ILLINOIS STATE BAR ASSOCIATION

APRIL 2021 VOL 66 NO. 10

Real Property

The newsletter of the Illinois State Bar Association's Section on Real Estate Law

A Weapon Against Condominium Deconverters: The Fiduciary Duty of Directors

BY RICHARD LEE STAVINS

The latest real estate game in town is the condominium deconversion. In the ongoing battle between condominium owners and deconverters, the appellate court has handed owners a weapon based on an old legal argument: breach of fiduciary duty by deconverters who sit on the condominium's board of directors.

The deconverters' goal is to change a property from a condominium ownership

Continued on next page

A Weapon Against Condominium Deconverters: The Fiduciary Duty of Directors
1

When a Tenant Files a Chapter 7 Bankruptcy During a Commercial Real Estate Transaction
1

Proving Up Damages in a Home Construction/ Remodeling Case
5

Did You Know?
6

When a Tenant Files a Chapter 7 Bankruptcy During a Commercial Real Estate Transaction

BY EMILY HOLMES

The journey started with a regular garden-variety commercial real estate transaction. Everything was smooth sailing between my owner seller and the investor purchaser. The parties completed attorney review and inspection contingencies, the purchaser turned over the second installment earnest money and were just one week away from closing! Then, it happened. The bankruptcy wrench was thrown into the mix. My client's tenant of the commercial space, a failing restaurant LLC in the midst of the coronavirus pandemic, which had been shuttered for months, filed a Chapter 7 Bankruptcy,

Continued on page 4

A Weapon Against Condominium Deconverters: The Fiduciary Duty of Directors

CONTINUED FROM PAGE 1

building to a standard rental apartment building. This is based on the changing economic reality that whereas money previously was made by converting rental buildings to condominium buildings and then selling off the units, the market changed so that more money can now be made changing condominium property into a rental property and renting out the apartments, either short- or long-term.

How Deconversion Works

Reduced to its essence, deconversion works like this: The deconverters quietly purchase individual condominium units from the owners as the units come onto the market. Then, at ensuing board of director elections, deconverter unit owners run as candidates for the board and coordinate their votes so that they get elected. While this is on-going, they rent out their acquired units, so they will have a stream of income while they are accumulating units.

Section 15 of the Condominium Property Act (765 ILCS 605/15) provides that if 75 percent of the unit owners vote in favor of a bulk sale of all of the units, the remaining unit owners must all sell their units to the bulk sale purchaser, as provided in the contract, regardless of whether they want to sell or not. Those buyers are supposed to be paid the fair value of their units, but deconverters are masters at keeping the price as low as possible. A Chicago ordinance increased the unit ownership vote percentage to 85 percent.

When the deconverters own a sufficient percentage of units (85 percent in Chicago, 75 percent elsewhere), their loyal board members call a meeting of the unit owners to approve a board-negotiated and board-recommended sale of the remaining units to an entity the deconverters and their board members control. The proposed sale price of each unit may be well below market. The contract of sale may provide that the bulk buyer, but not an individual seller, may unilaterally cancel any sale. The directors might use their positions on the board to approve the association's spending of association funds to pay the deconverters' own expenses and fees, suppress dissent, block other potential buyers from being considered, and block dissenting discussion at the owners' meeting.

The *Kai* Decision

This is essentially what occurred in the recent second district appellate court case *Kai v. Board of Directors of Spring Hill Building 1 Condominium Ass'n, Inc.*, 2020 IL App (2d) 190642, where the court handed condominium associations and unit owners a weapon in their battle against deconversion. In *Kai*, 28-unit owners filed suit against the board, the deconverters' directors, and the association. When they lost in the Circuit Court on a motion to dismiss under 735 ILCS 5/2-619(a)(9), 27 of the 28 plaintiffs threw in the towel. One brave soul appealed and prevailed in the appellate court.

Distilled to its essence, plaintiff-appellant's theory of the case was that although the directors-defendants had fully com plied with section 15 of the Act, they breached a fiduciary duty they owed as directors to the association and the unit owners. Defendants contended that the fiduciary duty theory was invalid. Defendants' argument was that section 15 was the sole remedy; that section 15 made no mention of a fiduciary duty; that the directors' compliance with section 15 was undisputed; and that the dismissal was therefore proper.

The appellate court resoundingly rejected the defendants' position, holding that section 15 is not the sole remedy, and reiterating the common law principle that condominium board members have strict fiduciary duties to treat their unit owners with the utmost candor, rectitude, care, loyalty, and good faith, and to treat the owners as well as they would treat themselves. *Boucher v. 111 East Chestnut Condominium Ass'n*, 2018 IL App (1st) 162233, ¶ 36.

Defendants' alternative theory of the case was that they were protected by the business judgment rule. That rule protects directors

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This is the newsletter of the ISBA's Section on Real Estate Law. Section newsletters are free to section members and published at least four times per year. Section membership dues are $30 per year. To subscribe, visit www.isba.org/sections or call 217-525-1760.

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against liability where they have been careful and diligent in performing their duties, and have not been guilty of bad faith, fraud, illegality, or gross overreaching. *Palm v. 2800 Lake Shore Drive Condominium Ass'n*, 2014 IL App (1st) 111290. ¶ 111. The appellate court likewise rejected that theory, because the essence of the complaint against the defendants was that they engaged in precisely that kind of misconduct.

Bottom line in *Kai*: Because the theory of breach of fiduciary duty was held to be well taken, the appellate court concluded that plaintiff could proceed with her cause of action for breach of fiduciary duty and also with her causes of action for constructive fraud and civil conspiracy. Dismissal of those three counts was reversed. The court stated that a fourth cause of action, for rescission, also would be proper; however, because of the passage of time the court held that it would not reverse as to that count. Nevertheless, *Kai* represents a substantial victory for condominium until owners and a substantial defeat for condominium deconverters.

Unpublished Rules

Finally, one other aspect of *Kai* is important. Defendants extensively relied upon an unpublished Rule 23(e) decision, *Hughes v. Cloonlara-Hughes Ltd Partnership*, 2016 IL App (2d) 150715-U. Such decisions prior to January 1, 2021 are not to be cited as precedent or for their stare decisis effect. The appellate court admonished defendants with the oft-repeated statement that Supreme Court Rules are rules, not suggestions; that they have the force of law; and they must be obeyed and enforced as written. Accordingly, the court disregarded all portions of defendants' arguments based on Hughes. Let this be an admonishment to legal researchers everywhere: When you find a pre-2021 absolutely perfect decision with a -U at the end of the citation, don't waste your time; just turn the page and keep searching.■

Reprinted from the January/February 2021 CBA Record with permission of The Chicago Bar Association.

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When a Tenant Files a Chapter 7 Bankruptcy During a Commercial Real Estate Transaction

CONTINUED FROM PAGE 1

naming my client as a creditor. The filing brought a screeching halt to our closing process and brought me into the realm of a Chapter 7. I was sucked up into a whirlwind of bankruptcy proceedings, navigating the world of restaurant equipment appraisals and finally, settlement negotiations with the debtor-tenant. It was unexpected because the principal of the tenant debtor told my owner he had closed for good.

The debtor was the assignee of an original tenant whose lease provided for a forfeiture of most of the built-in restaurant improvements at the end of the lease. The debtor was far behind in rent but had abandoned what it scheduled as $120,000 in lien-free equipment. I quickly learned I was the only interested party in the equipment but that no credit bids would be allowed. My client's photos of all of the restaurant equipment were submitted to the trustee. But, the trustee could not make a decision about whether to administer the estate where the debtor's placement of value ($120,000) was so far apart from the landlord's assertion of value over the property, particularly since the landlord claimed that the most valuable items had been forfeited under the lease.

The Fight Over the Leasehold Improvements

The threshold issue that may come up in the fight between the creditor- landlord and the debtor-tenant is this: who has rights to the leasehold improvements. Where a tenant has paid for improvements to the property to run a restaurant or other business, it will be an issue the debtor's attorney may try to convince the trustee that the tenant is entitled to the leasehold improvements. The answer in my case was in the language of the lease. If the landlord entered a poorly drafted lease with their tenant, the tenant may have the upper hand. However, if the landlord entered a properly drafted lease, the leasehold improvements should revert back to the landlord, notwithstanding who installed the leasehold improvements.

In my case, the debtor claimed he was entitled to $60,000 for the restaurant's black iron ventilation hoods. The ventilation hoods are welded to the property up through the ceilings and out the roof. The debtor's argument was that he purchased the ventilation hood from the original tenant via a purchase and sale agreement. This was a major fight between debtor's attorney and me during the bankruptcy. The trustee ultimately agreed with the landlord and found that the debtor's interest in the ventilation hood reverted back to the landlord per the terms of the lease. If there was any value in the hoods to the tenant, it was a nominal possessory interest only and only existing until the lease was terminated. In a Chapter 7, that is referred to as the "rejection" of an executory contract.

The Decision to Order an Appraisal

Reluctantly, I made the decision to order an appraisal from a reputable used restaurant appraisal company. I was at the mercy of the schedule of the appraiser during a pandemic during a polar freeze and 36 inches of snow. Once the appraisal came back, I learned that the personal property and restaurant equipment was worth less than the cost to remove it from the premises. The appraiser explained that there is just too much of this used restaurant equipment out there. His warehouses are full and he can't lease any more space to store the stuff. He explained that COVID-19 is taking a toll on the market for used restaurant equipment. Suddenly, it became clear that all of the debtor's optimism for a successful auction was probably just a pipe dream.

For those relatively inexperienced in bankruptcy, like me at the time, it is valuable to understand that ordinarily, a debtor has little incentive to encourage a trustee to administer assets and pay creditors. Here, because the debtor was an LLC, it was ineligible for a discharge and was using the Chapter 7 as a strategy to minimize the member's liability as a guarantor of some of the debt, and so was actively encouraging the trustee to sell the equipment to pay claims. When an LLC files Chapter 7, not only will filing close the business, but LLCs don't receive a debt discharge. It isn't needed. A creditor can't collect from a company (or pursue actions against the individual) if it is no longer operational. There is nothing of value left to take.

I decided to share the appraisal with the trustee with the understanding that if he did decide to open an estate and liquidate, my administrative expense associated with the appraisal would be reimbursed.

I requested that the trustee make a decision quickly, so my owner did not lose his buyer. I asked the trustee to expedite his search for a bidder for the personal property. I asked if the trustee planned to reimburse my landlord/owner for its post-petition administrative expenses associated with storing the property and obtaining an appraisal under section 365(d)(3). As the landlord-creditor with clear priority in this case, I reminded the trustee that there was zero incentive for the landlord to make any bid for this personal property if the trustee planned to deny any credit bid or reimbursement for the landlord's administrative expenses, particularly, where the trustee did not timely perform any of his obligations of this unexpired lease under section 365(d)(3): "[t]he trustee shall timely perform all the obligations of the debtor... arising from and after the order for relief under any unexpired lease of non-residential real property . . . notwithstanding section 503(b)(1) of this title."

I reminded the trustee of the multiple lease obligations of the debtor, namely, insurance, utilities, and rent. I expressed my client's impatience with the debtor causing a delay to the Landlord's sale of the property. I reminded the trustee that the black iron ventilation hood is clearly attached, welded to the walls and through the ceilings, and is a leasehold improvement with nominal value. I pointed to the lease language providing authority to support the

fact all leasehold improvements belong to the landlord. I tried to persuade the trustee to ignore the debtor's push to sell items of nominal value and the Bankruptcy must be concluded. Simply put, during the pandemic, there was no money in the failed restaurant equipment because of (i) its low value; (ii) low demand and huge supply; and (iii) the administrative expense of the landlord to administer the assets largely outweighed any dollar amount the trustee would have recovered through a liquidation process or auction.

Next, I respectfully requested that the trustee remove the debtor's personal property from my client's building immediately since he refused to pay storage. I desperately needed to move forward with my client's 1031 exchange and sale. My current buyer remained interested but there would soon be monetary damages if we failed to settle this matter quickly with the debtor. I had already extended the buyer's mortgage contingency and delayed the closing date by three months.

The trustee ultimately rejected the lease, filed a no asset report and the bankruptcy judge agreed and closed the bankruptcy. The effect of the closing of the Chapter 7 bankruptcy simply set the stage for a quick settlement with debtor to avoid eviction proceedings. My landlord client was forced to store the abandoned restaurant equipment and personal property of the debtor, with no reimbursement, for the entirety of the bankruptcy. No outside bidders were willing to pay much for used restaurant equipment during a pandemic in the dead of unprecedented winter snowstorms and polar ice freeze.

Changing Venue

At the closing of the bankruptcy, with no discharge for the debtor entity, suddenly the venue for the action with the tenant changed. I was forced to scramble to draft an eviction and back-rent complaint and used it to make a settlement demand with the tenant. I needed the pleadings ready to file in the event the tenant refused to settle or vacate the property and hand over keys. We were back to where we were pre-bankruptcy, with no keys, no release of lease, and no bill of sale for the abandoned equipment. I felt like Alice in Wonderland shrinking down to the size of a mouse, suddenly running through the state eviction court maze, where time was of the essence.

Luckily, in this case, there was still a semblance of a good relationship between the landlord and tenant. The parties were able to settle the matter quickly and avoid further litigation and eviction proceedings. With the complaint ready to file, the settlement was successful. My client promptly closed on the building, including the leasehold improvements and the restaurant equipment.

PRACTICE TIP: If representing an owner-seller or landlord in a commercial real estate transaction, during due diligence and prior to concluding attorney review and inspection contingencies, confirm the financial status of your client's tenants before moving forward with the real estate transaction. If the tenant is in arrears on rent, pin down the landlord's rights under the lease in writing. Be proactive in obtaining a tenant estoppel letter. Review the commercial lease and any assignments carefully to identify what rights, if any, the tenant has to any leasehold improvements. Ask the tenant if they are anticipating filing bankruptcy or if they have already filed bankruptcy. Then, perform a search on Pacer to confirm the tenant has not filed bankruptcy. The automatic stay prohibits the landlord from contacting the tenant with respect to rent or as to any assets of the debtor. It is wise to have the difficult conversations upfront to avoid any pitfalls or delays in the closing. Finally, during due diligence, carefully review the real estate contract to confirm which non-leasehold equipment and/or leasehold improvements are included in the contract, to avoid any final walk-through problems with the investor purchaser. ■

Proving Up Damages in a Home Construction/Remodeling Case

BY ADAM WHITEMAN

Proving up damages in a residential construction defect case can be tricky business. Whereas the general rule is that the cost of repairing the defective work might seem the appropriate path to proving up damages, this is not the case when correction of the work would require a substantial tearing down and rebuilding of the structure, in which case the measure of damages is the difference in value between the work if it had been performed according to the contract and that which was actually performed.

In the case of *Witty v. C. Casey Homes*, Inc., 430 N.E.2d 191 (1st Dist. 1981), the plaintiff alleged that contrary to the specifications in their building contract for a new home, which called for "face brick veneer," the defendant contractor substituted defective ordinary brick. At trial, the plaintiffs called an engineer as a witness who testified about the defects in the brick and that "it would cost $50,000 or more to replace the face brick in the residence." The trial court determined that the plaintiff had applied the incorrect measure of damages on the case and denied their request for repair damages. The appellate court affirmed, and the plaintiff went back to their defective home empty handed.

The court initially set out the general rule

as follows:

> As a general rule, the measure of damages or the credit due the purchaser, when performance by the builder has been less than full performance, is the cost of correcting the defects or completing the omission.

But then the court explained:

> But this general rule only applies where the correction or completion would not involve unreasonable destruction of the work done by the contractor and the cost thereof would not be grossly disproportionate to the results obtained. If to repair the defects or omissions would require a substantial tearing down and rebuilding of the structure, the measure of damages is the difference in value between the work if it had been performed according to the contract and that which was actually performed.

The court used the phrase "dimunition in value" to describe "the difference in value between the work if it had been performed according to the contract and that which was actually performed". Because the plaintiff in the Witty case had failed to introduce any evidence of "diminution in value", their complaint was denied. In other words, the court determined that the plaintiffs failed to prove the proper measure of damages. See also *Park v. Sohn*, 89 Ill.2d 453 (1982) (stating rule of damages calculation).

How, then, does one go about proving dimunition in value? For this, expert testimony will be required.

In *Knowles v. Westbrook Builders Ltd.*, 544 N.E.2d 121 (3rd Dist. 1989), the plaintiffs sued their builder for failing to complete the home it had been contracted to build in conformity with applicable building codes. In proving up their damages, the plaintiffs provided evidence of both the cost to repair the defects as well as the lost value of the home given the existing defects. The expert witnesses who presented this testimony included a real estate appraiser and an architect. The jury verdict in plaintiff's favor was affirmed, the evidence being deemed sufficient to prove damages.

As a litigator, if you are presented with a case where the cost of repairs would exceed the dimunition in value of the defective structure, then it is prudent to submit evidence of both the cost of repairs and the dimunition of value since you cannot reach the question of dimunition of value until you have first shown it exceeds the cost of repairs, the jury should then be instructed to consider both elements of damages. Thus, where the question of dimunition will be addressed, the jury should be instructed that, "it must first consider costs of repair, and that it could go to diminution of value only if it found (1) the cost of correcting the defects was unreasonably disproportionate to the benefit of the purchaser, or (2) if correcting the defects would entail an unreasonable destruction of the builder's work." *Wells v. Minor*, 578 N.E.2d 1337, 1343 (4th Dist. 1991)

The lesson here is to be very careful about how you prepare for trial in regards to a residential construction defect. Nothing would be worse than spending the time and money to construct what you believe is the foundation for a winning case, only to see it come tumbling down because you did not present proper evidence of damages.■

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Did You Know?

It appears that the state of Utah is the first to allow law firms with non-lawyer owners and non-traditional legal service providers to operate. An entirely non-lawyer-owned law firm is currently servicing clients in the state of Utah. This format was approved by the Utah Supreme Court during the summer of 2020. Illinois is probably a long way off from following what Utah is now doing, however, it is always wise for the Illinois legal profession to know what is happening in other jurisdictions. We are already aware of companies that operate in Illinois and other states, that come close to practicing law.

The most recent official position of the Illinois State Bar Association is opposition to nonlawyer ownership of law practices.■