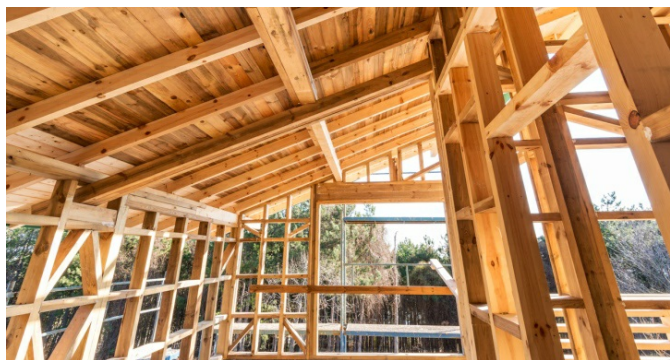


Property Owners Association Considerations for Incomplete Developments

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Incomplete Developments - Property Owners Association Considerations

The recent economic storm has left many incomplete real estate developments in North Carolina, and that number is likely to increase. Acknowledging the increased need for legal counsel in connection with incomplete condominiums and planned communities, the purpose of this article is to identify and describe considerations related to the property owners associations in those incomplete developments. In addition to property owners associations, these considerations may be relevant to other types of clients, including opportunistic developers evaluating the possible acquisition of an incomplete project, lenders exercising the right of foreclosure on an incomplete project, struggling developers trying to keep a project afloat, and residents who own property in an incomplete development. There are certainly significant considerations beyond the scope of this presentation, including valuation questions, potential successor liability, and options for cooperation among lenders, contractors, developers, and municipalities. However, as mentioned above, this presentation will focus only on considerations related to property owners associations. A checklist of some of those considerations is attached as [Exhibit A](#).

Incomplete developments or projects as described in this article include planned community and condominium developments that were interrupted prior to the sale of substantially all of the lots or units. In the most common example, that interruption was the result of the expiration or termination of the developer's financing before the developer completed the project. Of course, the level of completion is project specific. If the initial phase of a project is complete, and the developer simply is unable to add additional phases, the development's distress may be relatively minor. However, if a project is interrupted in the middle of the construction of a particular phase, or prior to the construction of required infrastructure, amenities, or other common element features, the development's distress could be substantial.

1. Legal Status of the Association

All owners associations for planned communities covered by the North Carolina Planned Community Act, N.C. Gen. Stat. §§ 47F-1-101, [et seq.](#) ("Planned Community Act"), must be incorporated as nonprofit corporations. All owners associations for condominiums subject to the North Carolina Condominium Act, N.C. Gen. Stat. §§ 47C-1-101, [et seq.](#) ("Condominium Act"), must be organized as corporations, or as unincorporated nonprofit entities. As a matter of practice, virtually all associations are incorporated as nonprofit corporations. Basic information about the incorporated status of an association can be determined by the public records available

through the North Carolina Department of the Secretary of State's website. That information includes the legal name of the owners association; the registered agent and address of the association; and, in most cases, a copy of the Articles of Incorporation for the owners association. As a threshold consideration, an attorney evaluating an incomplete development should verify the status of the owners association by checking those records.

In addition to the legal status of the owners association, one also should consider the fundamental obligation of a unit or lot owner in a planned community or condominium to be a member of a particular owners association. Under the provisions of both the Planned Community Act and the Condominium Act, an owners association membership must include exclusively all of the owners of units or lots included in the development. In some cases, the governing documents for the named community or condominium also may require the unit or lot owners to be members of additional owners associations or clubs.

The Bylaws of owners associations are the fundamental operating document for the association. Under the Condominium Act and the Planned Community Act, there is no requirement that the Bylaws be recorded. Part of the appropriate due diligence regarding an incomplete planned community or condominium should include a determination as to whether Bylaws have been properly adopted and a review of the Bylaws.

2. Officers and Directors

Active and effective governance of an owners association is essential to the health and success of a development. Although the responsibilities for an association are typically more critical in a condominium than in a planned community, most developments cannot operate effectively without active participation by the governing directors and officers of the association. Insurance premiums must be paid, maintenance of common elements must be performed, and an appropriate budget must be adopted and maintained so that assessments can be collected from the unit and lot owners to fund the fundamental obligations of the owners association. When there is an absence of leadership for the owners association, the association is at risk for liability to third parties, and the quality and condition of the common elements will inevitably suffer.

Unfortunately, the operation of an owners association often falls by the wayside when times get difficult for a development. All too often, developers consider the healthy operation of the owners association as a tangential concern or annoyance rather than as an essential aspect of the health of the development. Therefore, the officers and directors of an owners association may not be well established in an incomplete development. Of course, for an owners association to be able to take effective corporate action, it must have a properly authorized board of directors, and also should have properly appointed officers. An evaluation of an incomplete planned community or condominium should include consideration of the current directors, current officers, and the authority for the action by which those directors and officers were elected or appointed. Because a developer often will retain a right to appoint directors and officers unilaterally, the identification of those directors and officers may not be well documented in the records of the owners association.

Developer control over the appointment and removal of directors and officers can be a significant factor in the governance of an owners association. The authority to make those appointments is a commonly-retained development right. Although it should be explicitly relinquished in the form of a recorded document, often the relinquishment of this control is not addressed in a timely manner. The unsuccessful developer's lack of continuing interest or participation can cause a meaningful problem if the unit or lot owners are not authorized to elect replacement directors and the developer is unwilling to appoint or remove directors or relinquish its unilateral rights to do so. In evaluating an incomplete community, it is important to consider the development right to appoint directors or officers, the duration of such appointment, and the facts related to the exercise of those rights. Remember that the declarant rights can be assigned to successors and, therefore, the entity

holding the right to appoint directors and officers may be different from the entity initially granted that right in the development's declaration. Also note that, with regard to condominiums, the Condominium Act limits the developer's right to appoint directors. Section 47C-3-103 of the Condominium Act requires the developer to allow the unit owners to elect members of the Board of Directors incrementally based upon the number of units conveyed in the condominium.

3. Financial Status of the Owners Association

The incomplete or distressed nature of a development typically bodes poorly for the financial status of the owners association. Whether as a result of unreasonably low assessments, mismanagement of association funds, the developer's legitimate exemption from the obligation to pay assessments or illegitimate failure to do so, or any number of other factors, the budget of the owners association in an incomplete development is almost always under-funded. Regardless of the client's perspective, evaluation of the owners association budget, balance sheet, and cash flow should be included in any due diligence investigation of an incomplete development.

The first essential question is whether a budget exists at all. Under both the Condominium Act and the Planned Community Act, the Board of Directors of the owners association is responsible for proposing and adopting a budget for the common expenses of the association. That budget then is to be ratified at a meeting of the membership. An investigation into the financial status of an owners association should include not only obtaining a copy of the purported current budget, but also verifying that the budget was adopted and ratified appropriately. A subsequent appropriate step is to compare the budget to the actual income and expenses of the owners association to determine whether or not it is realistic. Some common areas of concern for an incomplete development include inadequate consideration of the cost of collections of past due assessments, inadequate funding of reserves, and failure to take into account the developer's financial contribution (or lack thereof) to the owners association. Without an appropriately adopted budget, the association may lack the authority to collect assessments from the owners, which, of course, would put the association in greater financial peril. Therefore, in the event that there is not a properly adopted budget, the association should take the necessary and appropriate steps to adopt and ratify a budget promptly.

The collection of assessments is the owners association's fundamental and, typically exclusive, source of income. Whatever the common expenses might be, they must be funded by the lot or unit owners in the community or condominium. Therefore, the levy and collection of assessments are critical to the financial vitality of the owners association. An evaluation of an incomplete development should include a critical analysis of the assessment collection efforts. The attorney should verify that the association is collecting assessments consistent with the budget, in proportion and pursuant to the allocations required by the governing community or condominium documents, and in a consistent and timely fashion. Owners associations also should have collections policies and should adhere to those policies. The appropriate collections policy for any given owners association will vary significantly depending on the needs of the community or condominium, but consistent application of a well-reasoned policy is universally appropriate.

The developer's obligation for financial contribution to the owners association may be established by the governing community or condominium documents, the provisions of the Condominium Act or the Planned Community Act, or additional agreements between the developer and the association. A developer's failure to make good on those obligations can be a significant problem for an incomplete development. Slow sales also can lead to inadequate developer contribution to the owners association budget. If the developer has a legitimate exemption from assessment obligations and the association adopts a budget in anticipation of a certain rate of sales, the simple fact that the developer owns lots longer than expected will cause a budget shortfall. Anyone evaluating the status of an incomplete development should consider both the developer's

obligations and the developer's history of performance under those obligations before drawing any conclusions about future contributions from the developer to the owners association. The following are provisions in the Condominium Act and the Planned Community Act that are particularly applicable to that analysis:

- Prior to the levy of assessments in either a condominium or a planned community, the developer is responsible for all of the common expenses. See N.C. Gen. Stat. § 47C-3-115(a) and § 47F-3-115(a).
- Allocations for the obligation to pay common expenses may not be described by a formula that favors the developer and units owned by the developer in a condominium. See N.C. Gen. Stat. § 47C-2-107(b).
- There is no provision in the Planned Community Act that prohibits the developer from retaining an absolute or partial exemption from the obligation to pay common expense assessments.

Often the governing documents of a condominium or planned community will provide for a developer obligation or right to cover any shortfall in the association budget. These provisions vary substantially with regard to the developer's obligation, the association's ability to enforce that obligation, and the association's obligation to repay those contributions at a future date. Analysis of any such provisions should be part of the due diligence evaluation of the financial status of an association.

The budget for any owners association that is responsible for the long-term maintenance of capital improvements should include reserves. The appropriate philosophy for calculating the necessary reserves will vary greatly depending upon the nature of the common element capital improvements, the membership's tolerance for special assessments, and the association's insurance coverage. Nonetheless, if there are capital improvements to be maintained by the association, the inclusion of at least some reserves in the budget is appropriate. An evaluation of an incomplete development needs to include inquiry as to the current status of the association's reserve accounts and investigation regarding any reserve studies performed for the community.

When sales are slow, there may be tremendous pressure on a developer to find ways to make the community as marketable as possible. Unfortunately, buyers have historically considered low assessments a desirable selling point. The inevitable result is that the developer-controlled Board of Directors often will establish a budget that sets assessments that are lower than they should be for the financial sustainability of the association. Often it is appropriate to encourage or initiate steps to revise the budget in a way that will allow the association to remain solvent.

4. Status of Common Elements

Condominiums always include common elements, and virtually all planned communities include some common elements. A fundamental distinction is that title to the common elements in a condominium is held by the unit owners as tenants in common, whereas the common elements in a planned community are owned by the owners association. Because the common elements in a condominium typically are dedicated to the condominium upon formation, there is rarely any issue related to the dedication or conveyance of common elements in a condominium. In a planned community, however, the developer often fails to convey property intended as common elements to the association in a timely manner. Therefore, an evaluation of the property that has, in fact, been conveyed to an owners association for a planned community in addition to the property that should be conveyed to the association is appropriate. Often the governing documents for a planned community will describe the conveyance of common elements to the owners association, the timing for the conveyance, and the nature of the deed that will be utilized to accomplish the same. In the absence of such language, one should consider the intent of the parties. To the extent that there are tracts of real property that should be conveyed to the association, it may be appropriate for your client to complete, initiate, or facilitate those conveyances. Although often included in the collateral for the developer's

construction or development loan, the land intended as common element for a planned community typically has little resale or collateral value. Therefore, the realistic valuation of that property by a lender is critical.

Conveyance of real property that is intended to be included in the common elements is typically beneficial for both the owners association and the developer. The developer rarely benefits from ownership of such property and very well may be subject to potential liability, maintenance obligations, ad valorem tax liability, and other undesirable effects related to the ownership of land. The owners association typically is motivated to obtain title to that property so that it has the authority and right to maintain and use that property, and to avoid any future concern about foreclosure, judgment liens, or bankruptcy that might interfere with the association's and its members' use and enjoyment of that property.

Some specific examples of real property that may be, or intended to be, common elements for a planned community include:

- Private streets and roads;
- Amenities, including clubhouses, pools, entryways, signs and features, and exercise trails;
- Stormwater management facilities; and,
- Utilities facilities.

The quality of title to the common elements also must be considered. In a condominium, title issues regarding the common element property usually arise from matters which occurred, or did not occur, at the formation of the condominium. If there was a development lender, that lender should have consented to the imposition of the condominium regime by signing off on the condominium's declaration. The absence of such consent raises meaningful questions about a condominium purchaser's rights in the event of a foreclosure (even if the unit itself was explicitly released from the development lender's deed of trust). A critical consideration of the property dedicated to the condominium is also appropriate. The real property dedicated to a condominium may be described in the development's declaration or depicted on the condominium plat, or both. A due diligence evaluation of an incomplete condominium needs to include a critical analysis of the property included in the common elements of the condominium, property that may be annexed as additional property in the condominium pursuant to development rights retained, and property that may be withdrawn pursuant to development rights.

The quality of title to common element property in a planned community is a frequent area of concern for an incomplete development. Real property intended for the common use and enjoyment of the members of the planned community should be conveyed free of liens and encumbrances other than the governing documents for the community. When a project develops or sells slowly, there is an increased risk that property intended to be conveyed to the owners association will become encumbered by contractor liens, judgment liens, or similar claims. Furthermore, if the relationship between the developer and the development lender becomes strained, the lender may be unwilling to release any collateral, including property intended for the common use and enjoyment of the lot owners in the planned community. From the lender's perspective, this may not be a wise tactic, as the common element property probably lacks meaningful resale value and also may be important to sustaining the resale value of the lender's other collateral (e.g., the lots in the planned community). These risks are exacerbated if the developer fails to convey common element property to the owners association promptly. Unfortunately, like governance of the owners association, developers for distressed projects often disregard conveyance of common element properties as an important step amidst the duress of trying to keep the development afloat. In addition to the concerns regarding liens, it is also a significant problem for an incomplete planned community if the developer files for bankruptcy prior to conveying intended common element property to the owners association. Developers rarely explicitly obligate themselves to convey specific common element property in the planned community declaration and,

therefore, an owners association may have a difficult position as a party in interest to a bankruptcy of the developer.

The physical condition of the common elements is also a relevant factor. An analysis of the physical condition of the common elements of a condominium should be an important part of the analysis of an incomplete development. The attorney conducting the investigation also should consider any claims or pending claims by a condominium owners association against the contractor or developer related to the physical condition of the common elements. In a planned community, a similar physical analysis of the common elements is also appropriate in connection with any analysis, particularly where those common elements include vertical improvements (like a clubhouse) or private roads and streets. One of the fundamental obligations of most owners associations is the maintenance, repair, and replacement of the common elements. In order to fully understand the extent of that obligation, one must have a reasonable understanding of the then-current physical condition of those common elements.

5. Contracts and Permits

Owners associations typically enter contracts with service providers, and often are named as the permittee under permits related to common elements. A due diligence investigation of an incomplete development should include a review of those contracts and permits. Because an owners association for an incomplete development is likely to be under some financial duress itself, a critical evaluation of the service contracts is appropriate to understand both the financial obligations of the owners association and the opportunities that may exist to reduce those financial obligations. Furthermore, permits to operate stormwater management facilities, utilities, and improvements adjacent to or affecting wetlands and waterways often are vested appropriately in the owners association, but also include responsibilities and liabilities that need to be addressed in terms of financial planning and risk exposure.

As business entities, transitional owners associations often do not pay sufficient attention to their contractual obligations. This situation is exacerbated when the governance of an association is uncertain. The result can include term-to-term contracts that continue simply by virtue of the association continuing to pay the bills, and possible inefficiency and provision of unnecessary services to the association. Another potential concern with regard to contracts is those that were entered into by a developer-controlled board and are not necessarily in the best interest of the association. Typically, the most significant service contract for an association is the community management contract, and certainly this contract should be considered carefully.

The Condominium Act and, to a lesser extent, the Planned Community Act, afford an opportunity for owners associations to terminate contracts entered into by developer-controlled boards:

- Section 47C-3-105 allows an owner-controlled Board of an association to cancel many types of contracts entered into on behalf of the association by a developer-controlled board without recourse from the service provider. Those categories of contracts that may be terminated include: (i) any management contract, (ii) any employment contract, (iii) any lease of recreational or parking areas or facilities, (iv) any contract between the association and the developer or an affiliate of the developer, and (v) any contract or lease that was not bona fide or was unconscionable.
- The similar provision of the Planned Community Act, N.C. Gen. Stat. § 47F-3-105, is significantly more limited, but does allow an owner-controlled board to cancel unconscionable contracts or leases, and those that are not bona fide.

The cancellation rights provided by both of these provisions in the respective Acts allow cancellation or termination anytime after the lot or unit owners take control of the Board, provided that the required notice is

given to the service provider. This can be a very valuable tool to an owners association in an incomplete development facing financial duress and in need of mechanisms to reduce expenditures.

Stormwater management is a significant consideration for developments along the coast, and is becoming a more and more significant consideration for developments throughout the state of North Carolina. Many stormwater management permits for planned developments and condominiums require continued maintenance after the completion of the appropriate stormwater management facilities. Because the stormwater management facilities are required for and benefit the property included in a development, it is appropriate that the stormwater management facilities be included in the common elements of the planned community or a condominium, and that the owners association ultimately be the permittee under the stormwater management permit. The transfer of a stormwater permit from the developer to an owners association typically includes a certification of the current physical condition of the stormwater management facilities (a requirement of the North Carolina Department of Environment and Natural Resources, Division of Water Quality ("DWQ")). The governing documents for the planned community or the condominium should provide a mechanism for the transfer of the stormwater management permit from the developer to the owners association and the responsibilities of each party before and after that transfer. In the absence of such guidance, all concerned parties should consider the transfer carefully from their perspective and act accordingly. It is reasonable for the parties to expect that the designated permittee under the stormwater management permit will have the primary liability for compliance with that permit. Nonetheless, DWQ may also seek recourse against the owner of the land where a violation occurs, particularly if the permittee no longer can be held accountable.

In addition to a stormwater management permit, there may be other permits applicable to the common elements including CAMA permits or sedimentation and erosion control permits. These should be identified as part of the evaluation of an incomplete development, and consideration should be given to any steps necessary and appropriate to transfer those permits from the developer to the owners association.

6. Infrastructure

As is the case in a new development, the infrastructure is a significant consideration in an incomplete development. Construction of the streets and roads and completion of the work and steps necessary to provide utilities to all of the properties in a project are often the most expensive aspects of site development. There are a significant number of potential concerns associated with the development of infrastructure for an incomplete project. The following are some examples of specific considerations pertinent to the owners association that relate to infrastructure in an incomplete project:

- If the development includes private streets and roads, the owners association is likely responsible for the maintenance of those streets and roads. The cost of that maintenance and the funding of reserves for the long-term replacement of those private streets and roads probably are a significant part of the association's financial responsibility. Therefore, appropriate budgeting for those expenses is crucial.
- If there are streets and roads in the development that have been offered for dedication to the public, an evaluation should include investigation regarding the acceptance of those streets and roads by the municipality or the North Carolina Department of Transportation. If the streets and roads have been dedicated but not accepted due to noncompliance with the applicable standards, someone will need to incur the expense of bringing the streets and roads into compliance with those standards. That expense can be substantial.
- Some planned developments include significant utility facilities that are maintained or operated by the owners association or other private parties. If an incomplete development has this type of facilities, a critical review of the condition of those facilities, operation contracts for them, and compliance of those

facilities with applicable permits is important.

7. Books and Records of the Owners Association

Owners associations should maintain accurate and complete records. These records should include without limitation annual meeting notices and agendas, board meeting minutes, accounting records including regularly updated balance sheets, and any and all contracts between the association and third parties. However, during the development period for a project, developers often fail to adequately promulgate such records or, if they do create them, fail to separate them from their own development records and documents. Part of the due diligence investigation of an incomplete project should include review of the association documents and, if appropriate, attempting to obtain apparently missing records.

8. Status of Declarant and Development Rights

When a developer forms a planned community or a condominium, that developer most certainly will retain certain rights regarding the development of the project and control over the actions of the owners association during the development and initial selling period. These rights are useful to developers, and also often are necessary to allow the effective development of projects. Nonetheless, if a developer loses interest or contact with a project, the developer's right to control certain aspects of the operation of the owners association or the project can make it very difficult for the owners association to operate and manage the development without the developer. Some specific examples of special declarant and development rights that fall into this category and that should be considered include:

- The authority to appoint and remove directors from the Board of the owners association;
- Unilateral control over the architectural review or control process; and,
- Purported unilateral rights to amend the governing documents for the development.

A declaration that retains these rights for the developer should provide a period of time after which the rights will expire (and, in fact, the Condominium Act requires such a limitation). However, that time period, even if specified, may be longer than is practicable for an owners association in an incomplete and struggling development that needs to be able to govern itself without the developer in the picture. Therefore, an evaluation of the special declarant and development rights included in the declaration and also the duration of those rights, and the mechanism by which those rights can be terminated is important to the due diligence investigation of an incomplete development.

Conclusion

An evaluation of an incomplete development should include a careful look at the owners association and the impacts of the incomplete nature of the development on the owners association. Whether your client is an involuntary or voluntary successor developer, a resident within the incomplete development, or the owners association for an incomplete development, there are many potential problems for the health of the development that arise as a result of the project stalling or halting before completion. Every project is unique. Nonetheless, this article provides a list of considerations that should be part of any evaluation of an owners association in an incomplete development.

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For further information regarding the issues described above, please contact Samuel B. Franck.

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