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HIDDEN TRAPS AND LIABILITIES

WHAT LURKS IN DISTRESSED CONDO AND
PLANNED UNIT DEVELOPMENT PROPERTIES?

DOMINIC G. COLLETTA, LANE POWELL PC

Hidden traps and liabilities

What lurks in distressed condo and planned unit development properties?

DOMINIC G. COLLETTA

The situation looks enticing: finished lots or condominium units in a great neighborhood being offered by a motivated seller. The price is bargain-basement, so buying and waiting for the market is a feasible strategy.

This scene is playing out in communities across the country. Failed projects are ending up in the hands of lenders anxious to move properties off their books, and buyers with cash can find deals that look very good. Before leaping at opportunities to purchase condominiums and planned unit developments, investors must look at a number of issues that will never show up in a title report or local jurisdiction development file. Acquisition of condominium units and planned development lots frequently includes special rights and ownership interests of a developer. An improperly structured acquisition may cause the purchaser to take on unexpected liability.

Potential liabilities fall into three broad categories:

1. COMMUNITY ASSOCIATION CONTROL

Condominiums and planned developments have recorded covenants ("CC&Rs") that, among other things, prescribe and restrict uses of the property, establish a community association with responsibility for common areas, and provide for assessment of the owners of units or lots by the association.

In most cases, CC&Rs and/or bylaws also provide for a period of time during which the developer has weighted voting rights or other authority that assures control of the association. In statutes that exist in many states, it is not necessary for the developer

to relinquish this control until as many as 75% of the units or lots are sold, or until a specific number of years have passed since the date of the first sale.

Most community associations are established as nonprofit corporations and are subject to state laws that govern their actions. Statutes and bylaws provide for certain duties and responsibilities, including notices of meetings to unit owners, meetings of the board of directors, and at least one meeting each year for the members (all owners of units or lots) of the association at which the board of directors is elected or appointed. Beyond these minimal requirements, the association must also keep adequate corporate and financial records, file any required tax returns or reports, perform its maintenance obligations, and establish assessments to cover operational and reserve costs.

When a project becomes distressed, there is a good possibility these obligations have not been fully performed. Failure to notice and hold meetings, to establish adequate reserves, to properly maintain common areas, or to turn over control of the association in a timely manner are all potential areas of liability that must be considered. Once owners of lots or units assume control of the association, you can be sure they will scrutinize the activities of the developer, looking to recover for failures to comply with statutes and the governing documents of the association.

2. ASSESSMENTS


Problems in this area can arise in two ways, either failure to set assessments at an appropriate level or failure to collect. The

lower the assessments, the more people can qualify for loans as purchasers. But if assessments are set too low, an association can find itself without adequate reserves, and possibly without enough to cover ongoing maintenance and operation costs. If the association, under developer control, sets unrealistically low assessments, potential liability can result.

Developers frequently have the right to defer payment of assessments until a lot or unit is sold. A buyer must determine whether unpaid assessment liabilities exist, whether payable by the developer or other owners. Also, even if deferred assessments of the developer have been regularly paid at the time of prior sales, a buyer must recognize that proceeds of future sales may be reduced by an amount equal to deferred assessments.

3. WARRANTY AND CONSTRUCTION DEFECT LIABILITY

Purchasers can unwittingly assume responsibility for construction liability and warranty obligations. Many states have statutes that provide a pass-through of certain liabilities from the developer to a purchaser or foreclosing party as a default position. Strategies exist to limit this liability, but require structuring the deal to avoid unnecessary assumption of liabilities.

Condominium and planned unit purchases require an additional level of due diligence and structuring of the transaction to avoid inappropriate assumption of liability. Awareness of hidden risks can help the buyer make an informed decision. 



DOMINIC G. COLLETTA is a shareholder at Lane Powell law firm, where he focuses his practice on real property developments, sales, acquisitions and financing transactions, including public-private partnerships and

commercial, residential and mixed-use development.
503-778-2182 :: COLLETTAD@LANEPOWELL.COM