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Insights

Legal Issues Associated With Selling & Purchasing Failed Residential Subdivisions In Florida

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There are many ways to acquire a distressed residential subdivision for what may seem to be a bargain price. Whether an investor is buying the property at a foreclosure sale or purchasing a defaulted mortgage loan on the property, issues may exist that, if known at the time of purchase, would affect the price. While most developers and builders who make these types of acquisitions are aware that distressed properties frequently require the performance of deferred maintenance, some problems are not so readily apparent. The euphoria of acquiring an investment at what appears to be a "bargain price" may quickly turn into costly disillusionment if the investor is unaware of the issues discussed in this article.

When a residential subdivision is developed, it is common for the developer to record a Declaration of Covenants, Conditions, Easements and Restrictions along with the subdivision Plat. This Declaration addresses use restrictions that will govern the residents, as well as easements for the use and enjoyment of common areas such as ponds, private roads and amenities, and other matters relating to the homeowners' association (HOA) that will govern the subdivision. It is also customary for many Declarations to reserve various rights in favor of the developer (usually termed the "Declarant"). Declarant rights may include the right to (i) appoint Directors to (and thereby control) the HOA Board of Directors, (ii) unilaterally amend the Declaration, (iii) appoint the HOA's Architectural Review Committee, (iv) fund HOA budget deficits instead of paying full assessments on its Lots, (v) use common areas for the developer's sales activities, (vi) grant easements in the common areas to others, (vii) grant exemptions from HOA assessments to builders, and (viii) annex additional land into the subdivision.

When a subdivision developer who still has control of the HOA experiences financial trouble, it is not uncommon for the first casualty to be the operation of the HOA. Non-functioning HOA's can result in many problems, including such things as failure to fund the HOA's operating and reserve accounts, absentee directors and officers, and neglected common facilities. While some issues may be relatively easy to fix, some require

much more effort (and money) than one might expect.

A failed developer in control of an HOA may not comply with its obligation to cause the HOA to fund ongoing operations, or fund reserve accounts for future repairs. Even if the HOA is collecting assessments from homeowners, it is possible (if not likely) that the developer is neither funding HOA budget deficits nor paying assessments to the HOA on Lots that it owns. This can mean that HOA common areas such as private roads, clubhouses, pools, retention ponds, entry features and other amenities may be in need of repairs without adequate funds available to pay for them. While improperly maintained common areas can be readily observed by a prospective purchaser, reserve funding obligations may be overlooked. Even if common areas have been maintained, it is possible that the funding of reserve accounts for future repairs may be mandated by the Florida Homeowners' Association Act (Florida HOA Act) in Chapter 720, Florida Statutes, by local government law, or by the HOA's governing documents. If these accounts are not adequately funded, a successor developer purchasing a failed subdivision could be liable to fund them retroactively.

If the failed developer has not been funding HOA operations, it may be that the HOA has been administratively dissolved by the Florida Division of Corporations for failure to file its annual reports. If an HOA has been dissolved, it can be reinstated by the surviving directors, or by the owners within the subdivision if the prior directors cannot be located. It may be tempting to try and save money by forming an entirely new HOA instead of paying the fees associated with reinstating an old one, but it is likely that the Plat and Declaration governing the subdivision vested certain rights in the old HOA, so if you form a new one, you still need the surviving directors of the old one to convey those rights to the new one. This is permitted without reinstating the old one, since Florida Statutes Section 617.1405 allows HOA's to wind up their affairs without being reinstated; however, you will need to track down the surviving directors to get some sort of conveyance to the new HOA. If they cannot be located, it is better for the owners within the subdivision to reinstate the existing HOA. Reinstatement of the HOA can require the payment of back filing fees to the state, and will require the election (or appointment) of new Directors, who must then appoint officers. It is not unusual in these instances for the HOA's legal and accounting records to be unavailable, making it more difficult to recommence HOA operations. Any HOA business that the failed developer purported to conduct without holding the required Board of Director meetings or that occurred during a period that the HOA was dissolved can be challenged by any disaffected homeowner.

Additionally, it is not uncommon for a failed developer to continue to hold title to common areas that are required to be deeded to the HOA, in which case they may still be subject to a mortgage given by the failed developer to its lender. It may be possible to get the failed developer to deed these common areas to the HOA, and to get a lender to release them from its mortgage, but if the failed developer is uncooperative or out of business, the purchaser of the subdivision will need to obtain title to them, failing which it would have to institute a lawsuit against the failed developer and/or its lender so that the HOA can acquire them. As such, a prospective purchaser of a failed subdivision should obtain a title search on all common areas in the subdivision, in addition to the Lots the purchaser is seeking to acquire, to verify the status of title to the common areas.

Another common occurrence in failed subdivisions is that permits may be in the failed developer's name, and may be expired. Such is often the case with permits applicable to the construction and operation of the subdivision's surface stormwater management system, which requires the issuance of two consecutive permits by the applicable Water Management District (WMD), one for the construction phase (issued to the developer) and one for the operational phase (issued to the HOA). If permits are expired, or if an operational permit in the name of the HOA was never obtained, then the process of obtaining the necessary permits from applicable governmental authorities must be undertaken. Additionally, an application for issuance of an operational permit by a WMD will trigger an inspection by the WMD with the potential to uncover all sorts of problems with the stormwater management system if it was poorly constructed or maintained.

Another potential issue that can easily go unnoticed is burdensome contractual obligations that may be binding on the HOA. Some developers have been known to cause an HOA that they control to enter into contracts for services (such as telecommunications services) with other entities that the developer also controls. Sometimes these contracts require the HOA to pay the developer's affiliates exorbitant amounts. In these instances, even after the developer no longer owns any part of the subdivision, the contracts in favor of its affiliates may still be binding on the HOA. While it may be possible for a purchaser taking over a subdivision to obtain relief from these obligations, it can easily take a lot of time and attorneys' fees to do so. If it is not possible to do so, the purchaser will need to account for its share of these HOA's obligations that may be attributable to the Lots the purchaser is acquiring.

Declarant rights are not generally transferred by the mere change of ownership of the subdivision from one developer to another, but have to be specifically assigned or foreclosed upon. Without them, a purchaser may have difficulty operating the subdivision's HOA and completing and/or selling out the subdivision. The Declaration typically dictates whether Declarant rights may be assigned to a successor developer, and how this must be accomplished. One of the most beneficial of the Declarant rights is the ability to control the HOA by appointing a majority of its Board of Directors. A purchaser of a failed subdivision may or may not be entitled to exercise this right, however. This will depend on whether the provisions of the Florida HOA Act requiring turnover of control of the Board to members of the HOA other than the developer have already been triggered. If a purchaser does not acquire the Declarant's right to appoint a majority of the Board of Directors of the HOA, or that right has lapsed by statute or the passage of time, it may be necessary to call a meeting of all Lot owners in order to recall absent directors and elect a new Board. Although a purchaser may own enough Lots (and therefore control enough votes) to achieve the desired outcome at an owners' meeting, the process can be time-consuming and require the purchaser and HOA to incur attorneys' fees, not to mention giving the other Lot owners a forum to lodge complaints about the subdivision and the HOA.

It is generally recognized that, under current Florida law, members of a residential HOA other than the developer are entitled to elect at least a majority of the Board of Directors of the HOA within 3 months after 90% of the parcels in all phases of the community which will ultimately be operated by HOA have been conveyed to others (or a lower percentage if provided by the Declaration). This occurrence is commonly referred to as "transition of association control," in that it allows the members other than the developer to control the HOA's Board of Directors and thereby direct the activities of the HOA.

What many people don't know is that such a transition is also triggered by the occurrence of any one of the following events specified in Florida Statutes Section 720.307: (i) the developer abandons its responsibility to maintain and complete the infrastructure as specified in the governing documents, (ii) the developer files a bankruptcy petition, (iii) the developer loses title to its property through a foreclosure action or deed in lieu of foreclosure (unless the successor owner has accepted an assignment of developer rights and responsibilities), or (iv) a receiver for the developer is appointed and is not discharged within 30 days (unless the court determines that transfer of control would be detrimental to the association or its members).

If one of these trigger events occurs, control of the HOA would pass to the HOA members other than the developer, who then have the right to elect a majority of the Board of Directors of the HOA. A specific subsection of Florida Statutes Section 720.307 states in relevant part that, *"[f]or the purposes of [Section 720.307], the term '<u>members other than the developer</u>' shall not include builders, contractors, or others who purchase a parcel for the purpose of constructing improvements thereon for resale."* This means that any successor developer, builder, contractor or other party that purchases a vacant parcel for construction of a home will <u>not</u> be entitled to vote in the election of the HOA's Board of Directors.

These statutory provisions create a potentially significant issue when a failed subdivision is purchased by a new developer or builder who intends to perform deferred maintenance, complete the build-out of the subdivision and sell the remaining parcels. For example, suppose that Builder A is an initial developer that records a Declaration and establishes an HOA for a new community of 100 homesites, but then goes bankrupt, is foreclosed, or abandons the community after building and selling only 5 homes. Suppose then that Builder B wishes to buy the rest of the community and finish it. If the statutory trigger for transition of association control has already occurred, Builder B will not be able to exercise certain developer rights that, under the terms of the recorded Declaration, would otherwise arise by virtue of the developer's control of the Board of Directors of the HOA.

Why is it important for Builder B to maintain control of the HOA Board as a successor to Builder A's developer rights? There are several reasons. By holding such rights, among other things, Builder B could establish the HOA's budget and administer the common areas of the community, and choose to fund deficits in the HOA's operating budget in lieu of paying regular assessments on its homesites. The Declaration may provide for other rights to be exercised by the developer while it is in control of the HOA's Board, such as appointing the members of the Architectural Review Committee responsible for approving new construction (and thereby ensuring that Builder B's proposed homes are approved), and obtaining the benefit of developer-friendly provisions in the Declaration that typically grant special privileges to developers for the purpose of facilitating ease of completion of the subdivision (such as the right to amend the Declaration, grant easements within the subdivision, utilize common areas for marketing, build and operate model homes, and similar matters). Sometimes a Declaration gives a developer these additional rights so long as it owns at least one homesite, but sometimes they are tied to developer control of the HOA Board.

In our scenario involving Builder A and Builder B, given these statutory provisions, Builder B would own 95% of the homesites but have no voting rights in the HOA that could be exercised to elect a majority of Directors to the HOA's Board. Instead, the owners of the 5 homes already sold by Builder A would vote for a majority of the Board. While such a Board might be composed of benevolent homeowners willing to be reasonable in addressing Builder B's concerns about the HOA's budget, the condition of the common areas, the types of homes that it wants to construct and sell, the need to build and operate model homes, the need to maintain marketing signs, and similar matters that are essential to a builder's completion of a residential community, the Board might instead view Builder B with suspicion, perhaps even as a "deep pocket" capable of paying exorbitant amounts in HOA assessments to cure every possible ill in the subdivision, or even fund substantial enhancements that the Board may wish to make to the common areas. It is not beyond belief that Builder B could be tyrannized by a minority of homeowners for the entire time that it takes Builder B to complete the subdivision and sell off all 95 of its homes. Such a situation could be disastrous for any developer or builder seeking to acquire, rehabilitate and complete the development, and there is no way for Builder B to know in advance what might happen.

Despite that such a consequence may not have been intended by the legislature, the provisions of the Florida Statutes governing this situation can have profoundly negative effects on a successor developer's attempt to "rescue" a failed subdivision. There may be options available to reduce the risks associated with these circumstances, but they depend on the specific facts involved, the status of the HOA, the history of the project and the provisions of its governing documents, and each presents its own unique concerns.

If Declarant rights have expired, or cannot be assigned, or if the Declaration is not well drafted, the owners within the subdivision may be able to terminate the old Declaration and replace it with a new one, or amend and restate the Declaration in its entirety, in order to improve it as well as to restore certain developer rights in favor of the new developer who is going to complete the subdivision. This will also allow the new developer to put in place its own form of Declaration rather than live with the one executed and recorded by the prior developer,

which may not suit the new developer's needs. It may even be possible for the new Declaration, or an amended and restated Declaration, to reinstate the period of developer control so as to delay turnover of the HOA, allowing the new developer (among other things) to exercise Declarant rights.

To do this, it will be necessary to review the old Declaration to determine the process by which it can be terminated or amended, and comply with that process. This may necessitate the approval of some or all of the owners and mortgage-holders already within the subdivision. Some Declarations include provisions requiring the local government which approved them to also approve their termination, in which case it is better to amend and restate the Declaration. Florida Statutes Section 720.306 should be consulted, as this controls how an HOA's governing documents may be amended, what percentage of owners must approve certain amendments, whether an amendment is so material as to require all owners to approve it (which could be a significant problem, so this analysis should be done early), and whether and to what extent mortgage-holder consents will be required.

Particularly problematic is Florida Statutes Section 720.306 (1)(c), which provides "*...an amendment may not materially and adversely alter the proportionate voting interest appurtenant to a parcel or increase the proportion or percentage by which a parcel shares in the common expenses of the association unless the record parcel owner and all record owners of liens on the parcels join in the execution of the amendment*." A new developer should expect that this will be construed as a barrier to the reinstatement of developer voting rights if an HOA turnover trigger has occurred. In such a case, it may be possible to otherwise amend the Declaration to grant the new developer concessions unrelated to voting rights, which may be sufficient for the new developer. Alternatively, if developer voting rights are paramount, the new developer may wish to negotiate with the existing owners as a group in order to obtain their consent to an amendment reinstating them, perhaps by offering to enhance the common areas, fund reserves, or address other owner concerns, for which purpose a meeting with the owners may be helpful. The owners may jump at the opportunity to have a reputable new developer complete their failed subdivision, which can only enhance their property values.

If the new developer can get developer voting rights reinstated, it should consider including in the form of sales contract for its new homes a specific acknowledgment by the purchaser that it has approved the new Declaration or the Amended and Restated Declaration, including the fact that the seller holds developer voting rights, so as to limit the chance that a future owner in the subdivision will complain later that HOA turnover should have occurred.

The potential issues facing a purchaser of a failed subdivision are numerous. If a subdivision HOA is inoperable, directors are absent, permits are ineffective, records and reserves are not maintained, or the original developer still retains significant rights under the Declaration, then expensive and time-consuming remedial actions may be necessary in order to enable a purchaser to successfully complete and sell out the subdivision. Identifying these issues in advance allows a developer or builder to make an informed decision about whether the property will be a good investment, and negotiate the price accordingly.

A new developer seeking to acquire a failed developer's residential subdivision should consult a real estate attorney before signing a purchase contract, and ideally include provisions in the contract for the seller to cooperate in reinstating a dissolved HOA, assigning Declarant rights, funding reserves, deeding common areas to the HOA, reissuing and assigning permits, terminating costly HOA contracts with seller affiliates, terminating or amending and restating the Declaration, and otherwise addressing the foregoing matters. Typically, however, many of these issues do not become apparent until after the purchase contract is signed and the new developer has had the opportunity to undertake its due diligence. A buyer's attorney should look at these issues early in the due diligence process, in any event before the earnest money deposit under the contract becomes

non-refundable, and, if possible, obtain from the seller a contract amendment that burdens the seller with the resolution of these issues. Only then can the buyer determine the risks it is willing to bear if there are issues that cannot be addressed or that the seller refuses to address. This will increase the likelihood that the new developer will be able to successfully complete the subdivision following closing.