How To Avoid Flopping When Flipping Fla. Real Estate

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In an economy where land prices are rising, it is not unusual for a buyer who has a property under contract to consider flipping all or part of the property to another purchaser for a profit. If a contract gives the buyer a long due diligence or governmental approval period, the value of the property in a rising economy could substantially increase, making such a flip very appealing to the buyer.

Flipping is also appealing when a buyer has contracted to purchase a large parcel for development, but is presented before closing with changing market factors such as increases in carrying costs and interest rates, as well as more stringent underwriting standards for acquisition, development and construction financing.

If the buyer has to close on the purchase of the entire parcel at once, but can only develop it in phases, the buyer is forced to carry the undeveloped land on its books and pay debt service on it for the duration of the development process.

Certain markets in Florida implicate one or both of these scenarios at the present time, resulting in more developers considering the possible benefits of flipping to a third-party purchaser all or part of the property they have under contract. This is especially true of developers contracting to buy large parcels of property for the development of residential communities in which they also build homes.

In the last year or so, more of these developers have been either (1) contracting to flip property or portions of property they already have under contract, or (2) contracting to acquire property being flipped to them by another developer.

The flipping process could take several forms, each of which presents its own unique issues.

Assignment of Contract

The simplest approach is to have a contract that allows the buyer to assign its rights to a third party without needing the seller's approval beforehand. However, sellers are cautious about accepting such clauses since they do not necessarily want to deal with an unknown third party as a potential buyer. This is especially true if they are relying on the buyer's reputation and creditworthiness to fulfill its contractual obligations.

Even if the contract provides that the seller's only remedy for the buyer's default is to receive the buyer's earnest money deposit, the seller might be concerned about the buyer assigning the contract for a profit.

In cases where the seller's approval is necessary for such an assignment, the seller could negotiate to share in the profit in return for granting approval. Consequently, it is relatively rare for a buyer to successfully negotiate a contract that permits the buyer to freely assign its rights to another purchaser.

Limitations on Assignment

It is common for contracts to include limitations on assignment. For instance, the buyer may only have the right to assign it to an affiliated entity. Sometimes, the contract may state that the seller will agree to the assignment so long as it receives notice.

In other cases, the seller may agree not to unreasonably withhold consent to the assignment. In either situation, it is important to note that the buyer cannot assign the contract to an unaffiliated entity with the intention of making a profit.

Some buyers try to include a provision in the contract whereby the seller agrees to deed the property to a third party designated by the buyer at the time of closing, without actually assigning the contract to that party.

However, this approach is rarely successful, since sellers prefer the designated party to be an affiliated entity in order to ensure that the buyer does not profit by selecting an unaffiliated entity willing to pay a higher price.

The same limitations on assignment also apply when the buyer wants to close on a portion of the property and flip the remaining part to another buyer.

No matter how the contract's assignment clause is worded, if the buyer assigns all or part of the contract, or selects a designee or nominee to take title, the buyer remains obligated under the contract unless the contract explicitly states otherwise. Sellers routinely refuse to release the buyer from its obligations if the contract is assigned.

Documentary Stamp Tax

The state of Florida imposes documentary stamp taxes on deeds and other instruments related to the transfer of real property or interests in real property, pursuant to Florida Statutes, Section 201.02(1)(a).

The tax rate is 70 cents per $100 of the consideration — i.e., the purchase price — for the real property or interest being transferred, with the exception of Miami-Dade County where the tax rate differs. This tax must be paid to the recording office when a deed is recorded in the public records.

Most real estate practitioners are aware that this tax is levied on deeds. However, fewer know that it also applies to other instruments in which a real property interest is "granted, assigned, transferred, or otherwise conveyed to, or vested in, the purchaser."

According to the statute, even an assignment of a contract to buy land is considered as conveying an interest in real property. Consequently, if the assignee or purchaser pays the buyer for the assignment, the consideration — the assignment fee or profit — payable to the buyer triggers this tax. Although no deed is recorded, this tax must be paid to the Florida Department of Revenue when the assignment is given.

Therefore, buyers should take into account this transaction cost when negotiating to assign a contract to a third-party purchaser for a profit. In this situation, the tax requires the filing of a FDOR Form DR-228 with the state, accompanied by the tax payment.

Simultaneous Closings

If a buyer's contract prohibits an assignment without the seller's approval, the buyer may consider negotiating with the seller to obtain that approval by offering the seller a share in the profit.

While this approach can work, it obviously alerts the seller to what is going on and reduces the potential profit for the buyer. Therefore, buyers typically seek alternatives that keep their intentions under the radar and give them the entire profit.

This brings us to the subject of simultaneous closings. In this circumstance, instead of assigning the seller's contract to the purchaser, the buyer enters into a separate contract with the purchaser. The buyer agrees to sell the property to the purchaser either on or after the date when the buyer acquires the property from the seller.

This new contract presents its own unique concerns, because the buyer doesn't own the property at the time the new contract is signed.[1]

If the buyer wants to use the purchaser's cash to finance its acquisition of the property instead of using its own funds and later getting reimbursed, the buyer should negotiate a new contract with the purchaser. In this case, the buyer should (1) require that the purchaser close on the same day as the buyer's acquisition from the seller, and (2) plan for both closings to occur simultaneously.

It is not unusual for a buyer to want to conceal its intention to flip the property from the seller. This is because the buyer fears that the seller may not cooperate, or may even hinder the resale transaction, because the buyer may be making a profit that could have otherwise been paid to the seller.

Hence, the buyer may choose not to inform the seller of the new contract for resale of the property until the closing, presenting it as a fait accompli or keeping it confidential entirely.

Closing Costs

When the buyer acquires title from the seller and then reconveys it to the purchaser, certain closing costs arise that do not occur in a scenario where only a contract is assigned.

In addition to the documentary stamp tax levied on the deed from the seller to the buyer, the tax will also apply to the deed from the buyer to the purchaser. This tax is not just for the profit the buyer makes, but for the entire consideration paid by the purchaser for the property, which includes the price the buyer paid to the seller and the buyer's profit.

A new title insurance premium is also required to insure the purchaser's title, since the buyer and the purchaser will each have their own title insurance policies. Documentary stamp taxes and title insurance premiums are the two largest closing costs incurred in Florida real property transactions.

Title Insurers, Title Insurance Agents and Closing Agents

Key considerations in simultaneous closings involve selecting the right title insurer, title insurance agent and closing agent. The title insurer is the licensed title insurance company that will issue the title insurance policies for the transactions.

The title agent is the company or law firm acting as agent for the title insurer in issuing these policies. The closing agent is the company or law firm responsible for closing the transactions and may also serve as the title agent or title insurer.

It is important to note that title insurers, title agents and closing agents may have different views regarding simultaneous closings. Some may liken them to check-kiting, where the buyer uses funds it doesn't have — the purchaser's proceeds — to pay the seller and acquire the property being resold.

If the closings are structured properly and occur simultaneously, it can be asserted that the buyer is entitled to the purchaser's proceeds when they are used to pay the seller.

Although the analogy to check-kiting is not perfect, it is similar enough in concept to deter some title insurers, title agents and closing agents from participating in simultaneous closings. Therefore, it is critical to ensure that the parties chosen for these roles are on board with the simultaneous closings concept.

This may present a problem if it requires disclosing the resale to a title insurer, title agent or closing agent selected by the seller, as they may have a duty or may choose to disclose the resale to the seller.

If these parties are not cooperative — or if concerns about disclosure arise — and the buyer cannot resolve them, then the solution is for the buyer to use its own funds or borrow the necessary funds to acquire the property and then resell it to the purchaser on the same day for reimbursement. This possibility is discussed in more detail below.

When all parties are on board, simultaneous closings require a specific flow of funds.

First, the purchaser wires the purchase price to the designated closing agent stated in the buyer's resale contract. The funds should not be released until the title agent under the resale contract, which may also be the closing agent, secures a commitment from the title insurer to insure the purchaser's title and any associated mortgage.

In the second step, the closing agent wires the purchase price to the seller when the title agent under the initial sale contract, which may also be the closing agent, secures a commitment from the title insurer to insure the buyer's title. This process allows both transactions to close at the same time.

If the title insurers, title agents and closing agents involved in this process are the same under each contract, this flow of funds can work. However, if they differ, it can present difficulties that may be insurmountable.

At a minimum, the closing agents should be the same, even if the title insurers and title agents are different. If different closing agents are involved, the flow of funds necessary to close both transactions is interrupted.

The closing agent for the resale will hold funds that cannot be released to the closing agent responsible for the initial sale until the purchaser's closing conditions under the resale contract are met, which includes obtaining title insurance coverage. This presents a chicken-and-egg situation, requiring cooperation between the two closing agents.

This cooperation, in turn, necessitates disclosing the buyer's intentions to the closing agent named in the contract between the seller and the buyer. Failure to achieve this cooperation could result in the buyer (1) not being able to close with the seller due to the lack of necessary funds from the purchaser, and (2) not being able to close with the purchaser due to the inability to obtain the necessary title insurance coverage from the seller.

When the title insurers and title agents are different, it can lead to additional complications if they fail to cooperate effectively. This cooperation may require disclosing that the buyer intends to use the purchaser's funds to pay the seller.

If the seller discovers the buyer's plans, it can potentially interfere with them, and both title insurers and title agents may be concerned about facing legal claims by the seller, whether justified or not. They may also be concerned about facing claims from multiple parties if the closings are not consummated because of such issues.

If the buyer intends to flip the property and knows this when signing the contract with the seller, it is advantageous for the buyer to select the parties that perform these three functions. Then, when the buyer signs the resale contract, it can designate the same parties to perform those functions under the resale contract.

It is not unusual for the parties involved in a purchase and sale transaction to select the title insurer's escrow closing service to handle the closing — in this case, two closings. This involves paying a closing fee of about $1,000 to $1,500 per transaction. Despite the cost, it is worthwhile for the buyer to pay these fees to facilitate simultaneous closings.

There are two potential problems when the buyer tries to designate the title insurer, title agent and closing agent in the contract with the seller. First, the seller typically designates the parties that perform these functions, so this will take some negotiation. Second, the party that selects the title insurer and title agent typically pays the title insurance premium.

Therefore, if the buyer wants to designate the parties having these roles and facilitate simultaneous closings, the seller may demand that the buyer incur this expense.

In the ideal scenario, the following conditions are met: (1) the buyer is able to use a single company, the escrow closing service of a title insurer, to act as the closing agent for both transactions; (2) that company is also the title insurer for both transactions; and (3) the buyer uses that title insurer to issue both title insurance policies, or selects the same title agent to do so on the insurer's behalf.

Alternative Financing Methods

If circumstances do not allow for simultaneous closings, there are alternative options for the buyer.

One possibility is for the buyer to use its own cash or borrowed funds to buy the property and then sell it to the purchaser, even on the same day. Another option is for the purchaser to provide a loan to the buyer, which would be evidenced by an unsecured promissory note due immediately upon the buyer's closing with the purchaser.

The note amount could be credited to the purchaser against the purchase price due at the time of closing, but certain conditions would govern the release of the funds to ensure their use exclusively for the buyer's acquisition of the property.

In Florida, an unsecured note currently requires the payment of documentary stamp tax at the rate of 35 cents per $100 of principal, with a cap of $2,450. Although this tax may be incurred, it is a small price to pay to make the transaction work. In either case — buyer using cash or loan proceeds to close — concerns about the identities of the title insurers, title agents and closing agents would be eliminated.

If the resale price is substantial enough and the buyer has the means to pay the seller or obtain a loan without providing collateral, this can be a feasible way to achieve the buyer's business goals.

Simultaneous closings can work in the right circumstances, but they take time, effort and skill to arrange.

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[1] This implicates a number of contractual issues discussed here.