How Fla. Homebuilders Can Protect Pre-Closing Deposits

Article
Law360
10.23.2020

Related Attorneys

Gary M. Kaleita

Related Expertise

Real Estate

Real Estate Development

Real Estate Transactions

© 2020 Portfolio Media, Inc. Reprinted with permission. Originally published in Law360 October 23, 2020.

The housing market in central Florida is booming despite COVID-19, thanks in large part to a growing population and low interest rates on home mortgages. As a result, developers are creating new subdivisions and homebuilders are seeking to acquire lots in them as fast as they can be developed.

Traditionally, developers acquired vacant property and began installing subdivision infrastructure before signing contracts to sell completed lots to homebuilders. However, the current market has homebuilders competing for lots, and it has become more commonplace for developers to sign contracts to sell lots even before they have acquired the property they intend to develop.

When this occurs, homebuilders are putting earnest money deposits under such contracts in escrow pending the developer's acquisition of the property.

This article addresses issues presented by the fact that many developers are successfully negotiating to have the homebuilder's earnest money deposit released to the developer when they close on the purchase of the land, so that they can apply the deposit toward the purchase price or the development costs incurred by the developer.

As you would expect, a homebuilder should be reticent about releasing its deposit to a developer while there exist any unfulfilled closing conditions. In addition to an inspection period, there are typically permitting or approval periods for development entitlements, as well as development obligations pertaining to the proposed subdivision, including its infrastructure, amenities and the lots being purchased, all of which have to be fulfilled before the homebuilder's deposit becomes nonrefundable.

As long as any unfulfilled closing conditions exist, it is possible that the homebuilder will become entitled to a refund of the deposit. This could also be triggered by the developer's default under the contract that the developer signs to sell lots to the homebuilder.

If the deposit becomes refundable but has been released to the developer from escrow, absent some other assurances, the homebuilder is left with an unsecured claim against the developer and must institute a lawsuit and get a judgment against the developer in order to recover its deposit, assuming the developer has any assets available at that point to pay it.

There are a number of ways a homebuilder can seek to protect itself in this circumstance.

A homebuilder's deposit should never be released to a developer until the developer actually acquires the property to be developed. By this time, the homebuilder's inspection period should be over, and the developer should demonstrate that it has acquired the government entitlements and approvals needed to develop the subdivision. This means that a lot of the typical closing conditions would have been fulfilled. Ideally, the only remaining conditions should be related to the developer's completion of the subdivision and platting of the lots.

A homebuilder should require that the developer grant the homebuilder a first mortgage on the property to secure the developer's contingent obligation to refund the deposit if it becomes refundable. The mortgage should be the subject of a mortgagee title insurance policy in favor of the homebuilder for the amount of the deposit, subject only to the title exceptions that the homebuilder has approved during its inspection or title review period.

A developer will no doubt be recording new title exceptions during the development process, such as a declaration of covenants creating a homeowners' association for the subdivision, service agreements with utility companies, development agreements with local governments and a subdivision plat. The mortgage should therefore contemplate that the homebuilder will subordinate its mortgage to these new exceptions, so long as the homebuilder retains the right to reasonably approve them.

Other customary mortgage provisions should also be included, such as the requirement for the developer to maintain insurance, pay real estate taxes, refrain from granting other mortgages, refrain from selling the property while the mortgage exists, etc. If the deposit becomes refundable and the developer does not refund it, or if any of the mortgage covenants are violated, it should trigger a default under the mortgage which allows the homebuilder to foreclose the mortgage and have the property sold in order to recover its deposit.

A mortgage is usually accompanied by a promissory note, but in this scenario it is the homebuilder's contract with the developer that evidences the developer's contingent obligation to refund the deposit, so a promissory note is not needed. Promissory notes are subject to documentary stamp tax and mortgages are subject to intangibles tax.

It is arguable that these taxes do not apply to a mortgage which secures a contingent obligation to refund a deposit under a land contract, but since the developer wants the homebuilder's deposit released to them, the developer should agree that if these taxes are imposed by the Florida Department of Revenue, the developer must pay them.

It is not unusual these days for a lot of the developer's subdivision infrastructure costs to be funded by the creation of a community development district, which issues bonds to investors and uses the proceeds to pay for the infrastructure installation. Of course this results in two different types of community development district assessments against the property being improved.

Usually, the proceeds of the bond issuance includes reserves for interest payable on the bonds during the construction period, but after the interest reserve runs out the principal and interest on the bonds must be repaid in installments by all owners in the subdivision. Once the community development district accepts the completed infrastructure that it will own and maintain, it begins levying a second type of assessment to cover operating and maintenance costs.

All community development district assessments are secured by a lien on the assessed property that has the same priority as real estate taxes, so they will be superior even to a first mortgage. As such, it is important for the homebuilder to be comfortable with the community development district budget and the amounts of assessments it will have to pay if and when it either (1) acquires the property in a mortgage foreclosure, or (2) acquires lots when they are developed.

If desired, additional security for the homebuilder's mortgage can be obtained in the form of a personal guaranty from one or more of the principals of the developer, obligating each of them to refund the deposit if the developer fails to do so.

These are not a panacea, however. The guarantors should demonstrate to the homebuilder that their net worth is sufficient, and the homebuilder should keep in mind that if they are relying on assets held jointly by a married couple, both spouses should sign the personal guaranty.

While it is possible that a letter of credit could serve as collateral for the refund of the deposit, these require the payment of fees to the issuing bank, and the bank will probably also require significant cash collateral to be held at the bank for the duration that the letter of credit is available.

It is not unusual for such a bank to require cash in the entire amount of the letter of credit, which defeats the purpose since the cash could be better used to acquire or develop the subdivision instead. It is unlikely that a developer will agree to incur the obligations associated with providing a letter of credit.

What has been discussed so far can work well in the context of a developer that is relying on only one homebuilder's deposit to acquire and develop property. It starts getting complicated when the developer also needs an acquisition and development loan from an institutional lender. In this scenario, there is no way that an institutional lender is going to agree to allow a homebuilder to have a prior mortgage on the property it is financing, so the homebuilder will be relegated to second position. This raises several issues.

If the homebuilder is going to hold a second mortgage, it is important that the homebuilder be comfortable with the projected value of the completed subdivision, in order to verify that the combined amounts of the community development district debt (if applicable), the institutional lender's loan and the homebuilder's deposit are lower — preferably significantly lower — than the projected value of the completed subdivision.

Although a loan-to-value ratio can change over time due to market conditions, like development cost overruns and property values, it is important at the outset to verify that the developer will have sufficient equity in the property absent such changes.

Given the increased risk associated with holding a second mortgage, you would think that other potential sources of recovery of the deposit may help, such as personal guaranties and letters of credit.

Unfortunately, however, many institutional lenders will not permit the developer's principals, who are often also guarantors of the loan, to incur other liabilities, even contingent, under personal guaranties or to pay such liabilities if they become due while their loan is outstanding. Similarly, the lender will want not want the developer's cash tied up with another bank as collateral for a letter of credit.

The most that a homebuilder can hope for in order to protect its second mortgage position is an intercreditor agreement with the institutional lender holding the first mortgage, and even such an agreement is not bullet-proof. This type of agreement contains various covenants by the holders of the first and second mortgage, addressing the types of issues discussed below.

The lender will want the homebuilder to expressly acknowledge its second priority lien position, and that if the deposit becomes refundable it will not get refunded unless the loan has been repaid, except that it will get applied as a credit against the homebuilder's purchase of lots in the manner provided by its contract with the developer so long as the loan is not in default.

The lender should therefore recognize the homebuilder's right to buy platted lots pursuant to its contract with the developer, if the lender forecloses its mortgage and acquires the property after the plat is recorded.

However, if the foreclosure occurs before the subdivision is completed and the lots are platted, the lender may not agree to complete the developer's obligations. In these cases, the agreement will typically allow the lender to terminate the homebuilder's contract with the developer, leaving the homebuilder to sue the developer and any guarantors to recover the deposit.

Lenders are not developers, so they are reticent about committing in advance to complete a defaulting borrower's subdivision. Their typical course of action would be to sell the partially completed development after they foreclose, but some lenders will agree to complete the development.

Usually, the lender will not allow the homebuilder to foreclose its second mortgage unless the first mortgage is also in default, but a foreclosure of a second mortgage that is subject to a first mortgage doesn't do the homebuilder much good.

The homebuilder will want the lender to agree to send the homebuilder notices of the developer's defaults under the loan, and give the homebuilder the right to cure those defaults, including the right to completely pay off the lender and either (1) obtain an assignment of the loan, thereby making the homebuilder the first mortgage-holder, or (2) obtain a satisfaction of the loan and first mortgage, thereby moving the homebuilder's second mortgage up to a first lien position.

A loan payoff is obviously an expensive proposition, and if a homebuilder does not have the cash to do that, it would have to obtain its own financing, which can take time that the lender might not want to give.

The agreement should also assure the homebuilder that during the development process the lender will consent to and subordinate its first mortgage to utility agreements, developer agreements, homeowners' association documents, the plat and other developer-related documents that must be recorded to complete the subdivision.

In addition, the homebuilder will want the lender to agree to release from the first mortgage any common area tracts (such as private streets, drainage ponds, entrance features and amenities) that the developer is required to convey to a community development district or homeowners' association, and other tracts required to be dedicated to a local government. If the lender forecloses and agrees to complete the subdivision, it should agree to make these conveyances itself.

There are a lot of other nuances associated with these concepts that an intercreditor agreement can address. They are typically heavily negotiated, but the lender holds all the cards and so has the most leverage.

It is important when a homebuilder negotiates a contract with the developer to buy lots that the contract give the homebuilder the right to terminate the contract and obtain a refund of the deposit before it is released to the developer in the event that the homebuilder and the lender do not agree on the terms of an intercreditor agreement. Once the form is approved, the execution of the agreement should be a condition to the release of the deposit.

As if this was not complicated enough already, consider what would happen if a developer's proposed subdivision is so large that multiple builders are signing contracts to buy lots throughout the subdivision either in blocks or spread around, under circumstances where the developer is requiring each homebuilder to release its deposit to the developer before their closing.

Multiple builders cannot have mortgages on the entire subdivision (i.e., they cannot all be second mortgages, so they would have to be second, third, fourth, etc.), and each homebuilder is going to want parity with the others so as to be treated similarly. This means that each homebuilder could only get a second mortgage on the lots that it is supposed to acquire, which is what developers are proposing. There are several problems with this.

When the second mortgages are recorded, the lots are not platted, so it would be necessary to create legal descriptions to put in the second mortgage specifying where the lots will be when they are platted. If the subdivision engineering data changes by the time the plat is recorded, the legal descriptions will not be accurate.

Even if the newly created legal descriptions turn out to be accurate, they will only describe the locations of the lots that are to be platted in the future.

The recording of such a plat will be done in conjunction with the creation of a homeowners' association or community development district that will own the common areas of the subdivision, including private streets (unless dedicated to the public), the drainage ponds, the amenities, entrance features and similar improvements. The plat will also dedicate utility easements needed for the lots.

Before platting, the lot locations that are the subject of second mortgage foreclosures by homebuilders will not have the benefits of any easements or use rights for these proposed improvements.

Is it even feasible to attempt to create private easements for the use of proposed subdivision improvements in advance of platting, and in advance of the improvements actually being built? That would require multiple legal descriptions of various types of easement areas throughout a subdivision that is not even developed at the time the second mortgages are recorded.

If the second mortgages are foreclosed, the change in ownership of the mortgaged properties is likely to trigger a violation of the local government's subdivision regulations, which usually require that property changing ownership be the subject of a recorded plat or a so-called lot split approval.

In the event an unapproved subdivision of land occurs as a result of a mortgage foreclosure, the local government can withhold permits for the land until it is cured by going through an approved subdivision process. This is going to be extremely difficult, if not impossible, to accomplish without completing and platting the subdivision, which will take the cooperation of all the homebuilders having second mortgages on various portions of the subdivision.

Also consider the relationship between multiple homebuilders holding second mortgages and the institutional lender holding a first mortgage.

To protect their deposits in the event the developer defaults in its obligations to either the homebuilders or the institutional lender, the homebuilders would have to be prepared to buy out the lender. Each would have to ante up some prorata share of the lender's payoff in order to either buy the first mortgage in the name of some consortium — presumably a new entity they form to compete the development together — or satisfy it.

If they form a consortium, they will need to negotiate a joint venture agreement governing their respective obligations for development, including the funding of development costs until the subdivision is completed and all their lots are platted, at which time the consortium would convey each homebuilder their lots in exchange for the applicable purchase price, which would have to take into account the consortium's costs to compete the development.

If the homebuilders have different opinions about how to address any of these issues, it is going to be problematic. Each homebuilder will probably have an intercreditor agreement with the institutional lender, but this will not govern the relationships between the homebuilders. It is extremely unlikely that the homebuilders will want to incur the time and costs associated with entering onto any agreements regarding these issues in advance of a problem actually occurring, given that it might never happen.

As you can see, there is no easy way for a homebuilder to protect its deposit when it is released to a developer. In most cases, the homebuilder negotiates the best deal they can get with the developer and its lender with respect to all these issues, assesses whether it can live with the risks it can't address, keeps its finger crossed and hopes for the successful completion of the subdivision by the developer.