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Recent Condominium Litigation and Risks to Developers

By Michael Bradford

Does anyone know of a recently completed condominium or condo-hotel project or one under construction that has not been subjected to threats of litigation, administrative action or purchase contract rescission? There may not be any. The current financial crisis, in which even the most credit-worthy developers cannot obtain construction financing, combined with a severe decline in real estate values has led to the real estate industry's very own version of a "run on the bank" in that persons under binding contracts to purchase condominiums are doing anything and everything they can to get out of their contracts and have their earnest money deposits returned. As a result, even the most carefully and competently drafted condominium purchase agreements are being micro-inspected for any flaw or defect that might allow a purchaser a foothold for a claim of rescission. Federal and state statutes and regulations are being analyzed to see if there is any ambiguity or provision that a purchaser can exploit. Some courts are ignoring industry standards and protocol and government agency rulings and stretching the plain meaning of statutes and regulations in order to rule in favor of purchasers seeking to rescind their purchase contracts. Is there anything a developer can do to protect itself in this environment?

There have been a number of lawsuits filed within the last year on behalf of condominium purchasers seeking to rescind their contracts prior to closing or, in some cases, seeking to unwind completed purchase transactions after closing. For every lawsuit that makes it to trial, you can bet there are hundreds, or even thousands, of disputes that are being handled privately through arbitration, administrative proceedings or settlements.

Several cases you are likely to have heard about are *Pugliese v. Pukka,* decided in October 2007, *Meridian Ventures v. One North Ocean,* decided in December 2007 and *Trotta v. Lighthouse Point Land Company, Inc.,* decided in February 2008. These are similar cases, each decided by Federal courts in Florida, which have set the tone for the current wave of purchaser claims. The plaintiffs in these cases attacked their purchase contracts for not complying with the requirements of the Interstate Land Sales Full Disclosure Act ("ILSFDA"). The courts held that the purchase contracts in question did not contain language required under the ILSFDA, resulting in the plaintiff purchasers being afforded the right to rescind their purchase contracts. The problem with these holdings is that they do not comport to the manner in which the ILSFDA has for years been interpreted not only by the development community but also by the Department of Housing and Urban Development ("HUD"), the agency responsible for administering the ILSFDA. In fact, the court in the Trotta case reached its decision despite the testimony including an affidavit from a former HUD attorney who stated that HUD had not previously interpreted the ILSFDA in the same manner as the court.

During 2008, there have been a number of new lawsuits filed and decided, mostly in Florida, although the lawsuits are spreading to other states as well. The common themes of these lawsuits are attempts by the plaintiff purchaser to show that the developers have failed to comply with federal and state laws, often because of defects in the purchase agreements or in representations made during the sales process. In particular, these lawsuits often include claims under the ILSFDA and Federal securities laws because these laws are difficult to comply with and the remedies for non-compliance can be severe (including rescission).

The ILSFDA claims usually are based on specific technical defects in the purchase agreement. In the Pugliese, Meridian and Trotta cases, the developers did not include specific language in the purchase contracts required under the ILSFDA (as interpreted by the courts). Violations of the ILSFDA can result in rescission rights regardless of how minor or technical the violation and regardless of whether the violation was even a factor in the purchase decision. For example, even where a purchaser is not in default under the purchase agreement or does not plan to be in default, if a purchase contract which is subject to the ILSFDA does not include specific language limiting damages to 15% in the event of a purchaser default, the purchaser will be afforded a two year rescission right. In other instances, developers have provided themselves too much flexibility in extending statutory completion

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date requirements. For example, in order to qualify for a commonly utilized exemption to the ILSFDA, developers must complete the sale of a condominium within two years from the execution of the purchase contract. The purchasers can rescind the purchase contract if the developers do not complete the sale within the two year period, unless the developers are able to extend the two year period. The ILSFDA, however, only permits extensions of the two year period under very limited circumstances. In their purchase agreements, some developers have improperly included broad rights to extend this window and have paid dearly for doing so. Several recent court cases have held that developers improperly included such provisions their purchase agreements and granted the purchasers rescission rights. It only takes one enterprising purchaser to win a lawsuit based on a defect in a purchase agreement. If all of the other purchase agreements for the project contain the same defect, which they most likely will, every such contract will be subject to rescission rights.

The securities claims typically arise in condo-hotel projects. The typical claim made by a condo-hotel purchaser is that the developer sold the condo-hotel units as investments and/or made misrepresentations regarding expected rental returns. Although most condo-hotel contracts include disclaimers and acknowledgments indicating that the condo-hotel units are not being sold as investments, purchasers are claiming that, through verbal communications with sales personnel and through various marketing materials, representations were made regarding returns on investment. If a purchaser is able to establish that the units were sold as investments, then the purchaser could be entitled to a rescission right and, possibly, damages. U.S. securities laws very clearly prohibit the sale of condominium units as investments, unless they have been registered as a security or sold as a private placement, which developers rarely do due to the excessive costs and advertising restrictions.

What can developers do to protect themselves from potential lawsuits or other actions by purchasers/owners to rescind or unwind purchase transactions? Although it may seem obvious, happy purchasers generally don't sue. Purchasers can become disgruntled for a number of reasons, including reasons that are within the developer's control (e.g., missing promised completion dates, rental income being lower than expected, higher operating costs, etc.) and reasons that are outside the developer's control (e.g., decrease in the value of the property, poor economic conditions, or purchasers who are simply dissatisfied by everything). There is often not much developers can do to prevent lawsuits arising from issues outside the developer's control, and developers cannot completely eliminate all risks of lawsuits regarding issues that are within their control, but they can take steps to minimize the risk of a lawsuits. Below are a few ways in which developers can minimize the risk of lawsuits, or at least of losing a lawsuit. Of course these are generalizations and the specific facts and situations of each project would require specific analysis.

- ***Prepare a good purchase agreement***

Possibly the most important thing a developer can do is to spend the time and money to carefully and painstakingly prepare a thorough purchase agreement. The purchase agreement should, among other things, fully disclose all costs and expenses involved in the purchase transaction (e.g., closing costs, pre-paid assessments, pro-rated taxes and assessments, developer fees, seed funding for reserves or HOA accounts), all costs involved in ownership (e.g., taxes, assessments, special assessment district fees, improvement bond fees, etc.), restraints on alienation (e.g., right of first refusal, resale restrictions, rental restrictions), disclaimers of liability, termination rights, arbitration, liquidated damages and a comprehensive set of disclosures (see below).

- ***Prepare comprehensive disclosures***

A thorough set of disclosures should be included in the purchase agreement or as an exhibit to the purchase agreement (we like to include our disclosures in the purchase agreement). We often are at odds with our developers and/or their sales team with respect to the extent and nature of the disclosures that we include in our purchase agreements; however, a comprehensive set of disclosures can really take the wind out of potential lawsuits and claims of rescission. Even though they may cause some difficulty at the sales table (e.g., you are selling an ocean front property and there is a disclosure indicating that view cannot be guaranteed), developers should not skimp on the disclosures. The disclosures should include any physical peculiarities of the project, legal issues, hazards and project features, to name only a few.

- ***Be as accurate as possible in the project documents***

There seems to be a trend toward commencing sales earlier and earlier in the development process. As a result, project documents provided to purchasers may be incomplete, speculative or factually incorrect. While we certainly understand the need to commence sales as soon as possible, this has to be balanced with the threat of affording purchasers with rescission rights that would be hanging over the developer's heads for several years until the project is complete. Some states, such as Hawaii, have a very low threshold for allowing purchasers to rescind contracts

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due to changes in project documents. While changes will always need to be made to project documents prior to project completion, developers should aim to minimize the materiality of these changes by being as accurate and thorough as possible in the versions of the project documents that are provided to purchasers even if this means delaying the commencement of sales until undecided issues are resolved.

- ***Don't be too optimistic with projection of completion dates***

Projected completion dates should be conservative. There is nothing that will turn a content purchaser into a disgruntled purchaser quicker then the realization that the project will not be completed when promised. Some of these purchasers may try to get out of their contracts while others may become difficult and demanding. Also, to the extent a developer has relied on the so-called "two year improved lot exemption" from registration under the ILSFDA, it is absolutely critical that the two year window not be missed (i.e., two years from the time a contract is signed until the time the project is completed and the contract is closed). Although there are some limited means to extend the two year window, they are risky and subject to challenge.

- ***Be cautious with deposits***

Another trend that is becoming more popular with developers is the use of purchasers' earnest money deposits prior to closing. In many states, deposits must be held in third party controlled escrow accounts until closing unless some form of security is posted (e.g., a bond or letter of credit). In many other states and foreign countries, however, no such security is required. Removing deposits from escrow can be a great benefit to the developer because it reduces the amount of the construction loan and, therefore, interest costs. The purchase agreement and any public offering statements should clearly disclose the developer's right to remove deposits from escrow and the purposes for which the developer may use them. The public offering statements should provide a warning that the deposits may be lost in the event the project is not completed (HUD requires such a statement).

- ***Draft project documents carefully***

Avoid absolute statements. For example, "the project is expected to include approximately 74 condominium units, but the developer is under no obligation to develop a minimum number of condominium units" is better than "the project will consist of 74 units." Plan for the unexpected. For example, in a condo-hotel project, the developer should have the right and ability to remove some or all of the condo-hotel units from the condominium regime or to add condo-hotel units to the condominium regime even if the developer has no plans to do so. Consider future development plans. Developers should always build in to the current plans and documents potential expansion of the project or expansion of nearby land owned by the developer.

- ***Carefully plan rental programs***

Condo-hotel rental programs have been a significant source of owner discontent. Due to securities law requirements, very little information can be disclosed about the rental programs during the sales process. Developers and their sales team must be very careful not to make representations regarding the rental program and, in particular, potential rental income. The purchase agreement should clearly state that sales of condo-hotel units should be based on the real estate and not on investment motives and that purchasers cannot rely on any oral representations. Provisions such as these will undercut an owner's ability to make a claim based on misrepresentations of rental income. Nevertheless, developers should take great care in designing their rental program to ensure that owners receive a fair return. Developers who are only interested in maximizing their own returns at the expense of their owners are more likely to be subject to lawsuits.

- ***Monitor the sales process***

Developers should not blindly turn over the sales process to the sales staff. Developers should review and approve the sales procedures and presentations and monitor them. Many of the current securities law claims stem from allegations by purchasers that the sales staff made improper representations of investment returns. Before sales commence, a meeting should take place among the developer, the sales team and the developer's attorneys to clearly set forth the rules regarding what the sales team can and cannot say (mostly what they cannot say) regarding the rental program.

- ***Know the law***

Complying with the many Federal and State laws can be a burden on developers. However, failing to comply can result in serious adverse consequences. For example, a failure to comply with the ILSFDA can provide purchasers with a two-year rescission right from the date of signing the purchase agreement. The ILSFDA includes very specific requirements that can easily be misinterpreted or overlooked by persons not familiar with it (and even those familiar with it). The securities laws are a minefield of

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potential issues, many of which are counterintuitive to developers and sales personnel. State registration and disclosure laws add yet another layer of rules and regulations that must be understood and followed. Developers should consult with an expert on such laws to ensure that their contracts comply with applicable law.

These are just a few of the issues that confront developers in today's litigious climate. It is essential that developers work with a qualified attorney and that they plan carefully to minimize the risk of a successful lawsuit or claim of rescission.