HOW TO SELL AN EXISTING COMMERCIAL CONDO PROJECT

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In the early 1980s, there was a boom in the construction of commercial condominiums. Some mimicked residential townhouses in design; others were single-story layouts. Many of these buildings have now reached the end of their useful lives because of the need for technological upgrades that are difficult (if not impossible) as well as the replacement of major systems like roofing or heating, ventilation, and air conditioning. Moreover, many of these condos are adjacent to areas undergoing major redevelopment.

How will the sale of these condominiums for redevelopment proceed? Analysis of the sale of the first such project may offer some guidance:

Sunset Hills Professional Center was a collection of 7 single-story buildings containing 30 units in total occupied by doctors, dentists, other professionals, and small businesses. The vast majority of the unit owners had purchased their units from the original developer in the early 1980s–and had either already retired or were about to.

In 2009, construction began on the multi-story underground parking garage for the Wiehle Metro Station in Reston, Virginia. That (and the adoption of a major rewrite of Fairfax County's Reston Master Plan) prompted the unit owners of the abutting Sunset Hills Professional Center condominium to begin the process of looking to sell the entire regime to a developer who would pursue redevelopment under the revised Reston Master Plan.

Because there were a limited number of potential buyers who would be prepared to take the land through the lengthy and expensive Fairfax rezoning process necessary to maximize the sales value of the property, the Condominium Board on advice of counsel chose to market the project directly to those potential buyers and thus save the unit owners the brokers' commission. (Dissenting owners justified opposition to the subsequently ratified contract on the basis that listing with a broker would have obtained a higher price.)

After an initial round of bids were received and interviews with the higher bidders completed, the Board, in an attempt to mollify the dissenting owners, solicited proposals from multiple brokers. In each case, however, the brokers wanted to be compensated for the portion of the purchase price already in hand. None of the brokers would guarantee delivery of a higher price than offers already received, nor were they willing to set their commission based solely on the enhancement to the existing highest price that their efforts accomplished. The Board therefore proceeded to solicit "best and final offers" from several of the highest bidders, leading to contract negotiations with the top bidder.

Under the Virginia Condominium Act[1], an entire condominium may be sold following a vote of the unit owners. Va. Code §55-79.72:1(B) allows the governing instruments of a non-residential condominium to set the threshold for termination by a lower majority than the 80% required for residential regimes. The Sunset Hills Professional Center Declaration[2] required an affirmative vote

[1] Virginia Code §55-79.39 *et seq.*

[2] *Deed Book 5619, at page 229, Art. XVI (A), Fairfax County Land Records*

of unit owners holding at least two-thirds (2/3) of the common element interests in order to sell the entire condominium.

Once negotiations were completed, the Board sent out the required notice for a special meeting of members to vote on the contract. To assure themselves that the contract was supported by the necessary majority, the contract provided signature lines for individual unit owners. Although this process had the benefit of inducing a psychological commitment to vote for the sale at the special meeting by those unit owners who signed the contract, it became a source of contention for the dissenters in the subsequent litigation. Prior to the special meeting, signatures had been obtained from one fewer than the 2/3 required.

The members' meeting was contentious. The prospective buyer attended to address the questions of the dissenters, to no avail. Five unit owners insisted that they would not vote for a contract that was not obtained through a broker; two unit owners would not vote for the sale because each of their units was subject to a long term lease which the buyer would not assume; and two unit owners (each of whom owned two units, conferring two votes per owner) wanted changes to specific contract terms other than the purchase price. When the roll was called, the motion to ratify the contract and terminate the condominium fell one vote short.

The Board renegotiated the sales contract to address the specific terms that had prompted the objection of two unit owners and convinced the buyer to take one of the units subject to the existing long-term lease. Once these changes were incorporated into the contract, the revised contract was again circulated for signature by the unit owners and a second special meeting was called to vote on the termination and sale.

Va. Code §55-79.72:1(C) provides for the execution and recordation of a termination agreement among the land records when the membership has voted to terminate and sell. However, Va. Code §55-79.72:1(G) provides that upon recordation of the termination agreement, the unit owners' interests are converted to tenant in common interest with each unit owner having an exclusive right to occupy its former unit. Because the rezoning would take an estimated thirteen (13) months from the date of ratification of the sales contract, the termination agreement was not recorded immediately after the membership vote, but rather was delayed to the post-rezoning closing. This allowed the Association to continue its operations through the existing management and assessment regime. Va. Code §55-79.72:1(C) specifically anticipates this prospect by providing that the termination agreement shall include a date after which, if not recorded, the termination would be void. An outside date for recordation of the termination agreement was included in the membership resolution ratifying the sales contract.

Va. Code §55-79.72:1(I) provides that sales proceeds are to be divided among the unit owners based upon the fair market value of each unit as determined by independent appraisers. Because the units at Sunset Hills were not significantly different one from another, the Board decided to forego the substantial expense of having each unit appraised and proposed to the unit owners that the proceeds be divided based on the percentage of common element interests of each unit. This choice was adopted by the membership as part of the resolution ratifying the sales contract.

One circumstance not anticipated by the Condominium Act was the means to pay off the debt encumbering each of the units. There was no debt encumbering the common areas or the assessment stream and some units were debt free; however, one dissenter's unit was encumbered by debt far in excess of the proceeds of sale attributable to that unit. The membership resolution ratifying the sales contract provided that the payoff of individual unit mortgages would come from the proceeds of sale allocated to that unit.

At the second special meeting, the membership resolution ratifying the sales contract and incorporating the foregoing provisions passed the needed super-majority by one vote.

With the contract ratified, the buyer proceeded to file the rezoning and the Association's counsel considered how to satisfy the contractual requirement of court action to remove any questions as to the effectiveness of the Association's vote. The contract contemplated the filing of a petition for partition by sale based on the tenant in common status described in Va. Code §55-79.72:1(G) but left open the possibility of other processes.

Ultimately, counsel concluded that partition was too convoluted a process inasmuch as it would require the appointment and compensation of a commissioner who could decide to rebid the property all over again. Instead, counsel sought a declaratory judgement that the Association had acted consistently with Va. Code §55-79.72:1(F) and that the dissenting unit owners were bound by the super-majority vote to comply with the terms of the contract despite their individual refusal to vote to ratify or to execute the sales contract.

Originally, seven dissenting unit owners were named in the complaint. (Fairfax Circuit Court Case No. CL-2016-15665.) Service was not immediately effected, but courtesy copies were delivered instead to the dissenting owners in the hope that some or all might change their minds once the cost and inconvenience of defending a lawsuit was no longer hypothetical. Four unit owners did so and signed the contract to evidence their willingness to comply with its terms. The remaining three were served. One of the unit owners failed to file an answer and a default judgement was entered against him. Two owners remained.

Each remaining unit owner presented a very different challenge to the Association. One unit owner had sold its business some years before and had rented its unit to the business purchaser under a long-term lease. Thus, it was necessary to consider the costs to relocate the tenant . One element of potential damages for termination of the lease was resolved when it was determined that the rent charged by the unit owner to the new business owner was higher than rent for comparable space in the area. However, the business had extensive trade equipment affixed to the unit. Further, the unit owner threatened to sue the Association for tortious interference in a business relationship in the event the Association attempted to negotiate a buy-out of the tenancy directly with the new business owner, necessitating adding the new business owner/tenant as a party defendant to the declaratory judgement action.

The Association's opening position was that the anticipated termination of the condominium would also terminate the lease, leaving the responsibility for the costs of relocation to fall on the new business owner/tenant. That position was based on the analysis that the "first in time" recordation of the condominium instruments together with the Condominium Act had put all prospective unit tenants on notice that the condominium, and the tenant's rights of occupancy, could be terminated at any time by a super-majority of the unit owners. The condominium termination was analogized to the foreclosure of a previously-recorded deed of trust which perforce terminated any subsequent leases.

The unit owner and its tenant argued that the anticipated termination of the condominium converted its interest into a tenancy in common with exclusive right of possession, pursuant to Va. Code §55-79.72:1(G); that exclusive right of possession was therefore capable of being leased and, pursuant to Va. Code §8.01-91, anyone who was a lessee before a partition would continue to hold the leasehold on the same terms by which it was held before the partition. The Association countered that because the property was not being sold by partition and the termination would be recorded simultaneously with closing on the sale, Va. Code §8.01-91 did not apply. After an exhaustive search, no case law could be found anywhere in the United States which addressed the survival of a commercial lease of a unit after termination of a condominium.

The unit owner also argued that its share of the sales proceeds could not be reduced by the costs to buy out its tenant's lease. This argument ran counter to the plain language of Va. Code §55-79.82(B) which authorizes special assessments against an individual unit owner for costs incurred by an association because of the acts of that unit owner. Unfortunately, the Sunset Hills By-laws had not incorporated this *optional* provision of Virginia Code. Thus, it was necessary to amend the condominium by-laws in the middle of the litigation to add this potential remedy for the Association. (This effort was complicated by the Sunset Hills Declaration's requirement to give secured lien holders thirty days' notice prior to the effective date of any amendment of the condominium instruments. *Declaration, Art. XII(B)(1).*) In retrospect, the power to impose a special assessment on unit owners who uniquely caused expenses to the Association should have been added to the condominium instruments once the existence of the long-term leases had been identified. Notice of the implementation of the by-law amendment would then be given to contemporaneously to the secured lienholders–well in advance of closing on the sale.

These complications, combined with comments from the presiding judge that foretold an adverse ruling, triggered the parties to enter into mediation. Negotiations lasted over 17 hours, but in the end the contract buyer and the Association agreed to provide the tenant with assistance in its relocation; the unit owner agreed to sign the contract; and the tenant agreed to enter into a new short-term lease with the contract buyer at closing. This resolution was facilitated by the fact that, prior to commencement of construction, the contract purchaser would have to receive site plan approval from Fairfax County for its redevelopment after the rezoning and the closing on the sale. In Fairfax, site plans can take eighteen (18) months or more to process, particularly a complicated mixed-use development of the type proposed to replace the Sunset Hills Professional Center. Thus, the tenant would not be faced with a relocation for 18 months or longer after the closing.

After the dismissal of the tenant and its unit owner from the suit, the Association proceeded to trial with the remaining unit owner, who attempted to convince the Court that it was not bound by the contract because: 1) unlike the other unit owners, it had not signed the contract; 2) not all of the unit owners had signed the contract within a time limit set out in the contract; 3) the condominium termination agreement had not been recorded; 4) no written consent of the secured parties to the termination had been obtained; and 5) one of the sales contract's conditions of settlement, the rezoning, had not been satisfied.

The Association responded to arguments 1 and 2 that the signatures of the unit owners, including the defendant, were surplusage as the 2/3 vote of the membership bound all unit owners to the contract under the Declaration and Va. Code §55-79.72:1. The Association relied on Va. Code §55-79.72:1(C) to rebut Argument 3 that the termination agreement did not have to be recorded immediately, but could be recorded at settlement. As to the secured parties (Argument 4), the Association countered that a) the proceeds of sale would be sufficient to pay off all but one of the secured parties at closing and b) the contract required each unit owner to remove any financial encumbrances on its unit as a condition of closing. Finally, Argument 5 was moot because the rezoning had been accomplished by the time of trial.

The Court found in favor of the Association, ruling that the defendant unit owner was bound by the contract of sale.

If only that had been the end of the story.

During the pendency of the sale, the remaining recalcitrant unit owner had bought another business and another office condominium nearby and had cross-collateralized those debts with the Sunset Hills unit, meaning that the total amount of the debt encumbering the defendant's Sunset Hills unit was equal to almost double the proceeds it would realize from the sale. When the date for closing came, all the other unit owners fulfilled their obligations under the contract except for the defendant unit owner who had not arranged to refinance its debt.

While a rule to show cause was prepared and filed, the lender of the defendant unit owner was contacted to determine if the Association could buy the defendant's debt from the lender. The amount of the loans greatly exceeded the value of the two condominium units and, therefore, the loan should have been categorized as "non-performing" on the lender's books and eligible for some discount on sale. The Association obtained a private line of credit to finance the purchase of the notes. The Association's plan was to acquire the notes, execute a partial release of the deeds of trust for the Sunset Hills unit; use the sale proceeds to reduce the line of credit and then foreclose on the off-site condominium unit and the personal guarantees of the unit owner to satisfy the remaining balance on the private line of credit. Unfortunately, the lender was in the midst of a sale of all of its stock and did not want to risk a suit from its borrower interfering with that sale. The Association's offer to buy notes at par was rejected.

When the Rule to Show Cause was heard, the defendant had no justification for its failure even to submit an application to refinance its debt to enable the closing. Despite having no articulable defense to the motion, the trial judge refused to hold the defendant unit owner in civil contempt, ruling, *sua sponte*, that the Association had not met the burden for *criminal contempt*.

The Association and the contract purchaser then agreed to increase the payment to the defendant unit owner, and the sale closed.

Lessons learned:

1) The membership resolution approving the sale should include an outside date for the expiration of the termination agreement that accounts for the satisfaction of any conditions of settlement (such as rezoning).

2) The membership resolution should also set out the means of dividing the proceeds of sale among the unit owners. (Considering that differences in the value of units are generally reflected in the differences in the percentage of ownership of common element interests, the legislature should amend the Condominium Act to eliminate the requirement of the expense of appraisals of individual units.)

3) The membership resolution should make clear that financial encumbrances on individual units will be satisfied from the sale proceeds attributable to that unit, and that the individual unit owners are responsible to deliver possession of their units free of encumbrances at closing. Again, the Condominium Act should be amended to set out these principles clearly.

4) Instead of having the unit owners who support the sale sign the sales contract, have them sign proxies to the President of the Association approving the sale; have the contract drafted to list the Association as the only seller with an acknowledgement by the purchaser that removing any financial or other encumbrances on individual units and delivery of possession of each unit at closing are the responsibilities of the individual unit owners.

5) Determine if the provisions of Va. Code §55-79.82(B) are incorporated into the condominium instruments before the sales effort is undertaken. If not, the declaration should be amended accordingly. This enables the Association to recover the costs to buy-out tenants or pay off lenders on individual units responsible for those expenses; this has the added benefit of making the risks facing recalcitrant owners clear at the outset.

6) Include in any motion for a rule to show cause an explanation of the different standards for civil versus criminal contempt.