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Caught by recapture

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On February 23, 2016, the Illinois Appellate Court, Second District, rendered an opinion on a topic of first impression regarding whether so-called "recapture rights" could be terminated via foreclosure. The case is *F.R.S. Development Co, Inc. v. American Community Bank and Trust*, 2016 IL App (2d) 150157, --- N.E.2d ---, (2d Dist. Feb. 23, 2016). Not only did the appellate court affirm the decision of the trial court, which found that recapture rights are not a part of real estate and cannot be terminated by foreclosure, it also affirmed the decision to award $179,000 in attorneys' fees to the appellee as the prevailing party in the litigation.

Recapture rights

While these rights are commonly referred to as "recapture rights," interestingly enough, the word "recapture" does not appear anywhere in the statute that authorizes them. The statute at issue is part of the Illinois Municipal Code, specifically *65 ILCS 5/9-5-1*. This statute authorizes a municipality to contract with a developer to install certain improvements within a proposed subdivision that will be used for the benefit of property outside of the subdivision that the developer is building. The developer is reimbursed for making these improvements from fees charged by the municipality to the owners of the property outside of the developer's subdivision when they are collected from those outside owners.

An example of a recapture situation is where a developer of a subdivision plans to install water mains for a residential subdivision that it is building and will connect those mains to the city's water supply. The city, however, knows that another developer is planning on developing another residential subdivision on the other side of the present developer, and requires the present developer to install water mains which are larger so that the next subdivision will be able to connect to the city's water supply with no water-flow issues. In order to allow the developer to be reimbursed for over-sizing the water mains that it is installing which will only benefit another property, the developer and the city enter into an agreement where the city will pay the developer for this over-sizing based on fees that the city collects—or recaptures—from the owners of the benefitted property when that subdivision is built and the other owners connect to the city's water.

The dispute

As with many real estate developments that began with such promise around 2003, the one at issue in this particular case fell victim to the real estate crash. This particular deal had many players, but the main ones were the Village of Huntley ("Village"), American Community Bank and Trust ("Bank"), F.R.S. Development Company, Inc. and F.G.M. of Huntley, LLC (collectively "FRS"). FRS had certain recapture agreements with the Village in relation to its development activities. The bank lent FRS $12,500,000 and received mortgages for two separate parcels of real estate and a security interest in all proceeds relating to a settlement agreement between FRS and another entity known as Huntley Venture as evidenced by a recorded UCC-1 statement.

Eventually the loan fell into default, and in 2009, the Bank filed foreclosure on the real estate as well as its security interest. The parties reached a settlement that resulted in a consent foreclosure.[1] As part of its settlement with the Bank, FRS assigned 80% of its recapture rights on one improvement to an unrelated third party, and the Bank agreed to release its security interests in all other chattel paper, accounts, and general intangibles of FRS, including those relating to a settlement agreement between FRS and Huntley Venture. Counsel for FRS also requested that the Bank formally release its security interests in recapture rights relating to a different improvement that was a part of the same development, and indicated its intention to assign those rights to a different entity known as Nelson's-Florida, LLC before title to part of the real estate was conveyed to the Bank in the foreclosure. The Bank did release any rights it had in any recapture rights that were to be assigned to Nelson's-Florida, LLC.

The consent foreclosure was finalized

and the requested releases and assignments occurred.

Problems arose between the parties when in 2011, Nelson's-Florida, LLC assigned its recapture rights back to FRS. When this occurred, FRS requested the Village to fulfill the terms of the recapture agreement and pass a recapture ordinance that would allow FRS to reap the benefits of the agreement which, according to the court's opinion, amounted to $1.3 million. The Bank informed the Village that FRS did not own the recapture benefits because, according to the Bank, they had been terminated via consent foreclosure. The Village indefinitely tabled the ordinance, and FRS sued the Village for breach of contract and sued the Bank for tortious interference with contract; the Bank counterclaimed for a declaratory judgment seeking an order that the recapture rights had been terminated in the foreclosure.

Court rulings

While multiple arguments were presented to the trial and appellate courts, this case ultimately turned on whether so-called "recapture rights" are real property – that can be foreclosed – or not. The appellate court eventually applied basic rules of statutory construction to determine that recapture rights are *not* real property, but are merely a contractual right to require a village to collect fees from others and re-pay the developer for benefitting real estate that the developer does not own. While the right to receive these payments certainly arose because of real estate, the right to those fees are not an interest in the real estate itself.

The Bank argued that the fact that the recapture statute requires recording of the recapture agreement shows a legislative intent that the rights be attached to real estate. The appellate court made quick work of this argument by noting that the legislature plainly stated in the statute (*65 ILCS 5/9-5-2*) that the purpose of recording the contract was only to give the owners of the benefitted properties notice of charges for connecting to and using public facilities. The "charge," as it were, was for connecting to improvements and not for merely owning real estate.

The appellate court also noted that if the legislature had intended recapture rights to be real property, Section *9-5-1* could have been drafted so that the benefitted properties had a lien on them for recapture payments. The fact that the legislature did not draft the statute in this way was telling for the court. Eventually, the court clearly held that recapture fees owed to a developer are not an interest in the benefitted property and are not subject to foreclosure.

Adding additional injury to the Bank is the fact that the settlement agreement it had with FRS contained a fee-shifting provision in the event of a dispute, with the prevailing party being entitled to have its fees paid by the non-prevailing party. The trial court awarded FRS $179,000 in fees, and the Bank did not contest the amount or the reasonableness of those fees. Curiously, the Bank merely argued that FRS was not the prevailing party. Because the appellate court affirmed the trial court's granting of summary judgment in favor of FRS, it had little choice but to affirm the decision to award fees.

Conclusion

While there were many parties, agreements and court orders surrounding this case, it all boiled down to whether recapture rights are a part of the bundle of rights that are real estate. The appellate court opined that *65 ILCS 5/9-5-1* is crystal clear and that no rights to real estate are implicated by the statute. While the Bank disagreed with that assessment, it simply could not persuade either the trial or appellate court of its position.

The oral argument to this case begins with the Justices asking if any court anywhere has dealt with the issue of whether recapture rights are real estate, and the appellant informs the court that neither party has found or cited to any case dealing with that particular issue. Certainly that makes this case one of first impression, but it also begs the question as to why this particular issue has never been ruled upon by any court. Has the issue simply never been raised, or was it something that contained ample clarity and needed no appellate guidance? If nothing else, this case solidifies the view that recapture rights are not a part of real estate.

It is interesting to note that oral argument before the appellate court in this case occurred on January 26, 2016, and the 11-page opinion was delivered on February 23, 2016. This short time-frame between argument and opinion signals that the appellate court had little difficulty in deciding the case against the Bank and in favor of the developer.

It is unclear if the Bank understood that it was allowing $1.3 million of recapture rights to be assigned away prior to the consent foreclosure being finalized, or if it simply did not understand that it could not foreclose any recapture rights because they are not real estate. It is also possible that the Bank doggedly pursued this litigation out of principle because it believed something unjust occurred when it released FRS and any guarantor with a consent foreclosure, and then FRS got the recapture rights worth $1.3 million re-assigned to it a few years later. While FRS receiving the benefit of the recapture agreement after being released from liability appears rather unfair, litigation based on principle is the most expensive litigation there is. ■

1. Consent foreclosures must release the mortgagor and anyone else against whom a personal deficiency judgment could be sought. *735 ILCS 5/15-1402(a)(1)*.