with notice and other requirements is essential in order for liens to be effective and for their priority to be maintained. In condominium projects particular attention must be paid to lien laws and common interest ownership acts to determine whether and to what extent a lien will attach to an individual owner's unit and/or to the common elements of a project.

(vi) Other laws. State homeowner warranty acts may provide additional or exclusive remedies for defective work. Local building codes may impose special, and unexpected, requirements on condominiums. For example, the Village of Westchester, New York Code § 14.44,090(4) requires condominiums to have a "high degree of appearance, quality and safety," much to the dismay of contractors and design professionals trying to insure against defect claims for failed aesthetics. The International Building Code has a number of relevant provisions, including a requirement that the construction documents include supporting documentation demonstrating that all openings in exterior walls will maintain water resistance and describing the testing procedures confirming the same. Failure to comply with these provisions may be negligence per se. Other consumer laws may be triggered by misrepresentations or allegations of fraud and may impose strict liability or additional warranty and other obligations. For example, Texas imposes a 10-year foundation warranty requirement and Virginia requires the provision of a 2-year warranty against structural defects.

D. **Considerations for Design Professionals**.

1. Background relating to design professionals. As with the general contractor and its subcontractors, the critical time to protect the design professional's interests is before the project has started. While circumstances may render contractors of a failed project antagonists of design professionals, they also share a number of substantive interests. Therefore, this section contains many of the same provisions as are set forth in Section III.C. of this paper. However, it also contains comments unique to architects, engineers and other design professionals. To the extent that design professionals succeed in negotiating some of the provisions suggested below, they will gain greater leverage in a loan workout setting and stand to limit their liability in design defect actions.

2. Considerations at the start of the project -- analysis of the project documents. Preventative measures should begin when the architect is first approached to work

on the project. Not all of the risk management strategies will be available on many, or even most, projects. In addition, some of them may not be enforceable under the applicable jurisdiction's relevant statutes and common law. However, these suggestions are intended to provide a broad range of options to the design professional, and to alert the parties to a condominium project of the requests they may receive.

a. Questions concerning the condominium declaration and other documents affecting unit owners. Often, the architect is brought into the project before the condominium documents have been prepared and given to buyers. That provides design professionals with significant opportunities to request the inclusion of provisions protecting their interests and modification or elimination of those that do not. Therefore, design professionals should attempt to obligate the developer contractually to include as many of the following protective measures in the condominium documents as possible.

(i) Prior to closing the purchase of a unit, is the buyer required to inspect the unit and sign a "certificate of satisfaction"? Is the general contractor required to certify to the developer and architect that the project has been completed properly and in a good and workmanlike manner?

(ii) To the fullest extent permitted by applicable law, is there a disclaimer of any implied warranties of habitability, merchantability or fitness for a particular purpose and any other implied or express warranties? (Note that relevant statutes may prohibit broad disclaimers and permit only specific, defined and limited disclaimers of warranties.)

(iii) Is there a disclaimer of liability for high risk and difficult to control issues, such as termite damage, mold and water intrusion?

(iv) Is the design professional required to execute or deliver any certifications to unit owners or the association? If the design professional must issue certifications to the developer and/or lender, is there a disclaimer that the unit owners and association are not entitled to rely upon any certifications that are rendered for the benefit of any other parties?

(v) Are the developer, unit owners, association and/or contractor, as applicable, required to provide to the design professionals detailed written descriptions of any alleged defects as a precondition to filing any claims, and copies of any notices provided to the other parties to the project (such as those given to the developer, contractor or subcontractors). Have the design professionals received all required notices? Note that some jurisdictions have right to cure laws that cover design professionals as well as contractors. These may mandate notice and an opportunity to repair defects before claims may be made. (See Section III.D.4.k.(iii) below.) Are design professionals given the right to inspect and test (accompanied by experts and counsel) and, as when needed, make records, including by photographing and/or videotaping such? Where preferable, do the purchase agreements and condominium documents provide that applicable right to cure laws take precedence over any conflicting laws or agreements? Where permitted and desirable, is the applicable right to cure act the exclusive remedy for the unit owners and condominium association?

(vi) Is the right to sue limited to the condominium association (as opposed to individual unit owners)? In addition to stating this restriction, do the purchase agreements, declaration of condominium and any other relevant documents include a covenant not to sue from the individual unit owners?

(vii) Do the condominium documents require a vote of a super majority of the unit owners and certification of merit from an expert as a pre-condition to commencing an action against a design professional? Must all expert and inspection reports and other information gathered by or on behalf of the unit owners and/or association be given to the architect and other relevant design professionals? Must all notices, claims, etc. be kept confidential and not be disclosed, except as required by law, or as necessary for prosecution of or response to claims?

(viii) Do the condominium documents limit the time within which claims may be instituted? If the design professional has entered into a form AIA agreement with the developer, have the parties agreed that those limitation provisions control (if they are beneficial)? Depending upon the jurisdiction, statutes of limitation may be shortened by agreement. If there is a warranty or repair period in any of the relevant documents, shortly before its expiration, the architect, contractor, developer and other appropriate parties should inspect the project together with representatives of the condominium association to agree upon and document whether there are any defects or work in need of repair. The condominium documents should permit the architect to monitor subsequent repairs and other compliance with warranty obligations and should require notices and other material information to be given to the design professionals concerning such. The architect should be paid for any services it provides in monitoring repairs and compliance with warranty obligations.

(ix) Are there limits in the condominium documents on the design professional's potential exposure? Limits may be to the amount of the design professional's fee or its existing insurance coverage, for example. Where high risk jurisdictions or types of projects are involved, it may be difficult to engage competent design professionals without limitations on their exposure. The potential amount of claims and the costs of defense often are so disproportionate to the amount of the fees received by architects or engineers that other parties may agree to accept limitations on the risks assumed by design professionals. If more comprehensive limitations cannot be achieved, at a minimum, have the design professionals disclaimed liability for consequential damages?

(x) Is the association required to fund adequate maintenance reserves, undertake periodic inspections and adhere to the maintenance programs recommended by the contractor or manufacturers? Is the association required to have maintenance contracts in place before the project is completed? Do the condominium documents require that anyone maintaining or repairing the project be licensed, insured and competent to do so?

(xi) Is the architect granted access rights (without obligation), to monitor and inspect the project from time to time after construction?

(xii) Is the association, or developer on behalf of the association, and/or unit owners, able to obtain insurance to cover defects and repairs, including pollution liability and other comprehensive coverages? Are the parties required to provide to the architect and engineers copies of the policies and notices of any modification, termination or failure to renew the insurance? Does the insurance include waivers of subrogation and are the architect and engineers additional insureds under the applicable policies? Do the policies cover repair and/or limitations periods post construction? As previously discussed, some types of insurance may not be available or may be prohibitively expensive, in which case the cost as reflected in the assessments or the price of the units may be an impediment to sales.

(xiii) If preferable, are the unit owners and association required to mediate and/or pursue other alternative dispute resolution procedures as a precondition to any litigation? Should the parties agree to an interest rate? Do the condominium documents provide that the design professionals will not be joined in the dispute resolution proceedings initiated by other parties (other than litigation) and others will not be joined in proceedings with design professionals, without the design professionals' approval? Consider including a provision (to the extent permitted by law), limiting any action with respect to the architect's license until the final determination of all other proceedings in which the architect is involved.

(xiv) In jurisdictions that retain joint and several liability among co-defendants, do the condominium documents require that fault must be apportioned and damages recovered only for the proportional fault of the party?

(xv) Do the condominium documents provide that the relevant provisions in the condominium documents dealing with design matters and liability of design professionals cannot be amended without the consent of the affected design professionals or, at a minimum, may only be amended by a super majority of the unit owners? Under any circumstances amendments should not be permitted if they affect vested rights or rights accrued or relied upon by design professionals in undertaking the project. Do the documents require that the design professionals receive copies of all proposed modifications and be given an opportunity to attend meetings where amendments will be proposed or discussed? Are the unit owners and condominium association required to pay the design professionals' legal fees and other costs if they violate any applicable protective measures in the condominium documents or if the design professional prevails in any claim?

b. Agreement between architect and developer (owner architect agreement).

(i) Does the owner architect agreement disclaim any third party beneficiary status under the contract and (unless prohibited by law) prohibit assignment of any warranties or claims to anyone, including the condominium association, unit owners and lender without the consent of the architect? Has the architect retained all copyright and other intellectual property rights to plans, specifications and other materials provided by or on behalf of the architect? The developer may receive a license to use such for the limited purpose of constructing the project. Is the license conditioned upon the architect remaining engaged on the project and the developer complying with all terms and conditions of its agreement with the architect? Is the continued use of the plans for maintenance and repair of the project conditioned on the developer's performance of its obligations under the agreement and the indemnification of the architect by the developer, unit owners and the association for all claims, losses, damages, etc. associated with use of the plans without the architect's involvement?

(ii) Does the owner architect agreement require the developer and/or contractor to enter into direct contracts with all specialty engineers and high-risk consultants, such as the soil engineer, environmental consultants, and structural and MEP engineers? Does it limit the architect's obligation to supervise or coordinate their work? If so, who is obligated to perform that critical task? (A minority of architects prefer more, rather than less, involvement with and control over the consultants in order to assure themselves that the project is being handled properly. This generally depends upon the experience of the architect, its philosophy of risk management and the mandates and sophistication of its insurer.)

(iii) Does the owner architect agreement allow the architect to maintain control over the project's quality by including in the scope of the architect's services

preparation of complete construction documents and full administration of the construction contract through final completion of the project? Is "value engineering" limited or permitted only with the architect's approval? Has the architect avoided or substantially limited any fast track, design-build or other high risk project delivery methods? Is the developer required to pay the architect as an additional service for the preparation of record drawings, and is the architect expressly allowed to rely on "as built" drawings prepared by the contractor? Are there any provisions mandating peer review of the design of major systems, including elevator, stairs, roof, structure, waterproofing, HVAC and plumbing systems? If so, who bears the cost of the peer review and is sufficient time allowed in the schedule?

(iv) Is the developer required to give the architect timely notice of all claims received by the developer or of which the developer is aware?

(v) Has the architect received an assignment of unit owner's deposits or other security, in addition to its statutory or common law lien rights, as long as there are any outstanding payments due to the architect? Any such assignment of deposits is typically subordinated to the rights of the purchasers and lenders.

(vi) Did the architect receive any guarantee of payment from the developer's parent, a letter of credit and/or other assurances of the developer's ability to pay at commencement of the project and if the architect's fee or cost of the project increases?

(vii) Does the contract give the architect the right to stop work if an invoice remains unpaid for more than a specified number of days after payment becomes due?

(viii) If the architect has assumed liabilities for mold, water intrusion, termite damage, compliance with the ADA and any other high risk claim areas, does the owner architect agreement define and limit the extent of the architect's liability, and if appropriate, liquidate potential damages? Does the agreement limit liability to the cost of redesign of work that is defective, or cap liability to the architect's fee or to the architect's available insurance coverage?

(ix) Does the declaration of condominium contain the provisions noted in Section III.D.2.a. above? Does the owner architect agreement include an indemnification (and obligation to defend) from the developer for any claims or losses arising out of the developer's failure to include the requisite provisions, and from breach of any of those provisions?

(x) Does the architect prefer participation in mediation or other alternative dispute resolution procedures as a precondition to any litigation against the architect? Is the prevailing party, as to each claim, entitled to its legal fees and costs? Does the agreement provide that the architect will not be joined in any dispute resolution proceedings initiated by other parties (other than litigation) and that others will not be joined in proceedings with the architect, without the architect's approval? To the extent permitted, is there a provision limiting any action relating to the architect's license until the final determination of all other proceedings in which the architect is involved?

(xi) Does the agreement require the developer and/or contractor to engage an inspecting engineer during construction that will provide a certification upon completion of construction on which the architect may rely? Are there provisions requiring

inspections and certifications by separate engineers for potential problem areas such as the roof and building enclosures? If so, who bears the cost?

(xii) Does the owner architect agreement require that the general contractor and significant subcontractors be experienced and/or approved by the architect before performing any portions of the work? (If the architect pre-approves any contractors or subcontractors the architect should disclaim liability for failure of those parties to perform their respective work properly.) Is the contractor and/or applicable subcontractors required to be insured for any design work they undertake? Is the architect's review of shop drawings and similar documents limited to compliance with design intent? Is the contractor required to maintain a marked set of "as built" plans and to certify to the architect that such are accurate and complete?

(xiii) Is the developer required to have the contractor include the architect in any indemnifications the contractor provides to the developer? Does the owner architect agreement obligate the developer to obtain a covenant not to sue the architect from the contractor?

(xiv) Does the agreement give the architect the right to review and approve all marketing and other promotional materials in order to determine whether the developer promises to prospective purchasers are reasonable or are potentially exposing the parties to greater risks by "over-committing" to what the project design provides?

(xv) Is the developer required to engage an independent cost estimator to review the developer's project budget? Does the project budget include sufficient amounts for the cost of contingencies and reserves for design errors and omissions, construction defects, and maintenance and repairs? Are there guarantees that the funds will be available and allocated properly for such purposes? Is the developer required to prepare and distribute a comprehensive maintenance manual to unit owners? Is the project schedule reasonable?

(xvi) Is there adequate insurance covering the project and design professionals, including professional liability and pollution coverage? Are there waivers of subrogation and is the architect an additional insured, as applicable? Require sufficient "tails" covering the project after it is completed (through any statute of limitation periods, if possible). Are all parties benefiting from insurance coverage required to receive copies of the policies, as the same may be amended, and notices of any modification, termination or failure to renew the insurance.

(xvii) Is the developer required to give the association and unit owners a list of the names and notice addresses of the architect and other design professionals within a specified time after closing, if necessary to fulfill any notice obligations? Have the architect and other design professionals provided the developer with this information?

(xviii) If preferable, does the applicable right to cure act (see Section III.D.4.k.(iii) below) take precedence over any conflicting acts or agreements? Where permitted and desirable, is the applicable right to cure act the exclusive remedy of the unit owners and condominium association?

c. Loan documents.

(i) Has the architect signed a consent to an assignment of the owner architect agreement or any certifications or warranties? Make sure that the lender is obligated to pay the architect in full for work performed before and after an event of default by the borrower.

(ii) In the event of an assignment of the owner architect agreement to the lender (or other third party), is the architect obligated to continue work if outstanding obligations and those going forward are not being met?

3. Other considerations at the beginning of the project. Residential condominium projects have been the subject of much litigation from disgruntled owners. This trend can only be expected to increase because of the downturn of the secondary market and the resultant impact on the ability to complete, sell and re-sell units. Before agreeing to design a residential condominium there are certain practical considerations that a design professional should bear in mind.

a. Evaluate the developer.

(i) Look for developers experienced with condominium projects.

(ii) Avoid developers with a history of claims or financial problems.

(iii) Review the development entity, which may be an SPE created for the project, and determine whether there are any payment ~~protections~~opportunities potentially available to the architect. Do not assume that just because the entity is an SPE or a corporate or other protective form such as an LLC that there is no way to recover from a member or other individual principal. *See Blue Hills Office Park v. J.P. Morgan Chase Bank*, 477 F.Supp. 366 (D. Mass. 2007) (holding that the members of the LLC were jointly and severally liable for the full value of the otherwise non-recourse loan where the independent director was not sufficiently active).

(iv) Avoid developers who change architects frequently.

b. Review the project's financing.

(i) Confirm that the project's budget contains appropriate contingencies and is sufficient to cover all of the project's costs.

(ii) Verify that the developer has procured sufficient funds through debt or equity to cover the entire project budget.

(iii) Verify that all sources of funds for the project costs are stable and that those providing funds are contractually committed.

c. Avoid high risk types of condominium projects.

(i) Some projects, such as those for first time residential condominium buyers, or condominium conversions or renovations, are more likely to generate claims than other types of projects.

(ii) Make sure the schedule is adequate and that the developer pays for sufficient supervision of the work. Fast track projects without adequate monitoring can generate more defects and, therefore, more claims.

(iii) Determine whether the developer is committed to a high quality project and will not "value engineer" important protections out of the project.

d. Evaluate the other project participants. Determine whether the contractor, major subcontractors and other significant consultants are experienced and otherwise qualified.

e. Confirm that sufficient insurance protecting the project and its participants is or will be in place during and after construction.

4. Considerations during the troubled project. Design professionals may not realize that a project is failing unless they have not been paid or claims have been threatened or initiated. This is particularly true when the architect's services have been completed before the project becomes troubled. Once the design professional becomes aware of problems, it must critically evaluate its compliance with the owner architect agreement and realistically quantify its potential exposure.

a. How far ahead of payment are the design professionals' services? Are payments in compliance with contract terms, and has the architect observed all notice and other provisions in its agreement with the developer? Unfortunately, many design professionals fail to see the necessity of becoming aware of their respective obligations and rights (whether arising under written agreements, statutes, common law or otherwise), until a claim is asserted or they have not been paid for a significant period of time.

b. Has the architect fulfilled the notice requirements under applicable agreements and statutes? What notices are required in order to exercise rights under any guaranty, letter of credit or escrow fund? Whether required or not, has the architect alerted the lender if the developer is not paying? Does the architect have statutory or common law rights to loan funds held or even previously distributed by the lender? Determine whether constructive trusts or other restrictions may be placed on loan funds for the benefit of the design professional. For the reasons discussed in Section III above, mezzanine or other junior lenders may be particularly inclined to make payments necessary to keep a project from going under.

c. Does the architect have updated copies of the project's insurance policies, bonds and other relevant documents? Review such to determine sources of funds that may be available to pay the design professionals or to respond to claims, as well as to identify other rights and obligations. Errors and omissions (professional liability) and CGL policies may provide coverage for certain claims. *See e.g.*, *Lamar Homes, Inc. v. Mid-Continental Casualty Co.*, No. 05-0832 (Tx. S.Ct. August 31, 2007) (allegations of unintended construction defects may constitute an "accident" or "occurrence" under the CGL policy and trigger duty to defend defective work claim) and *U.S. Fire Ins. Co. v. J.S.U.B.*, 2007 W.L. 4440232 Fla. S.Ct. (faulty soil preparation causing structural wall and foundation damage constituted "occurrence" and CGL policy therefore provided coverage to repair property damage). *But c.f., Auto-Owner's Inc., Co v. Pozzi*, 2007 WL 4440389 Fla. S.Ct. (defective installation of windows constituted "occurrence" but defective work itself did not constitute property damage, thereby relieving insurance company from liability for cost of repair). Have proper notices of losses or claims been given in a timely manner? The failure to notify surety

company at first hint of potential claim may void rights under the bond. *See* unrecorded slip opinion, *Methuen Construction Co. v. Often Co.*, No. 04-1207-G (Mass. Sup.Ct. 9/1/06). Terms of bonds are often strictly construed. See *J. C. Gibson Plastering Co., Inc. v. XL Specialty Ins. Co., et al.*, 521 F. Supp. 2d 1326 (M.D. Fla. 2007); but see *Dooley & Mack Constructors, Inc. v. Developers Surety & Indemnity Co.*, 2007 WL 3274333 (Fla. App. 3 Dist.) (terms of subcontract incorporated in bond permitted general contractor first to declare subcontractor in breach and to finish its work before notifying surety and asserting claim under bond).

d. If a lender or other third party attempts to assume rights under the owner architect agreement, does the design professional have the contractual right to withhold its services unless past and current obligations are paid and, if applicable, adequate assurances are received for full and timely payments going forward? Lenders or others may want access to record plans and other project documents. The architect will have significant leverage if it can threaten to refuse to deliver materials in its control or to assign licenses or rights to use plans and other documents, unless and until it is paid in full and receives any other desired protections. The right to withhold documents or services also provides an opportunity to revise existing, unfavorable contract terms.

e. Have the design professionals complied with the applicable lien laws and any other statutes benefiting them? Design professionals often are unaware that in many jurisdictions construction (mechanics') lien statutes provide significant remedies and rights to design professionals, and not just to contractors, subcontractors and material suppliers. Does the relevant jurisdiction also have any "right to pay" or similar statutes, mandating payment of design professionals within specified periods of time? Design professionals may be entitled to interest, attorneys' fees and other costs if the developer or lender fails to comply with the provisions of these acts.

f. Has the design professional demanded compliance with notice, alternative dispute and other relevant provisions? Make sure a record is kept of the design professional's compliance with contract terms and statutory requirements, as well as whether others have complied with same.

g. Does the architect have any claims which may be asserted against other project participants for defective work, improper design, failure to supervise or coordinate work, etc.? Has the contractor, subcontractors, developer, lender or any third party interfered with the proper delivery of the architect's services? Was evidence destroyed or impaired by the tests or activities of other parties, such as unit owners investigating allegations ("spoliation of evidence")? Although lack of privity may prevent claims against third parties such as contractors, subcontractors and consultants with whom the architect does not have a contract, that defense has been eroding in both tort and contract actions.

h. Has the architect complied with and enforced the terms of its agreements with other design professionals or consultants? Has the architect asserted available claims against other design professionals or consultants? Evaluate what liabilities the architect may face from claims by other design professionals or consultants. Are the parties property licensed? Note that unlicensed entities may work for free. *MV Erectors, Inc. v. Niederhauser Ornamental Metalworks Co., Inc.,* (Califa. S.Ct. 7/14/05). While the contrary result was found in *Sammarone v. Bovino*, 395 N.J. Super. 132 (2007) (individual with history of engaging unlicensed brokers in order to avoid paying for services may not use lack of a license as a defense against payment), that case likely is limited to its extreme facts.

i. What defenses does the architect have to any claims being asserted? For example, claims for economic loss arising in a contract action, as opposed to personal injury or property damage claims, is not recoverable in many jurisdictions. Architects are professionals, subject to standards of care that may not have been breached, despite the work being considered by some as "defective". Force majeure also may be a defense to certain claims and may be the basis of affirmative claims for payment for additional services by design professionals. Have the developer and unit owners complied with maintenance manuals and warranty documentation? These materials are important not only to protect the asset but they may establish the proper standard of care and serve as a basis for a negligent misuse defense to defect claims.

j. Analyze the impact of any threats of bankruptcy. Determine whether it is an appropriate negotiating tactic or a necessary outcome.

k. Review applicable statutes to determine the possible defenses, claims and exposure under each.

(i) Acts governing the creation of condominiums. A number of jurisdictions have enacted versions of the Uniform Common Interest Ownership Act and other statutory schemes governing the creation of condominiums, planned communities and projects with common ownership interests. These acts may contain express and implied warranties, limitations on disclaimers, notice obligations, statutes of limitation and other restrictions, obligations, and rights. A recent California case interpreting that state's condominium act, held that a tolling agreement entered into between the developer and a homeowner's association bound the contractor despite the contractor not being a party to the agreement or having any notice of it. *Landale-Cameron Court, Inc. v. Ahonen*, 155 Cal. App. 4th 1401, 66 Cal. Rptr. 3d 776 (2007). The court therefore permitted the homeowners' association to bring an action against a contractor for a leaking roof after the applicable statute of limitations had expired. It is essential to understand what applies, whether it modifies any contract terms, and to comply with any applicable requirements. Marketing brochures, plans and models also can turn into warranties of quality. These statutes also may provide significant negotiating opportunities. For example, liens may have to be disclosed or removed before a unit may be transferred or the existence of a lien may trigger rescission rights or damages. The potential of these outcomes understandably gets a developer's or lender's attention. Uniform acts also may provide limitations on unit owners or serve as a defense to claims, such as where they prohibit unit owners from altering or impairing the structural integrity of a unit.

(ii) Interstate Land Sales Full Disclosure Act. The architect should understand whether ILSFDA has an impact on project resources or requirements. (See Section III.B.1.g above).

(iii) Residential right to cure acts. While these statutes often are intended to protect contractors and subcontractors, in a number of jurisdictions they provide the architect with rights, such as limiting the circumstances under which design professionals may be sued by unit owners or condominium associations. Where in place, these so-called right to cure laws may provide the following substantial protection to design professionals:

(a) Comprehensive coverage of many types of claims, including defects in materials, products or other components, failure to construct in accordance with plans, construction not in a workmanlike manner or meeting acceptable standards and failure to meet applicable codes.

(b) Before proceedings may be initiated, there must be specific notice of the defect claimed within a specified period after discovery of the problem. Super majority votes or approval of every affected unit owner may be required before they may bring an action.

(c) Design professionals may have multiple options in responding to the notice, including offering to inspect or settling, or disputing the claim. After inspection, options may include offering to repair all or part of the allegedly defective work, offering to settle without repair, offering to buy back affected units or refusing to repair or settle. The design professional generally is permitted to inspect the project and may have a right to have its attorney present, to videotape inspections and to engage in testing of the project. Testing by unit owners may require licensed individuals, notice to the design professional, and an opportunity to observe the test. Some acts provide specific procedures for any destructive testing in order to preserve evidence and the project.

(d) Some acts limit recovery to reasonable costs of repair, actual direct damages, or reduction in value of the project or unit because of the defective work. Others provide interest on amounts recovered, costs attributable to loss of use, if any, and attorneys' fees and costs to prevailing parties.

(e) An unreasonable rejection of a settlement offer or offer to repair may prevent the rejecting party from later recovering an amount exceeding the offer or more than the reasonable cost to repair property damaged, to the extent attributable to the design professional's fault.

(f) Statutorily provided defenses to claims include designing in compliance with codes, unforeseeable acts or acts of God, nature or third parties, owner's failure to mitigate or prevent damages or to follow the design professional's, contractor's or manufacturer's recommendations, failure to properly maintain the project, damage caused by misuse, alteration or third parties, defects disclosed or otherwise accepted before purchase, and damage caused by insects, rot and mold.

(g) The act may prohibit claims for certain types of damages such as economic loss or consequential damages, and may provide attorneys' fees and costs to the prevailing party in the event of a frivolous claim or one brought in contravention of the terms of the act.

(h) Mediation may be a mandatory precondition to litigation. Other acts require arbitration in all cases or where the damages at issue are less than a specified amount.

(i) At least two states apparently are concerned with the possibility of fraudulently induced claims because they prohibit a person from providing anything of value to a unit owner, association or property manager, etc. to encourage that person to file a claim.

(iv) Prompt payment acts. Many jurisdictions have enacted statutes, among other things, requiring timely payments be made to the parties to a construction project, including design professionals. Where these acts exist, they may establish the time within which payments must be made, specific procedures for withholding payments and obligate non-complying parties to pay interest on late payments and the prevailing parties'

attorneys fees. Often the protections provided in the statute may not be waived by contract. These right to payment acts can be of immense value to design professionals.

(v) Lien laws. Although the right to lien generally is thought of as a contractor's or subcontractor's right, common law and the statutes of many states provide similar remedies to design professionals. Generally, strict compliance with the law is necessary to achieve an enforceable lien and to obtain and maintain its desired priority. Particular attention must be paid to relevant provisions of the lien laws and applicable common interest ownership statutes to determine whether and under what circumstances a lien will attach to an individual's unit and/or to common elements.

(vi) Other laws. State homeowner warranty acts may provide additional or exclusive remedies for defective work. Local building codes may impose special, and unexpected, requirements on condominiums. For example, the Village of Westchester, New York Code § 14.44,090(4) requires condominiums to have a "high degree of appearance, quality and safety," much to the dismay of contractors and design professionals trying to insure against defect claims for failed aesthetics. The International Building Code has a number of relevant provisions, including a requirement that the construction documents include supporting documentation demonstrating that all openings in exterior walls will maintain water resistance and describing the testing procedures confirming the same. Failure to comply with these provisions may be negligence *per se*. Other consumer laws may be triggered by misrepresentations or allegations of fraud and may impose strict liability or additional warranty and other obligations. For example, Texas imposes a 10-year foundation warranty requirement and Virginia requires the provision of a 2-year warranty against structural defects.

E. **Condominium Association Considerations.** Although the developer frequently controls the condominium association through its appointees to the board of directors, the association is a separate entity with extensive obligations to the unit owners. Its obligations are established in the condominium documents as well as by corporate and condominium law. Typically, the directors have a fiduciary duty to the unit owners, which may at times put them in direct conflict with the developer and pose troublesome conflicts of interest for the developer-designated directors.

1. Is the developer-controlled association operating independently of the developer? To whom does the manager report, operationally and as a matter of practice? Is the management capable and is it performing necessary duties? What triggers transition from developer to owner control? Who is responsible for planning and undertaking preparations? What happens if there are not sufficient, or too many, volunteers to serve as owner directors.

a. Are the funds of the association segregated from those of the developer? Where are the association's bank accounts and check books? Who has the right to sign checks? Are there any internal controls? Has the association retained an independent accountant? Is one required by applicable law?

b. Is the property of the association segregated from that of the developer? Often this is difficult to determine if the developer or an affiliate of the developer is managing the association from the developer's office.

c. If the condominium association is paying legal counsel or if there is an attorney providing counsel to the association, then is there a proper fee agreement with appropriate disclosures and appropriate waiver of conflict provisions?

2. If the developer collects capital contributions from buyers at closing, have those funds been remitted to the association? Have those funds been set aside for use after turnover or termination of the developer's deficit funding (subsidy) program, if required by law?

3. Is the developer enforcing the condominium documents consistently? Have waivers and permissions been properly documented?

4. Is the association maintaining current, accurate financial records? Is there a legal standard for keeping records and reports? Does the association have billing and collection procedures and are they being enforced against the other unit owners? Is the developer paying its assessments and/or subsidies in a timely manner? Is management reporting to the board on the accounts receivables and financial condition of the association? Is there an accountant's management letter?

5. What is the status of the association's obligations to third parties, including vendors, suppliers, master associations or other associations, mandatory membership clubs, lessors, governmental entities? Does the association have a comprehensive list of all of the agreements which bind it and schedule of termination and notice of termination dates? Is management reporting to the board on the association's accounts payable?

6. Does the association have a schedule of completion dates for the unfinished units and the incomplete recreational and other common areas?

7. Has the association compiled a punch list of items in the common areas to be corrected? Is there an engineering or other report required by law? Is the condition of physical plant documented, including photographs?

8. Is the condominium property being properly maintained? Is the association adhering to inspection and testing schedules and maintenance programs recommended by the general contractor and/or manufacturers?

9. Is the developer-run association observing corporate formalities? If the developer is seeking reimbursement for advances, is there proper documentation of advances? Are personnel paid by the association performing association duties?

a. Does the association schedule, notice and conduct meetings of the board of directors? Does it keep minutes of the meetings? Are the meetings open to the unit owners?

b. Does the association schedule, notice and conduct meetings of the members? Do members receive agendas, proxies and ballots? Does the association maintain minutes of the meetings?

c. If the developer or developer-controlled association intends to waive association or owner rights, then does the waiving entity have the right to waive and has it complied with legal requirements for waiver, such as for the waiver or reserve/deferred maintenance accounts?

10. Is the association maintaining the official records so that these items can be delivered to the association when the developer relinquishes control of it? See attached checklist of typical documents and items for turnover. Is there a proper collection of deeds for current owners? If leasing is allowed, does the association have copies of all leases for units,

along with a schedule of commencement and termination dates? What is the timing for keeping records pursuant to law?

IV. **UPDATED HYPOTHETICAL**. Fast forward to May, 2008. The situation at Platinum Condominium has continued to deteriorate. The situation is as follows:

- Neither the equity investors nor the mezzanine lender are willing to advance any additional funds. The developer has been unable to raise additional equity and its efforts to refinance another property to free up money to invest in the Platinum Condominium property have been thwarted by the lack of liquidity in the capital market.
- Sales have stalled. Only 10 units have closed since October, and those buyers willing to close are encountering difficulty obtaining financing because of lenders' tougher underwriting requirements, higher spreads and rates for jumbo loans, and units not appraising at the contract purchase price.
- 240 units have closed; however, 12 of the units which closed are the subject of foreclosure by the first mortgagees. Forty (40) non-developer units are over 60 days delinquent in payment of assessments to the Association. The developer now owes the association $1,825,000 in unpaid assessments and subsidies.
- All of the units are now substantially completed, as are the common areas with the exception of the movie theatre and spa.
- The general contractor and several sub-contractors have filed claims of lien against the property. The window subcontractor made good on its threats and filed a petition under Chapter 11 of the Bankruptcy Code but is expected to convert to a Chapter 7 proceeding. The window subcontractor was one of the subcontractors required to post a performance bond. The general contractor has devised a method of remedying the improper window installation and, at the request of the developer and lender, has started performing corrective work on the installation. Once it is clear that such repair work will not be effective, the developer and lender notify the surety of their claim against the bond for defective product and installation. The general contractor also procured a payment bond assuring payment to the subcontractors. The bond requires that affected subcontractors must provide detailed notices to the Surety of all claims, Several subcontractors have made claims under the bond. The surety is required to respond to all claims within 45 days after receipt of the detailed notice. Thirty days after notice, the Surety requests further information from the subcontractors.
- Litigation activity has accelerated. 110 units are now in litigation (buyers' complaints typically include counts for breach of contract, purported misrepresentations by the developer's sales staff; and claims for rescission and a refund of their deposits, based on alleged material changes in the offering statement, and claims based upon violations of ILSFDA, including various damages claims). A group of 60 buyers are represented by a lawyer working on a contingency fee basis. Compounding these difficulties is the fact that the local trial court judges have sided consistently with the buyers in contract disputes with developers.
- An additional 60 buyers are in default and their status is presently in limbo, although it is expected that they will be claiming that the developer is in default and that they are entitled to walk away from their contracts.
- The group of investor/speculators with contracts on 50 units has not yet closed. The group has renewed its offer to buy the unsold units if there is a substantial reduction in the purchase price. However, the latest offer calls for a 35% reduction from their 2003 pre-construction purchase prices. They have insisted that the condominium documents be amended to (1) remove all restrictions on rentals and pets, and (2) give the investor owner group the right to approve the annual budget, all capital or special assessments,

any change in management, any loans incurred by the Association, and any amendments to the condominium documents so long as the group owns at least 30 units.

- The interest reserve in the construction loan has been fully expended and the developer has not made any payments on the loan. The lender group has sent the developer a notice of default and is threatening to commence foreclosure. The developer has informed the lender that it is willing to throw in the towel given the current state of the project and economy. The developer has discussed the bulk sale offer from the investor with the lender which will require a write off of a portion of the loan principal.

V. FORECLOSURE SCENARIO

A. Lender Foreclosure Issues.

1. Who are the necessary parties in an effective foreclosure proceeding? — check title reports and title record.

a. Junior lenders of record

b. Mechanics lienors

c. Judgment creditors

d. Contract buyers

e. Condominium association and other owners associations

f. Tenants and other occupants

2. Should all parties be named? Consider whether to name a tenant if lease is desirable. Should those contract buyers who want to perform under their contracts be named? Are there any Subordination, Non-Disturbance and Attornment Agreements in place? Whether the lender names some or all of the contract buyers or tenants in the foreclosure action will require business and legal analysis.

3. Are there expedited procedures for a foreclosure action in the relevant jurisdiction, and are there any trade offs in that approach?

4. Consider time frames—in jurisdictions such as New York, an unopposed foreclosure proceeding will take about 2 years to complete.

5. Election of remedies issues are critical—be sure to check rules in each state.

6. Review loan documents to ascertain all of the collateral. Lender should have received an assignment of rents, leases, purchase agreements, contract deposits and special developer rights. Typically, the lender will want to enforce the collateral assignment of special developer rights.

7. Determine lender's rights in the deposits and payments for options, upgrades.

a. Form of deposit – cash, letter of credit

(i) If a deposit is in the form of a letter of credit, is it assignable? When will the letter of credit expire? What action is required to extend the expiration date or draw on the letter of credit? Can it be drawn on by lender or by escrow agent at the direction of lender? Or must lender wait to conclude the foreclosure and step into position of developer?

(ii) If deposit is cash held in escrow, lender must evaluate the buyer's and developer's claims and rights under the purchase agreement. Typically, the lender's rights to a deposit are derived from the developer's rights. If the developer has performed as required under the purchase agreement and the purchase agreement is valid and enforceable, then lender would be entitled to buyer's deposit in the event of a buyer default, subject to limitations on damages under Section 15 U.S.C. 1703(d)(3) of ILSFDA.

(iii) If a buyer's deposit has been disbursed to developer or used in construction, then examine whether the lender has any liability to the buyer which would survive the foreclosure.

b. Review statutes governing treatment of contract deposits, if any, and the escrow agreement

c. Payments for upgrades or options

(i) Buyer's rights if in escrow

(ii) Buyer's rights if disbursed to Seller

8. Will the lender petition for appointment of a receiver or will it allow the developer to manage the inventory during the foreclosure? What safeguards will be imposed?

9. Lender will need to quantify the costs of carrying the units until they can be resold, including taxes, insurance, assessments. Although the lender's first mortgage lien will allow it to extinguish the lien of the association, except to the extent the association has a superpriority lien by statute (typically 6 months of assessments), the lender must contemplate the effect on the value of its collateral if no provision is made for payment of operating costs of the condominium building during the foreclosure. The non-developer unit owners may lack the financial resources to support the building if a large percentage of the units are in foreclosure and not paying assessments.

10. Was any work performed by the contractor or any subcontractors before the mortgage liens were recorded?

11. Are any actions of the mortgagee, such as requesting the contractor to exercise remedial efforts, sufficient to make it a co-venturer of the developer, and thus unjustly enriched if it fails to pay outstanding obligations of the contractor and subcontractors? Are there defenses such as negligent disbursement of loan proceeds or any basis for constructive trust of loan funds? Note that there may be statutes obligating lenders to notify contractors if they determine not to fund the loan.

12. Regulatory issues—some states may consider a foreclosure proceeding a material adverse change or otherwise require the sponsor to offer rescission.

13. Intercreditor issues—if there are other lenders, the intercreditor agreements should define rights of various creditors in a foreclosure proceeding.

B. **Developer Foreclosure Issues.**

1. Will this be an actual foreclosure, or can it be a takeover of the developer entity without having to actually foreclose? If the latter, what responsibilities will the developer principals have (either at the specific direction of the lender or with limited autonomy) in the project?

2. How aggressive will the lender be in commencing the foreclosure action?

3. Are there other properties which can be cross-collateralized as a means to pacifying the lender and buying some time to turn the project around?

4. Will the developer be required to remain as the face of the development, so as to avoid having the foreclosure proceed?

5. What happens to the personal guarantees of the principals of the developer?

C. **Considerations for Condominium Association and Unit Owners.**

1. The Condominium Association will be concerned on multiple levels, contractors liens, mortgage liens and association assessment liens.

a. Construction (Mechanic's) Lien Foreclosures. Contractor liens will likely be the first issue the association will face. This may create a crisis because of the continual process of resales and refinancing. Even in distressed communities there will be some owners who sell at any price. If market conditions are appropriate, then other owners will be refinancing.

The contractor's liens will trigger demands for action from the owners seeking to sell or refinance. The association will not be able to control the liens and may recommend to owners, if their state law allows, for owners to bond off the lien by posting a equivalent of the unit owners pro rata share of the lien, again if that is feasible. The non-developer director will interpose an objection to the Association paying a lien as an improper developer subsidy.

If state law and/or state rules of procedure permit, then the condominium association may seek action on behalf of the owners collectively to contest the lien or seek an order to show cause why the lien should not be discharged. Doing so may force all other players to address issues, especially if the situation has stagnated with all parties "locking up." While the down side may very well be a determination that the liens are effective and that the developer has no funds, it is doubtful that project lenders would allow the liens to be foreclosed.

The association should not immediately assume that there is no title insurance coverage. Depending upon when the lien was recorded in relation to sales, especially later sales, the title insurer may have omitted the lien, innocently or deliberately and holding funds in escrow. Under appropriate circumstances the association on behalf of owners, or by encouraging owners, may obtain assistance from a title company.

The association has an interest in addition to unit owners because of the status of

common elements/common area. The non-developer director will likely seek a review of the developer/seller no-lien affidavit. In most jurisdictions, the developer at the time of initial sale will provide the unit purchaser and the title company with an affidavit that there is no basis for any liens and that there have been no claims.

Taking due care not to step over the ethical line and asserting that the developer will be subjected to criminal proceedings for perjury, the affidavit does raise the specter of developer fraud. The fraud is normally not a matter that the corporate veil would protect the affiant because the execution of the affidavit is done on an individual basis. Note that in some jurisdictions a condominium association is unable to bring a class action claim on behalf of owners for fraud. Nevertheless, in this situation, there may be many owners who are willing to bring a personal claim against the developer principal who fraudulently signed a false affidavit.

b. First Mortgage Foreclosures. Concerning lenders foreclosures, normally, an association lien will be inferior to a properly-secured mortgage. This does not mean that the association must just watch the association's claims for delinquent assessments against the developer to be foreclosed. Especially when there is a large inventory of units being foreclosed, the association should seek to engage the lender regarding payment of assessments even if the association's rights are extinguished by the lender. Depending on how the association is financed, the lender may find it in the lender's best interest to ensure that the association has adequate cash flow. In this regard the association will want to carefully consider whether the association's claim should slow down the lender foreclosure action or whether the association will want the lender's efforts to be expedited so that there are new owners of the units in bringing the units back unto the assessment line.

c. Condominium Association Lien Foreclosures. The non-developer director will also seek to push the association to enforce the association's liens. Association counsel will want to determine the priority of the association's lien. In some jurisdictions the association's lien may have "super priority" and thus trump the contractor's lien. In addition, if the association is planning on recording a lien and there is an existing lis pendens recorded against the property, state law may require the association to immediately intervene in the lien foreclosure action.

A fundamental question in this regard is whether the uncompleted units are subject to assessment. Depending on state law, thresholds for levying assessments may or may not have been reached. The association will want to do what is appropriate to ensure that where there is a high threshold for assessments, such the issuance of certificate of occupancy, that such occurs. The association will also want to consider the obligation of the lender to complete the project particularly if a third party is anticipated to purchase the units at the foreclosure sale.

For the unit owners in a condominium with high foreclosure activities, the foreclosures inevitably result in lower values, higher assessments, greater difficulty in obtaining or refinancing unit mortgages and a tainted reputation for project. There may also be significant discrepancies between the expectations, financial resources and demographics of original buyers and those of the new buyers.

D. Considerations for Contractors and Design Professionals.

1. Impact of Liens and Claims. Despite the ability of a foreclosing lender to extinguish liens, the existence of construction defects and warranty claims may make the project unmarketable, or at least more difficult to market, and the lender may be willing to negotiate with the contractor and design professionals to resolve outstanding issues in

exchange for agreements to design and implement repairs to the project and committing to be available for future work. There are a number of incentives to work with the existing contractors and design professionals. They arguably will know the project better than any new entities and therefore there should be fewer requests for information, change orders and delays, resulting in a more economical and efficient project.

2. Delays During Foreclosure Proceedings. As noted above, foreclosure proceedings may be very lengthy. The resulting delays may make it more difficult to obtain completion certificates and may cause parties to defer making claims under bonds, thereby rendering them ineffective. Delays causing extensions of completion dates may offer negotiating leverage for the contractor and subcontractors.—Similarly, the lender may be willing to accommodate contractor or subcontractor needs to avoid permits lapsing. Foreclosure delays also risk the expiration of statutes of limitation and repose and may result in the passage of the time within which warranty claims may be made, all resulting in grabbing the attention of the lender.

3. Co-venturer liability. Determine whether the lender's activities may impose successor developer or builder/vendor liability upon it. Sufficient directing of repairs and involvement in the management and operation of the project may render the lender a co-venturer and strip away its critical mortgagee-in-possession protections. Generally, extensive activities are necessary and the hypothetical does not rise to that level. *C.f.*, *Pride Furn. Corp. v. Hollywood Fed'l Savings & Loan*, 547 So.2d 717 (Fla. App. 4 Dist. 1989) (question of fact whether lender acted as co-venturer and obligated itself to pay creditors, including subcontractor with mechanic's lien); *Capital Heights Condo Assoc., Inc. v. Little Falls Savings and Loan Assoc.*, 251 N.J. Super 335 (1991) (facts insufficient to relieve lender of protection of homeowner warranty indemnity program). In unusual circumstances, being treated as a successor of the developer may have a negative impact on a contractor. Although the work and alleged misrepresentations occurred before the creation of the homeowner's association, a court held that under the N.J. Consumer Fraud Act, the homeowner's association was permitted to sue the contractor despite the absence of reliance on the work or statements by the association. The court viewed the homeowner's association as an entity occupying the same role as the developer regardless of the fact that there could be (and were) many years between the time the developer registered the condominium and the date the independent homeowner's association was created. Contractors and materialmen were deemed on notice that the condominium eventually would be turned over to an association. The implication was that other subsequent third party purchasers would not be entitled to enforce the same rights. *Port Liberté Homeowner's Association, Inc. v. Sordoni Construction Co.*, 2007 N.J. LEXIS 168 (App. Div. June 4, 2007).

4. Other Lender Liability. In jurisdictions that mandate notice to a contractor before loan funds are withdrawn, there may be a claim for unjust enrichment if the contractor is not paid for work ordered subsequent to the lender's knowledge that the project was failing.

5. Revival of Subordinate Liens. Determine whether junior liens may be revived. In the hypothetical, twelve of the units are subject to foreclosure by their respective first mortgagees. If the lender forecloses and the unit owner re-purchases its former unit there is case law that suggest that subordinate liens thought to be extinguished may be revived. *See Old Republic Ins. Co. v. Currie*, 665 A.2d 1153, 284 N.J. Super 571 (Ch. Div. 1995).

6. Timely Enforcement of Liens. In many jurisdictions, the contractor is obligated to enforce its lien within a limited time period or it may lose its right to do so. A contractor may be required to commence its action before the lender intends to foreclose its

lien. Because many uniform condominium acts permit unit owners to pay their percentage interest of a lien claim or to bond the applicable amount and thereby have the lien released as to their unit, there may be incentives for unit owners to do so. This is especially the case if a unit owner is hoping to refinance or sell its unit. Of course, the lender may decide to proceed with foreclosure of its mortgage lien, which will wipe out the contractor's or design professional's mechanic's lien. The mechanic's lien also may be subordinate to liens for assessments in jurisdictions that deem assessments to have super-priority.

7. Deed-in-lieu of Foreclosure. If the lender takes a deed-in-lieu of foreclosure, determine if there is any basis to argue that the mortgage has merged into the deed so that junior liens are not extinguished. This may be the case if the debt is not completely forgiven, if the appraisal does not show that the property is worth less than the debt, or if there otherwise is not sufficient consideration for the deed-in-lieu. See the arguments discussed in *Aetna Life Ins. Co. v. Terry B. Haeger, et al.*, Case No. 84-CI-41 (C.P. Ross County, Ohio 1984), although in that case anti-merger language in the agreement was held to control.

E. **Considerations for Contract Buyers**

1. What is the contract buyer's priority vis a vis the first mortgagee?

a. Most lenders of funds for condominium construction or conversion required that a certain percentage or dollar amount of units be presold before extending the loan. If the purchase agreement was signed before the recordation of the first mortgage, it should contain language subordinating the purchase agreement to the lien of any mortgage for construction or development of the project.

(i) Does the subordination cover first mortgages or all liens regarding development/construction of project

(ii) Does the scope of the subordination include the mortgage as modified, amended, etc., and all advances or increases

b. Contracts signed after construction loan mortgage

(i) Determine whether buyer has any viable defenses or claims for rescission or damages. Because of the falling property values and difficult mortgage market, many buyers are seeking to rescind their purchase agreements and recover all or some of their deposits. See analysis in Section III.B.1.e-j.

2. What is extent of buyer's exposure under the purchase agreement in the event of a default by buyer: loss of the deposits; damages, specific performance, loss of payments for upgrades, options?

VI. BANKRUPTCY ISSUES:

A. Lender Considerations.

1. Carefully consider the position of all present and likely future secured and unsecured creditors, their interests and their need to cooperate in the development process.

2. Consider pros and cons of a bankruptcy proceeding or a pre-packaged bankruptcy plan.

a. Bankruptcy may provide the lender with better protection in funding ongoing advances to preserve the priority of the lender's lien priority through DIP or similar loans. DIP financing also will enable lender to obtain restrictions on use of funds, as well as controls over project's operations and construction.

b. If most creditors are in line, a "prepack" can be done quickly to minimize interference with the progress of the project. This works best when no creditors are impaired, at least in the secured class.

c. Consider intercreditor issues in bankruptcy.

d. Consider triggering rights of the estate to reject certain obligations in a bankruptcy.

e. Have a good handle on leverage points--personal guarantees and springing recourse provisions.

f. Consider regulatory issues, such as the triggering of a material adverse change or requiring an offer of rescission.

g. Cost and timing of bankruptcy versus a restructuring outside of bankruptcy.

h. Other benefits sale free and clear of liens and encumbrances, transfer taxes and mortgage tax preservation.

3. See Appendix A for further information.

B. Developer Considerations.

1. Can the developer save itself with a Chapter 11 filing, or is the project destined for a Chapter 7 liquidation?

2. Can the process work to allow for continued flow of monies into the association's accounts so that proper maintenance can occur and the assets remain viable for sale via bankruptcy?

3. Will the bankruptcy court take action beyond the scope of the ordinary statutory and case law framework in an effort to allow for the future success of the project?

4. What happens to the personal guarantees of the developer's principals? How long will they be on the hook?

C. **Considerations for Contractors and Design Professionals.**

1. It is critical to take the proper steps to perfect the mechanic's lien before a bankruptcy intervenes. A recent New Jersey case analyzed the procedures to file a residential lien and emphasized the importance of completing all the steps entitling a party to a lien. Where only the first part of the procedure was completed (notice was filed) before a bankruptcy proceeding was commenced, the court held that the lien was not yet perfected (despite the fact that the lien would relate back to the date of the notice had the balance of the procedures been completed before the bankruptcy proceeding was initiated). Therefore, the subcontractor was

only a general, unsecured creditor, rather than having the significant benefits of a secured creditor. *In re Kara Homes, Inc. v. Century Kitchens, Inc.*, 347 BR. 542 (Bankr. D.N.J. 2007).

2. If the developer made any payments to the contractor or design professional before commencing a bankruptcy proceeding, make sure that the liens are not released until any possible preference period passes. There also should be an agreement that in case of determination of a preference payment, any claims that were released are reinstated. Such is of limited value if there are intervening liens.

3. Determine whether contractors and design professionals with unsecured claims have any basis to assert equitable lien status.

4. Bankruptcy proceedings, including those instituted by subcontractors or consultants, may affect timing of critical activities, including compliance with right to cure laws, etc.

5. Generally, insurance and surety bonds are not part of the bankrupt's estate so claims may be enforced even while a bankruptcy proceeding is pending. However, it is prudent to request leave of the bankruptcy court to do so before taking affirmative steps. *See Hidden Canyon Homeowner's Assoc. v. Griffin Homes, et al.* (Califa. Superior Ct.).

6. If agreements with the contractor are terminated in the bankruptcy proceeding, warranties and future obligations arising under those agreements also may be terminated, although this is not always the case. Depending on the jurisdiction, this likelihood may provide another useful basis for negotiation with the developer or lender. If contracts are terminated, however, it also may make it difficult for the contractor or design professional to pursue claims against their respective subcontractors or consultants if flow down provisions have been eliminated.

D. Considerations for the Condominium Association and Unit Owners.

Bankruptcy may bring delays; however, it may also bring a cleansing solution. Particularly if one or more parties is stonewalling or has unrealistic expectations, bankruptcy may be the only alternative. One disadvantage for the association practitioner is if the developer has an office outside of the jurisdiction and the bankruptcy filing is made in that remote location.

The association is the one innocent party, dragged into the proceedings not because of any affirmative decision on its own, and individual member residences are at risk. The association must consider seeking relief from the bankruptcy estate to enforce assessment liens and either alternatively or in conjunction make a claim for administrative expenses. The Association is unlike all other creditors because the principle balance due to the association is constantly increasing; thus, a motion for adequate protection or for relief of the stay may force the developer to immediately pay assessments.

The key may be in addressing whoever has possession. If there is a Chapter 11 reorganization, then there is a need to convince the developer that a plan will only work if the project remains beautiful and operational, which requires the developer to pay assessments. If in Chapter 7, an uninvolved trustee is appointed to administer the bankruptcy estate, who must be convinced that assessment payments are necessary to preserve the value of units held by the bankruptcy estate.

The Association will want to take care to help ensure that warranties are preserved. Careful examination of a Chapter 11 plan is necessary to ensure that payments are made to contractors and subcontractors. An objection to the plan may be necessary if warranties are negotiated away in exchange for a reduction in debt. Decisions may have to be made swiftly whether to file adversary proceedings to enforce rights.

The unit owners and the association become unsecured creditors as to the warranty claims against developer and claims for unfinished amenities, improvements, facilities, FF&E.

One recurring problem for counsel is determining who is the client, and if there are many clients, then creating a cohesive body that makes decisions. Representing multiple owners may result in multiple conflicts.

E. **Considerations for the Contract Buyer**

Contract buyers become unsecured creditors as to deposits which have been disbursed from escrow and payments for upgrades, options. Bankruptcy judges have reputation for having little tolerance for frivolous claims of buyers.

VII. **BULK SALE OF UNITS.**

A. **Lender Considerations.** These are mostly issues governed by local law and federal housing regulations. In some jurisdiction, a bulk sale may trigger the need to name a new sponsor, raise sponsor obligations/liabilities and also trigger rights of rescission. The usual considerations are economic and what effect a bulk sale will have on the lender's recovery of its debt.

B. **Developer Considerations**. When seeking to undertake a bulk sale of units in a condominium project, the developer/borrower should first consider the viability of obtaining lender consent to the transaction. Depending upon the nature of the relationship between the borrower and lender, and more importantly to what degree is the loan upside-down, the contemplated transaction may prove to be more problematic than beneficial. For example, the bulk sale of a group of units at a particular discounted price may have a beneficial short-term effect (i.e., stemming the tide for a period of time and providing an infusion of capital), as both the borrower and lender receive a benefit, but the long-term effect may be to damage the potential sale price for the remainder of the units down the road (appraisals may become a problem for both the developer as to its unsold inventory and third party owners, whose values may drop significantly as a result of the sale). The long-term implications of the bulk sale need to be analyzed on both the short-term and long-term level, and a prudent lender will seek to protect the overall outcome for the project and not just seek the short-term capital infusion. Thus, a developer must factor these potential outcomes into the contemplated purchase price for the bulk sale.

When completing a bulk sale transaction, especially one which will shed the developer/borrower of all remaining units, there are several practical considerations that have to be considered. First, the developer must be prepared to determine the potential for the bulk purchaser to either take, or leave behind, developer liabilities pertaining to the development of the improvements. Certain jurisdictions treat a successor developer in the same manner as an originating developer for purposes of warranty obligations and construction liabilities, but this may mean that the originating developer remains jointly and severally liable with the successor developer for any such issues. Counsel for a prudent bulk purchaser would seek, to the extent possible and practical under the circumstances, indemnification and hold harmless agreements

and protections from the seller as well as certain holdback monies at closing that are to be used to pay for claims that may arise during a given period of time. The transfer of developer liabilities and responsibilities will have an impact on this decision. If the bulk purchaser does not take an assignment of developer rights, the sale may trigger turnover of the association, which will lead to the developer being held responsible for delivery of various actions involving the association (delivery of various association records and plans and specifications for the condominium improvements, conducting a turnover audit, and providing permits and licenses and contractor and subcontractor information, to name a few). Even if the bulk purchaser takes the assignment of developer rights, the originating developer will still need to provide these materials to the bulk purchaser for its use when turnover in fact occurs, so collection of the association document will be essential as part of the deliverables at or in connection with closing. Finally, a prudent bulk purchaser will ensure that proper funding of reserve accounts has occurred prior to the closing, so the developer needs to ensure that the funds are properly accounted for, or otherwise make any outstanding required funding the responsibility of the bulk purchaser as part of the consideration for the sale.

C. **Considerations for the Contractors and Design Professionals**. A bulk sale likely would benefit the contractor and design professional by providing a deep pocket against which claims may be asserted. However, for reasons discussed elsewhere in the outline, it is the least likely outcome given the facts of this hypothetical. While initially it may be assumed that there will be no direct discussions with prospective bulk sale purchasers, the fact that completion certificates and other documents may be needed, defective work remains to be remedied and the balance of construction has to be completed, may provide negotiation and settlement opportunities. Moreover, successful marketing may require successors voluntarily to assume ongoing liability, giving the contractors and design professionals more possibilities to resolve claims. Otherwise, given the limitations in the contractor's and design professional's contracts, it may be difficult to assert certain claims against a bulk purchaser (other than limited statutory claims under uniform common interest ownership acts and other statutes, such as right to cure acts). The circumstances of a multi-party bulk sale can make asserting these rights difficult, however, because there likely is not one person who is in control and able to bind all potential claimants. Therefore, some exposure may remain. In the event a bulk purchaser or other entity agrees to pay off liens, remember that a subsequent bankruptcy could render these payments preferences, subjecting them to recovery by the bankrupt estate. Liens should never be released until potential preference periods have passed or unless there are bonds or other guaranties of payment that are not subject to being re-characterized as preferences or property of the bankrupt's estate. The right to reinstate liens previously released may not be helpful if there are intervening claims affecting the priority of the reinstated liens.

D. **Considerations for the Condominium Association and Unit Owners.**

For the condominium association, a quick bulk sale may be the best solution. Unfortunately, in this scenario, the steep discount of 35% may lead to a unit owner revolt as owners see their equity dissolve before their eyes. Nevertheless, it is imperative to communicate with the owners how a sale at a discount is better than foreclosures.

Complicating matters is the fact that normally the condominium association is not part of any negotiations. However, the buyer will need an estoppel letter from the association as to the status of monies due to the association, and perhaps the status of units. To help ensure that the buyer contacts the association, the association must record its liens for delinquent assessments. While association liens may be a relatively small amount, that amount increases

substantially with accrued interest and attorneys' fees. Thus, the delinquent assessments may become a point of leverage for the association.

Undoubtedly, the developer controlled board of directors will not want to record liens. In this regard, the developer appointed directors and officers should be reminded of their fiduciary duty and potential personal liability when that duty is breached. This especially so for developer directors who will profit from the transaction, or at least not lose as much if there was a foreclosure or bankruptcy.

The association will undoubtedly be bargaining with the buyer concerning a completion schedule. If under state law construction warranties are not assumed by the buyer, then warranty claims must be valued. To the extent that though the bulk sale is being accommodated because subcontractors are releasing liens, then the association and the unit owners will want to seek to avoid any releases from the developer to the subcontractors for warranty work.

Ownership of 10% or more of units by one person or entity can have an adverse affect on the ability of a unit owner to obtain a conforming Fannie Mae or Freddie Mac loan or a VA/FHA loan.

E. **Considerations for the Bulk Buyer (i.e. buyer of multiple units in a condominium)**

1. Bulk buyer could purchase units from either the developer or lender. Although the analysis and due diligence is typically the same, there are some noteworthy differences:

a. If the seller is the lender following a foreclosure, many if not all of the outstanding claims of the junior lienors, contract buyers and condominium association will have been eliminated. If the seller is the developer, then the negotiations will include the following:

(i) Who will be responsible for the outstanding claims relating to design and construction, purchase contracts (including any pending litigation), other contracts, delinquent assessments and subsidies, operation of the association and acts and omissions of the developer-appointed directors and officers

(ii) Whether the bulk buyer will acquire

(a) only the unsold units unencumbered by outstanding purchase contracts

(b) the unsold units unencumbered by outstanding purchase contracts + contracts in good standing

(c) the unsold units unencumbered by outstanding purchase contracts + contracts in good standing + contracts in default and/or litigation. Will need to determine whether the deposit is recoverable.

b. The lender will not be particularly knowledgeable about the project and will have limited information and resources to assist in the due diligence process. If

the seller is the developer, then the developer will likely have more information available or access to knowledgeable staff (if they have not been terminated or resigned).

c. The lender will very likely be selling the units "as is" without any representations or warranties or very limited ones. If the developer is the seller, he may be more willing to make representations or warranties, but they may be of limited long term financial value unless they are backed by an escrow.

2. Understand buyer's business plan and exit strategy

a. Does the buyer intend to continue sales?

b. Does the buyer intend to rent and sell units?

c. Does the buyer intend to rent units and hold them for the long term?

d. Does the buyer intend to rent units for 2-3 years or until market recovers and then selling in bulk or as dealer/developer?

e. Build in flexibility in case business plan does not work

3. Will the bulk buyer inherit any of the developer's liabilities? If so, which ones and to whom? Are the developer's liabilities primary or secondary? These could include the following:

a. Construction warranties. Verify whether the developer has any contractual, common law or statutory construction warranties. Has the developer disclaimed them to the extent possible? If the developer has given construction warranties, is it receiving ones of comparable scope and duration from the contractors, subcontractors? Do the general contractor's and subcontractors' performance bonds cover their respective warranties if they are not contractual?

b. Buyer deposits. If the buyers' interests are not extinguished in the foreclosure action, what is the liability for repayment of deposits if buyers rescind their purchase agreements and the full amount of the deposits is not in escrow?

c. Liabilities to the general contractor and subcontractors. What amounts are owed to the general contractor, subcontractors and design professionals for completion of the project, including common areas? Even if these claims have been extinguished by the foreclosure, will the bulk buyer require the services or cooperation of the general contractor, subcontractors or design professionals?

d. Payment of assessments on developer owned units. Is the developer obligated to pay assessments on its units? Has the developer guaranteed the assessments? Is the developer obligated to subsidize the shortfall between the association's operating costs and the assessments? Has developer's obligation for assessments and subsidies been extinguished in the lender's foreclosure? If these payments have not been made, what effect have the delinquencies had on the operation of the association and the level of assessments?

e. Official records of the condominium association. Has the developer-controlled or lender-controlled association maintained official records?

(i) Will the bulk buyer be able to obtain from the developer or lender the necessary documentation that has to be provided to the association at turnover? See the checklist at end of this paper for typical documents and items to be delivered by the developer to condominium association.

(ii) Is the developer required to deliver to the condominium association, "as built" plans or record drawings? Have the contractor and subcontractors been documenting the changes? Will these be available to the bulk buyer and at what cost?

f. What documents must be filed in order to comply with statutory requirements, including HUD or state regulatory agencies? If there are existing contracts for units, will the bulk purchase trigger any rescission rights?

g. If a bulk buyer takes over the project, determine whether or not it can avoid becoming a successor developer. For example, will the bulk sale of the entire inventory of units in a single transaction by the lender or developer allow the bulk buyer to avoid developer liability? Did the lender receive an assignment of developer's rights as part of the loan documentation? If not, are there other means of asserting or obtaining developer rights, such as a statutory provision or case on point?

h. A major concern for the bulk buyer will be whether it will be entitled to control the condominium association by appointing or electing a majority of the members of the board of directors. The board establishes the budget and reserves and sets the assessments. If the bulk buyer is not able to control the association, are there other mechanisms by which it can manage or control the expenses of the Association.

i. If the bulk buyer becomes a developer, will it be entitled to exercise the developer's rights and reservations? What documentation will be required?

j. What regulatory filings must be made before it is entitled to sell units?

4. Strategies for the Bulk Buyer

a. Carefully evaluate the risks and conduct detailed due diligence

(i) Talk to association management.

(ii) Talk to general contractor and design professionals.

(iii) Analyze state and quality of construction. Quantify cost of corrective work.

(iv) Analyze association budget, expenses, revenues, delinquencies, ownership of other units.

(v) Determine whether the condominium documents can be amended to give bulk buyer protection, such as requiring approval of bulk buyer to "major decisions" of the board, such as the annual budget, increases in the budget after it's been

approved, special assessments, capital assessments, loans in excess of ___% of the annual budget, termination of the condominium regime, decision not to repair and reconstruct following a casualty loss or condemnation, increasing the insurance deductible or reducing the insurance coverage, amends to the condominium governing documents, amends to the rules and regulations, sale of association property, or a change in management.

(vi) Analyze whether taxes on the units can be reduced by reducing the assessed value based on depressed sales or lower rents.

(vii) Is termination of the condominium regime an option.

(viii) Determine whether the bulk buyer can control board after purchase; can buyer vote to elect directors after turnover?

(ix) Determine whether any developer-owned units in inventory are leased. Analyze leases, income and expenses.

(x) Determine the cost of completing or supplying incomplete or missing amenities, facilities, FF&E.

(xi) Investigate the financial ability of:

(a) developer

(b) association

(c) general contractor and architect

(d) ownership of other units. Are they owned by their primary occupants, or as vacation homes or by investors/speculators

(e) number of units in foreclosure by mortgagees; by condominium association.

(xii) Determine the number of units owned by mortgagees or condominium association.

(xiii) Determine the structure of community; often a condominium may be located in a planned community and be subject to multiple associations; the developer or lender may not control other association or their assessments

(xiv) Budget for association and year to date expenditures

(xv) Accounts receivable aging reports for all condominium units including developer owned units.

(xvi) Has developer been paying assessments on its units. If developer has guaranteed the assessments or is subsidizing the association's expenses, is the developer current on funding the subsidy or paying the shortfall between the assessment payable by non-developer unit owners and the expenses of the association. Have reserves been funded? Have working capital contributions been collected from unit owners? Has the developer or lender used the working capital contributions for association operations?

(xvii) Evaluate competition for rentals

b. Determine what Developer Rights were reserved in the condominium documents. Can buyer obtain an Assignment of Developer Rights from seller. Did lender's collateral and final order for foreclosure include the Developer Rights?

5. Additional closing documents in a bulk purchase

a. Resignation of Lender/Developer appointed directors and officers

b. Assignment of Developer's Rights

6. Purchase from Developer. If the developer is in serious financial straits or has threatened bankruptcy, the bulk buyer must be aware of the risks of a constructive fraudulent transfer.

(i) 11 U.S.C. 548(c). Transferee that takes for value and in good faith has a lien on any property transferred.

(a) Good Faith.

(1) No definition is Bankruptcy Code – courts evaluate on a case by case basis.

(2) Objective Standard. Standard is what transferee knew or should have known about solvency of transferor.

(b) Inquiry Notice. Did transferee have sufficient knowledge to put it on inquiry notice of voidability of transfer? If so, did he inquire – need a financial investigation. Transferee cannot be "willfully ignorant." Mere failure to make inquiry can preclude good faith defense

(c) Requires an arms-length transaction.

(1) Honest belief in propriety of activities.

(2) No intent to take unconscionable advantage of others, and

(3) No intent to or knowledge of fact that activities will hinder, delay, or defraud.

(d) Case law: *In re World Vision Entertainment, Inc.*, 275 B.R. 641 (Bankr. M.D. Fla. 2002); *In re Model Imperial, Inc.*, 250 B.R. 776 (Bankr. S.D. Fla. 2000); *In re M&L Business Machine Co., Inc.*, 84 F.3d 1330 (10th Cir. 1996)

(ii) 11 U.S.C. 550(a). Trustee may recover the property transferred or the value of such property.

(a) Remedy – Property or Value.

(1) Where debtor cannot be made whole by return of property, court may enter money judgment equal to value as of date of petition.

(2) Some courts say the greater of the value of the transferred property at transfer date or value at time of recovery.

(3) Purpose is to restore estate to position it would have been if transfer had not occurred.

(b) Case law: *In re Donald Brun*, 360 B.R. 669 (Bankr. C.D. Cal. 2007); *In re First Software Corp.*, 107 B.R. 417 (D. Mass. 1989); In re Blitstein, 105 B.R. 133 (Bankr. S.D. Fla. 1989); *In re American Way Service Corp.*, 229 B.R. 496 (Bankr. S.D. Fla. 1999)

(iii) Value Under 11 U.S.C. 550.

(a) Not the same as reasonably equivalent value under s. 548.

(b) Fair market value is relevant factor and starting point.

(1) Focus is not on what transferee gained but what estate lost.

(2) Courts agree that value is market price at transfer, less the consideration received by debtor – where value depreciated.

(c) Case law: *In re Kemmer*, 265 B.R. 224 (Bankr. E.D. Cal. 2001); *In re Colonial Realty Co.*, 226 B.R. 513 (Bankr. D. Conn. 1998); *In re Integra Realty Resources, Inc.*, 354 F.3d 1246 (10th Cir. 2004)

(iv) Establish lack of market and basis for price

(a) Have appraisal supporting purchase price

(b) Sample recital regarding lack of market, basis for price and buyer's assumption of risk:

The Multiple Listing Service for _____ County, _____ reflects that as of _____, 2008, there are _____ condominium units located in _____ County which were constructed within the past 2 years currently listed for sale, which represents an increase of ____% over the number of listings available for sale during the same period in the previous year.

Seller has represented to Buyer that it has unsuccessfully marketed the Units on a retail basis to individual purchasers for the previous ____ months and on a bulk basis for the previous ____ months. Seller has determined that it is in the best interests of the Seller and the holders of the mortgages encumbering the Units to sell the Units in a bulk sale to Buyer and for Buyer to assume the risks and obligations of owning, holding, renting, maintaining and selling the Units in a deteriorating and distressed market and location.

Sample Contract Provisions for Bulk Buyer

DUE DILIGENCE.

A. Seller's Information; Inspections. As of the Effective Date of this Agreement, Seller represents that it has delivered the following documents (collectively referred to as the "Seller's Information") to Buyer: (a) any environmental reports or other documents concerning the environmental condition of the Condominium; (b) any surveys, subdivisions and/or plat maps or related documents concerning the Condominium; (c) any documents pertaining to wetlands concerning the Condominium; (d) any documents or correspondence from governmental entities concerning approvals or denials of applications for entitlements or otherwise; (e) certificates of occupancy for all Units; (f) all documents, including final approved construction drawings, pertaining to construction of the Units and any improvements to the common areas or recreation amenities of the Condominium, including but not limited to Condominium infrastructure; (g) all civil engineering and architectural documentation concerning the Condominium and the Units; (h) all "official records" of the Association [as defined by statute]; and (j) any other document in possession of Seller or Seller's agents or contractors, which a prudent Buyer would wish to examine as part of reasonable due diligence on the Condominium and the Units.

……

OTHER CONDITIONS AND COVENANTS OF SELLER.

A. Model Unit. Buyer acknowledges and agrees that the following Units have been previously used by Seller as a model unit ("Model Unit"): [list]. Seller shall not be required to paint or touch up the paint on the walls of the Model Unit as the Model Unit is sold in "as is, where is" condition. All furniture, fixtures, equipment, decorative objects located in the Model Unit including Sales Equipment are included in this transaction. Sales Equipment consists of all signage, sales and marketing materials, computers, copiers, fax machines, office cabinets, storage cabinets, office furniture, telephones, telecommunications equipment, cable lines, cable wiring, sales supplies and office supplies (collectively, the "**Sales Equipment**") located within the Model Unit.

B. Sales Office. At Closing, Seller will grant Buyer the exclusive right to use and occupy the sales office located at _____ ("**Sales Office**") together with all Sales Equipment located therein for a period of one (1) year at no charge on the terms and conditions set forth in the Occupancy Agreement in the form of Exhibit "C" ("**Occupancy Agreement**").

C. Amendment to Remove Rental and Resale Restrictions. Prior to Closing, Seller shall cause the Declaration of Condominium to be amended in compliance with the governing documents of the Condominium (a) to remove all restrictions on rental of the Units and all rights of the Association to approve tenants or occupants of the Units in Declaration or any amendments as to the Units; (b) to remove all restrictions on sales of the Units and all rights of the Association to approve purchasers of the Units in Declaration or any amendments as to the Units and (b) to prohibit the re-imposition of any such restrictions or approval rights without the prior written consent of Buyer or its successors or assigns so long as Buyer owns any of the Units ("**Rental/Resale Amendment**"). The Rental/Resale Amendment shall be subject to the reasonable approval of Buyer and shall be recorded prior to Closing.

D. Working Capital Contribution. Seller shall cause the Association to deliver an agreement delaying payment of all working capital contributions for a Unit to the Association until such time as Buyer resells the Unit to a third party buyer.

E. Assignment of Developer's Rights. Seller agrees to deliver at closing a partial assignment of Developer's rights ("**Partial Assignment of Developer's Rights**") under the Declaration and other governing documents of the Association. In the Partial Assignment of Developer's Rights, the Seller shall assign to Buyer all of Developer's rights as to the Units (but no other units in the Condominium), including but not limited to the following: (i) to make any additions, alterations, improvements, or changes to the Units, (ii) to maintain sales, leasing, general office and construction operations at any Units; (iii) to place, erect or construct portable, temporary or accessory buildings or structures at any Units for sales, leasing, general office, construction, storage or other purposes; (iv) to post, display, inscribe or affix to the exterior of any Units or upon any portion of the Condominium, signs and other materials used in developing, selling, leasing, or promoting the Units; (v) to exercise weighted voting rights, if any, of the Developer as to the Units; (vi) to be exempt from the rental and other use restrictions, and (vii) to appoint a majority of the members of the Board of Directors for the Association and so long as Seller or its successors or assigns are entitled to control the Board of such association.

CHECKLIST OF DOCUMENTS AND ITEMS FOR TURNOVER

____ The original or a copy of the recorded declaration of condominium and all amendments thereto.

____ A certified copy of the articles of incorporation of the association, or other documents creating the association, and all amendments thereto.

____ A photocopy of the bylaws of the association, whether or not recorded, and all amendments to the bylaws.

____ Any rules and regulations which have been promulgated.

____ A copy of any declaration of covenants and restrictions governing the condominium and all amendments thereto, such as a declaration of covenants for master associations or neighborhood associations.

____ The minute books for the condominium association including:

____ Copy of notices and agendas of all unit owners meetings;
____ Affidavit of mailing of notices of unit owners meeting;
____ Minutes of all unit owners meetings;
____ Notices of board of directors meetings;
____ Affidavit of posting for each notice of board of directors meeting;
____ Minutes of all board of directors meeting;
____ Minutes of all committee meetings, if maintained;
____ Resignations of officer and director who resigned when the first non-developer unit owner was elected;
____ Corporate seal
____ Other corporate records of the association, if any; and
____ Certificate of good standing for the condominium association.

____ A current roster of all unit owners (name, address, telephone numbers, email address), their unit identifications and voting member as designated on their voting certificates.

____ Resignations of officers and members of the board of directors who are required to resign at turnover of the association.

____ All financial records, including financial statements of the association, and source documents from the incorporation of the association through the date of turnover. The accounting records include but are not limited to:

____ Accurate, itemized, and detailed records of all receipts and expenditures;
____ All payroll and personnel records of the association;
____ All invoices for purchases made by the association;
____ All invoices for services provided to the association;
____ A current account and a monthly, bimonthly, or quarterly statement of the account for each unit designating the name of the

unit owner, the due date and amount of each assessment, the amount paid upon the account, and the balance due; and

____ All audits, reviews, accounting statements, and financial reports of the association or condominium.

____ Association funds or control of them. The association can transfer control of the funds by adding the directors and/or officers as signatories to the association bank accounts and removing the developer-appointed directors.

____ All tangible personal property of the association, including any property represented by the developer to be part of the common elements or which is part of the common elements.

____ An inventory of all tangible personal property.

____ Bills of sale or transfer for all property owned by the association.

____ A copy of the plans and specifications used in the construction of the condominium, supplying equipment to the condominium and construction and installation of mechanical components.

____ A list of the names and addresses of all contractors, subcontractors, and suppliers used in the construction of the improvements and in the landscaping of the condominium or association property.

____ All current insurance policies of the association and the condominium and a copy of all other insurance records.

____ Copies of all certificates of occupancy issued for the condominium property.

____ Any other permits applicable to the condominium property which have been issued by governmental bodies and are in force or were issued within one year prior to the turnover date.

____ Operating manuals.

____ All written warranties of the contractor, subcontractors, suppliers, and manufacturers, if any, that are still effective.

____ Any leases or licenses of the common elements and other leases to which the association is a party.

____ Employment contracts to which the association is a party.

____ Service contracts in which the association or the unit owners have an obligation, directly or indirectly, to pay some or all of the charge for a service and bids. These may include the following:

_____ Management agreement
_____ Cable TV and broad band internet access agreement
_____ Pool maintenance agreement
_____ agreement with security company

_____ elevator maintenance agreement
_____ exterior landscaping maintenance agreement
_____ interior landscaping maintenance agreement
_____ HVAC maintenance
_____ Cooling tower maintenance
_____ garage or parking lot sweeping agreement
_____ valet parking agreement
_____ alarm, life safety systems monitoring agreement
_____ pest control agreement
_____ janitorial services
_____ waste collection agreement
_____ computer maintenance agreement
_____ window washing
_____ concierge agreement
_____ other

____ All other contracts to which the association is a party.

____ All contracts for work to be performed. Retain bids for work for a reasonable period.

____ Ballots, sign-in sheets, voting proxies, and all other papers relating to voting by unit owners.

____ All rental records when the association is acting as agent for the rental of condominium units.

____ If Association must approve leases of units, copies of all current leases.

____ If any audio or video recordings are made of a board of directors, unit owner, or committee meetings, retain until the minutes of the meeting that was the subject of a recording are approved by the body authorized to approve the applicable minutes. After the approval, discard the recording unless the body authorized to approve the minutes elects to preserve the recording.

____ All other records of the association not specifically listed above that relate to the operation of the association.

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APPENDIX A

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March 4, 2008

Condominium Bankruptcies - The Lender's Perspective

I. Introduction

A. The Pros of Bankruptcy - Bankruptcy as an Opportunity for Lenders

1. The prospect of a failing condominium project leading to a bankruptcy filing may, at first blush, seem like a disaster for those lending into the project. The fact of the matter, however, is that a bankruptcy filing may provide opportunities, specifically control over the debtor entity, for lenders.

2. A debtor will require sources of funds to finance its operations during the pendency of it bankruptcy case. Although many debtors generate insufficient cash flow, if it has sufficient cash collateral (cash proceeds or similar equivalent pledged to debtors secured creditors), the debtor can use such cash collateral as long as it establishes that the secured creditors are adequately protected.

3. From the debtor's perspective, obtaining permission to use cash collateral (pursuant to section 363 of the Bankruptcy Code) or post-petition financing (pursuant to section 364 of the Bankruptcy Code) is not without cost. In order to obtain the much needed financing to fund its bankruptcy case, the debtor will be required to make a variety of concessions to its lenders. As a result, a lender will be able to obtain restrictions on use of funds based on a budget, as well as tighter controls over the project's operations, marketing, and construction.

4. Section 1146(a) of the Bankruptcy Code provides that the making of an instrument of transfer under a plan confirmed under section 1129 may not be taxed. Whereas the sale of a failing condominium development outside of bankruptcy may give rise to multi-million dollar transfer tax obligations, this may not be the case for sale implemented within a bankruptcy.

i. There is a split of opinion among the courts whether the "under a plan confirmed" language requires the sale to be implemented as part of a plan, *see Baltimore County v. Hechinger Liquidation Trust (In re Hechinger Liquidation Trust)*, 335 F.3d 243 (3d Cir. 2003), or merely that the sale is necessary to the consummation of a plan. *See Florida Dep't of Revenue v. Piccadilly Cafeterias, Inc. (In re Piccadilly Cafeterias, Inc.)*, 484 F.3d 1299 (11th Cir. 2007), *cert. granted* 128 S. Ct. 741 (2007).

B. Cash Collateral v. DIP Financing

1. Use of cash collateral may be a suitable alternative, under circumstances, or necessary supplement to traditional section 364 DIP financing.

    a. By using cash collateral in lieu of a credit facility, a DIP can avoid the expenses associated with negotiating and documenting a credit facility

    b. Can avoid the payment of various fees typically imposed under a credit facility.

    c. Depending on the DIP/creditor dynamic, the DIP may avoid the imposition of default and other burdensome provisions, including provisions requiring the rollover or paydown of pre-petition secured debt often required in a DIP.

2. For debtors who cannot secure a DIP financing facility, using cash collateral may be the only means available to finance a chapter 11 case.

3. Even where cash is sufficient to finance the DIP's operations, a DIP may opt to obtain a postpetition facility for public relations purposes - maintain the confidence of the DIP's unit purchasers, creditors, and employees.

C. The Cons of Bankruptcy

1. There is no guaranty that the DIP will seek post-petition financing from any particular lender. The potential exists for the DIP to obtain financing from a third-party lender and prime the pre-petition lender. To the extent this occurs, the pre-petition lender's control over the case is more limited.

2. Various states have enacted laws requiring developers of bankrupt condominiums to offer unit purchasers the right of rescission which, if exercised will require the developer to return deposits and increase vacancy.

3. Bankruptcy is an expensive process. The estate bears the costs of not only its own professionals but that of the unsecured creditors committee and any other committee formed in the case, including a committee of condominium unit owners.

4. Debtor may be able to force a restructuring of loan, including a lower interest rate, on terms not agreeable to lender under cramdown provisions.

D. Prepackaged and Pre-Arranged Bankruptcies

1. Where a restructuring has been consented to by all major creditor classes, a prepackaged bankruptcy case may be utilized to implement the restructuring. Generally, a prepackaged plan is one in which the votes needed to confirm a chapter 11 plan are obtained prior to commencing the case. Once the votes are obtained, the chapter 11 case may be commenced to implement a restructuring under pre-approved lender guidelines, to implement

a sale or transfer of the property, and to realize on the benefits of section 1146(a). The advantage of a prepackaged plan is that it can be implemented very quickly – within 30 days – and thus minimize the costs and expenses associated with a normal chapter 11 case.

2. Alternatively, a chapter 11 case may be commenced without the requisite votes needed to confirm a chapter 11 plan, but with the approval of the DIP's major creditors, including its lenders. Such pre-arranged cases may be commenced to force a restructuring on non-consenting junior lenders.

II. Use of Cash Collateral

A. Section 363(a) of the Bankruptcy Code defines "cash collateral" as cash, negotiable instruments, documents of title, securities, deposit accounts, and other cash equivalents in which the debtor's estate and a creditor have an interest. It also includes the proceeds, products, offspring, rents, or profits of property, and the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties, subject to the creditor's perfected security interest.

B. Although a DIP may use non-cash collateral in the ordinary course of business, it may not use cash collateral unless the entity whose claim is secured by the cash collateral consents or the court authorizes the use. 11 U.S.C. § 363(c)(2).

C. Authorization to Use Cash Collateral

1. Section 363(c)(2) - consent of each entity having an interest in such cash collateral or bankruptcy court authorization of such use, after notice and a hearing.

2. Consensual Use

a. If the DIP and the pre-petition secured lenders can reach an agreement on the terms of the use of cash collateral and there are no objections to such use from parties required to be noticed pursuant to Bankruptcy Rule 4001(d)(1), the DIP may avoid a possibly drawn-out legal battle over the valuation of such collateral and whether the pre-petition lenders are adequately protected.

b. Consensual Route is not Without Costs.

i. debtor may have to make various concessions, and such concessions may be costly and result in the debtor's relinquishing a certain amount of control over its reorganization to its secured lenders.

3. Contested Use

a. Failure to reach an agreement on the terms of a DIP may be followed by failure to reach an agreement on the consensual use of cash collateral - in many instances the debtor is attempting to negotiate the terms of a cash collateral agreement with the very same parties from whom it tried unsuccessfully to obtain a DIP.

b. In the absence of lender consent, the debtor will have to seek bankruptcy court approval of its use of cash collateral after notice and a hearing. 11 U.S.C. § 363(c)(1)(B). This will require the DIP to prove to the court that its pre-petition secured lenders are adequately protected.

D. Adequate Protection

1. The adequate assurance requirement balances the debtor's right to a fresh start against a secured lender's desire to prevent the dissipation of cash collateral securing such lender's liens. More importantly from a lender's perspective, the need for adequate protection potentially provides a lender with a great deal of control over the case.

2. Methods of Providing Adequate Protection

a. Section 361 non-exclusive list - (i) periodic cash payments – usually in the form of postpetition interest, (ii) replacement liens, or (iii) the indubitable equivalent of its interest.

b. Adequate protection frequently takes the form of a combination of replacement liens and monthly cash payments.

c. Courts have found that when the DIP has sufficient equity in the property, the so called "equity cushion," without more, will adequately protect the secured lender's interest.

d. Some courts have found that a secured – and even unsecured – third-party guarantee could constitute adequate protection.

e. Limitations on the use of cash collateral and the imposition of reporting requirements may provide sufficient adequate protection and warrant the use of cash collateral.

f. The debtor's efforts in preserving the value of the collateral may rise to the level of adequate protection.

III. DIP Financing

A. Introduction

1. Adequate third party postpetition financing is the lifeblood for most chapter 11 debtors and use of cash collateral may not be enough or may not have cash collateral altogether.

2. To promote "paramount goal" of reorganization, the Bankruptcy Code provides numerous protections and incentives to encourage lenders to provide postpetition financing.

B. Statutory Predicates

1. Section 364 provides a hierarchal structure for obtaining post-petition financing.

a. 364(a) - obtain unsecured credit in the ordinary course of business without prior court authorization.

b. 364(b) - unsecured credit incurred outside the ordinary course afforded an administrative claim under section 503(b)(1).

c. 364(c) - If DIP cannot obtain adequate financing on an unsecured basis, the DIP may seek secured financing afforded a “superpriority.”

i. The superpriority claim awarded to a postpetition lender pursuant to section 364(c) ranks senior to all other administrative claims, including the priority status of the so-called "inadequate" adequate protection claim. The section 364(c) superpriority claim also outranks administrative expense claims associated with professional fees.

d. 364(d) - If the DIP is unable to obtain credit otherwise and the pre-petition lienholder is adequately protected, the DIP may seek a facility secured by liens senior or equal to its pre-petition liens.

i. Lending pursuant to section 364(d) may provide the lender with a court-approved, “iron-clad” first priority (priming, if needed) lien over every lien.

C. Extracting Control in Return for Use of Cash Collateral or DIP Financing

1. Use of a Budget and Timetable

a. Lender has ability to require DIP expenditures to made pursuant to a lender-approved budget; expenditures outside of this budget cannot be made absent lender authorization. The budget typically has an outside date after which no expenditures may be made absent lender authorization. This allows the lender to control (at least to some extent) the duration of the bankruptcy case and any asset sales.

2. Provisions Affecting the Operation of a Debtor in Possession's Business

a. Terms that could alter the chapter 11 process, such as a waiver of preference, fraudulent conveyance, lender liability or similar actions against the postpetition lender, provisions triggering default upon the appointment of a trustee or examiner, or the requirement that the debtor retain exclusivity is highly scrutinized.

b. case examples

i. *In re Tenney Village Co., Inc.,* 104 B.R. 562 (Bankr. D.N.H. 1989) - court did not approve the debtor in possession financing agreement which included terms which would give the lender numerous rights concerning the debtor in possession's operations and the chapter 11 reorganization, including: (i) the lender must first approve all specifications for certain planned improvements, (ii) the work was to be done under the direct supervision of the lender's consultant who would have authority to stop the work at any time, (iii) the debtor in possession was to obtain the lender's approval of its marketing plan, (iv) the debtor in possession was to hire a new chief executive officer approved by the lender, (v) if the debtor in possession fires the chief executive officer without the lender's consent, the entire debt is subject to acceleration, (vi) the occurrence of any "termination event" vacates the automatic stay to permit foreclosure, without further court order, unless during a seven day notice period the debtor in possession obtains a court order preventing foreclosure, and (vii) "termination events" include (a) a chapter 11 plan being confirmed over the lender's objection, (b) a third party obtaining relief from the automatic stay without the lender's consent, and (c) any creditor or other party in interest taking any action against the lender.

ii. *In re UAL Corp.*, Ch. 11 Case No. 02-B-48191 (ERW) (Bankr. N.D. Il. Dec. 30, 2002) - approval of a debtor in possession financing agreement for up to an aggregate amount of $1,200,000,000, which included the following provisions: • the appointment of a trustee or examiner having enlarged powers shall be an event of default; • a prohibition against the sale or disposition of any assets, (except for certain assets enumerated in the financing agreement); and • a waiver of the debtors' rights to seek any relief under the Bankruptcy Code to the extent such relief would in any way restrict or impair the rights and remedies of the lenders.

iii. *In re Adelphia Communications Corp.*, Ch. 11 Case No. 02-41729 (REG) (Bankr. S.D.N.Y. 2002) – Approval of a debtor in possession financing agreement for up to an aggregate amount of $1,500,000,000, which included the following provisions: • the debtor is required to pay $300,000,000 in interest for a pre-petition $4,600,000,000 loan; and • a change in management shall be an event of default.

iv. *In re Nat'l Steel Corp.*, Ch. 11 Case No. 02-08699 (JHS) (Bankr. N.D. Il. 2002) - Approval of a debtor in possession financing agreement for up to an aggregate amount of $450,000,000, which included the following provision: • the requirement that the debtor repay the postpetition lender's pre-petition loan with the debtor's cash collateral.

v. *In re U.S. Aggregates Inc.*, Ch. 11 Case No. 02-50656 (GWZ) (Bankr. D. Nev. 2002) - Approval of a debtor in possession financing agreement for up to an aggregate amount of $17,500,000, which included the following provision: • at the lenders' option, the debtor shall relinquish its exclusive right to file a chapter 11 plan and to solicit plan votes if it files a chapter 11 plan contested by the lenders.

3. Provisions Binding Third Parties as to Validity and Enforcement of Pre-petition Liens

   a. Cash collateral/DIP Financing orders frequently require adversary proceedings to be commenced by parties seeking to dispute the extent, enforceability, or priority of pre-petition liens within a certain time frame or be bound to the DIP's stipulations on these matters.

4. Findings regarding pre-petition conduct of lender

   a. credit facility constitutes a valid and binding liquidated obligation of the debtor.

   b. such obligation is not subject to any defenses or counterclaims.

   c. pre-petition liens are valid and enforceable.

   d. most DIP lenders will be unwilling to lend without a finding of good faith which immunizes the postpetition credit facility from appellate attack, at least to the extent that money has already been borrowed.

   e. Bankruptcy courts seem to have become increasingly uncomfortable with making such findings, particularly on the first day, on limited notice, and with a limited record. But generally, these findings are ultimately approved.

5. Liens or Superpriority Claims on Article 5 Causes of Action.

    a. purely creatures of the Bankruptcy Code and are not available under applicable nonbankruptcy law

    b. Many bankruptcy courts view liens on Article 5 Causes of Action as overreaching by the DIP lender given that the Legislative history suggests that these causes of action were created to alter nonbankruptcy law and to promote uniform distributions to unsecured creditors

        i. Allowed in *Mellon Bank v. Dick Corporation*, 351 F.3d 290, 294 (7th Cir. 2003), the court held that where the bankruptcy court had agreed to give pre-petition lenders a lien on the first $30 million of any preferences recovered in order to induce the lender to provide financing, such a lien was proper and for the benefit of the estate because it allowed the debtors to obtain financing and therefore sell its business as a going concern which benefited all creditors.

6. Expedited Relief from the Automatic Stay to Foreclose

    a. Option to terminate the automatic stay unilaterally upon a default. Courts routinely authorize expedited relief, generally upon limited notice to the creditors' committee and the United States Trustee

    b. Typically, stay relief is provided in the cash collateral order to allow the pre-petition lender to collect payments on the pre-petition facility or to record financing statements, *see, e.g., In re Magellan Health Servs., Inc.,* Ch. 11 Case No. 03-40515 (PCB) (Bankr. S.D.N.Y. 2003).

    c. At least one court has approved such a provision where the debtor reserved the right to move for injunctive relief in the event of default.

7. Waivers

    a. Waiver of the debtor's future ability to seek to use cash collateral without the lender's consent.

    b. Waiver of the debtor's ability to file a plan of reorganization without the lender's consent.

    c. Waiver of the debtor's right to challenge the perfection and scope of the DIP lender's pre-petition liens.

    d. Local practice and/or local rule generally requires that the creditors' committee be granted some opportunity, generally between 45 and 90 days, to investigate the DIP lenders' pre-petition liens.

    e. Section 506(c) waiver - Section permits the trustee to surcharge a secured creditor's collateral to the extent that

an administrative claimant has benefited the secured creditor's collateral.

i. In light of the Supreme Court's decision in *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 120 S. Ct. 1942 (2000), it is unclear as to whether the debtor's standing under section 506(c) can be delegated to the creditors' committee or any other entity

8. Cross-Collateralization

a. In return for making new loans to a debtor in possession, a financing institution obtains a security interest on all assets of the debtor, both those existing at the date of the order and those created in the course of the proceeding, not only for the new loans, the propriety of which is not contested, but for the existing indebtedness.

c. While no clear consensus has emerged, the majority of courts (at least a majority of the courts outside the Eleventh Circuit) seem to have concluded that cross-collateralization is permissible in some limited circumstances.

d. "Backward" cross-collateralization, in which the post-petition debt is secured, in part, by the pre-petition collateral, is far less controversial.

9. Roll-up of Pre-petition Debt

a. Lenders improve their pre-petition position by "rolling" their pre-petition debt into the post-petition facility.

b. The DIP lender does not necessarily need to even advance new money in order to effectuate a roll-up, if cash collateral is "deemed" to be advanced.

c. May grant to the pre-petition lenders a veto over any plan as a debtor must be prepared to fully pay the lender on the effective date. A debtor cannot "cram down" its pre-petition lender under section 1129(b) once the roll-up has been completed, unless agreed to by lender.

10. Payment of Attorneys' Fees

a. A secured creditor may try to obtain payment of fees outside the requirements of section 506(b) by requiring attorneys' fees as adequate protection.

11. Payment of Post-petition Interest

a. A secured creditor may try to receive current payment of interest notwithstanding section 506(b) by requiring post-petition interest as adequate protection.

12. Carve-outs

a. Since administrative priorities are ranked behind secured claims, administrative claims, including the claims of professionals, generally cannot be paid without the consent of the secured lender

a. It is almost always appropriate for a DIP financing order to provide a carve-out from the lender's collateral in order to ensure that certain costs of administration are paid

b. Lender may withhold carveout of expenses related to litigation or investigations against itself.