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Equity Financing Under Florida Law

Janis K. Cheezem*

I. RESTRAINTS ON ALIENATION .............................................. 713
II. INDEFINITENESS ........................................................ 716
III. USURY ................................................................. 718
IV. LENDER LIABILITY IN AN EQUITY LOAN ............................. 731
V. CONCLUSION ............................................................ 739

When money is tight and interest rates are high, real estate development and construction financing in which the lender receives consideration in addition to the stated rate of interest becomes more prevalent. Such additional consideration often takes the form of participation in the profits of the enterprise, and is sometimes called the "equity kicker," or contingent interest. The financial success of the project that the lender is financing determines the value of the equity kicker or contingent interest.

The lender and borrower may choose to structure project financing in a variety of ways that will yield a contingent return to the lender.¹ This article will consider one mode in which the lender seeks to maintain its traditional role as a lender of money instead of increasing its involvement to become a joint-venture partner of the builder.

In addition to the return of principal and a stated rate of interest, the lender in the equity participation arrangement would receive as consideration a percentage of the net profits of the de-

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¹ For an analysis, primarily dealing with Texas law, of the choice of various entities, see Barton & Morrison, Equity Participation Arrangements Between Institutional Lenders and Real Estate Developers, 12 St. Mary's L.J. 929 (1981) (this article considers the tax ramifications of the choice of various structures for the lender-borrower relationship). In Glass, The Structuring and Use of Equity Participations by Real Estate Investment Trusts, 27 U. MIAMI L. REV. 22 (1972), the author discusses structuring the use of equity kickers by Real Estate Investment Trusts to comply with applicable provisions of the Internal Revenue Code.
velopment venture realized from the sale, refinancing, or other disposition of the completed real estate project. The financing of a residential condominium project is considered here.

The contingent interest financing arrangement requires several additions to the typical documentation for a development and construction loan. The typical loan is documented principally by a promissory note, a mortgage encumbering the project, and a construction loan agreement governing the disbursement of the loan in stages. The agreement should contain a provision requiring the borrower to pay to the lender a percentage of the net profits derived from the development and sale of the project. The typical construction loan provides that the lender will release individual units from the lien of the mortgage upon payment of a "Release Price." The release price is usually the greater of either a stated sum or a stated percentage of the proceeds from the unit sales, and is applied toward the principal and interest due under the loan. In a contingent interest transaction, a separate contingent interest mortgage could be used to secure the contingent interest. The contingent financing agreement would provide that the release price for units to be released from the lien of the mortgage would be applied not only to regular principal and regular interest, but also to the equity kicker or contingent interest.

The net profits of a real estate venture generally consist of the difference between the gross revenues derived from its sales and the cost of the project. Because the amount of the lender's equity participation will depend upon the net profits of the venture, the borrower and lender will need to agree as to the precise manner in which the net profits are to be calculated. The lender will advocate a broad definition of gross revenues and a narrow definition of allowable costs, thus increasing its contingent interest. To the extent that the borrower can narrow the definition of gross revenues and broaden its allowable costs, it will succeed in containing the lender's contingent interest. For example, the borrower may wish to allocate a greater percentage of overhead to the project than the lender feels is justifiable.

Additionally, the lender will want to provide that the lien of the regular mortgage will not be released until the equity participation is satisfied in full, thus furnishing maximum security for the contingent obligation. This can be accomplished by a provision that the last payment of a sum certain will not be applied against the note and mortgage until the sums secured by the contingent interest mortgage are paid in full.
In an equity participation transaction, the lender will not normally intend to extend its involvement in the operation of the developing entity beyond its typical role of positive approval over the borrower's activities. The contingent interest would be due to the lender as a lender of money, not as a participant in the development process. As will be discussed below, the legal issues are more unclear when the lender assumes additional active roles. Whether the lender can escape the additional liability of a joint venturer, whether it can avoid subjecting the entire transaction to the taint of usury, whether it can avoid challenges based on the indefiniteness of the debt, and whether the contingent interest obligation will be considered a restraint on alienation, are the subject of this article.

I. Restraints on Alienation

The lender's equity participation interest will attach both in the event of a bulk sale of the project, and, more typically, to the proceeds from the sale of the project, unit by unit. Loan documents usually include a formula for the release of the lender's participation interest in the case of the sale of individual units. When there is no similar formula for bulk sales, determining the effect of an equity interest as a restraint on alienation is more troublesome.

A developer holding an equity participation loan who wishes to make a bulk sale might attempt one of two practical solutions. The developer might attempt to sell the project subject to the lender's equity interest. The implementation of this solution would, of course, be subject to both the lender's and buyer's consent to the assumption. Alternatively, the original buyer might attempt to negotiate a payoff amount with the lender, which amount would then be deducted from the closing proceeds of the bulk sale. A problem with this approach is that the lender and borrower might find it difficult to agree on the amount for such an early payoff.

As in many negotiations, the degree of mutuality of interest of the lender and borrower will largely determine the ease in reaching a solution satisfactory to both. By the nature of the equity participation arrangement, the lender will benefit most as the borrower maximizes its profits. The interests of the parties are, therefore, complementary. Nevertheless, the parties may differ on what course of conduct will, in fact, maximize profits. The borrower's entrepreneurial, risk-taking approach may run up against the lender's more conservative, institutional perspective. While the
borrower may want to make a bulk sale in order to get its money out, and go on to seemingly greener pastures, the lender may not wish to place its security in the hands of a third party and, in a market with falling interest rates, may not wish to settle for an early payoff. Thus, while the parties share a mutual interest in the ultimate profitability of the venture, their different roles may require complex negotiations prior to any bulk transfer of the property.

The equity participation interest may well have a chilling effect on the borrower's ability to convey its property. At best, it can be said that the equity participation device would neither facilitate nor simplify the disposition of the owner's interest, because the lender would not allow a bulk sale without its consent, which would be tied to an early payoff. Because the probable effect of such conditions is to impair the borrower's ability to convey its property, the issue arises as to whether the equity participation arrangement imposes an unreasonable restraint on alienation.

Although the rule against restraints on alienation is an ancient one, its purpose could have been conceived by a chamber of commerce committee. According to the Florida courts, the rule "is founded entirely upon considerations of public policy, specifically the idea that the free alienability of property fosters economic and commercial development."2

A restraint imposed by an equity participation arrangement bears a paradoxical relationship to the tests of validity of restraints. While the purpose of the rule against restraints "is to ensure that property is reasonably available for development by prohibiting restraints that remove property from a beneficial use for an extended period of time,"3 the very purpose of the equity participation arrangement is to provide funding so that the property can be developed. Florida courts have held that "[t]he validity or invalidity of a restraint depends upon its long-term effect on the improvement and marketability of the property. Once that effect is determined, common sense should dictate whether it is reasonable or unreasonable."4 Thus, the restraint imposed by the equity participation loan can be supported as an interim inhibition that is part of a larger program to finance, develop, and market property.

The courts have generally shifted from a test based on the "dura-

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2. Seagate Condominium Assoc. v. Duffy, 330 So. 2d 484, 485 (Fla. 4th DCA 1976) (citations omitted).
4. Id. at 614.
tion, type of alienation precluded, or the size of the class precluded from taking," to the more flexible, common sense test stated as the reasonableness of the restraint viewed in light of the competing social policies involved. Nonetheless, the factors of duration, type and size can be useful in evaluating the reasonableness of the restraint.

When the restraint is imposed by a requirement that the grantor, lessor or lender approve any subsequent transfer, its validity may depend upon the conditions under which approval must be granted. In Mowatt v. 1540 Lake Shore Drive Corp., a requirement that the board of directors of a cooperative apartment approve any assignment or sublease by a stockholder-lessee of the corporation was subjected to the test that it would be validated "if the power to withhold consent must be reasonably exercised in light of the purposes of the arrangement, and would be void if it need not be." Similarly, in Davis v. Geyer, an agreement stating, "[n]o sale of said property is to be made by the party of the first part until the same is approved by the party of the second part," executed simultaneously with a deed conveying the property in fee simple, was held void on the basis that it imposed an unlimited restraint on alienation.

Section 689.18(3) of the Florida Statutes provides a guide for evaluating the reasonableness of the time during which a restraint would be effective:

All reverter provisions in any conveyance of real estate or any interest therein in the state, now in force, shall cease and terminate and become null, void and unenforceable 21 years from the date of the conveyance embodying such reverter or forfeiture provision.

While the effect of the equity participation as a restraint occurs in the context of a loan, not in the context of a conveyance, the rule against perpetuities shares a "common public interest and

5. Seagate Condominium Assoc., 330 So. 2d at 485.
6. Iglehart, 383 So. 2d at 614; Seagate Condominium Assoc., 330 So. 2d at 486.
7. Seagate Condominium Assoc., 330 So. 2d at 485 n.1.
9. Mowatt, 385 F.2d at 137.
10. 151 Fla. 362, 9 So. 2d 727 (1942).
11. Id. at 362, 9 So. 2d at 727.
12. Id. at 370, 9 So. 2d at 730.
purpose" with the rule against unreasonable restraints on alienation. Both rules attempt to facilitate the free alienation of property. They differ in that the rule against perpetuities deals with the time of vesting, while the rule against unreasonable restraints deals with the "duration of a restraint . . . rather than the time of vesting." Since a typical construction loan would be for a term far less than the twenty-one years suggested by the statutory rule against perpetuities, the conservative lender might wish to adopt the statutory term for repayment of its equity interest. This may be impractical, however, in long-term phased developments. Such a limitation may also endanger the lender's security if the project is stopped and restarted due to economic or market conditions.

Parties seeking to finance a project through granting the lender an equity participation interest have, then, several means of avoiding the prohibition against unreasonable restraints on alienation. First, they can provide that the lender's consent to any transfer will not be unreasonably withheld. Second, if the project is not a phased development, or one for which a protracted buildout period is anticipated, the duration of the restraint can be limited to less than twenty-one years. Lastly, the parties can expressly link the lender's right of approval to the loan program as a whole, thereby invoking the public policy of promoting economic growth. The restraint on alienation would then appear not as an inhibition on the full utilization of property, but rather as a part of a program of development.

II. INDEFINITENESS

Unlike conventional mortgage financing, a contingent interest transaction will not specify the amount of the borrower's obligation under the contingent interest note and mortgage. Instead, as noted, the contingent interest mortgage will be for an amount based on the profits of the venture as they are defined in the loan agreement. Because of the uncertain nature of the obligation, the issue arises whether the obligation is too indefinite to be enforced. This issue is linked to the restraints on alienation problem: the borrower may not be able to determine how to buy out the lender's

15. Id. at 614 (emphasis supplied).
16. While it is difficult to test such a standard, the reasonableness language does mirror the case law that upholds the transactions. See Mowatt, 385 F.2d at 137.
Any challenge to the enforceability of the contingent interest mortgage would have to overcome the strong policy of the Florida courts that "[t]he contract should not be held void for uncertainty unless there is no other way out."\textsuperscript{17} In \textit{Blackhawk Heating \& Plumbing Co. v. Data Lease Financial Corp.},\textsuperscript{18} a seminal Florida case, an optionee sued for specific performance of an option agreement to purchase bank stock which provided, "[a]ny cash flow benefit, including any tax benefits, derived by Data as a consequence of its holding, hypothecation, assignment, pledge, etc., of MNB stock shall inure proportionately to Blackhawk in calculation of any payments due between the parties."\textsuperscript{19} In upholding the agreement, the court found that the conduct of the parties gave meaning to the cash flow benefits referred to in the option.\textsuperscript{20} The court invoked equitable principles in observing that extreme hesitancy should be exercised before invalidating a contract for indefiniteness when one party has performed and the other has enjoyed the benefits of such performance.\textsuperscript{21} After so narrowing the basis on which a contract can be voided for indefiniteness, the court, quoting Professor Corbin, substantially rejected the indefiniteness argument unless there is no other way: "If the parties provide a practicable, objective method for determining this price or compensation, not leaving it to the future will of the parties themselves, there is no such indefiniteness or uncertainty as will prevent the agreement from being an enforceable contract."\textsuperscript{22}

The court in \textit{Tipton v. Woodbury}\textsuperscript{23} cited \textit{Blackhawk} in further narrowing the grounds for the indefiniteness argument. The court granted specific performance of an oral contract in which the defendant agreed to sell shares of bank stock to the plaintiff for a sum certain when the exact amount of stock and the arrangement for transferring payment were not fixed.\textsuperscript{24} The apparent good faith

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17. \textit{Blackhawk Heating \& Plumbing Co. v. Data Lease Fin. Corp.}, 302 So. 2d 404, 409 (Fla. 1974).
18. Id.
19. Id. at 406.
20. Id. at 408. The court distinguished the option agreement before it from the agreement found in \textit{Truly Nolen, Inc. v. Atlas Moving \& Storage Warehouses, Inc.}, 125 So. 2d 903 (Fla. 3d DCA 1961), \textit{writ discharged}, 137 So. 2d 568 (Fla. 1962), in which a lease was held to be so indefinite that the court refused to enforce it. The lease contract was for "an appropriate advertising sign for the use and benefit of the lessee." 125 So. 2d at 905.
21. \textit{Blackhawk Heating \& Plumbing Co.}, 302 So. 2d at 408.
22. Id. at 409 (quoting A. CORBIN, \textit{CORBIN ON CONTRACTS}, § 97, at 146 (1952)).
23. 616 F.2d 170 (5th Cir. 1980).
24. The case was decided under the provisions of Florida's Uniform Commercial Code,
of the plaintiff and the circumstances surrounding the transaction, such as the need for the Florida Comptroller's approval of the transaction before a written agreement could be signed and the transfer made, were vital factors in the court's enforcement of the contract. Courts have also enforced contracts containing blank spaces where the blanks dealt with nonessential contract terms.

The cases suggest that an equity participation loan drafted with Corbin's admonition in mind would not be readily subject to attack on the basis of indefiniteness. Such documents would contain objective standards for the calculation of profits, the lender's profit participation, and the borrower's repayment schedule. The lender's performance of its obligations under the loan agreement to fund the project would strengthen the enforceability of the transaction. While counsel may encourage the inclusion of such objective standards as insurance against the indefiniteness attack, the client may independently desire to resolve these matters as part of the negotiation of the business of the transaction.

III. Usury

The uncertainty of the amount of contingent interest under an equity participation loan, giving rise to the indefiniteness objection, may also give rise to a usury problem under the applicable law. This will occur if the actual rate, impossible to calculate at the time the loan is documented, exceeds the permissible rate. Nevertheless, this very uncertainty may save the transaction under Florida law.

An inherent feature of the contingent interest transaction is that the interest payable cannot be specified as a percentage of the amount loaned. Indeed, the amount of the contingent interest obligation is, by definition, uncertain at the time the loan is documented. Whether the contingent obligation would be considered to be interest is a critical inquiry.

If the contingent obligation is found to be interest for usury purposes, and it causes the effective rate of interest on the loan to exceed the applicable usury limits, the transaction will be subject
to a harsh penalty. Florida law provides that any person, agent or officer willfully violating the Florida usury statute "shall forfeit the entire interest so charged, or contracted to be charged or reserved . . . ." The statute specifies that the lender would be allowed to collect only the principal amount of the loan. This penalty applies whether or not usurious interest was ever collected by the lender. If the lender actually receives the usurious interest, an additional penalty is imposed by statute. In that event, the lender must forfeit double the amount of interest actually collected. If the rate of interest exceeds twenty-five percent, an action for the entire principal is also unenforceable in Florida. If the rate of interest falls between twenty-five and forty-five percent, the lender would be guilty of a second degree misdemeanor. If the rate of interest exceeded forty-five percent, the lender would be guilty of a felony of the third degree.

Under Florida law, there are four elements of a usurious transaction:

1. There must be a loan express or implied;
2. An understanding between the parties that the money lent shall be returned;
3. That for such a loan a greater rate of interest than is allowed by law shall be paid or agreed to be paid, as the case may be; and
4. There must exist a corrupt intent to take more than the legal rate for the use of the money loaned.

The allowed rate of interest is discussed later with the preemptive role of federal legislation. With the possible exception of this third element, the fourth requisite of "corrupt intent" has led to the most complex definition.

While the corrupt intent requirement may appear to have such unsavory connotations that the typical prudent lender would feel absolved from any such motives, the Florida courts have, in fact, broadened its applicability so that corrupt intent may well be present in an otherwise typical mortgage transaction. Corrupt intent is not gauged simply by a mathematical computation, but is,

29. Id.
34. See infra note 66 and accompanying text.
35. For purposes of this discussion, the first and second elements of usury can be treated at face value.
instead, "determined from all the circumstances surrounding the transaction . . .". For example, the bargaining position of the parties is one such circumstance.

Corrupt intent does not require the lender "to consciously decide to charge a borrower greater than the legal rate, when the lender consciously intends and does in fact make the charges which add up to usury." If the equity participation is deemed interest for usury purposes, the lender may be charged with corrupt intent even if it negotiated its equity participation in good faith. One area of concern arises in estimating the amount of contingent interest. The lender may underestimate the profitability of a project, contemplating a contingent interest that will fall within usury limits. If the venture is successful beyond expectation, the lender's intent can be subject to attack.

In light of the broad definition of corrupt intent and the ease of meeting the remaining elements of the usury test, the conservative lender may desire to expressly limit all interest, both fixed and contingent, to applicable usury ceilings, or otherwise ensure that the transaction falls within an exception to the usury doctrine.

The contingency rule, a doctrine with a long historical basis, may assist the lender in avoiding usury limits. As early as 1912, the Florida Supreme Court said in dicta that shared loss and participation in control or management may allow the lender to charge more than the statutory rate without being subject to usury penalties. Florida has since codified the contingency rule excepting certain contingent obligations from the interest limits set by the usury statutes.

The statute commonly known as the "equity kicker" statute, provides:

If . . . a loan, advance of money, line of credit, forbearance, or other obligation exceeds $500,000, then . . . interest on that loan, advance of money, line of credit, forbearance or other obligation shall not include the value of property charged, reserved, or taken as an advance or forbearance, the value of which substantially depends on the success of the venture in which are used the proceeds of that loan. . . . Stock options and interests

38. Cooper v. Rothman, 63 Fla. 394, 403, 57 So. 985, 987 (1912); see also Kmiec, Shared Appreciation Mortgages: Step Toward Making Housing a Bad Investment, 10 REAL EST. L.J. 302, 312-13 (1982).
in profits, receipts or residual values are examples of the type of property the value of which would be excluded from calculation of interest under the preceding sentence.\textsuperscript{39}

The statute's common law and code precursors are helpful in assessing its impact and applicability.

The classic statement of the contingency rule is contained in the Restatement of Contracts, which provides:

**CONDITIONAL PROMISES FOR PROFIT EXCEEDING THE PERMISSIBLE RATE OF INTEREST.**

A promise, made as the consideration for a loan or for extending the maturity of a pecuniary debt, to give the creditor a greater profit than the highest permissible rate of interest upon the occurrence of a condition, is not usurious if the repayment promised on failure of the condition to occur is materially less than the amount of the loan or debt with the highest permissible interest, unless a transaction is given this form as a colorable device to obtain a greater profit than is permissible. In that case it is usurious.\textsuperscript{40}

The Restatement provides several tests for determining whether a transaction falls within the contingency exception, but the successful application of these tests depends upon their further definition by case law. For example, the creditor is entitled to the return of the principal plus interest at the highest lawful rate and, according to the Restatement, must contract for a materially lesser return in order to be eligible for the exception. The Restatement balances the scope of risk with the extent of contingent profit to gauge the exception's applicability. Whether risking some part of the interest


\textsuperscript{40} RESTATEMENT OF CONTRACTS § 527 (1932). Comment a provides:

Usury laws do not forbid the taking of business chances in the employment of money. A creditor who takes the chance of losing all or part of the sum to which he would be entitled if he bargained for the return of his money with the highest permissible rate of interest is allowed to contract for greater profit. On the other hand it is not permissible to use this form of contract as a device for obtaining usurious profit. If the probability of the occurrence of the contingency on which the diminished payment if promised is remote, or if the diminution should the contingency occur is slight as compared with the possible profit to be obtained if the contingency does not occur, the transaction is presumably usurious. See Kmiec, supra note 38, at 312 n.47 (quoting RESTATEMENT OF CONTRACTS § 527 (1932)).
permitted by statute is sufficient, or whether some portion of the lender's principal must be jeopardized in order to meet the materiality standard, is left unclear.

In *Diversified Enterprises, Inc. v. West*, a private investor made a series of loans so that the defendant-purchaser could close his purchase of property. The plaintiff-investor's first advance of $10,000 cash was secured only by an oral promise to repay. A subsequent advance of $30,000 was secured by two notes of $10,000 each, and the assignment of an option of additional acreage acquired for $10,000. In defending against the plaintiff's action for recovery on the notes, the defendant alleged that the two notes were given as security for the initial advance of $10,000, giving the plaintiff a usurious return of one hundred percent. The plaintiff argued that the transaction should be viewed as a whole, and "that the two notes were given to him to reduce to $20,000 the amount of risk-capital he would have in the option, and in addition to secure his return of the other $20,000." In upholding the transaction against the usury defense, the court relied on several principles. The court preferred an interpretation of the transaction that would render it lawful.

The defendant was required to establish his charge by "clear and satisfactory evidence," and, in considering the transaction, the agreement and the intent of the parties were carefully scrutinized. The court upheld the transaction against the usury defense in view of the fact that the plaintiff's only requirement was that the $40,000 loaned to the defendant be repaid, and that the plaintiff had only two $10,000 notes plus the option to secure the debt. The option's role in the transaction caused it to fall within the scope of the contingency exception, as it appeared that the plaintiff sacrificed full security for his debt for the speculative profit that the option might provide. The court cited the rule that "the lender may lawfully require, in return for the risk, as large a sum as may be reasonable, provided it is done in good faith," and that "mere colorable hazard will not preclude excessive interest charges

41. 141 So. 2d 27 (Fla. 2d DCA 1962).
42. Id. at 29.
43. Id. at 30.
44. Id. at 29.
45. Id. at 30.
46. Id.
47. Plaintiff ultimately sold the option for $60,000. Id. at 29.
48. Id. at 30.
from being usurious." The profit from the sale of the option was treated as interest, and cleansed from the taint of usury because of its speculative nature.

The contingency exception has also been applied to preferential participation in profits granted to certain stockholders of a condominium development corporation. In *Little v. Caswell-Doyle-Jones Corp.*, the stockholders had made loans to the corporation that provided equity financing for the project. The loans were evidenced by notes that provided for interest at the annual rate of six percent; a separate stockholders agreement granted the stockholders their proportionate share of the cash remaining after the notes were paid. The stockholder-creditors were to receive a preferential distribution amounting to one half of their loans.

The corporation defaulted on the notes and the stockholders sued the guarantors to recover; the guarantors raised the affirmative defense of usury. The appellate court overturned the trial court's holding that the preferential distribution was in actuality usurious interest, finding that neither the corporation nor the guarantors had any fixed obligation to pay more than principal and interest. Invoking the principle that "freedom of contract as between shareholders of competent understanding is not a contract to be rewritten by the courts," the court applied the contingency exception.

That two individual mortgagees were granted profit participations which, if earned, would have yielded a return of thirty to thirty-five percent did not invalidate the transaction in *Schwab v.*

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49. *Id.* at 30 (citations omitted); see also Goodman v. Olsen, 305 So. 2d 753 (Fla. 1974), cert. denied, 423 U.S. 839 (1975). The Goodman court, applying the New York version of the contingency rule, stated:

[A] loan is usurious where the lender is entitled to the return of the principal and the full legal rate of interest plus a bonus to be paid upon a contingency over which the borrower has no control. . . .

However, an agreement to pay an amount which may be more or less than the legal interest, depending upon a reasonable contingency, is not *ipso facto* usurious, because of the possibility that more than the legal interest will be paid. *Id.* at 755 (emphasis added). The court also referred to the principle under New York law that a loan is not usurious "where the money is in fact advanced for the purpose of a joint venture . . . or where there is no certainty that the bonus plus the stipulated interest will exceed the legally allowable rate of interest." *Id.* (emphasis in original). In American Insurers Life Co. v. Regenold, 243 Ark. 906, 423 S.W.2d 551 (1968), the Supreme Court of Arkansas held that a loan, where the creditor took no great risk of losing either principal or interest but yet received one-half of the profits from the ultimate sale of land, was usurious.

50. *West*, 141 So. 2d at 31.

51. 305 So. 2d 842 (Fla. 1st DCA 1975).

52. *Id.* at 844.

53. *Id.*
The mere existence of an unearned equity kicker in loan documents is not a sufficient basis on which to subject the lender to any usury penalty.

Florida case law applying the contingency exception, does provide some guidelines. First, it is notable that the several cases dealing with the exception involve private, not institutional lenders. When the lender's advance is not fully secured, and when the possibility of loss of principal is balanced by the opportunity for speculative gain, the transaction is not usurious. Corporate shareholders may contract for the preferential distribution of profits, which if treated as interest, would render the transaction usurious when the shareholders have made a loan to the corporation that obligates the corporation and guarantors to make no payments other than principal and interest. The rule of Schwab v. Quitoni merely appears to exempt documented but unearned contingent interest from inclusion in interest for usury purposes.

Florida case law does not clearly resolve the question raised but left ambiguous by the Restatement; that is, whether a lender who places statutory interest but not principal at risk in return for the opportunity for speculative profit is subject to usury limits. The language of the Florida "equity kicker" statute liberalizes and clarifies its Code predecessor in expressly excluding contingent interest from usury calculations.

A liberalizing trend in Florida usury law is also apparent in the willingness of Florida courts to recognize a choice of law provision in the loan agreement, when the chosen law permits the lender to charge a higher rate of interest than permitted under Florida law. In Continental Mortgage Investors v. Sailboat Key, Inc., the Supreme Court of Florida held that a choice of law provision would be upheld "so long as the jurisdiction chosen in the

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54. 362 So. 2d 297 (Fla. 3d DCA 1978). The profit participation was never earned as the project failed, and the mortgagees foreclosed. Id. at 297. The participation was tested, however, when the mortgagors raised the affirmative defense of usury in the foreclosure action. Id. at 297-98. The court cited Diversified Enters., Inc., v. West, 141 So. 2d 27 (Fla. 2d DCA 1962), for the principle that the usury defense must be clearly and satisfactorily proven. Schwab v.Quitoni, 362 So. 2d 297, 298 (Fla. 3d DCA 1978).
55. See supra notes 38, 41, 51-54 and accompanying text.
56. See supra notes 41-49 and accompanying text.
57. See supra notes 51-53 and accompanying text.
58. 362 So. 2d 297. See supra note 54 and accompanying text.
59. See supra note 40 and accompanying text.
60. FLA. STAT. § 687.03(4) (1983). See supra note 39 and accompanying text.
61. 395 So. 2d 507 (Fla. 1981).
contract has a normal relationship with the transaction." The court found that such a normal relationship did exist when Continental Mortgage Investors, a Massachusetts business trust, made a loan to a Florida corporation secured by a mortgage on Florida real estate. The lender's investment advisor, a separate entity based in Coral Gables, Florida, originated the loan and prepared the loan documents. The loan closing took place in Massachusetts, and the loan was made payable in Massachusetts. Further, the lender's only office was in Massachusetts. The supreme court reversed the district court's decision that the selection of Massachusetts law was a sham intended to evade Florida usury law and reversed the district court's finding that notwithstanding the equity kicker statute, the lender's receipt of fifty percent of the borrower's stock caused the transaction to be usurious. The supreme court also disagreed with the district court's finding that usury laws represent a strong public policy of the state. In view of the commercial setting of the case, the court held that the public policy of upholding normal choice of law rules was stronger than "any overriding public policy against usury qua usury in a choice of law situation." The court did not consider the usurious effect of the lender's stock interest in the borrower corporation, as it found the conflict of laws issue to be dispositive.

Federal law may also play an important role in determining what usury limits apply to a loan transaction. The Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) provides that:

[any state law] expressly limiting the rate of amount of interest, discount points, finance charges, or other charges which may be charged, taken, received, or reserved shall not apply to any loan, mortgage, credit sale, or advance which is

(A) secured by a first lien on residential real property

(B) made after March 31, 1980; and

(C) described in section 527(b) of the National Housing Act (12 U.S.C. 1735 f-5(b)) . . . .

62. Id at 508.
64. 395 So. 2d at 510.
65. Id. at 507.
67. Id. § 501.(a)(1), amended by Pub. L. No. 96-399, § 308(c)(6), § 324(a) (1980) (codi-
The purpose of the Act is to “ease the severity of the mortgage credit crunches of recent years,” to stabilize the financial system, and to encourage a national housing policy.\textsuperscript{68} It is interesting to note that the conditions that led to the Act’s passage, namely tight credit and rising interest rates, are also the factors that encourage equity financing arrangements.

Congress preempted state law with the Act through the power granted to it by the supremacy clause of the United States Constitution.\textsuperscript{69} Since the Act effects the availability of credit, the commerce clause provides an additional avenue for preemption.\textsuperscript{70} Although the validity of the DIDMCA has not been tested beyond the Supreme Court of Arkansas,\textsuperscript{71} the ruling of the United States Supreme Court in \textit{Fidelity Federal Savings and Loan Ass’n v. de la Cuesta}\textsuperscript{72} affirmed federal preemptive authority in a different, although analogous setting. The case confirms the power of the Federal Home Loan Bank Board to exclusively regulate and override conflicting state regulations regarding “due-on-sale clauses.” The due-on-sale clause is “a contractual provision that permits the lender to declare the entire balance of a loan immediately due and payable if the property securing the loan is sold or otherwise transferred.”\textsuperscript{73} The Federal Home Loan Bank Board issued regulations confirming the power of savings and loan associations to enforce due-on-sale clauses because it felt that any restriction on such enforcement would endanger the stability of the institutions, would lead to a general increase in interest rates, and would reduce availability of funds for residential loans by making loans unsaleable in


\textsuperscript{69} U.S. Const. art. VI, cl. 2. See McInnis v. Cooper Communities, 271 Ark. 503, 611 S.W.2d 767, 769-70 (1981). The court determined that the DIDMCA is a valid exercise of congressional authority, and concluded that the loan under consideration was not usurious because it was within the limits set by the federal act. 271 Ark. at 507-08, 611 S.W.2d at 772. See also Sanders v. Federal Nat’l Mortgage Assoc. 393 F. Supp. 739 (E.D. La. 1975) (Federal regulation, 24 C.F.R. § 221.525 (1977), concerning late charges on a mortgage was reasonable and within the delegated authority granted by Congress; the court held that the regulation preempted, and was supreme over, state law).

\textsuperscript{70} U.S. Const. art. I, § 8, cl. 3.

\textsuperscript{71} McInnis v. Cooper Communities, 271 Ark. 503, 611 S.W. 2d 767 (1981).

\textsuperscript{72} 458 U.S. 141 (1982).

\textsuperscript{73} Id. at 145.
the secondary market.\footnote{Id. at 146 (citing 41 Fed. Reg. 6283, 6285 (1976)).}

The due-on-sale controversy thus arose out of the same regulatory environment that surrounds the DIDMCA: an economy in which rising interest rates and tight credit threaten the normal functioning of the housing market and its financial sources. As noted, these economic factors relate closely to the business considerations that prompt the lender and the borrower to enter into an equity financing transaction.

The Act provides that each state may reimpose usury ceilings by adopting a law expressly stating that it “does not want” the Act to apply.\footnote{See DIDMCA § 501(a)(1)(C)(2)(B)(2). The state override would apply from April 1, 1980.} The preemption is permanent, subject to the right of any state to overrule it by April 1, 1983.\footnote{DIDMCA § 501(a)(2)(B)(2).} Florida has not overruled the Act.

In order to fall within the boundaries of federal preemption, a transaction must meet several requirements. The loan must “be secured by residential real property.”\footnote{See id. at § 501(a)(1)(C)(ii). The Act provides that this requirement “shall not apply to a loan secured by stock in a residential cooperative housing corporation or to a loan or credit sale secured by a first lien on a residential manufactured home[.]” Id.} Counsel to the Federal Home Loan Bank Board has applied a “primary use” test to determine if a structure is residential. This test “will be satisfied if over half the value or over half the area of the structure is attributable to residential use.”\footnote{Letter from Ira L. Tannenbaum, Acting General Counsel to the Federal Home Loan Bank Board (March 31, 1981). This and other letters referred to infra are available from the information services of the Office of the General Counsel to the Federal Home Loan Bank Board. The Federal Home Loan Bank Board “is authorized to issue rules and regulations and to publish interpretations governing the implementation” of the Act. DIDMCA § 501(f).} The Board has also ruled that “a developer of a recreation, vacation, and retirement community whose business consists of selling lots in such communities”\footnote{Letter from Jerome S. Plapinger, Special Counsel for Milan C. Miskovsky, General Counsel to the Federal Home Loan Bank Board (June 20, 1980).} qualifies as a seller of residential real property. In addition, the Board has included certain forms of timesharing interests in its definition of residential real property.\footnote{Letter from Rebecca H. Laird, Senior Associate General Counsel to the Federal Home Loan Bank Board (August 11, 1981).} These broad interpretations of the residential real property requirement extend the availability of federal preemption to equity financing for various types of development ventures.

To be eligible for federal preemption, a lender must make or
invest more than $1,000,000 in such residential loans annually.\footnote{See DIDMCA § 501(a)(1)(C)(v).} This requirement is satisfied if the lender makes $1,000,000 in loans in the current fiscal or calendar years, or has made them in the prior fiscal or calendar years.\footnote{Letter from Rebecca H. Laird, Senior Associate General Counsel to the Federal Home Loan Bank Board (March 31, 1981).} If, however, individually licensed subsidiaries of a common parent together meet the million dollar threshold, this would not satisfy the requirement.\footnote{Letter from Rebecca H. Laird, Senior Associate General Counsel to the Federal Home Loan Bank Board (July 21, 1982) (citing DIDMCA § 501(a)(1)(C)(V)). Ms. Laird does state that junior mortgages can be applied toward the million dollar figure.} Only active lending transactions qualify; a mere static investment portfolio would not.\footnote{Letter from Jerome S. Plapinger, Special Counsel for Milan C. Miskovsky, General Counsel to the Federal Home Loan Bank Board (August 5, 1981).} Finally, the term "creditor," under the statutory definition, does not apply to parents or holding companies, but only to the immediate creditor.\footnote{Laird, supra note 11 (citing DIDMCA § 602).} For the sizable institutional lender that makes a large volume of construction loans for residential or mixed use developments, it is probable that the lender will easily reach the $1,000,000 a year minimum.

The Federal Home Loan Bank Board has issued several other interpretive rulings which confirm that federal usury preemption is available in the typical equity financing transaction.

The Board has ruled that a property acquisition and development loan used to finance overhead as well as direct construction costs would qualify under the DIDMCA, when "guarantees and other non-land collateral represent a minor portion of the total value of the collateral."\footnote{Letter from Jerome S. Plapinger, Special Counsel for Milan C. Miskovsky, General Counsel to the Federal Home Loan Bank Board (June 30, 1980).} Further, the Board has ruled that the number of units financed by the loan is not material, as neither the Act nor the implementing regulations place a limit on project size.\footnote{Id.} Thus, an equity financing transaction for a large project secured in part by collateral other than the land would not be disqualified \textit{per se} from federal preemption.

A lender who, for title insurance reasons, required two notes in "\textit{pari passu}" and "of equal dignity" to evidence the debt was not prevented from being eligible for usury preemption.\footnote{Letter from Jerome S. Plapinger, Special Counsel for Milan C. Miskovsky, General Counsel to the Federal Home Loan Bank Board (August 8, 1980).} By analogy, the equity financing transaction in which the contingent interest

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82. Letter from Rebecca H. Laird, Senior Associate General Counsel to the Federal Home Loan Bank Board (March 31, 1981).
83. Letter from Rebecca H. Laird, Senior Associate General Counsel to the Federal Home Loan Bank Board (July 21, 1982) (citing DIDMCA § 501(a)(1)(C)(V)). Ms. Laird does state that junior mortgages can be applied toward the million dollar figure.
84. Letter from Rebecca H. Laird, Senior Associate General Counsel to the Federal Home Loan Bank Board (August 5, 1981).
85. Laird, supra note 11 (citing DIDMCA § 602).
86. Letter from Jerome S. Plapinger, Special Counsel for Milan C. Miskovsky, General Counsel to the Federal Home Loan Bank Board (June 30, 1980).
87. Id.
88. Letter from Jerome S. Plapinger, Special Counsel for Milan C. Miskovsky, General Counsel to the Federal Home Loan Bank Board (August 8, 1980).
obligation is secured by a separate note and mortgage would be available for federal preemption. The Board has also confirmed that construction lending is included in the coverage of the DIDMCA. Thus, although equity financing has not yet been addressed in an interpretive ruling, the Board’s policy of broadly construing DIDMCA and its approval of various elements analogous to those used in such a transaction indicate that it would be eligible for federal usury preemption.

Assuming that any state usury ceilings would be preempted by the federal statute, the parties must determine what usury limitations, if any, apply to the transaction. Section 522 of the DIDMCA provides that preempted savings and loan associations may charge

interest at a rate of not more than 1 per centum in excess of the discount rate on ninety-day commercial paper in effect at the Federal Reserve bank in the Federal Reserve district where such institution is located or at the rate allowed by the laws of the State, territory, or district where such institution is located, whichever may be greater.

Any institution charging in excess of this rate of interest shall, when such charge is knowingly made, forfeit all interest due under the loan. The same interest ceiling and penalty for its breach apply to state banks or insured branches of foreign banks. On business and agricultural loans, the preempted lender may charge not more than five per cent in excess of the discount rate as defined above.

In accordance with the authority granted by the Act, the Federal Home Loan Bank Board has ruled, in view of the Comptroller of the Currency’s interpretation, that “the most favored lender doctrine allows national banks to charge the highest rate

89. Letter from Jerome S. Plapinger, Special Counsel for Milam C. Miskovsky, General Counsel to the Federal Home Loan Bank Board (No. 000060).
90. The Board has stated “that section 501 is a remedial statute and should be construed broadly.” Letter from Rebecca H. Laird, Senior Associate General Counsel to the Federal Home Loan Bank Board (July 22, 1981) (citing Braugh v. Corpus Christi Bank & Trust, 605 S.W.2d 691, 696-97 (Tex. Civ. App. 1980)).
92. Id.
95. See supra note 78.
available on a class of loans when making that type of loan." 96 The
highest rate would be either the floating rate based on the Federal
Reserve discount rate as established in section 522 of the
DIDMCA, "or the rate allowed to the most favored lender on the
particular class of loans under state law whenever the greater of
either of these rates exceeds the rate the institution is permitted to
charge by State law." 97

Florida law exempts institutions making loans secured by liens on.
real estate from the state usury ceiling, even without reference to
the DIDMCA. Section 665.077 of the Florida Statutes 98 exempts
from usury limits loans by savings and loan associations secured by
first liens on real estate. Florida's interest parity statute 99 permits
out-of-state national banks to take advantage of the usury exemp-
tion granted to savings and loan associations.

While the interrelationship of state and federal law may ap-
pear to be a tangled web, it also creates great latitude for structur-
ing an equity financing transaction in which the lender's contin-
gent interest is not subject to rigid usury limits.

Several avenues are available. First, the lender can take com-
fort from the Florida equity kicker statute's exclusion of any re-
turn "the value of which substantially depends on the success of
the venture" 100 from interest for usury purposes. Second, if the

Lender status codified at 12 C.F.R. § 570.11 (1983)).
97. 12 C.F.R. § 570.11(a) (1983).
98. The statute reads as follows:

Collection of fines, interest, or premiums on loans made by as-
sociations.—No fines, interest, or premiums paid on the following loans made
by any association shall be deemed usurious, and the same may be collected as
depts of like amount are now collected by law in this state and according to the
terms and stipulations of the agreement between the association and the
borrower:

(1) Loans secured by a first lien on real estate.
(2) Loans secured by savings accounts to the extent of the withdrawal value
thereof.
(3) Loans secured by the pledge of those loans described in subsections (1) and
(2) and by the pledge of investments of a type in which the association is author-
ized to invest, provided the loans and investments so pledged shall be subject to
all restrictions and requirements which would be applicable were the association
to invest directly in such loans or investments.
(4) Loans secured by a wrap-around mortgage, inferior to the first mortgage, in
which the mortgagor is contractually obligated to make the payments required
under the first mortgage.

100. FLA. STAT. § 687.03(4) (1983). See supra note 39 and accompanying text.
transaction has a "normal relationship" to a jurisdiction, other than Florida, having more favorable usury laws, the parties can select the law of that jurisdiction to govern the transaction. Third, if the lender makes or invests in more than $1,000,000 in qualifying loans secured by residential real property, the lender may be able to rely on the preemptive effect of federal law. Finally, Florida law exempts from Florida usury limits loans made by savings and loan associations and national banks when secured by first liens on real estate.

IV. LENDER LIABILITY IN AN EQUITY LOAN

Since the lender in the equity participation loan shares in the profits of the venture, it clearly has an interest in the project beyond that of a typical lender of money. Because of this, the borrower's purchasers and suppliers may seek to make the lender vicariously liable for defects in the property or other defaults of the borrower in either payment or performance. This section will examine the extent to which the lender's equity participation interest may subject it to such liability.

Connor v. Great Western Savings & Loan Association, was the first case to hold a lender liable to purchasers for defective construction. The court found the lender liable for financial losses to the homebuyers resulting from the faulty foundations of their homes.

Great Western required submission of plans, specifications,

102. See supra notes 66-94 and accompanying text.
103. See supra notes 98-99 and accompanying text.
104. For a general discussion of the construction lender's liability in the typical lending transaction, see Reitz, Construction Lenders' Liability to Contractors, Subcontractors, and Materialmen, 130 U. Pa. L. Rev. 416 (1981). The author analyzes "the extent to which judicial relaxation of a contract privity requirement . . . has increased the scope of construction lender liability." Id. at 418. Cf. Pfeifer, Construction Lending and Products Liability, 25 Bus. Law. 1309 (1970). The author explores the historical development of product liability theory in residential construction, analyzes the effect of Connor v. Great Western Savings and Loan Assoc., 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968) (en banc) and subsequent cases in expanding the lender's liability to home purchasers for construction defects and reviews the reaction of the California legislature and of a lower state court in limiting Connor's effect. The author argues that such an expansion of liability is appropriate only if the project and its participation in profits, assumes the role of a joint venturer with the builder. Pfeifer, at 1332. But see Comment, 35 U. Chi. L. Rev. 379 (1968). The author argues for the desirability of shifting the loss from the home purchaser to the construction lender.
105. 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968) (en banc).
and costs analyses. It employed a geologist to assure itself that sufficient water was available. It did not, however, examine foundation plans, require soil tests, or recommend design modifications. Contrary to its usual practice, Great Western did not review and approve plans and specifications before making its loan commitment. Instead, it “was preoccupied with selling prices and sales,” imposing a presale requirement for its loan commitment and suggesting that the borrower increase its selling prices.

The court noted that there was no express joint venture between lender and borrower, and found that no joint venture could be inferred because:

Although the profits of each were dependent on the overall success of the development, neither was to share in the profits or losses that the other might realize or suffer. Although each received substantial payments as seller, lender, or borrower, neither had an interest in the payments received by the other.

The finding that vicarious liability was not present did not prevent the court from imposing liability on Great Western on the basis of its own negligence. In imposing such liability, the court focused on Great Western’s “extensive control of the enterprise,” which it could have exercised to prevent the harm. It also focused on Great Western’s role as something more than the usual money-lender. The court reasoned that the lender breached a duty of care to its own shareholders, and concluded that the lender’s conduct justified an extension of that duty to the plaintiffs. The majority reasoned that imposing liability at the point of effective financial control would encourage responsible building practices. Although the Connor decision has been abrogated by statute and restricted in application by case law, it is the point of departure for

106. Id. at 860, 447 P.2d at 614, 73 Ca. Rptr. at 374.
107. Id. at 863, 447 P.2d at 615, 73 Cal. Rptr. at 375 (footnote omitted).
108. Id. at 864, 447 P.2d at 616, 73 Cal. Rptr. at 376.
109. CAL. CIV. CODE § 3434 (West 1970). The statute provides:
A lender who makes a loan of money, the proceeds of which are used or may be used by the borrower to finance the design, manufacture, construction, repair, modification or improvement of real or personal property for sale or lease to others, shall not be held liable to third persons for any loss or damage occasioned by any defect in the real or personal property so designed, manufactured, constructed, repaired, modified or improved or for any loss or damage resulting from the failure of the borrower to use due care in the design, manufacturer, construction, repair, modification or improvement of such real or personal property, unless such loss or damage is a result of an act of the lender outside scope of the activities of a lender of money or unless the lender has been a party to misrepresentations with respect to such real or personal property.
subsequent consideration of the lender's liability to its borrower's purchasers.

The Florida courts have clearly held that a lender is not responsible to purchasers for construction defects if its role is strictly confined to that of a pure lender of money.\textsuperscript{110} The cases are less clear, however, in setting forth the special circumstances or additional control, short of a clear-cut joint venture or lender's usurpation of the builder's role, that would warrant the imposition of liability on the lender.

In \textit{First Wisconsin National Bank v. Roose},\textsuperscript{111} a condominium owner filed a class action suit against the construction lender seeking to hold the lender responsible for the builder's failure to maintain the project's recreational facilities. The plaintiff alleged that the mortgagee knew that the project was insufficient security for the loan, and further alleged that the value of the owners' apartments was diminished by the developer's failure to perform. In holding that these allegations did not establish the lender's liability, the court outlined those that would have been sufficient:

There is no allegation of any agreement between the mortgagor and mortgagee except the agreement for financing. There is no allegation of a joint proprietary interest in the development. There is no allegation of a community of interest in the performance of a common purpose and no allegation that each would share in the profits and losses.\textsuperscript{112}

Arguably, the lender holding an equity participation interest could possess both a joint proprietary interest in the development and a community of interest with the developer. Such a lender would not, however, ordinarily share in the losses as well as the profits of the venture, except to the extent that its loans were at risk. Thus, the critical question after \textit{Roose} is whether the court intended an equity participant's liability to flow from the allegation of any of the listed factors or whether it intended that every factor be alleged before liability could be found.

An allegation that the lender conducted inspections of the construction site and imposed an associated fee on the mortgagors is not sufficient, however, to impose an implied duty on the lender to conduct the inspections on the borrower's behalf or the pur-

\textsuperscript{110} Armetta v. Clevertrust Realty Investors, 359 So. 2d 540 (Fla. 4th DCA 1978); First Wis. Nat'l Bank v. Roose, 348 So. 2d 610 (Fla. 4th DCA 1977).

\textsuperscript{111} 348 So. 2d 610 (Fla. 4th DCA 1977).

\textsuperscript{112} Id. at 611.
chaser's behalf. The court in *Armetta v. Clevetrust Realty Investors* affirmed that Florida courts will not ordinarily hold a construction lender liable to third parties as a result of project inspections intended for the lender's own protection. The court rejected a broad reading of *Connor* that would hold

a lender liable to third party purchasers of dwelling units constructed and sold by the developer-borrower. Absent unusual circumstances. . . . provisions contained in a loan agreement solely for the protection of the lender do not create a duty on the part of the lender to others.

Citing *First Wisconsin National Bank v. Roose*, the court repeated that case's admonition that vicarious liability will not be found when no "profits or losses were anticipated by the . . . lender beyond those anticipated as interest charged in the money loaned."

Liability because of the inspection effort have been imposed when insurance companies, rather than construction lenders, have made such inspections. In *Hill v. United States Fidelity & Guaranty Co.*, an insurer was alleged to have made safety inspections to detect conditions hazardous to hotel occupants. A subsequent hotel fire injured the plaintiff, a hotel guest, and killed her husband. The Fifth Circuit held that the complaint stated a cause of action under Florida law for negligent performance of a duty owed to a person not in privity with the actor, since the element of reliance had been alleged. The court relied on *Gallachio v. Corporate Group Service, Inc.* and *Investment Corporation of Florida*

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114. 359 So. 2d 540 (Fla. 4th DCA 1978).
115. Id. at 543.
116. 348 So. 2d 610.
117. 359 So. 2d at 543 (emphasis added).
118. 428 F.2d 112 (5th Cir. 1970) (applying Florida law), *cert. denied*, 400 U.S. 1008 (1971). The court cites the decisions of the Illinois courts in *Nelson v. Union Wire Rope Corp.*, 139 Ill. App. 2d 73, 187 N.E.2d 425 (1963), *rev'd*, 31 Ill. 2d 69, 199 N.E.2d 769 (1964) (applying Florida law). Although the Fifth Circuit asserts that the Illinois decision was not binding on Florida courts, the court agreed that the *Nelson* decisions correctly described Florida law when either the insured or a "third person for whose protection the services should be recognized as necessary" relied on the insurer's inspections. *Hill*, 428 F.2d at 117. The Illinois courts held the insurance company liable when there was such reliance.

119. Because reliance was alleged in *Hill*, the Fifth Circuit did not reach the question of whether liability would be imposed on an insurance carrier without such reliance on its safety inspections. *Hill*, 428 F.2d at 117.
120. 227 So. 2d 519 (Fla. 3d DCA 1969).
v. Buchman.121 Both cases involved defendants who owed a contractual duty to each other and not to the plaintiff. The result in Hill, therefore, could be sustained on the basis that the plaintiff was a third party beneficiary of the contract between the hotel and the insurer.

Inspections performed by a construction lender are distinguishable from those performed by an insurer. While insurers are in the business of taking unknown risks and set their fees on the basis of the likelihood of injury, construction lenders are in the business of realizing a return on their capital, and may, like their borrowers, seek to reduce their exposure to unknown risks by requiring or securing hazard insurance. Second, while the insurer may direct its inspections toward safety and, thus toward the ultimate benefit of hotel guests and potential plaintiffs, the construction lender's inspection may have as its primary objective such matters as determining the extent of completion of the project. Third, in the case of inspection by construction lenders, the element of reliance alleged in Hill would be absent, as the construction lender's inspections are not ordinarily intended to gauge the safety of the building.122

The Florida courts have found liability when the lender "took title to the condominium project, completed construction, and, holding [itself] out to be the developer and owner of the project, advertised and sold units to purchasers."123 The court held the lender "liable for performance of express representations made to the buyer, for patent construction defects in the entire condominium project and for breach of any applicable warranties due to defects in the portions of the project completed by [lender]."124

In Blosam Contractors, Inc. v. Republic Mortgage Investors,125 a lender that foreclosed on condominium units and received the benefit of its security was held liable to a contractor for $250,000 when the sum due to the contractor had not been disbursed from the loan fund and the contractor's efforts had enhanced the value of the lender's security. The court imposed an equitable lien on the undisbursed portion of the loan fund. Similarly, the contractor in Fred S. Conrad Construction Co. v. Conti-

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121. 208 So. 2d 291 (Fla. 2d DCA), cert. denied, 216 So. 2d 748 (Fla. 1968).
122. See supra note 114 and accompanying text.
123. Chotka v. Fidelco Growth Investors, 383 So. 2d 1169, 1170 (Fla. 2d DCA 1980).
124. Id.
125. 353 So. 2d 1225 (Fla. 2d DCA), cert. denied, 359 So. 2d 1218 (Fla. 1978).
nental Assurance Co.\textsuperscript{126} was held to have stated a cause of action for undisbursed construction loan funds when it alleged that the lender had not notified the surety and contractor of the borrower's default but instead had allowed them to continue work, and when the surety and contractor alleged that the lender's mortgage was not superior to the lien for completed work. *Giffen Industries v. Southeastern Associates, Inc.*\textsuperscript{127} summarizes the exceptions to the rule that a laborer or materialman has no claim for an equitable lien superior to the mortgage lien when the mortgagee forecloses on an *uncompleted* project. The exceptions are when "there is fraud on the part of a mortgagee" or when "a mortgagee has in some way induced a materialman or laborer to forego taking action which would have protected his interest."\textsuperscript{128}

The point at which a lender becomes liable to purchasers of the builder is not clearly delineated by the Florida courts. The lender in *Chotka v. Fidelco Growth Investors*\textsuperscript{129} had, in effect, taken over the role of developer of the project. In contrast, a lender who merely conducts inspections for its own protection without enjoying a proprietary interest or participating in profits and losses is not charged with liability to the purchaser. The opportunities for diverse lender roles between these two extremes would appear to be great. In different terms, the lender's liability may be predicated on one of three bases: its vicarious liability arising from a joint venture, its extensive and extraordinary control, and its duty to perform inspections without negligence. In view of these bases for liability, the key to the equity participant's exposure may hinge, as previously noted,\textsuperscript{130} on whether its participation in losses as well as profits is a necessary element of liability.

\textsuperscript{126} 215 So. 2d 45 (Fla. 1st DCA 1968), cert. denied, 222 So. 2d 749 (Fla. 1969).
\textsuperscript{127} 357 So. 2d 217 (Fla. 1st DCA 1978).
\textsuperscript{128} Id. at 219.
\textsuperscript{129} 383 So. 2d 1169 (Fla. 2d DCA 1980).
\textsuperscript{130} See supra notes 112-17 and accompanying text. For a discussion of the loss sharing requirement in joint ventures, see Comment, *Joint Adventures—The Sharing of Losses Dilemma*, 18 U. MIAMI L. REV. 429 (1963). The author argues that the Florida decisions imposing the requirement that joint venturers share in losses as well as profits are inconsistent. The author summarizes his argument by noting:

Perhaps the only assertion that may be made without fear of contradiction is that Florida appears to require loss-sharing as a necessary prerequisite to the existence of a joint adventure relationship. How it is to be recognized and in what manner it must be presented and satisfied are more difficult questions which have not, as yet, been satisfactorily answered.

*Id.* at 453.
In *Berkan v. Brown*\(^{131}\) summary judgment against a counterplaintiff who claimed that a joint venture existed was sustained on the basis that no joint venture could have existed without an agreement by the alleged joint venturers to participate in any loss.\(^{132}\) The purported joint venture was between sellers of an interest in a cafeteria who became tenants in common in an interest in notes secured by a chattel mortgage on the sale.

An allegation that a joint venture existed also failed in *Kislak v. Kreedian*\(^{133}\) when the requisite agreement to share in losses as well as profits was not shown. The plaintiff alleged that the defendant wrongfully denied its joint-venture interest in a contract to purchase certain property. The purported joint-venture agreement was an oral one to purchase and develop a seven hundred lot tract in Palm Beach County, Florida. The plaintiff's sole assertion that it had always been ready to make its capital contribution was not sufficient to show a joint venture in view of the size of the project, the lack of a written agreement, and the failure of the complaint to state the necessary allegation of an agreement to share in losses as well as profits.

The court in *Phillips v. United States Fidelity and Guaranty Co.*\(^{134}\) refined somewhat the sharing-of-losses requirement. Plaintiff Phillips had agreed with Bates to enter the transportation brokerage business. Phillips was named as the employer in the agreement and was to furnish operating capital for the business. Bates was designated employee, and was given a "draw" of $100 per week. Net profits were to be divided equally between them. The action arose when Phillips attempted to recover on a fidelity bond after Bates' conversion of company funds. The issue of whether a partnership or joint venture existed between Phillips and Bates was critical to Phillips' recovery attempt, as the insurance policy expressly excluded any loss caused by a partner of the insured.\(^{135}\)

The court held that no joint venture or partnership existed for the sole reason "that the parties did not intend that Bates should share in or be responsible for the losses, if any."\(^{136}\) The venture in *Uhrig v. Redding*\(^{137}\) was distinguished on the basis that, while one

\(^{131}\) 242 So. 2d 207 (Fla. 3d DCA 1970), cert. denied, 246 So. 2d 111 (Fla. 1971).
\(^{132}\) *Id.* at 209.
\(^{133}\) 95 So. 2d 510 (Fla. 1957).
\(^{134}\) 155 So. 2d 415 (Fla. 2d DCA 1963).
\(^{135}\) *Id.* at 416.
\(^{136}\) *Id.* at 418.
\(^{137}\) 150 Fla. 480, 8 So. 2d 4 (1942).
party provided capital and the other services, the working partner did not receive any compensation for his efforts. If the venture were to have failed, he "would have exercised his skill and effort in vain," while the monied partner would have suffered loss of his capital. The working partner's "draw" of one hundred dollars in *Phillips* saved the agreement from being held a joint venture when there was also "no contemplation in the agreement for him to share losses." The court also provided a working definition of "share of losses," which "means to be responsible or liable for the losses created by the venture and liability, if any, to creditors or to third parties." The court thereby extended the requirements for the sharing of losses from the mere investment of labor without return to the necessary financial exposure based on the success of the enterprise. In *Russell v. Thielen*, the Florida Supreme Court similarly held that a joint venture existed when the working partner did not make a capital contribution per se, but instead stood to lose monies invested in preparing vacant lots for sale, together with their "more than two years of time and energy in promotion, advertising and development."

In *Navarro v. Espino*, the plaintiffs contended, and the court affirmed, that they were joint venturers entitled to a one-third interest, rather than mere lenders when they advanced the funds that enabled the defendant to close on property, when they were not to receive interest on the advance, and when they were listed as officers of the developer entity. Further, there was testimony that the plaintiffs were to have received shares of stock to evidence their joint-venture interest. Since the litigation was apparently prompted by the success of the project, the loss-sharing requirement, while stated by the court, was not developed.

While the cases hardly provide a precise answer to whether a lender with an equity participation interest could be construed to be a joint-venture partner of the developer, and therefore vicariously liable for the losses of the developer, they do provide some guidance for the lender who wishes to avoid such exposure. The problem is admittedly circular; that is, whether the lender could be

138. 155 So. 2d at 418 (quoting *Redding*, 150 Fla. at 484, 8 So. 2d at 6).
139. *Id.* at 419.
140. *Id.*
141. 82 So. 2d 143 (Fla. 1955); see also *Florida Tomato Packers, Inc. v. Wilson*, 296 So. 2d 536 (Fla. 3d DCA 1974), *cert. denied*, 327 So. 2d 32 (Fla. 1976).
142. *Russell*, 82 So. 2d at 145.
143. 316 So. 2d 646 (Fla. 3d DCA 1975).
EQUITY FINANCING

V. CONCLUSION

The equity participation loan for the development and construction of real estate projects may be viewed as something of a hybrid: the lender participates in the profits but, except to the extent that its loan funds are at risk, does not share in the losses. Thus, assuming that certain safeguards are taken, the loan invokes, but does not fall within, the scope of joint-venture law.

Yet the lender's dependence on the success of the venture for its equity participation may cause it to fall under the contingency exception to the Florida usury statute. With careful drafting, the parties may avoid an attack based on the indefiniteness of the contingent interest obligation or one based on its effect as a restraint on alienation.

The equity participation loan may be a solution to development financing needs during periods of higher interest and tight money, or when the speculative economics of a project make the prospect of a high contingent return sufficiently attractive for the lender to forego the maximization of its fixed return. The device's attractiveness to the borrower stems from its reduction of the fixed liability of stated interest, and the possibility that loan funds would be available on a contingent interest basis when they might not otherwise be offered.