HYATT & STUBBLEFIELD, P.C.

The Client Letter

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This newsletter addresses current issues and developments in the law relating to development of planned communities. It is published periodically for distribution to clients and friends of Hyatt & Stubblefield, P.C., Attorneys and Counselors. The information presented is not intended as specific legal advice to any person. Principles of law expressed in this newsletter are subject to change from time to time.

Workouts 101: Finding a Way to Survive in Today's Real Estate Market

"Workout" - when this term was used a year or two ago, chances are the speaker meant some form of exercise. Today, however, the use of the term in the context of a business workout has almost become a part of popular vernacular. A few years ago, a community association lawyer most likely would not have said he or she was in the workout business. Unfortunately, due to the state of real estate and financial markets, workouts are now an important part of our practice.

So, just what is a workout? Webster's New World Dictionary defines "workout" as any work requiring great effort. Traditionally, a workout meant a restructuring of debt, usually in the context of a bankruptcy filing or an overdue loan. Today, it can mean much more. While a workout is generally driven by financial factors, a real estate workout can mean restructuring the real estate deal or development plan entirely.

A real estate developer holding land may be forced to turn over that land to satisfy a creditor when it cannot make the regular loan payments. But, there are a number of additional rights and obligations that generally go with the land. Does the creditor also want these rights and obligations? Is it even capable of acting on the rights and fulfilling the obligations? Should the creditor acquire the right to build in the project? Does the creditor want to become the successor developer? Does it want to control the homeowners or condominium association where the developer is still in control of the association? Is the creditor in a position to capably operate the association even if it desires control?

These questions often go unasked and unaddressed in a traditional debt restructuring, but they should be an important part of any real estate workout. There can also be other types of real estate workouts where a project is in trouble, where a developer is unable to fulfill obligations to homeowners or an association, where valuable development rights are expiring but the developer is unable to proceed at this time, or where development under an existing plan is no longer practical or feasible but the developer lacks the ability to change the plan without the consent of others.

A failure to understand a planned community as a combination of real estate product and community association process will certainly doom any workout effort involving the community. A developer that only relies on financial consultants in a workout could be left with liabilities that may not be readily apparent to financial consultants. A planned community workout is complicated by the presence of residents with direct and indirect ownership interests in the collateral and by the existence of a community association, an independent legal entity with an interest in the collateral independent from the interests of the lender, the developer, or the individual property owners. These various ownership interests and the legal and equitable interests of the community association require adding an extra chapter to the "workout handbook."

A workout involving a distressed developer with rights and obligations in a master planned community

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should not only seek to minimize the liability of all parties but also aim to maximize development flexibility and project marketability. These goals deserve special planning and response. Certainly, each master planned community is different, and these differences are magnified and multiplied when the project is in distress and construction and development loans are in default or approaching default. There are as many approaches to developing a solution as there are problems. The master planned community workout is not an instance where the one-size-fits-all standard approach works.

The work out of a distressed master planned community can be expensive, frustrating, and involve significant potential liability. But, it can also prevent devastating consequences, such as bankruptcy, and allow the developer to continue to operate. To reduce the potential for liability, all of the players in the deal must become involved in the workout and must become involved with a talented support team able to do a comprehensive job of creating a redevelopment plan. The team must be knowledgeable, forward-looking, and must appreciate all of the risks and duties inherent in the creation, re-creation, and operation of a master planned community and community association. If all of those involved in the workout are as innovative on the process side as they are on the product side in the creation, operation, and, if necessary, restructuring of a master planned community, the product and the process can be successful.

Does it Make Sense to Give Up Control of the Association Early?

If you are a developer who is still in control of a homeowners or condominium association, you may be asking yourself whether it would be beneficial to just go ahead and give up control now rather than waiting for the mandatory turnover date established by the community's governing documents or statute. You may have an inventory of unsold homes or lots that have already been created and submitted to the governing documents, but sales are moving at a snail's pace in most parts of the country. You may also have land that has not yet been developed or submitted to the community, but it could be years before it would make sense to sink money into additional development. So why should you continue to spend time and money running the association? Quite simply, to protect your investment.

The carrying costs for maintaining control of an association can be high for a developer, particularly when there is little or no income coming from the community. The developer has to spend his or her time to manage the association and likely pay employees to also sit on the association's board of directors and manage the day-to-day operations. If homeowners were on the board, these would be unpaid, volunteer positions.

However, losing control of the board could significantly impact future sales. A homeowner-controlled board could decide to increase dramatically the amount of assessments. The board could decide to reduce services, defer maintenance of community facilities, or cease funding of a reserve fund in order to decrease assessment levels. If the association has architectural review authority, the board could make architectural standards onerous. The board could also become lax in enforcing rules and maintenance and architectural standards. In a nutshell, when you give up control of the association, you give up the power to shape the community and steer it in the direction that will have the most appeal to buyers in your target market. If you can afford the overhead costs, maintaining control of the association is one of the best ways to protect your investment in unsold inventory or development rights.

However, homeowners may be clamoring for control of the association if, under current market forecasts, control may not be turned over for many years to come. It can be particularly difficult to deal with homeowners in situations where the owners are shouldering the bulk or perhaps even all of the community costs. It is difficult to implement an increase in assessments if the developer is not also paying assessments or is paying very little by comparison.

You can help satisfy homeowner concerns by bringing them more into discussions of operations. You can put more homeowners on the board without giving up control by maintaining the right to appoint a majority of the directors. You can form committees of owners to work on assigned tasks and to bring ideas back to the board. You can let homeowners perform some management functions while still guiding the process and managing expectations. You can make the owners feel part of the team while still maintaining control. Standard management models for maintaining absolute control simply may not work in today's ever changing climate. Both developers and owners must work together to keep communities vibrant. This helps protect everyone's investment, developers and residents alike.

Interstate Land Sales in a Down Market

A number of questions may arise where a developer has registered a project with the U.S. Department of Housing and Urban Development ("HUD") pursuant to the federal Interstate Land Sales Full Disclosure Act, 15 U.S.C. § 1701 – 1720 (the "Act"), but now sales have come to a stand-still in the project or the developer is not continuing with additional phases of the project. The developer may ask whether he or she should suspend or withdraw the registration? There is no requirement that the registration be suspended simply because the developer is not actually selling in the project. However, it could be beneficial to do so.

Regardless of whether sales are continuing, unless the registration is suspended, the developer is required to keep the Statement of Record filed with HUD up-to-date. Under the Act and the corresponding regulations, 24 C.F.R. § 1710, *et seq.* (the "Regulations"), a developer is required to describe in the Statement of Record filed with the project registration all amenities and recreational facilities in the subdivision that are promised by the developer or the developer's agent or are depicted in marketing or sales materials. If there is a change in any material fact stated in the Statement of Record, the developer is required to file an amendment to the Statement of Record within 15 days of the date the developer knows or should have known of the change in the material fact under Section 1710.23 of the Regulations. For example, the developer may decide to modify or eliminate facilities or amenities that no longer fit into the developer's plans for the community.

In addition, Section 1710.310 of the Regulations requires the developer to submit an Annual Report of Activity to HUD each year within 30 days of the anniversary of the initial registration approval. The developer must also submit annually to HUD updated audited financial statements within 120 days of the close of the developer's fiscal year pursuant to Section 1710.212(d)(1) of the Regulations.

In these uncertain economic times, the costs associated with maintaining a HUD registration may seem too high, and developers may be temped to stop complying with the Act and the Regulations. However, penalties for violating the Act can be severe and may include civil and criminal fines and/or imprisonment of up to five years. An alternative to this course of action is for a developer to request the suspension of the Statement of Record, which is permitted under Section 1710.21(b) of the Regulations so long as no administrative proceedings are currently pending against either the developer or the subdivision. Upon acceptance of the developer's request by HUD, the project registration will be suspended and will remain suspended until the developer requests that it be reinstituted.

Once a HUD suspension is accepted by HUD, a developer may not enter into a contract with a purchaser to sell any home or lot in the subdivision during the term of the suspension. However, by suspending the Statement of Record, the developer is under no obligation to provide HUD with amendments to the Statement of Record, annual reports of activity, or audited financial statements. When a developer chooses to reactivate the registration, an amendment to the Statement of Record must be submitted to HUD disclosing all the material changes that have occurred from the last effective date until the date of reactivation.

Federal Law Imposes New Requirements on Community Pools

The federal government has now decided to regulate the safety of public pools and spas, which has traditionally been left to the states. The Virginia Graeme Baker Pool and Spa Safety Act, 15 U.S.C. § 8001 (the "Act"), was adopted in 2007 and went into effect on December 19, 2008. The Act regulates "public" swimming pools and spas, but this includes privately owned community pools and pools owned or operated by a homeowners association, condominium association, apartment building, or other residential real estate development.

As of December 19, 2008, all public pools and spas must have drain covers that meet the American National Standards Institute and American Society of Mechanical Engineers ("ANSI/ASME") A112.19.8-2007 standard on every drain and/or gate. If the pool or spa does not have these drain covers, it must close immediately. A list of drain cover manufacturers can be found at the Consumer Product Safety Commission's website: www.cpsc.gov/whatsnew.html#pool.

In addition, if the pool has a single main drain (other than an unblockable drain), the operator must either disable the drain or install a second anti-entrapment device or system. This can take the form of an automatic shut-off system, gravity drainage system, Safety Vacuum Release System ("SVRS"), or suction-limiting vent system. If a pool has dual or multiple main drains more than three feet apart, it may be exempt from this second requirement. Pools and spas with single main drains that are unblockable are also exempt from this requirement. A list of

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SVRS manufacturers can be found at www.cpsc.gov/businfo/draincman.html.

The Act is not without controversy. The National Swimming Pool Foundation ("NSPF") argues that the legislation was pushed through to satisfy special interests. The Act was named in memory of former U.S. Secretary of State James Baker, III's granddaughter, who died when entrapped on a drain in a private in-ground spa. While Congress issued findings that drowning is the second leading cause of death in the U.S. of children aged 1 to 14, the NSPF asserts that suction entrapment claims only about one to two victims per year. The NSPF also argues that the Act has severe unintended consequences by forcing pools and spas to close. In a statement issued in December, 2008, the NSPF stated that some compliant drain covers were only just then becoming available and that specialty drain covers are not available at all. In addition, NSPF contends that many drains are field fabricated by the pool builder and are unique in size and shape and that complaint drain covers are simply not available for such drains.

The Consumer Product Safety Commission has issued technical and legal interpretations of Act, which can be found at www.cpsc.gov/businfo/vgpsa.pdf.

Inside News

- Check out the blog on our website at hspclegal.com for articles and helpful information.
- David Herrigel and Jan Bozeman were presenters at the National Business Institute program "Legal Aspects of Condominium Development and Homeowners' Associations" in January in Atlanta.
- Jo Anne Stubblefield served on the faculty of the ALI-ABA Advanced Course of Study on "Drafting (and Redrafting) Documents for Condominiums and Planned Communities in Troubled Times" held February 26-28, 2009 in San Antonio, Texas.

We would be pleased to send **The Client Letter** to friends and business associates who you feel would benefit from receiving it. Just send our office a note with their names and addresses or give us a call at 404-659-6600.

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