Preparing for Condominium Loan Workouts

How Lenders Can Identify and Minimize Their Legal Risks

By Robert M. Quinn

Real estate professionals have benefited from thriving condominium markets for the past several years. Developers and speculative unit purchasers have enjoyed remarkable success. But recent announcements of cancelled projects and news articles reporting a retreat by lenders reluctant to make new loans for condominium projects may indicate a slowdown in some previously hot markets.

No doubt, experienced lenders will watch for early warning signs of problems with their condominium construction projects. Slow pre-sales, construction delays, adverse publicity, budget increases, or problems with a borrower's reporting will receive immediate attention. Any of these events may signal approaching problems for a condominium project and increased risk of borrower default.

Enough warning signs will trigger action by lenders to deal with the business risks presented. For example, at the first signs of trouble, a lender may take a fresh look at the borrower and the project. Is the borrower trustworthy? Does the borrower have the resources and skilled management necessary to do the job? How far is the project from completion? Is the budget or business plan still realistic? Are the expected sources of repayment still available? Should the lender urge the borrower to seek financing elsewhere, or can the project be saved and the loan repaid?

Lenders do not make such decisions overnight. They investigate each issue carefully and revisit them often, constantly balancing the risks and rewards of a workout over enforcing the lender's remedies. Yet, lenders often wait until much later to address legal issues that could slow or frus-

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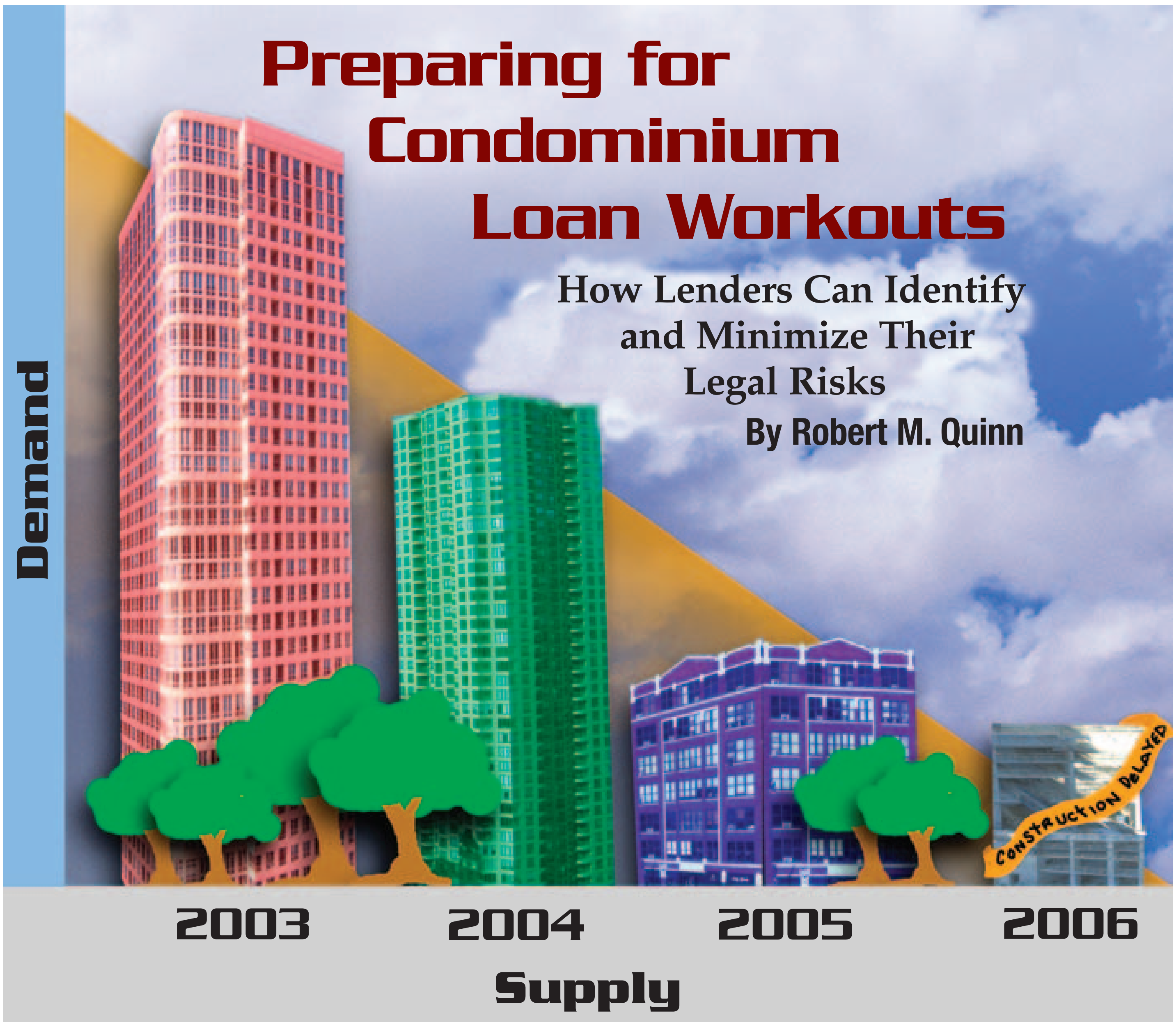

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trate the enforcement of their loan documents and to take actions that might increase their legal options if litigation becomes necessary. Likewise, they often overlook the opportunity that even an unsuccessful workout provides to cure defects in loan documents, disengage from messy waiver situations, negotiate releases from possible lender liability claims, and demonstrate and build a record of the lender's good faith and fair dealing. This article proposes a framework for early identification of a lender's legal risks before and during construction loan workout negotiations, with a particular focus on the unique problems of condominium development. It also suggests simple steps that can be taken to strengthen a lender's legal position during and after a workout.

Loan and Construction Documents

A lender's preparation for a workout begins with a thorough review of the loan documents. Hopefully, the key documents, survey, and mortgagee title policy are adequate and contain no unusual provisions. Before exercising remedies, a lender should check whether it is required to give notice of default or an opportunity to cure to the borrower and any guarantors or any other third parties. An updated title search should be performed to identify any new liens that have been filed against the project. Next, a lender should review all permits, government authorizations, and development agreements and should check for zoning changes or moratoria to determine if necessary authorizations might be jeopardized by a delay in construction.

If problems with the loan documents, title to the project, or needed permits are identified, granting concessions in a workout may be a reasonable price to pay to fix them. Likewise, if the lender and borrower have ignored important terms of the loan agreement since the closing, entering into a workout agreement that requires the borrower to return to strict compliance with all loan terms and conditions, including those previously not enforced, may be worth a period of additional forbearance or other concessions.

After looking at the loan documents, the lender should review construction-related documents. The borrower should have assigned its rights under the general construction contract to the lender. But, were the architect's and engineer's contracts also assigned, and did each of these third parties consent to the assignment? Do any of the assigned contracts require that the lender give notice of a default by the borrower, a material adverse change to the borrower's financial condition, or of the lender's decision to temporarily suspend funding construction draws? The lender should

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also determine whether it received all periodic inspection reports, certifications, affidavits, and title updates specified in the loan agreement.

Often critically important to a lender's decision to continue working with a borrower is to ascertain whether the remaining undisbursed loan proceeds are sufficient to complete construction. If the contractor posted a payment and performance bond, the lender should verify that it remains in force. Do the general contract and the contracts of important subcontractors and suppliers require performance for fixed prices, or do any provide that increased construction costs pass through to the borrower?

The lender should determine whether all subcontractors and suppliers on the project have been paid on time and if they provided lien waivers for each payment. If not, may unpaid contractors, subcontractors, or suppliers assert claims to the remaining loan proceeds, or do state construction lien laws protect a lender's right to use those funds to complete construction? Even if the remaining loan proceeds may be used to fund prospective construction costs, will the project remain subject to construction liens that will prevent the borrower from selling units unless these liens are paid or foreclosed?

If problems with the project have grown to the point that the lender must consider refusing to make any more advances, it must first determine whether state laws require that the lender notify contractors and other construction lien claimants of its decision. See, e.g., Fla. Stat. Ann. § 713.3471. Such statutes may impose substantial liability on a lender who decides not to fund but fails to give written notice in a timely manner to the parties affected.

Moreover, these laws may not establish clear guidelines for lenders. For example, the Florida statute requires a lender to give written notice to construction lien claimants within five business days of making a "final determination" to cease funding a construction loan. See id. § 713.3471(2)(a). But the statute does not describe when a temporary decision to delay funding one or more construction draws hardens into a final determination to cease funding. Nor does the statute describe how a lender should document such a final determination or what facts a court should consider persuasive if called on to decide this issue. Lenders may find it very difficult to prove precisely when they made a final decision to stop funding given the back-and-forth flow of negotiations on a troubled construction project.

Insurance Issues

Insurance coverage questions have become increasingly complex in recent years. Certainly a borrower should maintain adequate insurance coverage, but there are other issues. Is the lender named as loss payee on all policies and entitled to payment, even if the borrower fails to pay premiums or is guilty of wrongdoing? If a hurricane or other disaster strikes, can the lender take the insurance proceeds to pay down the loan or must insurance proceeds be applied to repairs on the project?

If the borrower may use funds from condominium purchase deposits to fund construction costs, as is permitted in some states, including Florida, may the purchaser assert claims to the insurance proceeds or demand that the proceeds be applied to effect repairs? None of these questions has an easy answer. How these issues are resolved may vary depending on the terms of individual policies and perhaps future judicial decisions.

Loan Participants

Did the lender sell participations in this loan? If so, the participation agreement should anticipate a workout and give the lead lender sufficient discretion to restructure the loan and grant concessions. The agreement should specify when or if participants must be notified and when or if their consents are necessary for particular actions. It also should provide workable notice, consultation, and voting procedures. In addition, the agreement should state whether the lead lender must advance workout expenses and when participants must pay their share of these costs.

Do the loan participation documents protect the lead lender? Each participant probably acknowledged relying on its own independent loan underwriting and exculpated the lead lender in the event of borrower's default or the lead lender's failure to require strict adherence to the loan terms. But do special circumstances exist that might limit the effect of these waivers or other protections granted to the lead lender?

Mezzanine Lenders

Mezzanine financing secured by a pledge of the ownership interest in the borrower/developer entity has become very common in condominium developments. If mezzanine financing exists, the parties should have an intercreditor agreement. If so, as with a participation agreement, the intercreditor agreement should anticipate problems and provide workable rules to govern a workout. The senior lender must determine whether it is required to give notices and whether the mezzanine lender must be afforded an opportunity to cure defaults on the senior loan.

At some stage, perhaps with the occurrence of default under the senior loan, the intercreditor agreement

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should prohibit the borrower from continuing to make payments to the mezzanine lender, although the senior lender may be required to give notice to stop the payments. Likewise, the agreement should prohibit the mezzanine lender from enforcing its legal remedies without obtaining the consent of the senior lender.

If the mezzanine lender can enforce its pledge of the ownership interest of the borrower/developer entity, the mezzanine lender or its assignee would become the developer of the project. This prospect may at first appear to be a promising solution if the mezzanine lender is another financial institution. On the other hand, it may not be so appealing if the mezzanine lender's assignee takes over and has a different investment strategy.

Unique Concerns

Condominium development presents unique problems and concerns for a workout lender. Lenders should obtain and review all condominium documents thoroughly, paying particular attention to the current offering prospectus used by the borrower. Changes during construction may have rendered the prospectus incomplete or misleading. If so, the lender should insist that the borrower correct the deficiencies and determine whether a revised prospectus should be delivered to each earlier contract purchaser.

If the project is in so much difficulty that the lender is considering removing the borrower and taking over the project, the lender should keep in mind that it faces additional risks as a "successor developer." The lender may become responsible for the same statutory and contract warranties imposed on the original developer of the condominium. If that happens and the project turns out to have substantial defects, a lender may lose more than its outstanding loan balance.

Lenders should review all existing unit purchase contracts to identify any troubling amendments or side deals that may have been overlooked earlier and to determine whether the contracts satisfy the eligibility requirements of the loan agreement. Lenders should not assume that they have received complete copies of all purchase contracts, although verification may be difficult at this point.

The lender also should determine the mix of owners and investors among the existing purchase contracts. Investors who intend to flip their contracts or immediately resell their units may be in competition with the lender unless the purchase contracts prohibit assignment and prevent resale of units for a time. Moreover, if enough unit sales have already closed, the lender may not control the condominium association. Insurance coverage issues mentioned earlier become even more complex after contract purchasers become unit owners.

Next, the lender should determine whether the project is subject to any time limits such that a delay may permit contract purchasers to cancel their contracts. Many projects are subject to the Interstate Land Sales Full Disclosure Act (ILSFDA) but depend on an exemption to the ILSFDA that imposes a two-year completion date. See 15 U.S.C. § 1702(a)(2). Every lender must be mindful of such time limits and be prepared for the consequences if the project is not completed on time.

If the project is far from completion when the lender begins to doubt the borrower's ability to complete construction, the lender may face a risk of litigation with disappointed contract purchasers. Some states, including Florida, permit a developer to use funds deposited by contract purchasers to fund construction costs. Fla. Stat. § 718.202. These statutes may not expressly impose a duty on the lender to these purchasers or a duty to monitor the borrower's use of these deposits. Nevertheless, once a lender has begun to doubt the borrower's ability to complete the project, it should be concerned whenever the borrower continues to spend deposit funds.

Loan documents often require the borrower to expend purchaser deposit funds before requesting construction draws. Lenders who benefit from a borrower's significant use of purchaser deposit funds—particularly during a period when the lender has delayed funding a draw request before ultimately deciding to cease funding the project—may face claims of misleading conduct or estoppel defenses.

Alternatively, while a lender ponders whether to cease funding, the borrower may enter into numerous new purchase contracts, acquiring and spending new deposits, which may improve a lender's collateral position substantially. Some combination of these or similar facts may put lenders in a difficult position and provide sufficient grounds for disappointed condominium contract purchasers to assert estoppel defenses or equitable liens against the project. Even if such novel litigation theories do not prevail, claims of misrepresentation or estoppel may result in costly and time-consuming litigation.

Lender Liability Claims

Lender liability claims are not as common as they once were. Still, a lender must evaluate possible lender liability claims and defenses. For example, prudent lenders should review all dealings with their borrowers. They should pay particular attention to any documents or communications that might suggest a lender's implied promise to give the borrower more time or additional funding, or to overlook the borrower's failure to meet financial covenants or construction schedules.

Alternatively, the lender may have initially accepted pre-sale or purchase contracts that did not satisfy all eligibility requirements of the construction loans for a time but has now become concerned over the decreasing quality of contracts presented by the borrower. A lender's failure to disengage from such possible waiver situations can lead to unnecessary and costly litigation.

As is the case with most people, lenders sometimes run out of patience. They may spend weeks or months dealing with a borrower on a troubled project. Promises will be made but not kept. Potential new investors may be wooed but not convinced. Sometimes the borrower will take actions that make things even worse. But lenders must not suddenly call the loan, set off the bank account, and liquidate pledged stocks without first warning the borrower and any guarantors. Lenders who take such precipitous actions may regret them later as routine foreclosures become vigorously contested cases of estoppel, waiver, and bad faith.

A review of the loan relationship may reveal a possible waiver situation in which the lender overlooked breaches of financial covenants, reporting obligations, late payments, or ineligible purchase contracts. *Dagnino v. Home Fed. Sav. & Loan Ass'n of St. Petersburg*, 183 So. 2d 846, 848 (Fla. Dist. Ct. App. 1966). If so, the lender must disengage from this waiver situation before taking action. In most circumstances, a lender need only give a borrower notice and a reasonable time period to get back on track. Lenders must be sure to give the borrower enough time to prevent claims of surprise or unfair action.

Lenders also should pay careful attention to any evidence of prior disputes with the borrower or guarantors. If problems occurred, are all

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notes and memos in the lender's files businesslike and factual? Letters or reports that contain subjective comments or opinions about the project or the borrower or the wisdom of the lender's prior decisions may present ammunition to a litigious borrower.

A lender's files may present other potential problems. For instance, self-serving letters from the borrower blaming the lender for delays or problems that were left unanswered may be much more difficult to refute in court months or years later. In addition, internal documents offering even a hint that a lender delayed informing a borrower of an adverse decision on a funding request until after investors committed more funds or unpaid subcontractors kept working past a critical construction event could lead to lawsuits. Similarly, documents that establish that one group of lender's management had lost confidence in condominium projects in the borrower's location while the staff working directly with the borrower expressed only

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great enthusiasm may look misleading, especially to third parties who continued to extend credit, invest funds, or make deposits.

The lender also should evaluate the risk that its prior actions might be viewed as an improper exercise of control over the borrower. Demands for changes to a borrower's business plan or a requirement that the borrower engage a particular consultant or pay particular subcontractors when funds were short should have defensible business purposes carefully documented in the lender's files. Similarly, lenders who communicate directly with the borrower's contractor or other third parties during a project may face claims of interference by the borrower or estoppel or worse from these third parties if they were never paid.

Almost any of these problems, if identified early enough, can be negotiated away as part of a workout. A lender should insist on a complete release from the borrower and any guarantors and a reaffirmation of the loan documents as part of the price for granting concessions. If third-party claims are possible from contractors, investors, or others, a lender should consider how these parties might be approached and potential claims resolved as part of the workout. Chances are that these third parties also would prefer a completed project to their prospects for success on possible lender liability claims. Then, if the project fails, the lender should have a fresh legal start when it becomes necessary to enforce those loan documents.

Workout Negotiations

After carefully evaluating its legal position to identify potential problems that must be addressed, the lender is ready to start workout negotiations. First, however, the lender should send a pre-negotiation letter to the borrower, setting ground rules for the negotiations. The borrower and any guarantors should be cautioned against assuming that the lender's willingness to participate in workout negotiations or to grant temporary forbearance means the workout will be successful. The letter also should make clear that the lender reserves all of its rights and remedies for any existing defaults.

The letter should also specify any limits to the authority of those conducting negotiations on the lender's behalf. Perhaps most importantly, the letter should emphasize that any agreement reached during the negotiations is not binding until it is reduced to a written agreement signed by all parties. Merely stating, however, that any oral agreement is subject to this condition or must be approved by a loan committee does not give the lender an unfettered right to reject a preliminary oral agreement. A disappointed borrower might challenge whether the lender made a good faith effort to produce a written agreement or to obtain approval from the appropriate committee if a lender decides not to follow through on a tentative agreement.

Once negotiations begin, it is important to avoid misunderstandings. A lender must say what it means and be careful not to misrepresent facts or intentions to the borrower, guarantors, and any third parties. The lender should avoid making oral agreements of any kind and should confirm any agreement to grant a waiver, or even slight concessions, in writing as quickly and in as detailed a manner as possible.

Finally, a lender should telegraph its punches. It should never put borrowers or guarantors in a position to claim they were taken by surprise. If a successful workout seems unlikely and further negotiations appear pointless, the borrower and guarantors should be given ample notice that things are not going well, long before negotiations are terminated. If the negotiations reach an impasse, the lender should confirm in writing that negotiations have ended and that it may begin enforcing its remedies at any time without further notice.

Dual Purpose

Workout negotiations have at least two purposes. First, workouts permit a lender to negotiate appropriate changes to loan terms, which may make it possible for a borrower to rescue the project and repay the loan. Second, lenders must take advantage of the workout to fix any legal problems, identify and resolve potential disputes, and build a record of their good faith and fair dealing that can be relied on in any subsequent litigation. If a workout involves a condominium project, the lender, in order to achieve these goals, must keep in mind the special problems inherent in such projects. ■