



**De-stressing the Due Diligence Process:**  
**Issues to Consider When Acquiring Distressed Residential Developments**

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“Distressed properties” is a term that for some represents opportunity - a chance to capitalize on bargain prices. A low price, however, is not always the benchmark of a good deal. Numerous issues beyond just the dirt and the bricks impact whether a distressed property is a good investment opportunity. If you are considering acquiring a distressed property, proper attention to adequate due diligence will help you understand the issues and obligations you stand to inherit and avoid costly hidden surprises.

Due diligence investigation need not be daunting. The focus of this article is to present issues that you, as a potential successor developer, should consider when purchasing distressed property within a planned community or condominium project (“Development”). While some of the issues raised apply to both residential and commercial distressed properties, the primary focus of the article is to raise issues particular to distressed residential properties.

This overview is broken down into three general categories of investigation and understanding: (1) the land, (2) the governance, and (3) the owners and contract holders.

**Understanding the Land**

The acquisition of distressed property should include all of the customary due diligence applicable to any land acquisition, but must also include consideration of issues that are unique to the acquisition of a distressed Development, as discussed below.

*Title Investigation*

When considering the purchase of distressed property, a thorough investigation of the condition of title is imperative. In addition to the standard search of recorded easements, plats, surveys, tax assessments, and other encumbrances, pay special attention to any liens, judgments, UCC Statements, and existing leases on the property as these may have significant implications. For example, if a predecessor developer pledged membership interest in the developer entity, a release of the UCC Statement may be necessary before the developer has the necessary authority to enter into a binding sales contract for the property. Carefully review any leases and determine whether the lease subordinates to a new owner or lender as well as what obligations and rights you retain under the lease, such as restrictions on uses within the property, rent increases or space renovations.

### *Land Use, Zoning, and Other Matters*

Failure to adequately investigate the land use and zoning requirements can result in unusable property. Ask whether the current use of the property is permitted under the local zoning ordinance or is a result of a variance granted to the predecessor developer. If a variance was obtained, be aware of any applicable conditions and confirm that each of your anticipated uses for the property is permissible. Be aware of permits issued for the property by federal, state or local authorities, utilities providers and others that have an impact on the Development. When reviewing permits issued for the Development, pay particular attention to whether such permits are transferable to a successor developer and whether there are any expiration dates, requirements for extensions and conditions imposed in the permits.

Review any Planned Use Development Order (“PUD”) issued by the controlling government authority affecting the property. A PUD may require that infrastructure within the Development be completed within a certain timeframe. Evaluate the status of construction of the infrastructure and, if necessary, whether extensions may be obtained for you to meet any deadlines under the PUD.

### *Environmental Considerations*

The federal, state, and local environmental laws are voluminous in number and complex in nature. The risk of environmental liability is continual and ongoing and can result in severe civil and criminal penalties for failure to comply. Proper environmental due diligence is essential to minimizing your exposure to future environmental liability. Review any environmental reports, notices of violations, internal reports or memoranda, any pending or threatened litigation involving the Development, and any other environmental-related documents pertaining to the Development. Inquire whether the predecessor developer is aware of any environmental matters relating to or affecting the Development. Examine any existing permits, licenses, authorizations, approvals, variances, and the like, issued for the Development and the assignability of such permits. Similar to any land use permits, verify expiration dates and renewal or extension possibilities for each permit. You do not want to purchase waterfront property with the expectation of building docks or a marina only to discover that the permit for doing so has expired and cannot be renewed.

## **Understanding the Governance Structure**

### *Governing Documentation*

Any developer considering the purchase of a distressed Development, be it a mixed-use community, master planned community or condominium, must understand the operation of the community governance structure. Review any documentation affecting the Development, including, for example: (1) the declaration of covenants, conditions and restrictions and/or declaration of condominium (including any amendments or supplements) (the “Declaration”); (2) the articles of incorporation and by-laws of each owners association; and (3) any cost-sharing agreements entered into by the predecessor developer or owners association for the purpose of sharing of expenses incurred on behalf of the Development or owners within the Development.

Review all documents for compliance with applicable state law governing planned developments or condominiums. Thoroughly review the governing documents to understand the rights that may be acquired by a successor developer as well as any responsibilities and financial obligations. It is especially important to determine whether you will retain or can assume the development rights and special declarant rights set forth under the governing documents. For example, review the Declaration to determine key issues such as:

(1) the period in which you, as “declarant” under the Declaration, have the right to: (a) annex additional property; (b) use portions of the property for sales activities; (c) appoint and remove directors, officers, and committee members of the owners association; (d) establish or exercise any architectural controls; and (e) unilaterally amend the Declaration and under what circumstances;

(2) declarant’s liability for assessments, any exemption from assessments or right to satisfy assessment and other payment obligations through “in kind” contributions of services or materials; and

(3) declarant’s right to convey property to the owners association as common area, and to require the association to accept such conveyance and maintain such property.

#### *Common Areas and Common Elements*

Review any master plan, recorded plats, and condominium surveys of the Development in conjunction with the Declaration. With respect to condominiums, determine how the boundaries of each unit are defined. In addition, it is important to understand which areas have been designated as common (or limited common) areas or elements. Assess the status of any improvements on the common areas. Determine whether the common areas have been subjected to the Declaration and conveyed to the owners association. If the common areas have been conveyed to the owners association, obtain and review the conveyance documents.

#### *Amenities and Recreational Facilities*

It is also important to know what the predecessor developer previously proposed to consumers concerning the amenities and recreational facilities (the “Facilities”) within the Development. This is of particular importance when lots or units have already been sold or you plan to assume existing sales contracts. Ascertain which Facilities have been promised versus merely proposed keeping in mind that purchasers may have relied on the promises of the predecessor developer when purchasing their lot or unit. Assess the construction status of the Facilities and determine if any of the partially built or unbuilt Facilities should be completed. Review all contracts related to construction, including architects’ contracts and other professional contracts, to determine any remaining obligations or rights of the predecessor developer that you may inherit, including whether you will be required to remedy any defaults of the predecessor developer. Analyzing the potential liabilities that you may incur with respect to construction defects is an important consideration.

Determine whether Facilities were intended to be owned by the owners association or as private facilities to be owned by a club or other third party. If a club is involved, review all of the club documents, including the membership plan, membership agreement, rules and any other

club documentation provided to consumers or recorded in the public records. Important issues to consider include, whether membership is optional or mandated by the Declaration, the type of fee structure, and whether the club is an equity or non-equity club.

### *Association Matters*

Essential to the operation of a Development is the owners association. Note that some Developments may have layers of associations, for example, a master association and sub-associations. Review the association's corporate and financial records and whether control of the association has been transitioned to the owners, either formally or de facto. Obtain and review copies of all association records, including the articles of incorporation, by-laws, corporate minutes, financial and tax records, and management and service contracts.

Determine whether budgets for the association have been properly adopted. Is the association adequately funded? Has an adequate reserve fund been established? Have any required payments been collected at closing? Determine whether the predecessor developer promised any exemptions to the payment of assessments. In addition, determine whether there are any caps on assessments or if the predecessor developer has delayed the commencement of the payment of assessments. A successor developer needs to understand what obligations it may incur under the Declaration and applicable state law to finance any deficit of the association (or an under funded budget) as well as any limitations that may exist on increasing owner assessments.

### *Architectural Control and Builder Program*

Review any architectural control provisions and procedures in the Declaration as well as any guidelines established by the predecessor developer or promulgated by the association and the ability for a successor developer to alter any such controls or procedures.

If the predecessor developer implemented a preferred builder program, any agreements with builders should be reviewed to confirm whether they may be terminated or, if desired, assumed.

*Federal Housing Administration ("FHA"), Federal National Mortgage Association ("FNMA"), and U.S. Department of Veterans Affairs ("VA")*

If you want FNMA loans or FHA-insured or VA-guaranteed mortgages available to purchasers within the Development, review the governing documents to determine whether they comply with the applicable agency's guidelines. In order for purchasers to be able to apply for such loan programs, the Development's governing documents must comply, or be amended to comply, with the applicable agency's guidelines.

### *Warranty Liabilities and Obligations*

Be cautious of any situation where there is risk of incurring significant liability with respect to construction defects and warranty claims. Review all construction-related contracts of any completed or partially completed improvements buildings to determine what rights and obligations you may assume in the event of a construction defect claim and what, if any, recourse exists against any contractors. In addition, obtain and review copies of any warranties issued to the predecessor developer, including, manufacturers' warranties for appliances to be acquired and warranties for work completed on the property to be acquired. Determine the remaining life of each warranty and whether the warranty may be assigned. Also, review any sales contracts you plan to assume to determine any warranty obligations created by the predecessor developer.

### *Terminating the Condominium Regime*

You may plan to terminate a condominium regime within a Development, for instance to convert a distressed condominium into rental apartment buildings. Terminating a condominium requires an understanding of the procedures required by the governing documents and state law. Before terminating a condominium, you must also evaluate the rights of any existing unit owners and contract holders.

## **Considering Existing and Future Owners and Contract Holders**

### *Contract Holders*

If there are sales contracts that have not closed, assess whether such existing contracts will, in fact, proceed to closing. In those Developments where there is a high percentage of speculative buyers (e.g. condominiums), there is a significant likelihood that contract holders may default on their closings and pursue legal action to recapture any earnest money deposits.

### *Land Sales Laws*

If a successor developer will assume sales contracts entered into by the predecessor developer, it is especially important to understand the federal and state land sales laws applicable to the Development and to each contract to be assumed. Noncompliance may result in rescissions and claims of damages.

### *Federal Land Sales Laws*

The offer and sale, within the United States, of property is regulated by the Federal Interstate Land Sales Full Disclosure Act (15 U.S.C. §1701, *et seq.*) ("ILSFDA"), administered by the U.S. Department of Housing and Urban Development ("HUD"). Under ILSFDA, unless an exemption is met, property must be registered with HUD. This is particularly important to a successor developer that assumes contracts from a predecessor developer because failure by the predecessor to comply with ILSFDA may open the assumed contracts to rescission by the purchasers. The Development acquisition agreement should include representations and warranties that the predecessor complied with ILSFDA and other applicable laws. The predecessor developer should also indemnify the successor developer against claims related to the Development concerning alleged ILSFDA violations by the predecessor developer.

If the Development is registered under ILSFDA, review all documents filed with HUD to confirm the registration requirements were fulfilled. Determine whether each purchaser received a complete effective Property Report prior to signing a sales contract. If a Development is not exempt from registration under ILSFDA and an effective Property Report is not provided to the purchaser prior to signing the sales contract, the purchaser is entitled to cancel the contract for two years after he or she signed the contract. This cancellation right survives closing. The acquisition agreement for the Development should be clear that if any contract that the predecessor closed is later cancelled as a result of the predecessor's failure to comply with ILSFDA, the liability for such rescinded contract remains with the predecessor developer.

If a Development is not registered with HUD, determine if an exemption under ILSFDA was satisfied. This analysis is crucial to measuring the risk that past sales may be rescinded. For example, if more than 99 lots were marketed pursuant to a common promotional plan<sup>1</sup> and sold in reliance upon the 100 Lot Exemption<sup>2</sup>, all of the sales that relied on the 100 Lot Exemption may be open to rescission. Another commonly used ILSFDA exemption is the Improved Lot Exemption<sup>3</sup>, which is available for lots or units sold pursuant to a contract that obligates the seller to complete a home or unit within two years of the date that the purchaser signed the sales contract. A contract under the Improved Lot Exemption may permit a delay in the seller's two year build period only under extremely narrow circumstances, otherwise the exemption is lost. Contracts that relied upon the Improved Lot Exemption should be reviewed closely as there has been significant recent litigation over specific contract provisions under this exemption.

#### *State Land Sales Laws*

Whether the predecessor developer complied with applicable state land sales laws should also be considered. Review sales contracts to determine if any purchaser's state of residence is a state that requires registration of a development prior to marketing it within the state (a "Closed State"). Review contracts with Closed State purchasers for compliance with the Closed State's land sales laws. If the Development was not registered in applicable Closed States, determine whether the transactions qualified for an exemption or were otherwise conducted in a manner that did not trigger the jurisdiction of the Closed State. Understanding the marketing activities of the predecessor and the status of any Closed State registrations is important to measuring the potential risk that prior sales may be open to rescission under applicable state laws.

If the Development is registered under ILSFDA or any state land sales laws, consider requiring, as a part of the acquisition closing, that the predecessor developer terminate such land

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1 "Common promotional plan" means a plan, undertaken by a single developer or a group of developers acting in concert, to offer lots for sale or lease; where such land is offered for sale by such a developer or group of developers acting in concert, and such land is contiguous or is known, designated, or advertised as a common unit or by a common name, such land shall be presumed, without regard to the number of lots covered by each individual offering, as being offered for sale or lease as part of a common promotional plan. 15 U.S.C. §1701(4).

2 15 U.S.C. §1702(b)(1) provides an exemption from registration under ILSFDA for the sale of lots (or units) in a subdivision containing less than 100 lots that are not exempt under 15 U.S.C. §1702(a). The 100 Lot Exemption provides an exemption from registration with HUD but not from compliance with certain disclosure and contract requirements.

3 15 U.S.C. §1702(a)(2) provides an exemption from registration under ILSFDA for the sale of land that is improved with a residential building or sold pursuant to a contract obligating the seller to complete such a building on the land within two years of the purchaser signing the sales contract. Commonly used with condominiums.

sales registrations. This may help reduce confusion with the state agencies when the successor developer files registrations for the Development.

### *Prior Representations*

It is important to understand the scope of the predecessor developer's promises and representations made to contract holders and lot or unit owners, which representations were obligations and which were proposed plans. Review any Property Report, contracts to be assumed, and promotional material produced by the predecessor, such as pamphlets, plans, websites, broadcast scripts, and mailers. Understanding the predecessor's marketing strategy will help you understand expectations of contract holders and owners within the Development and weigh the consequences of making changes. An analysis of the representations made by the predecessor developer is essential to determining whether planned changes to development plans or the governing documents may open sales contracts to rescission by the contract holder.

### **Conclusion**

The above is an overview of many of the due diligence issues to be considered by successor developers when acquiring a distressed Development. While this list is not exhaustive of the matters of concern to successor developers, it provides a starting point by which to review potential Development opportunities and to avoid unintended consequences.