Who Controls the Ghost Subdivision? The Missouri Supreme Court Addresses the Competing Rights of Homeowners and a Foreclosing Bank in a Failed Residential Development

By: Jacob W. Reby and Jackie M. Burkhardt

If a subdivision developer defaults on its bank loan with only a handful of the platted lots built out and sold, and the bank forecloses on the remaining lots, can the bank use its new majority ownership position to take control of the homeowner's association ("HOA") and install its designees as HOA directors? If the bank does so, what duties do those directors have in administering the subdivision indenture and approving designs for the construction of new homes under the indenture's architectural review provisions?

A protracted legal battle presenting these issues came to an end recently when the Missouri Supreme Court issued its opinion in *The Arbors at Sugar Creek Homeowners Assn. v. Jefferson Bank & Trust Co., Inc. et. al.*, No. SC94693 (Mo., June 30, 2015). The bank prevailed, with the Missouri high court affirming trial court findings that the bank had acted consistently with the indenture and had acted in good faith toward the homeowners who had contested the bank's actions. However, the costly dispute thwarted development of the unsold lots for five years. It presents a cautionary tale to lenders, suggesting that they should take steps to protect themselves at the underwriting stage. Doing so might avoid the deadlock that can result when a subdivision fails and the parties that are still standing post-foreclosure have differing views about how the development should be completed.

In 2005 and 2006, Evolution Developments L.L.C. ("Developer"), borrowed $4,900,000 from Jefferson Bank and Trust Company, Inc. ("Bank") to develop an 18-lot subdivision of luxury homes. The Developer's marketing materials included designs that were unusual for the area, with extensive use of masonry and stucco exteriors, hip roofs, angular wall and roof shapes, and a limited color palette. Before selling any lots, the Developer recorded a standard form of indenture. The indenture did not mandate use of any of the described architectural features, but did provide for a process of architectural review, to be administered by the HOA directors, designed to "maintain the uniform quality and aesthetics of exterior architectural design for the best interests of the Community as a whole." The HOA directors, other than those appointed by Developer, were required to be residents of the subdivision. The Bank subordinated its loans to the indenture. Developer incorporated an HOA, but did not appoint directors or maintain its legal status with the state, so that the HOA never functioned and became defunct.

Developer built and sold five luxury homes. Its plans then ran headlong into the "Great Recession" and housing market collapse of 2008. In 2009, after not having sold any homes for more than a year, Developer defaulted. In March 2010 the Bank foreclosed on the thirteen unsold lots in the subdivision. After foreclosure, the Bank contracted with a long-established residential builder, McKelvey Homes LLC ("New Developer") to complete the development. New Developer announced plans to sell homes at a

lower price than the original homeowners had paid for theirs. Its designs did not incorporate all of the architectural features of the original five homes built.

The owners of the five homes formed a new HOA, from which they expelled the Bank. They announced that their HOA had rejected New Developer's designs because they did not comply with the indenture. New Developer's designs, they said, were not in harmony with those of their homes. In May 2010, the homeowners and their HOA filed suit against Bank and New Developer for a declaratory judgment and an injunction against construction of the New Developer's homes.

The Bank looked for a way to complete the subdivision despite the pendency of the lawsuit. It sought and obtained an assignment of the original Developer's rights under the Declaration. In September 2010, it called a meeting of lot owners and voted its thirteen lots in favor of forming a new HOA. Using a provision of the indenture that permitted amendment by vote of owners of two thirds of the lots, it proposed and passed an amendment that designated its HOA as the governing HOA under the indenture. The Bank then voted its lots to elect Bank officers to the three seats on the HOA Board. Those directors approved New Developer's designs for a number of homes the New Developer had under contract.

The owners of the original five built homes cried foul because, they argued, the Bank officers were ineligible to serve on the Board; they had not been appointed by Developer and these appointed officers did not live in the subdivision. The Bank then voted its lots to amend the indenture a second time, removing the residency requirement. Following this second amendment to the indenture, the Bank-controlled board voted to "ratify" its executives' prior actions. The Board approved New Developer's development plans to build a single house. (New Developer had lost contracts with other buyers who were unwilling to await the outcome of the lawsuit). The Bank also required all existing homeowners to reimburse the HOA for their pro rata share for upkeep and maintenance of the subdivision's common grounds.

In the meantime, the lawsuit proceeded. The trial court granted a summary judgment that the Bank-formed HOA was the governing association in the subdivision. A hearing was held on homeowners' motion for preliminary injunction against construction by New Developer of the one home it still had under contract. The injunction was denied. After further summary judgment briefing and a four day court trial on the merits, the trial court found for the Bank. The court found it important that the Bank officers serving on the HOA Board had sought and obtained the opinions of an independent architect that the New Developer's designs were consistent with the indenture, and of an independent appraiser that the home to be built by New Developer was comparable in value to the existing homes. The trial judge specifically found that the Bank had acted in good faith in its amendment of the Indenture to eliminate the residency requirement, and that the HOA Board had acted reasonably in approving the New Developer's home design.

The Bank's actions in this situation were not unexpected or unreasonable for a lender attempting to recover money and minimize its loan losses. At trial, the Bank's President testified "our interests are different" than those of the homeowners, and he acknowledged that the Bank's interests were "short term." He admitted that the Bank understood it needed to control the HOA's board of directors in order to approve the development plans it had already entered into with New Developer. Later, he explained "[t]he market has spoken...the market spoke that it wanted a different kind of home [in the Subdivision]."

The homeowners appealed to Missouri's intermediate appellate court, the Missouri Court of Appeals. The Court of Appeals agreed that the Bank-formed HOA had authority to govern the subdivision; the indenture contained language expressly permitting an amendment to name a substitute HOA. The court also found, however, that the amendment eliminating the residency requirement for HOA directors was invalid. The amendment had been adopted, the Court of Appeals said, in violation of the "implied covenant of good faith and fair dealing" that inheres in every contract, including subdivision indentures. The Court of Appeals held that the covenant of good faith and fair dealing was breached because the "Bank's actions violate[d] the spirit of the Declaration

and thereby den[ied] the other lot-owners an expected benefit of the Declaration"; the benefit so denied was the right to "a board composed solely of Subdivision residents." The Court of Appeals remanded the case for further proceedings on the remaining issues in the case. One judge dissented, concluding that the Bank had acted in good faith.

The Bank then filed a motion to transfer the case to the Missouri Supreme Court. That Court granted transfer, heard argument, and issued its opinion on June 30, 2015.

With one judge dissenting, the Supreme Court rejected the reasoning of the Court of Appeals that the Bank had violated the covenant of good faith and fair dealing. The Court began its analysis by stating that the principles of contract law apply when interpreting a subdivision declaration; that if a contract's language is unambiguous, the intent of the contract must be determined solely from the contract's language. As a result, the Court found that the Bank's amendments of the indenture to create the new homeowner's association and removing the board member residency requirements were appropriate. The court stated that "there can be no breach of the implied promise or covenant of good faith and fair dealing where the contract expressly permits the actions being challenged, and the defendant acts in accordance with the express terms of the contract." The Court indicated that the Bank provided fair notice, held discussion about the amendment, and did not attempt any subterfuge to obtain its 72% vote. As a result, the court found that the terms of the Declaration were followed in good faith.

The Supreme Court also determined that deference to the actions of the HOA Board were appropriate because its decisions were reasonable, particularly with respect to the association's determination that the New Developer's plans were in architectural compliance with the subdivision's covenants. The Court noted that the trial court found that members of the board had reviewed the home designs, consulted an architect, and reviewed nearby neighborhoods to determine if mixed architectural styles would be harmonious in the subdivision. Based on these findings of fact, the Court concluded that the homeowner's association acted reasonably and in good faith in approving the New Developer's building plans.

The Court reversed the trial court's granting of the Bank's motion for reimbursement of certain upkeep expenses for the subdivision from the other lot owners, including the New Developer. The Court concluded that under the subdivision Declaration's plain language, the homeowner's association, and not the Bank, had exclusive ability to impose certain assessments through a particular process and timeline. Therefore, the Court reversed the grant of the Bank's motion for reimbursement.

Practice Tips:

The housing market collapse taught lenders many lessons about underwriting and administering subdivision development loans. The *Arbors at Sugar Creek* case highlights some of those lessons. Before subordinating its debt to a subdivision indenture, a lender should carefully scrutinize the indenture's terms to make sure its rights are protected and confirm that the indenture sets forth a course of expected and approved lender actions in the event it decides to take back its collateral. If possible, the lender should ensure that: (a) in the event of foreclosure or deed in lieu of foreclosure, the lender has the express right (at its option) to succeed to the developer-borrower's customary right to control the membership of the HOA board during the period of development; (b) the indenture contains express rights of amendment exercisable by the lender should it come to own the requisite number of lots, including the right by amendment to designate a substitute HOA; (c) the indenture contains no unusual restrictions on new homes that might render them unsaleable; and (d) the indenture disclaims implied covenants to the extent permitted by law. If foreclosure occurs, and the lender finds itself in control of the HOA Board, its designated directors must appreciate, as did the Bank's appointed directors in the *Arbors at Sugar Creek* case, that they have duties to all lot owners in the subdivision, and must exercise those duties in good faith and for the benefit of the subdivision as a whole. ◆

Jacob W. Reby is a member of the firm of Lewis Rice LLC in St. Louis, MO.

Jackie M. Burkhardt is an Associate with Lewis Rice LLC in St. Louis, MO.