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Condominium Lending: Lessons from the Bust

By Joel C. Solomon

__Joel C. Solomon__ is Of Counsel at Foley & Lardner LLP in Chicago, IL. He recently represented Corus Construction Venture, LLC (CCV) in its sales to date of 13 multifamily projects, all of which were built as condominium developments. CCV was the most prominent public private partnership between private equity (including Starwood Capital, TPG, Richard LeFrak, and Richard Perry Capital) and the Federal Deposit Insurance Corporation (FDIC).

In 2010 it appeared that many major cities were overloaded with empty and often unfinished condominium developments, collectively containing thousands of seemingly unsellable condominiums. It appeared that the condominium boom and the bust resulting from the Great Recession of 2008 and 2009 would have a long lasting adverse impact on an important aspect of urban home ownership. Since that time however, unfinished condominiums have been completed, marketed, and sold to the investors and end users. The market gradually is coming full circle, with many new condominium projects in the planning stages or underway in major metropolitan areas such as Miami and New York.

The precise explanation for the turnaround is complex, but one significant aspect is that many of the condominium construction loans in existence were supported by sound legal and underwriting infrastructure, so that banks and new investors were able to finish troubled projects and sell the extensive inventory to a market that re-emerged more quickly than many predicted. This article focuses on the fundamentals underlying such loans and emphasizes the importance of lenders taking full advantage of consent rights in the loan documents during the development process.

THE BUST

The housing boom and bust that led to the 2008 Great Recession has been well chronicled. Beginning in 2003, Corus Bank, N.A. (Corus), located in Chicago, Illinois, focused primarily on financing condominium developments on a national basis. Many of the projects involved high-rise buildings in large cities including Miami and other parts of Florida, Los Angeles, Las Vegas, Phoenix, Chicago, Houston, and other urban locations around the country.

In 2007 many loans started to exhibit signs of stress. New sales and closings for existing sales slowed. During this early phase of the slowdown, Corus entered into many loan modifications in which it agreed to delayed maturities and lowered minimum release prices for the sale of individual units, usually in exchange for an equity contribution from the borrower. For many loans, these accommodations resulted in eventual payoffs with no losses for Corus. However, once the real estate market collapsed in 2008 and 2009, condominium unit buyers who were under contract to purchase the unsold condominium units were either unable or unwilling (or both) to close on their contracts.

The economy was so bad that modifications became less effective. Many large condominium construction loans and condominium conversions plunged into default and Corus began in earnest enforcing the loan agreements, mortgages, collateral assignments, and other security instruments that comprised the governing agreements and security interests for every loan.

As a result of the changing market, the bank was required to obtain new appraisals for many of the properties that were the collateral for its loans. The appraisals resulted in significant write downs based on current market conditions. On September 11, 2009, Corus was placed into receivership with the FDIC. The bank's $4.5 billion loan portfolio consisted almost entirely of real estate loans, including a hotel, offices and apartments, but the majority of the loans were for condominium development construction loans. Some of the projects under construction included high rise condo projects financed by loans in excess of $100 million. The FDIC as Receiver was faced with significant unfunded construction loan commitments. Once a lender has invested material dollars to fund construction, there is no turning back because a partially completed building is worth less than the investment already made. The FDIC, recognizing the demands of a large construction loan portfolio, chose to pursue a partnership with private, real estate industry specialists that among other things could better respond to complex, weekly draw requests for dozens of projects that had to be funded to prevent collapse.

THE RESPONSE

A month after it was appointed Receiver, the FDIC orchestrated one of the largest public private partnerships of the era. It transferred the portfolio of loans (some performing and many not) and about 20 large projects that the bank had acquired as "real estate owned" (REO), to a new entity called Corus Construction Venture, LLC (CCV).

It was clear that the condominium projects would have far greater value once completed, and that the ultimate recovery of the loans would be enhanced greatly, not by bulk selling at the bottom of the market, but rather by completing construction and slowly selling into the market as the economy improved. In a public bidding process, the FDIC sold 40 percent ownership of the new company, along with the right to manage the process, to a consortium of private equity investors including Starwood Capital and TPG. The private equity managing member of Corus Construction Venture was ST Residential, LLC.

ST Residential was composed of bankers from Corus Bank and experienced real estate personnel hired by the private equity managers. I transitioned from my role as General Counsel of Corus Bank to the same position at ST Residential. Through its structured finance agreement with FDIC, CCV had access to credit facilities that provided a source of capital to support the continued funding of construction loans as well as REO construction and enhancement needs. In addition, it was under no pressure to sell until the market was ready for repositioned assets. The new team set about the task of funding the constructions loans, and foreclosing or working out troubled loans with borrowers who were in default. A half dozen of the borrowers took the adversarial approach and filed Chapter 11 bankruptcy petitions. Nearly every bankruptcy resulted in CCV obtaining ownership through its subsidiaries, albeit at increased expense for both sides. In some instances, borrowers who could have negotiated a walk away incurred significant "bad boy" exposure under guaranties that allowed personal recourse for the lender's loss once a bankruptcy filing occurred. Other borrowers who were completely underwater chose to work hand in hand with ST Residential to complete the projects and maximize returns. The experience confirmed for me the importance of a borrower's character as fundamental to a successful loan.

Across the portfolio, there were hundreds of challenges arising out of entitlement issues, lien claims, and borrower lender liability claims. There were more than a thousand disputes by purchasers regarding claims for the return of their earnest money on pre-sale contracts, and countless other issues. In addition, there were many condominium projects that needed to be completed, marketed, and sold. ST Residential met each issue head on, and within a year was the owner of many multifamily projects, both rental and condo. Many of the projects were significantly upgraded by investments in entranceways, pool decks, landscaping, and lobbies.

THE RECOVERY

Miami was the first market where condominium sales rebounded, often with cash purchases by foreign buyers. By the time the national media started reporting the story in early 2012, prices already had rebounded substantially, and by 2013 the price per square foot for some high end condominium units was approaching pre-recession levels.

In 2014, it is clear that at least for Miami and the New York City markets, condominium development and the lending that supports such developments are coming back. Condominiums, the most beleaguered of property types over the past few years, are reemerging as a desirable form of lender investment and property ownership. The ownership of hundreds of condominium projects commenced in 2005 through early 2008 have been transferred to banks or their successors through foreclosures or deeds in lieu of foreclosure. Once lenders obtained ownership, they completed projects and sold them out through individual sales as the developers had originally intended or they converted projects to multifamily rental housing and bulk sold them as multifamily investments. CCV has sold thousands of units in the larger markets, including more than 2,000 units in Southern Florida.

In secondary markets such as Las Vegas, Phoenix, and Tampa, sales values of unsold units diminished too much for the new project owners to return to a condominium sellout strategy. Fortunately, consumers have displayed an appetite for rental housing and projects in those regions were successfully repositioned to multifamily rental. As these reinvented projects have come on the market, institutional investors have snapped up both fractured (condominium declarations recorded and some units sold to individual owners) and non-fractured properties as income/rental properties. During 2012, CCV capitalized on the demand for multifamily rental projects by selling 13 separate former condominium projects (2,850 units) as multifamily assets.

The CCV public private partnership has been extraordinarily successful. Barry Sternlicht, CEO of Starwood Capital, in a *Wall Street Journal* "Deal of the Week" article, recently stated that the private equity investors had doubled their $1.4 billion dollar investment, and that "this has been a great, great risk adjusted trade for everyone." One of the reasons that the ST joint venture with the FDIC was so successful was that the legal agreements underlying the loans were comprehensive and clear. Whenever it was necessary, CCV enforced its security interests, completed construction, utilized the essential rights of the developer to market the condominium units for sale, or turned projects into multifamily rentals.

Rather than delving into the legal analysis of best practices for mortgage, loan agreements, guarantees, intercreditor agreements, and the other agreements that form the basis for a sound lender's position for a loan, this article instead focuses primarily on the "bones" of sound condominium construction loans.

FRAMEWORK FOR SOUND CONDOMINIUM CONSTRUCTION LENDING

The Lender as Underwriter

The lender and the borrower must start with a clear understanding of the purpose of the loan. What EXACTLY is the project that will be built? A construction loan by its nature contemplates loan disbursements that will occur (and remain subject to many conditions and hurdles) over 18 to 36 months. With a condominium construction loan, the parties must consider many layers of legal relationships. A lender cannot limit its requirements to a finished building that conforms to the drawings, plans, and specifications contemplated by the parties. As CCV and lenders across the country have learned, a lender must be prepared to assume ownership of a project that is subject to entitlements, contractual obligations with contractors, and the covenants, conditions, and restrictions of record that comprise a condominium regime. As a potential future owner, a lender must assure itself that every aspect of the proposed project will fully support the intended economic use.

Although no lender should unduly interfere with a borrower's business, a prudent condominium construction lender must satisfy itself that if there is a material default in a condominium loan, the lender will be able to assume ownership of the project, complete construction, and ideally market and sell the units as condominiums. The lender must have collateral that not only includes the physical project, but the full assortment of rights and entitlements that provide for the unit by unit sale of the project, and the enforceability of contracts for the purchase of units that were pre-sold to retail buyers. In the event that a given market does not support condominium sales, then Plan B for a defaulted condominium loan is to repurpose the project to a multifamily rental use for eventual sale. Thoughtful attention to details in underwriting a condominium development, and carefully drafted and well developed lender approval rights of the construction and draw process, should enable the lender to retain the potential for full economic access to the project, while avoiding the potential for lender liability.

The Borrower

While the lender is conducting its underwriting of a proposed loan, the developer/borrower often is simultaneously negotiating with multiple parties regarding the ultimate capital structure for the project. Investors likely will obtain a combination of debt and equity positions in the borrower, and often use a complex corporate structure. If any investor is seeking a mezzanine debt position in the project, a detailed intercreditor agreement should govern the subordinated rights of the junior lender vis-a-vis the borrower, the collateral, and the senior lender. The lender must be certain to understand who it is doing business with, the relationship of the various constituents, and the levers of control that have been negotiated among the borrower parties.

When problems occur during the long road from conceptual drawings to ultimate sales, the lender must fully comprehend the motivating objectives and relative leverage for the borrower constituents. For example, an institutional investor will have a perspective different from an entrepreneurial developer who has invested a large portion of its assets into the project. A well-drafted loan agreement requires approval of the organizational structure as evidenced by the governing documents and approval of all agreements with affiliates.

The Loan Purpose

No lender should approve a loan for a project without a thorough analysis of whether the market will accept the development, and consideration of the economics. Lenders must fully understand the project to be built in relation to the market. For example, the detail should include the location (site plan), the number of floors, the number and configuration of residential units, a description of the commercial units, the parking, access points, and ceiling heights. Square footage of units must be described precisely for all key aspects of the project, especially the units to be sold. Beyond the basic outline of what the project will contain, the loan documents should require approval of detailed plans and specifications. The lenders should use qualified consultants and carefully consider both feasibility and desirability of the proposed project with respect to floor layouts, mechanical, electrical, plumbing, life safety, and site plan issues. In addition, the parties must agree on finish standards, which they should then memorialize in the loan agreement. This should include the kitchen finishes, fixtures, windows, floors, etc.

The Contractor, Professionals, and the Construction Process

The selection of a competent and well-funded general contractor is fundamental to the success of the project. The general contractor and important sub-contractors must be capable of conforming to the plans and specifications, the construction schedule, and the budget. The choice of the general contractor must be carefully underwritten, with due consideration to the contractor's experience on relevant similar construction, its reputation and abilities, and consideration of its financial strength. In addition to the choice of the company, the lender should identify and vet the contractor's key personnel who will be responsible for the specific project. The contractor should not be affiliated with the borrower. The lender also should analyze the type and terms of the construction contract. If the borrower fails, in most circumstances the lender will still want the original contractor to complete the job. The construction contract is collaterally assigned to the lender, who should have notice and cure rights for any claimed default. In addition to the general contractor, the lender should review and underwrite material ancillary contracts for design professionals, owner's representatives, and key consultants.

Once construction commences, the lender must monitor every aspect of the process. I firmly believe that the monthly sign off by an inspecting architect or other consultant is wholly inadequate by itself. As a start, the reporting documents for the project construction should include modified AIA G702 and G703 forms, pay applications for subcontractors, suppliers and materialmen, a lien waiver and tracking log, a contingency transfer record, a change order log, drawings and specifications changes log, shop drawings and submittal log, permits and development authority approvals, including municipal inspection log, and a drawings and specifications changes log. This is far from an exhaustive list, but it illustrates the nature and extent of dynamic information a lender must watch as a project is being built. A knowledgeable staff that truly understands the process is essential to making sure an on-time, in-balance (with the budget) project is being built that conforms to the original expectations.

Entitlements, Building Permits, Zoning, and Utilities

The lender and lender's counsel must fully understand the entitlements for the project. Whether it is a pure residential project, or a mixed use development, the lender must carefully examine entitlements (zoning, permits, special uses, flood zone issues) allowing the project to be built and used as contemplated. There often are quirky aspects unique to most projects, such as easements for access to a property from different streets, temporary easements for staging construction in urban areas, and location specific sewer laws. There may be air rights, and there may be municipal obligations that paved the way for the development entitlements. In a project in Honolulu, for example, in order to create the sewer access necessary for the project, the developer had to form a separate company called a "hui" with adjacent property owners. The hui constructed and paid for the sewer infrastructure that resulted in the hui members (or other owners who purchased the hui's credits) obtaining rights to use the sewer system. Also, it is not unusual for sales centers to be on separate property that may be leased from a third party. Assuring access to a sales center for a major project is critical to the marketing and sales that will monetize the project. If it includes built out model units, the sales center represents a material item in the budget.

The lender must understand all of the continuing and subsequent obligations of the owner. For example, the borrower may have granted entitlements subject to future performance by the developer of an exterior art contribution, a play lot, or other public benefit. Without fully understanding the entitlement process, the lender could easily miss an obligation of this nature, and the inherent cost it creates. Similarly, a prevailing wage requirement could affect assumptions regarding costs to complete based on local union prevailing wages. Assurances with respect to compliance for entitlements may include zoning opinions from qualified counsel, architect's certifications, and comfort letters or other assurances from the relevant governmental authorities. In addition, the lender must obtain evidence of all necessary utilities for the contemplated project, and appropriate environmental and soil reports.

In addition to the entitlements, the lender must carefully study the condominium regime. During the boom years the issues associated with stepping into the developer's shoes seemed remote. The lender typically was paid off after a little over half of the units were sold. However, as we have learned in the past few years, a lender has to be prepared to take ownership and to be subject to the condominium regime as drafted.

In Florida, after the Great Recession commenced, the specter of significant responsibilities and developer liabilities arising from claims by the Homeowner's Association after formal turnover was deterring lenders and new buyers from investing in distressed condominiums. In 2010, in response to the concern of the investor community, Florida responded uniquely by passing the Distressed Condominium Relief Act. Briefly, the statute provided significant relief for bulk purchasers (including foreclosing lenders) from developer's liabilities under Florida law. The law allows a bulk assignee to avoid responsibility for statutory developer warranties, and relieves a bulk assignee from the prior developer's failure to fund previous assessments or resolve budget deficits. The key point is that in a severe downturn, absent extraordinary legislative relief, a lender who seeks to assume ownership of unsold condominiums may inherit many duties and obligations of the developer pursuant to state law. Lender's counsel must understand the specific state laws and draft agreements that contain the broadest possible limitations of potential successor developer liability including waivers of potential claims. In some states, the risks could include claims asserting liability for construction defects. Lenders should specify detailed insurance requirements that include coverage broad enough that it will respond not only to perils such as fire and wind, but in addition will respond to future claims for construction defects in the event the lender (or its affiliate) steps into the owner's shoes.

Lender's also should ensure that the developer has retained the rights necessary to have maximum flexibility for the sales and marketing of the project, and that the developer will maintain effective control of the project as long as permissible under applicable state law. The lender should understand the funding of the common expenses as well as the state law reserve requirements. In certain cases, even after sales commence, a developer or a successor owner may be entitled to pay the difference between collected assessments from third party unit owners and the actual costs of operation, rather than the actual assessments for the unsold units. The loan agreement should contain covenants by the borrower requiring that it fulfill its obligations under the condominium documents and state law, and prohibit unauthorized changes. The lender should also understand the timing of the turnover of the association to the condominium purchasers under applicable state law, and should appreciate the nature and extent of the turnover obligations, which can be substantial. In other words, the lender must assume it will own the project, and assure itself that the developer is exercising high standards of care and diligence.

Project Budget

Fundamental underwriting includes the analysis of the proposed project budget and study of the individual line items. Even with a guaranteed maximum price contract or a stipulated sum contract, there typically are many open items that have not been determined at the point when a loan is being underwritten or even closed. Many of those undetermined items will be provided for in the construction contract as allowances. A careful analysis of allowances is critical to make sure that the $300,000 line item for "bathroom sinks and fixtures" is adequate to purchase the appropriate level of finishes for the price points associated with this project. Otherwise, a future budget shortfall (out of balance) could be hidden in the allowances line items. Closely related to the budget analysis is the decision whether to insist on a Performance Bond requiring that a surety guaranty performance of the general contractor's obligations including payment of sub-contractors and material suppliers.

The lender should study various contingencies as part of the budget analysis. The loan budget usually will contain a soft cost contingency and a hard cost contingency, separate and apart from the contingency that is incorporated in the construction contract. The adequacy of the contingencies is important, but so is the timing of how the contingencies may be drawn. For example, in the first phase of the project, it is reasonable to allow some additional percentage of the contingency in excess of a strictly pro rata amount. But the lender also should retain reasonable percentages of the contingency in reserve until project completion. In addition, a contingency should not be available to cover an interest payment shortfall in the event the interest reserve line item is depleted or unavailable for some other reason.

Upgrades

A unique feature of condominium sales are upgrades. Upgrades are part of the sales and marketing process, and may have a material impact on the developer's profits. An upgrade typically is any alteration from the approved construction finish standards that results in extra cost to complete the unit. The loan agreement should carefully regulate all aspects of upgrades so that the borrower does not agree to changes that increase the lender's exposure. A reasonable approach is that upgrade costs to the borrower should not exceed 70 percent of the charges to the condo unit purchaser, and (if allowed by local law) the entire upgrade costs should be funded from the upgrade deposits. The borrower should place upgrade deposits into a specified upgrade deposit escrow account, and the lender will retain a perfected security interest in the account. In addition, notwithstanding a buyer who requests outlandish upgrades, the borrower should not be able to over-improve or make odd improvements to units under contract that are not customary in the market. The lender should retain approval rights on upgrades for a dollar value that exceeds a certain amount, and for unusual upgrades. No pink granite floors!

Pre-Sales

Most lenders require that contemplated projects achieve significant pre-sales (pre loan contracts with buyers). Lenders presume that the pre-sale contracts provide significant comfort that the market accepts the project, and that upon completion the loan will be quickly reduced by the sale of pre-sold units. For pre-sales to offer meaningful support for a loan, the lender must assure itself that the contracts are enforceable under state and federal law. As a starting point, contracts must comply with state condominium laws, conform to the requirements of state approved offering memorandums, and be immune from defenses involving fraud. Fortunately, Congress recently has amended the Interstate Land Sales Full Disclosure Act to remove its applicability to condominiums.

After the downturn, borrowers seeking cancellation and the return of their earnest money attacked every conceivable weakness in their contracts. To defend against the possibility of buyers seeking cancellation of their pre-sale contracts, lenders should insist that every possible protection is built into the purchase agreement. For example, borrowers made fraud claims against developers based on discrepancies in the measurement of unit square footage. Developers often were guilty of using one formulation for measuring the size of units that was larger in marketing materials than in actual condo drawings. To avoid defenses to pre-sales, the description of how square footage will be measured should be clear (*e.g.*, "condominiums shall be measured from the interior of the glass in the exterior walls, the middle of demising walls between Units, and to the public side of any common area walls"). In addition, purchase contracts should contain protective language stating that borrowers should only rely on square footage representations in the contract, and further allowing for some deviation in the finished units which is inherent in the construction process.

CONCLUSION

The goal of this article is to provide an overview of the key issues in condominium construction lending. While a lender may hope that it will be paid off by completion and sale of a condo project, it must underwrite the deal as if it will exercise remedies and become the developer. In a worst case scenario of taking ownership of a project, the lender will step into a complicated, multi-faceted asset, which includes state law developer obligations, relationships with contractors, potential buyers and actual unit owners, and regulators. The lender may have to finish construction, market the project, consummate sales, and manage a condominium community. The law relating to foreclosures and interim remedies such as appointment of receivers vary widely from state to state, and therefore local law must be carefully considered. Although a cardinal rule of lending is that the lender should not run the borrower's business, the lender must be diligent and specific in legitimate loan requirements to manage the risks of a condominium loan without veering into the thicket of lender liability.

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