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Development Plans for New or Partially Completed Housing Developments

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I. [3.1] SCOPE OF CHAPTER

Over the last several decades, as land became more scarce and expensive and construction costs increased, the planned-unit development (PUD) concept has become a popular vehicle for building attractive, high-density housing developments. Often a residential PUD consists of one or more different types of housing products and includes common facilities owned and/or maintained by a homeowners' association, as opposed to being dedicated or conveyed to a governmental agency. In PUDs that include multifamily housing units or non-dedicated common facilities, it is generally necessary to create a mechanism for administering and maintaining the PUD, allocating the costs of this work, and collecting the money to pay the costs. Such a mechanism usually is contained in a complex set of legal documents that are recorded against the real estate that makes up the PUD and that create covenants, conditions, restrictions, liens, and encumbrances that run with and bind the land. The legal documents must deal with and anticipate a number of issues. This chapter does not attempt to address all such issues but discusses primarily those basic issues that need to be resolved before the legal documents for a residential PUD are drafted so that the PUD will be workable and provide the developer with the flexibility to react to changes in market and financing conditions during the development of the PUD.

As a result of the severe and prolonged depression in the housing market that began in 2006 and that, as of early 2010, has not yet shown any significant signs of a sustained recovery, many PUDs have stalled midstream, forcing developers, lenders, owners, and municipalities to deal with a myriad of difficult and challenging issues. Some of the issues could have been minimized by a well-thought-out development plan. Unfortunately, many developers and builders did not understand or appreciate the risks involved in developing a large PUD. Many of the issues that are jeopardizing partially completed PUDs today are neither new nor unique; many are repeats or reinventions of the issues previously faced in the housing downturns of the 1970s, 1980s, and early 1990s. There had not been a significant downturn in housing since the early 1990s, and over that long period of time, some builders who lived through the earlier downturns forgot what can go wrong, and a new generation of builders evolved who had no experience with a down market and did not appreciate how bad it could get. This chapter identifies many of the issues that must be reviewed and analyzed by a lender considering taking over control or ownership of a partially completed PUD that it financed or by an investor or developer considering acquiring a partially completed PUD, either for investment or development.

II. BASIC PROJECT DOCUMENTATION

A. [3.2] In General

Generally, in a residential planned-unit development, the developer sells dwelling units and grants nonexclusive transferable rights and easements to the purchasers so that they may use and enjoy the common areas and facilities. The different forms of unit ownership generally found in a residential PUD are listed in §3.3 below.

B. [3.3] Forms of Unit Ownership

In order for units to be sold, they must fall into one of the following categories:

1. a lot (*i.e.*, a subdivided area of land, or a portion of a subdivided lot, that is improved with a single-family residential unit in the form of a detached or attached home such as a townhome or duplex home);
2. a condominium unit (*i.e.*, a unit in a building that has been made subject to the Condominium Property Act, 765 ILCS 605/1, *et seq.*); or
3. a co-op unit (*i.e.*, a unit in a building that is owned by a co-op association, which is generally a business corporation whose member-shareholders have the exclusive right to occupy the units, usually under a proprietary lease with the association).

C. [3.4] Single-Product PUD

A single-product planned-unit development is a PUD that is planned to be built over a relatively short period of time (less than three years) with units of substantially the same design and construction. This type of PUD may be developed using only one of the forms of unit ownership listed in §3.3 above. For example, the entire PUD may be developed as one condominium, in which case a condominium declaration will be recorded against the PUD and the common areas of the PUD generally are made part of the common elements of the condominium. When one unit does not encroach into the airspace above another unit, the PUD may be subdivided into lots, and a homeowners' declaration may be recorded against the entire PUD. Under this approach, each unit owner will own his or her lot, and the homeowners' association will own the common areas.

D. [3.5] Multiproduct PUD

A multiproduct planned-unit development is a PUD that is planned to be built over a relatively long period of time (greater than three years), will contain different style units, and will include substantial common areas and facilities. In this case, the use of an “umbrella” or “community” declaration is suggested. See §3.26 below for a more detailed discussion of the suggested structure for this type of PUD.

III. [3.6] CHOICE OF FORM OF UNIT OWNERSHIP

The developer should choose the form of unit ownership that will best suit the physical aspects of a particular product and will appeal to the targeted marketing base. When a unit is located above another unit, the most common approach is to market the units as condominium units, although another alternative would be to market them as co-op units. When units do not overlap each other, the developer has the additional option of marketing the units as lots. Several issues that should be considered in choosing the form of unit ownership are discussed in §§3.7 – 3.13 below.

A. [3.7] Governmental Regulation

The Condominium Property Act has been amended numerous times since its original adoption in 1963. A number of municipalities also have adopted ordinances regulating condominium developments, particularly condominium conversions. Because compliance with the Act and local ordinances often adds to the costs of development, many builders prefer to use a form of ownership other than condominium.

Non-condominium homeowners' associations remain relatively free from regulation in Illinois except for those that fall within the definition of "master association" in §18.5(a) of the Condominium Property Act (765 ILCS 605/18.5(a)), the definition of "community association" in §18.7(a) of the Condominium Property Act (765 ILCS 605/18.7(a)), or the definition of "common interest community association" in the forcible detainer provisions of the Code of Civil Procedure, 735 ILCS 5/9-102(b). A "master association" is a not-for-profit corporation or an unincorporated association created pursuant to a non-condominium declaration and authorized to exercise or delegate powers on behalf of one or more condominium associations for the benefit of owners of the condominium units in the condominiums. 765 ILCS 605/18.5(a). Section 18.5 imposes certain procedural requirements on a master association that are similar to those imposed on condominium associations, including procedures for the adoption of annual budgets, record-keeping, the conduct of meetings, and the turnover of control of the association three years after the declaration providing for the creation of the master association is recorded. The community association referred to in §3.26 below would be a master association if, under the project documentation, powers of the condominium associations in the development are delegated to or exercised by the community association.

B. [3.8] Surveying Requirements

To sell lots, the real estate must be subdivided, and a surveyor must prepare a plat of subdivision. To create condominium units, a surveyor must prepare a three-dimensional survey of the condominium property and each unit. 765 ILCS 605/5. To create co-op units, a surveyor may not be needed at all. Generally, the surveying cost for condominium units is greater than the surveying cost for lots.

It is not necessary to subdivide real estate that will be made subject to a condominium declaration, but it is necessary to subdivide land that will be sold as lots. Subdividing land often requires the approval of one or more public bodies or agencies. See 55 ILCS 5/3-5029. Obtaining these approvals may not be simply or quickly accomplished and is often politically difficult.

C. [3.9] Real Estate Taxes

Under §10 of the Condominium Property Act, each condominium unit owner will receive a real estate tax bill for his or her unit. The condominium unit's assessed valuation will include the undivided interest in the common elements of the condominium that are appurtenant to the unit. 765 ILCS 605/10(a). The owner of a lot will receive a separate real estate tax bill for his or her lot. The failure of a condominium unit or lot owner to pay real estate taxes on his or her unit or lot may result in the tax sale of the unit or lot but will not affect the interests of other unit or lot

owners in the planned-unit development. A co-op association will receive the real estate tax bill for the entire building, and the bill will be paid from assessments collected from the owners. If some of the co-op unit owners are delinquent in the payment of assessments and, as a result, real estate taxes are not paid, then the entire building may be sold for unpaid taxes unless the non-delinquent owners make up the deficit.

Section 10(a) of the Condominium Property Act provides that real property owned by a condominium association or a master association that is used exclusively for recreational or other residential purposes for the benefit of the unit owners shall be assessed for real estate tax purposes at \$1 per year, and the balance of the value of the property shall be included in the taxes assessed to the condominium unit owners. Thus, the tax bills that are sent to the unit owners will include the value of the condominium unit, the value attributed to a percentage ownership in the common elements, and the value attributed to the right to use a common area owned by the condominium or master association. A similar provision is found in the Property Tax Code, 35 ILCS 200/1-1, *et seq.*, and covers situations in which real estate used for recreational or other residential purposes is owned by a non-condominium homeowners' association for the benefit of its unit owners. 35 ILCS 200/10-35. Pursuant to §10-35(b), in counties of three million or more inhabitants, a person desiring to establish a \$1-per-year assessment must submit an application to the Assessor's Office. Pursuant to §10(a) of the Condominium Property Act, in counties of one million or more inhabitants, a person desiring to establish a \$1-per-year assessment must submit an application to the Assessor's Office.

Thus, the real estate tax treatment of property in all residential PUDs should be the same regardless of whether the common areas are part of the common elements of a condominium or real property owned by a non-condominium homeowners' association.

D. [3.10] Owner Financing

An owner of a lot can mortgage his or her lot separately. Likewise, under the Condominium Property Act, each condominium unit owner may mortgage his or her unit separately. 765 ILCS 605/6. However, as is discussed more fully in §3.39 below, as of late 2009, it is significantly more difficult to obtain a mortgage loan on a condominium unit than on a similar unit that is not part of a condominium.

Because all of the real estate in a co-op is owned by the co-op association, a co-op unit owner cannot give a lender a first mortgage on a fee-simple interest in real estate. Instead, a co-op unit owner may grant a leasehold mortgage on his or her proprietary lease and pledge the stock that he or she holds in the co-op association as collateral for a loan on his or her co-op unit.

E. [3.11] Insurance

Fire and casualty insurance on co-op and condominium buildings is obtained by the residential association. This procedure has the administrative advantage of avoiding potential disputes between multiple insurance companies in the event of a loss that affects more than one unit. Also, the board of a condominium association may require unit owners to obtain insurance covering their personal liability and compensatory damages to another unit owner caused by the

negligence of an owner or his or her invitees or (regardless of negligence) originating from his or her unit. Responsibility for obtaining fire and casualty insurance on lot improvements usually falls on the individual owners, potentially creating administrative confusion. The documentation for a non-condominium townhome-style development often will require the association to obtain fire and casualty insurance for the entire development, thus resulting in insurance coverage similar to that which is obtained by a condominium association.

F. [3.12] Financial Interdependence

Each residential association will be responsible for paying various “common expenses” incurred by it on behalf of its unit owner-members. The greater the common expenses of a residential association, the greater the financial interdependence of the unit owners. In general, the level of common expenses is highest in the co-op because the co-op association is generally responsible for the payment of mortgage service on the blanket mortgage (if any), real estate taxes, insurance, and maintenance costs for the building. The condominium usually will generate the next highest level of common expenses because the condominium association is responsible for the payment of insurance costs for the building and maintenance costs for the common elements but not real estate taxes. A homeowners’ association generally will have the lowest level of common expenses because it will not pay mortgage service or real estate taxes, it may not pay fire insurance premiums (except in the case of a non-condominium townhome development, as mentioned in §3.11 above), and its maintenance costs usually will be limited to exterior maintenance rather than maintenance of the building interiors or of operating systems that serve the building.

G. [3.13] Marketing Considerations

The choice between lots, condominium units, and co-op units is often based on marketing considerations. Many marketing consultants believe that townhome-style dwellings marketed as lots will sell better than the same units marketed as condominium units because a purchaser understands ownership of real property in the form of a subdivided lot more easily than ownership of airspace in the form of a condominium unit. This perception has changed over the years as the condominium concept has gained broader market acceptance. However, as will be discussed more fully in §3.39 below, currently if the developer-builder has the option to make a particular type of unit (generally a townhome-style unit) part of a condominium or subject to a non-condominium declaration, it will be much easier to obtain end-loan financing on the unit if it is not a condominium unit.

IV. [3.14] PROJECT DOCUMENTATION — ISSUES TO BE COVERED

Sections 3.15 – 3.24 below briefly discuss the basic issues that should be covered in the documentation for a planned-unit development.

A. [3.15] Access Easements

Unless each unit is adjacent to a dedicated road, it is necessary to grant an access easement to the owner of each unit to permit the owner and his or her tenants, invitees, and guests to gain

access from a public way to the unit over and across the common area. In a phased planned-unit development, an access easement also should be reserved or granted for the benefit of the owner of portions of the development that are not yet subject to the project documentation. This is necessary in order to preserve the marketability of the balance of the development so that, if the PUD is not developed as originally anticipated or a different developer acquires the balance of the project, the balance of the project can be developed separate and apart from the original development.

B. [3.16] Use Restrictions

Although usually the local zoning ordinance or the planned-unit development ordinance that applies to the development will establish the permitted uses, it is often advisable to include certain additional use restrictions in the project documentation. The most common use restrictions relate to such matters as the keeping of pets in the units, fencing, signs, leasing, parking, limitations on use of a unit for business purposes, and other matters that generally affect the quality of life within the development.

C. [3.17] Maintenance Covenants

The documentation should specify who is responsible for what types of maintenance. In a development that will be administered by a homeowners' association, the association is generally responsible for maintaining common areas and facilities in the development, such as private roads, detention areas, and recreational facilities. Also, in developments that include attached units, the association is usually responsible for at least the exterior maintenance of the buildings. If the development is a condominium, then the condominium association will be responsible for maintaining all of the common elements of the condominium, which consist of structural portions of the building, interior corridors, elevators, roofs, and other common elements.

In both condominium and non-condominium developments, there are certain areas that serve less than all the units and often only one unit. In a condominium situation, these areas are referred to as "limited common elements." In non-condominium situations, these areas often are referred to as "limited common area" or "limited community area." Examples of limited common elements or areas include balconies, patios, tennis courts, or swimming pools that serve only a portion of the units in the development; courtyards that serve several buildings within a complex; and other similar areas. The drafter has several options in dealing with the maintenance responsibility for limited common elements or areas. One approach would be to have the owner or owners who use the limited common elements or areas furnish the maintenance at their own expense. Another approach would be to have the homeowners' association or condominium association furnish the maintenance but charge the owners who use the limited common elements or areas on some basis. Under the Condominium Property Act, the cost of maintaining limited common elements may be allocated on any reasonable basis. 765 ILCS 605/9. Most often, in both the condominium and non-condominium situation, the costs of maintaining limited common elements or areas are allocated in equal shares to the units that use these areas.

When the individual owners are made responsible for maintaining their units and limited common elements or areas that they use exclusively, the association often is given the right and

power to furnish appropriate maintenance if an owner fails to do so and charge the cost to the delinquent owner.

D. [3.18] Architectural Controls

Often the documentation for a planned-unit development will contain architectural control provisions governing the construction of a home or the alteration, addition, improvement, or renovation of an existing home. There are several ways to approach architectural controls. One approach would be to enumerate certain basic standards in the documentation, such as floor area ratios, minimum square footage requirements, and limitations on the types of materials that may be used in connection with the construction or alteration of the exterior of the home. Alternatively or additionally, the documentation may include a procedure by which proposed plans must be submitted to a committee that will review the plans with the power to approve or disapprove them. Often, the committee is given the power to make judgments based on aesthetic considerations in addition to specific basic standards.

E. [3.19] Assessment Procedure

In a development that will be administered by an association, the association will need money to fulfill its obligations. In order to raise this money, the association must have the power to levy assessments against units within the development. Generally, the documentation will require the association to establish an annual budget of its anticipated expenses and the buildup of reserves for anticipated periodic repairs that will have to be made by the association with respect to improvements maintained by the association. The amount of the annual budget is then divided among the units based on some rational basis. If the association is a condominium association, the assessments must be allocated among the units based on the percentage interests assigned to the units. See 765 ILCS 605/4(e). In a non-condominium situation, any reasonable approach may be used to allocate the assessments, but most often in a residential development, the assessments are levied equally among the dwelling units.

The association needs a mechanism for enforcing the failure of a unit owner to pay assessments. The Condominium Property Act establishes a statutory lien in favor of the condominium association for the failure to pay assessments. 765 ILCS 605/9(g). In a non-condominium situation, the documentation must create a common-law lien against each unit.

F. [3.20] Mortgagee Rights

The documentation for a planned-unit development should include provisions dealing with the rights of the holders of mortgages or trust deeds on individual units. This subject is dealt with more fully in §3.39 below. Basically, however, the documentation should give each mortgagee who so desires the right to receive notices or other information of interest with respect to the development and its mortgagor's unit. Also, mortgagees should be given certain rights with respect to cash distributions made by the association to the unit owners in connection with insurance, settlements, or condemnation awards, and the lien of a first mortgage should be given priority over the association's assessment lien.

G. [3.21] Developer Rights

There are certain rights and powers the developer of a planned-unit development should reserve to itself:

1. The developer should reserve to itself the right to maintain model units and to erect signs or other advertising and sales material on the PUD, including the right to use the model units to sell units at other sites being developed by the developer.

2. The developer should reserve to itself the right to permit prospective purchasers or lessees of units to come onto the PUD and to use the common areas and parking areas without the requirement that any fee be paid to the association.

3. The developer should reserve to itself the right to sell or lease units to whomever the developer desires on such terms as it deems appropriate.

4. The developer should reserve to itself the right to come onto the PUD in order to construct improvements to the PUD and to store necessary equipment on the PUD common area while construction continues.

5. If the PUD is to be administered by one or more associations, the developer should retain the right and power to control the associations, at least during the initial stages of the development, by reserving the right to designate all members of the board of directors of the association. Under the Condominium Property Act, a condominium association may be controlled by the developer only for a period of three years after the condominium is first created or until the conveyance of 75 percent of the units in the project, whichever occurs first. 765 ILCS 605/18.2(a), 605/18.2(b)(i). The same rule applies to master associations (see 765 ILCS 605/18.5) and certain common interest communities (see 735 ILCS 5/9-102). Other than turnover restrictions on condominium associations, master associations, and certain common interest communities, there are no limitations on when control of a homeowners' association must be turned over to the unit owners.

6. The developer should reserve to itself a limited right to amend the documentation unilaterally, if necessary, in order to bring the documentation into compliance with applicable law, correct errors or omissions in the documentation, or bring the documentation into compliance with the requirements of the secondary mortgage market. In addition, the documents should provide that any provisions relating to the rights of the developer may be amended only with the prior written consent of the developer.

7. The documentation should provide specifically that any of the rights reserved to the developer are assignable by the developer. This will give the developer the option to sell the balance of the project together with the developer rights that are necessary to complete the development. These rights are critical to a lender, investor, or developer acquiring a partially completed project. It also would permit the developer to assign collaterally its developer rights to a lender.

8. Some builders, especially national homebuilders who have divisions on the coasts, desire the inclusion of provisions in the documentation that discourage the association from bringing a lawsuit against the declarant, especially a lawsuit that would be heard by a jury. To this end, the documentation often includes a provision requiring a supermajority of the owners to vote affirmatively in favor of instituting a lawsuit for any purpose other than collecting delinquent assessments or enforcing provisions of the documentation. Other documentation contains provisions requiring that any dispute between the association and the declarant be resolved by mandatory mediation and, if mediation is not successful, mandatory binding arbitration.

9. Although it is not technically a developer right, a developer should consider seriously setting up associations that will administer the PUD as limited-liability companies instead of not-for-profit corporations. There are several reasons to do this, not the least of which is that prior to turnover a limited-liability homeowners' or condominium association can be managed by the developer entity. Prior to turnover, a not-for-profit association needs to be managed by a board of directors consisting of at least three individuals appointed by the developer who later can be sued individually for alleged breaches of fiduciary duties to the owners.

H. [3.22] Municipality Rights

Occasionally, the municipality in which the development is located will require that certain rights and powers be granted to it in the project documentation. Generally, a municipality will be concerned about maintenance of storm water runoff facilities, private utility lines located on the development, and private roads. However, more and more frequently, a municipality will want the right to come onto a development to cause other types of maintenance or repairs to be furnished if the association or an individual unit owner fails to do so. Often, a municipality will require the developer to include in the documentation a provision that gives the municipality the right to charge the association or an individual unit owner for the cost of doing any work the municipality believes is necessary and to impose a lien on portions of the development if any such amounts are not paid when due. The drafter should be careful, however, to make any such lien subordinate to the lien in favor of holders of first mortgages or first trust deeds on the units.

Some municipalities require that the documentation for a planned-unit development be subject to the review and approval of the municipality. Occasionally, as a condition to approval, a municipality will attempt to require the developer to impose restrictions that cannot be imposed legally or politically by the municipality by ordinance. In particular, a municipality occasionally will ask that a developer prohibit or restrict the leasing of dwelling units, presumably on the theory that owner-occupants will take better care of their property, although other motivations may be at work. A developer should be wary of agreeing to these requests because they could adversely affect marketability of the dwelling units or the ability to obtain mortgage loans on the dwelling units. An entity that is considering acquiring a partially completed project needs to review the project documentation to determine if there are any government-imposed restrictions (*e.g.*, limitations on the leasing of units) that could interfere with the ability of the developer of the project to complete the project successfully.

I. [3.23] Enforcement by Association

In a planned-unit development that is administered by an association, the association generally has the primary responsibility for enforcing the covenants. Enforcement may take the form of levying fines, an action for specific performance, or an action for eviction. The documentation should provide that if the association does bring enforcement action and prevails, it also shall be entitled to recover its costs, including attorneys' fees.

J. [3.24] Enforcement by Owners

The documentation also should provide for a private cause of action by one owner against another owner for a violation of the documentation. This is particularly important in a planned-unit development in which there is no association. However, the secondary mortgage market generally requires that each owner be given a private right of action, even in a PUD that is administered by an association.

V. [3.25] THE NEED FOR AN ASSOCIATION; ALTERNATIVES

A homeowners' association that administers a planned-unit development has the power to levy assessments and act on behalf of the unit owners. A well-run homeowners' association can enhance the appearance of the PUD and the value of the units. However, in recent years, a disturbing trend has developed. Homeowners' associations have become, in some cases, the battleground for old-time "fence fights" and local political battles. A homeowners' association often is controlled easily by a small group of proactive individuals whose arrogant use, or abuse, of power can lead to divisive disputes within the PUD that occasionally lead to costly and debilitating litigation.

Because of these developments and for other reasons, in recent years, developers have increasingly attempted to avoid the creation of homeowners' associations, minimize the number of homeowners' associations that are created in connection with the development of PUDs, or at least minimize the likelihood that an association will initiate litigation against the developer.

The type of development in which it is easiest to avoid the use of a homeowners' association is one in which the units are single-family, detached homes. In this situation, each owner can be made responsible for the maintenance of his or her own home and lot. However, in these developments, occasionally there are common areas that may consist of private roads, detention areas, wetlands, or recreational areas. In years past, developers were reasonably successful in causing the municipality to accept the dedication of the roads or causing the municipality or a park district to accept a dedication or conveyance of detention areas, wetlands, or other types of open space. In recent years, however, governmental agencies have become increasingly reluctant to accept dedications of common areas, preferring instead to require the developer to establish a homeowners' association to own common areas and maintain them at the expense of the owners of the homes.

One approach that has met with some success in this area is the use of a special service area (SSA). SSAs are authorized under the Special Service Area Tax Law, 35 ILCS 200/27-5, *et seq.*

Basically, a “special service area” is an area that is subject to a real estate tax, the proceeds of which are used for a specific purpose that generally relates to the area that is being taxed. In the context of a PUD, an SSA can be established for the purpose of maintaining roads, detention areas, or wetlands located within a PUD. The roadways, detention areas, or wetlands would be dedicated or conveyed to the municipality, but the cost of maintaining these areas would not be paid out of the general funds of the municipality; instead, the cost would be paid with the tax revenues generated from the SSA.

In response to the 2003 Cook County office building fire, the Special Service Area Tax Law was revised to include special service areas created for the purpose of “providing improvements to any one or more buildings if the improvements are required by municipal ordinance in order to protect the health and safety of workers, tenants, and visitors in the buildings.” 35 ILCS 200/27-87. An application for such requires 100 percent of the owners who would be subject to the tax to join in the filing of the petition for, and the clerk of the municipality to agree with, the establishment of the SSA. A converter may attempt to establish such an SSA to provide funding for improvements required by a municipality, such as the installation of a fire suppression system, so that instead of the developer having to pay the entire cost of the improvements upfront (which cost would ultimately be passed on to the first buyers), the cost can be amortized over a number of years.

Occasionally, a PUD may be served by a detention area or a monument sign area that needs to be maintained. If the detention area is relatively small, a developer may include the detention area as part of one or more subdivided residential lots when platting the subdivision and impose the obligation to maintain it on the owners of the lot or lots. Similarly, a monument sign can be included on a subdivided residential lot and the obligation to maintain it imposed on the owner of the lot.

VI. [3.26] THE USE OF MULTIPLE ASSOCIATIONS

Large planned-unit developments, which may include several different types of buildings and active recreational facilities that will be available to all residents, may need to be administered by more than one association. An example of the type of project that might require multiple associations is a large new construction project that is planned to include several mid-rise buildings containing condominium units, a number of townhome-style buildings, a number of single-family detached homes, a clubhouse or recreational facility that will serve all residents of the development, green space, park areas, and private roads. In this situation, it is recommended that one or more condominium associations be created for the purpose of administering the mid-rise condominium buildings, one or more condominium or non-condominium townhome associations be created to administer the townhome-style buildings, and an “umbrella” or “community” association be established for the purpose of owning and maintaining the common areas and recreational facilities that serve all of the residents, as well as administering architectural controls and overseeing maintenance by the sub-associations. It may not be necessary to set up a separate association to administer the single-family detached homes, unless for some reason it is desirable to have an association to furnish exterior maintenance to the homes, landscape maintenance, or snow removal.

There are benefits to using multiple associations. For example, through the use of a community association to furnish maintenance of common areas throughout the project, there is a greater likelihood that the development will be maintained in a uniform and consistent manner and that economies of scale will be realized because the community association will be buying certain essential services, such as snow removal and landscaping, for the entire development. However, this approach does have its drawbacks and disadvantages. The existence of multiple associations makes the management and administration of the development more complicated and costly. This approach also tends to create political factions within the development based on the division of responsibilities among the various associations.

From the developer's point of view, in a large PUD in which multiple associations must be utilized, it is advisable to centralize control of the development in a community association and maintain control of the community association as long as possible. Unfortunately, the current state of the law in Illinois discourages this type of approach. In particular, under the Condominium Property Act, any association that is delegated the powers of a condominium association is defined as a "master association," and control of a master association must be turned over to the unit owners within three years after the declaration that provides for the creation of the master association has been recorded. 765 ILCS 605/18.5(a), 605/18.5(f). In order to avoid a community association's being deemed a master association, the drafter must structure the documentation in such a way that the community association is not delegated the powers of a condominium association. For example, a community association should not be given the power to maintain the common elements of a condominium or even exercise architectural control over a condominium within the development. If, however, there is no condominium association planned for the development, then the community association can exercise powers that otherwise would be exercised by non-condominium homeowners' associations without falling under the definition of "master association."

Even if a community association can be structured to avoid being deemed a master association under the Condominium Property Act, it is still possible that it may be deemed a common interest community association under the Act and §9-102 of the Code of Civil Procedure (735 ILCS 5/9-102). Although it appears that §18.5 of the Condominium Property Act and §9-102 of the Code of Civil Procedure are intended to impose certain provisions of §18.5 on non-condominium homeowners' associations that are not master associations, with careful planning a non-condominium homeowners' association can be established in such a way that it is not subject to §§18.5(c) – 18.5(h) of the Act. A party considering acquiring a partially completed project should determine who controls the associations that administer the project and, with respect to those associations that have not yet been turned over, when they will be required to be turned over.

VII. [3.27] CONVERSION PROJECTS

Conversion of an apartment project to individually owned condominium units has been an option available to apartment project owners since 1963, when the Condominium Property Act was first adopted. Condominium conversions were most popular in the mid-1970s, at which time concerns about the treatment of tenants and the shrinking rental stock caused a number of

municipalities, including the City of Chicago, to pass ordinances governing condominium conversions. With the high interest rates of the 1980s, condominium conversions were not a significant factor in the marketplace. In the late 1990s and early 2000s, with home loans available at lower interest rates, the buy-versus-rent comparison once again favored buying, and condominium conversions returned.

The conversion plan for an existing apartment project differs in a number of respects from a development plan for a new construction condominium or a planned-unit development project. The discussion in §§3.28 – 3.30 below covers some of the issues that should be considered when formulating a conversion plan.

A. [3.28] Statutory Constraints

Section 30 of the Condominium Property Act deals with the procedures for making an apartment project subject to the Act. Basically, the owner of the property must give written notice of its intention to make the property subject to the Act (and thereby convert the property to a condominium) to all tenants of units in the property. 765 ILCS 605/30(a). The notice must be accompanied by an offer to sell to each tenant the unit in which the tenant resides and the price at which the offer is being made. The tenant then will have 30 days in which to accept the offer. If the tenant does not accept the offer and within 120 days after the date of the notice of intent a contract is entered into to sell the tenant's unit to someone else, the tenant must be given notice of the contract and must be given the right to buy the unit at the price and terms set forth in the contract. The tenant then may exercise this right to purchase by notifying the converter within 30 days after the tenant has been given notice of the contract. This is commonly known as a right of first refusal. Section 30(a)(2) of the Act provides that, in the event that an owner fails to provide notice of its intention to convert, when a tenant vacates the premises as a result of his or her lease not being renewed and the tenant's unit is later converted to a condominium, the owner is liable to the tenant for actual moving expenses (not to exceed \$1,500), three months' rent, and reasonable attorneys' fees and costs.

In addition, any tenant whose tenancy expires within 120 days after the date on which the notice of intent is given has the right to extend his or her tenancy to the end of the 120-day period by giving written notice to the owner of the building within 30 days after he or she receives a notice of intent. If the tenancy is so extended, it shall be extended at the same rental the tenant is currently paying. 765 ILCS 605/30(c).

Furthermore, the Condominium Property Act requires certain disclosures to be made to the first purchaser of a unit. 765 ILCS 605/22. Section 22 of the Act provides that the purchaser has the right to cancel his or her contract until five days after the last of the designated documents has been delivered to the purchaser or the closing of the sale of the unit, whichever occurs first. In the case of a condominium conversion, these documents include the condominium declaration, the bylaws of the condominium association, a floor plan of the unit, a budget for the condominium association, an engineer's report concerning the condition of the property in a form described by the Condominium Property Act, and, if available, an operating history of the property.

Effective July 29, 2005, P.A. 94-386 amended the Condominium Property Act to authorize a municipality to inspect units in a proposed condominium conversion and require that the units

comply with current codes. 765 ILCS 605/30.5. Although municipalities arguably had this right without the amendment, and in fact some had already imposed such a requirement, the likely result of this amendment is that more municipalities will adopt ordinances that require inspections and evidence of current code compliance as a condition to conversion to condominium status. The most common impact has been on life safety issues such as sprinkler installation. Municipalities have passed ordinances that regardless of the status of a building's current code compliance, require an owner to install a sprinkler system that previously was not required when the building was a rental structure. See §3.25 above regarding possible funding for sprinkler improvements under the Special Service Area Tax Law.

In 1978, at the height of condominium conversions, the Chicago City Council adopted the Chicago Condominium Ordinance, Chicago Municipal Code §13-72-010, *et seq.* The purpose of this ordinance is to give additional protection to purchasers of units in condominium conversions, with an emphasis on protecting tenants, particularly elderly and handicapped tenants.

The notice requirements of the Condominium Property Act and the Chicago Condominium Ordinance generally apply to the conversion of an existing apartment project. In a loft conversion (discussed in §3.31 below), in which the building is vacated, gutted, and rebuilt or expanded, there are usually no tenants who would be entitled to receive notices or rights under the Act or the Chicago Condominium Ordinance.

The Chicago Condominium Ordinance is primarily a disclosure ordinance. It requires that, before the offering for sale of a unit in a newly constructed, newly rehabbed, or newly converted condominium project of more than six units, certain specific disclosures be made in the form of a property report. The property report must follow a prescribed format that includes, among other things, copies of all the condominium documentation required to be given to prospective purchasers pursuant to §22 of the Condominium Property Act, a survey of the condominium property, a statement as to the condition of title, a disclosure of any and all building code violations over the past ten years, estimates of monthly assessments and real estate taxes, information concerning any financing that will be furnished by the developer, certain basic information concerning the identity of the developer and certain professionals working with the developer, and disclosures concerning contracts and other obligations that will bind the condominium association, such as management agreements, laundry leases, and insurance contracts. In the case of a conversion, the property report also must include an engineer's report covering the structures and operating systems. The property report must be available no later than the commencement of the sale and marketing program for the condominium. Violations of the ordinance are punishable by fines. Condominium property reports are discussed in detail in Chapter 5 of this handbook.

In addition, a number of municipalities in the Chicago metropolitan area have adopted condominium conversion ordinances patterned after the Chicago Condominium Ordinance. Some, however, include additional substantive requirements that tend to make it more costly or risky for a developer to convert a property in the municipality to condominiums. Anyone who is contemplating the conversion to condominiums of property located within a municipality should check with municipal authorities to see if the municipality has adopted ordinances that would impact a condominium conversion.

There are additional issues that must be dealt with in connection with a phased conversion of an apartment project. For example, the Federal Housing Administration (FHA) has lifted its ban on insuring loans for the first 12 months after the condominium conversion of an apartment project begins. The FHA previously limited its willingness to insure loans made to tenants of the apartment project only in the first 12 months. The FHA, however, requires that the entire condominium project where rehabilitation or remodeling is taking place, including in the common areas, must be 100 percent completed before any mortgage may be insured. The FHA guidelines provide some opportunity for escrow provisions when delays are weather-related for common areas only. A converter must plan carefully the phasing of a conversion and rehabilitation of the units and common areas in order to maximize the number of purchasers who will qualify for FHA-insured mortgages.

B. [3.29] Single Building Conversions

When an apartment project consists of a single building, the building usually is converted at one time to the condominium form of ownership. Occasionally, large buildings have been converted in phases in order to facilitate the satisfaction of presale requirements that may be imposed by lenders. Such phasing, however, may have an impact on the ability of purchasers to qualify for mortgages to be sold or insured in the secondary mortgage market. When the building contains commercial space in the form of stores or offices, it is often advisable to carve the commercial space out of the condominium. This can be done in one of two ways. One approach would be to record what is commonly known as a “vertical subdivision” plat that would divide the building into a number of three-dimensional lots. The lot or lots that contain the residential portion of the building then would be made into a condominium, and the lots that contain commercial space would either be made into a commercial condominium or be owned and operated as commercial property separate from the residential condominium portion of the building. Another approach would be to exclude the commercial space from the legal description of the real estate that is being made part of the condominium. The commercial space then could be owned and operated as commercial property separate and apart from the condominium. In those buildings in which the value of the commercial space is relatively small compared to the value of the residential portion of the building, it may not be necessary to separate the commercial and residential portions of the building. In such a situation, the commercial portion of the building may be made into one or more condominium units in the same condominium as the residential units. Of course, the commercial units would have to be made subject to different use restrictions than those imposed on the residential units. Generally, the secondary mortgage market will limit the amount of space in a mixed-use building that may be designated as commercial to 20 to 25 percent of the total floor area.

C. [3.30] Multi-Building Conversions

In an apartment project that consists of multiple buildings, care must be taken to establish a phasing plan that gives the converter maximum access to end-loan financing. Generally, the secondary mortgage market will require that between 50 and 70 percent of the units in the portion of a conversion development that will make up the condominium be subject to sale contracts before loans on units in the condominium may be sold in the secondary mortgage market. Thus, for example, in a 500-unit apartment project that consists of ten 50-unit buildings, instead of

attempting to convert the entire project to condominium at one time, the converter should phase the conversion building by building. Thus, the first phase of the conversion can be made part of a condominium and unit loans may be sold in the secondary mortgage market when 50 – 70 percent of the units in the first building (25 – 35 units out of 50) are subject to sale contracts. Generally, the presale requirement operates on a cumulative basis. Thus, if the presale requirement is 70 percent, then loans in the first phase will be saleable in the secondary mortgage market when 35 units in the first building have been sold. When the second building is added to the condominium, the presale requirement will be 70 percent of 100 units, or 70 units, but instead of being required once again to satisfy a 70-percent presale for the second building, units in both the first and second buildings can be used to satisfy the presale requirement for the first two buildings. This approach works only if the condominium is what is commonly referred to as an “add-on” condominium.

If the apartment project has significant amenities, such as a clubhouse, swimming pool, and tennis courts, the converter must pay attention to when and how the amenities are made part of the condominium. The secondary mortgage market may not approve a conversion if a large amenity package is made part of the condominium before there are sufficient units in the condominium to pay for the cost of maintaining the amenity package. However, if the condominium unit owners do not have a perpetual right to use and enjoy the amenity package, the amenity package may not be advertised as being available to the unit owners, and no portion of the value of the amenity package may be included in the value of units for appraisal purposes.

VIII. [3.31] MULTI-BUILDING AND PHASED DEVELOPMENTS

In the 1990s, builders and developers, with the encouragement and cooperation of local authorities, converted a large number of buildings that had been used previously for nonresidential purposes into residential buildings, many of which were made into condominiums. This process, which began years ago with the conversion of old factory and warehouse buildings into residential buildings with loft-style units, is commonly referred to as a “loft conversion.” Since the 1990s, however, the units created in buildings that formerly were used as office buildings or warehouses have taken on a much more conventional look. Instead of very high ceilings with partitions that do not extend from the floor to the ceiling and with exposed duct work, units in many subsequent loft conversions, particularly those in former office buildings, are virtually indistinguishable from units in newly constructed apartment and condominium buildings. Many of these so-called loft conversions have involved a large number of units, often in excess of 200, and often involve more than one building with different types of construction. Also, a number of high- and mid-rise new construction developments have subsequently been constructed in urban areas, both in the City of Chicago and in the suburbs. Formulating a development plan for a large new construction condominium or loft conversion presents certain issues that are not normally found in the condominium conversion of an apartment project or new construction of a smaller building. Sections 3.32 – 3.34 below discuss some of the issues that commonly arise in connection with a large new condominium or loft conversion development.

A. [3.32] Phasing

Because a loft conversion generally involves the gutting and rehabilitation of an old structure, there are no tenants. A new construction or high-rise building also has no tenants. Although the fact that there are no tenants makes it easier from a legal point of view because there is no need to give notice of intent to convert and no rights of first refusal, the lack of tenants means that there is no source of rental income during the course of the development of the buildings. In a large apartment project conversion, if the entire building is made subject to the Condominium Property Act as part of a condominium, the building generally will be substantially occupied with both owners and tenants. The tenants will be paying monthly rent to the developer, who can use this rent to pay assessments levied against the units that are still owned by the developer. In a new construction or loft conversion project, once a condominium unit exists, the owner of the unit must pay assessments on the same basis as the owner of every other unit, regardless of whether the unit is occupied. In multi-floor buildings, units on the lower floors of the building are often ready for occupancy before the units on the higher floors. Also, in multi-building projects, one building may be ready for occupancy before another building. One way to deal with this issue is to add portions of the project to the condominium in phases, *e.g.*, floor by floor, building by building, or floor by floor within each building. The Condominium Property Act specifically provides for and permits property to be added to a condominium in phases. 765 ILCS 605/25. When P.A. 80-1110 (eff. Jan. 1, 1978) was enacted to permit phasing, the particular type of phasing that was occurring was the addition of entire buildings in new construction or apartment project conversion projects, primarily located in the suburbs. The phasing of a large, new construction building or multiple buildings in a loft conversion project can be done legally under the provisions of the Act. This type of phasing, however, does present some unique issues, including:

Cross Easements. When portions of a building are added in phases, it is necessary to provide for various support and access easements in the declaration so that, until all of the building is part of a condominium, the condominium association and the owner of the portion of the building that is not yet part of the condominium have the right to maintain the portions of the building that they are responsible for maintaining. Also, to the extent that the condominium property and the non-condominium property share a common wall or floor divider, the use and maintenance of the common wall or floor divider should be covered by what are commonly known as “party wall” covenants.

Assessments/Reserves. If a project is phased, then only the owners of units that are part of the condominium property from time to time are obligated to pay assessments to the condominium association. The Condominium Property Act provides that each owner must pay his or her proportionate share of the common expenses for each unit owned. 765 ILCS 605/9(a). Until all proposed units in a phased building are made part of the condominium, the developer needs to determine how the budget for the condominium should be prepared and what level of assessments should be payable by owners of units. For example, in a high-rise building that is being phased, it is unlikely that the roof will be made part of the condominium property until the last phase, and until the entire building is made part of the condominium, portions of the operating systems, such as elevators, heating, air conditioning, and hot water, will be both within and outside of the condominium property. Also, because the building will be only partially

occupied, the cost of certain services, such as maintenance of hallways, may be less because of the lower occupancy. On the other hand, certain overhead costs, such as the cost of a 24-hour doorman or security service, may not be affected by the level of occupancy.

There are basically two ways to deal with this issue. One approach is to reduce the budgeted expenses to reflect reduced costs because of the reduced occupancy. Another approach would be to levy assessments based on what is commonly referred to as a “stabilized budget,” which is a budget based on the assumption that all portions of the property that are intended to eventually become part of the condominium are part of the condominium and that all units are fully occupied and all services are being furnished. Under a stabilized budget approach, each owner of a unit that is part of the condominium from time to time, including the developer for units owned by the developer (regardless of whether they are occupied), will pay full assessments under the stabilized budget for each unit owned. Depending on the costs that are actually being incurred, the assessments payable with respect to the existing units may not be sufficient to pay the actual operating expenses of the condominium as it then exists. If the assessments levied to pay operating expenses are not sufficient to cover these expenses, the developer should consider subsidizing the shortfall. If the assessments levied to pay operating expenses exceed the operating expenses, the developer could reduce the budget to come closer to actual costs, thus reducing the assessments payable by all owners, including the developer. The benefit to the developer of phasing is that the developer will not be required to pay those portions of the assessments that are to be set aside and added to replacement reserves for a unit until the unit is added to the condominium. An entity that is considering acquiring a partially completed project that is being phased needs to understand what is in the condominium and what is not yet in the condominium. The acquiring entity also needs to determine if the budget for the association is sufficient to operate the condominium and if there are adequate reserve buildups provided for in the budget. An acquiring entity may need to subsidize an association that is underfunded due to the phasing or under-budgeting in order to avoid the financial failure of the association.

B. [3.33] Commercial Space

Many mid-rise, high-rise, and loft conversion buildings contain commercial space that is generally located on the ground level and sometimes on the second or third levels. Commercial space can be made part of the condominium property as common elements, made into nonresidential units, or carved out of the condominium property. If the commercial space is made part of the common elements, then the condominium association would have control over how the commercial space is used and would apply any rent received with respect to the commercial space to pay common expenses. If the commercial space is made into one or more nonresidential units, the commercial units can be used for nonresidential purposes, would have a percentage interest, and would pay assessments based on the percentage interest assigned to each commercial unit. The most significant difference between nonresidential units and residential units would be the use restrictions. However, because the nonresidential units are units within the condominium, they would be subject to rules and regulations adopted from time to time by the condominium association.

One potential problem with making commercial space into units is that generally the commercial space represents a small amount of the space in the building, which means that its

owner would not have much voting power. A board dominated by residential unit owners could pass rules and regulations or institute procedures that could make things difficult for the owners of the nonresidential units and adversely affect the marketability of these units.

The third alternative, carving commercial space out of the condominium, is often the best choice from the point of view of the developer. By carving the commercial space out of the condominium property, the commercial space would not be subject to rules and regulations adopted by the condominium association. The commercial space would not participate in the condominium association in that it would not have a percentage interest and therefore would not have any right to attend meetings or vote. Similarly, the commercial space would not be required to pay assessments based on a percentage interest. Instead, the declaration should be drafted so that it contains provisions that require the owner or owners of the commercial space to pay a designated share of certain expenses, such as maintenance of the roof, the exterior of the building, and any common access areas, loading docks, or other areas or systems that serve both the condominium property and the commercial space. Under this approach, the commercial space owners would not be required to pay a percentage interest of all costs that would include costs for services that the commercial space would never use, such as elevator maintenance or the cost of maintaining residential areas of the building. This method of expense allocation should result in the commercial space owners paying substantially less for maintenance costs than they would pay if they owned condominium units. Since the commercial space will not become part of the condominium property unless the developer reserves the right to add commercial space to the condominium property at a later date, the declaration will need to include cross-easements of support and access between the commercial space and the condominium property. Also, there will need to be party wall provisions dealing with the walls or floor dividers that separate the commercial space from the condominium property.

As mentioned in §3.29 above, the secondary mortgage market will limit the amount of space in a mixed-use building that may be designated as commercial to 20 to 25 percent of the total floor area whether the commercial space is part of the common elements, a unit, or carved out as described above.

C. [3.34] Parking

Most larger buildings have parking as part of the project. Because most larger buildings are located in areas where parking is at a premium, the developer generally sells parking spaces. There are several ways to approach parking. They include (1) creating each parking space as a separate condominium unit, which is then sold and conveyed to a purchaser; (2) setting up each parking space as a limited common element, which is then assigned to a unit; (3) setting up the parking spaces as part of the general common elements, which are then assigned to the owners by the condominium association board; or (iv) creating a valet parking facility within the condominium whereby each owner of a unit who desires to park a car will purchase a parking right, which will be the right to park his or her car at any time and from time to time in the parking garage using the valet system.

Since a purchaser who is asked to pay for parking will want to know that he or she will have a specific assigned parking space, the most commonly used approaches are to either create the parking spaces as condominium units or assign the parking spaces as limited common elements.

The valet parking approach has been used in situations in which it is possible to park a larger number of cars in the garage but, because of the way the garage is configured, the only way to be able to get cars in and out when they are needed is to set the garage up as a valet parking facility.

When a specific parking space is to be assigned to a unit, the typical choice is between parking spaces that are units and parking spaces that are limited common elements. If a parking space is set up as a unit, it will have a percentage interest assigned to it, which means that an assessment will be payable with respect to the unit, the unit will have a vote equal to its percentage interest, and in addition, because it is a condominium unit, a real estate tax bill will be issued with respect to the unit. If, on the other hand, a parking space is set up as a limited common element, it will not necessarily have a percentage interest assigned to it (although it could be required to pay a share of the cost of maintaining the garage), and it will not be issued a separate real estate tax bill (although the value of the parking space may be picked up and included in the real estate tax bill for the unit to which it is assigned). Lenders prefer that parking spaces be limited common elements because a limited common element parking space will be covered automatically by the mortgage on the unit to which it is assigned, whereas a parking space unit would have to be made specifically subject to the lender's mortgage. Also, a limited common element parking space may be assigned only from one unit to another, usually requiring mortgagee consent, whereas a parking space unit can be conveyed separate from a residential unit without the mortgagee's consent, although to do so may be a default under the mortgage or a breach of the terms of the declaration.

IX. [3.35] ISSUES UNDER THE INTERSTATE LAND SALES FULL DISCLOSURE ACT

The Interstate Land Sales Full Disclosure Act (ILSFDA), 15 U.S.C. §1701, *et seq.*, was passed by Congress in the late 1960s in response to scandals involving land developers who sold subdivided lots in places like Florida and Arizona who were unable, or never intended, to build the necessary infrastructure for the lots, thus rendering the lots virtually worthless. The ILSFDA requires a developer to register a development in which the developer intends to sell lots or condominium units with the Department of Housing and Urban Development (HUD) and requires that a HUD-approved property report in a form prescribed by HUD must be delivered to each prospective purchaser prior to the purchaser entering into a contract to purchase a lot or condominium unit. 15 U.S.C. §1704. Although the intention of the ILSFDA is laudable, being essentially a consumer protection statute, it is viewed by builders and developers as another unnecessary governmental regulation. The biggest problem with registering under the ILSFDA is the time it takes (approval generally takes eight to ten weeks after a submission is made to HUD) and the tenor of the property report, which contains bold type warnings prescribed by HUD that are intended to make a purchaser aware of the downside risks of buying a lot or condominium unit from the builder or developer with language that is often overstated and inappropriate for the circumstances. In addition, under the ILSFDA, the purchaser of a lot or unit that is registered with HUD must be given a seven-day right of rescission from the date on which the contract becomes effective. Although the process is cumbersome, most builders and developers will register a development with HUD if they have the time to do so.

For those builders and developers who do not have the time to register with HUD or who choose not to do so, there are several exemptions from the registration requirements that are available. See 15 U.S.C. §1702. There is an exemption for the sale of lots by one developer or builder to another, as long as the purchasing builder is not acting together with the selling builder or developer in what amounts to a “common promotional plan” under HUD’s regulations. See 24 C.F.R. pt. 1710. Another exemption relates to projects that have less than 100 lots or units, although this exemption is not available with respect to a phase that is a part of a larger development. The most commonly used exemption, especially for projects of more than 100 units, is commonly referred to as the “two-year exemption.” Under this exemption, the sale of a lot or condominium unit is exempt from registration if the purchase agreement obligates the builder-seller to complete construction of a home on the lot (or a condominium unit) within two years after the purchase agreement is executed by the purchaser. 15 U.S.C. §1702(a)(2). In order to qualify for the exemption, the purchase agreement cannot limit the remedies of the purchaser in the event that the builder-seller violates its obligation to complete the home or unit within the two-year period. The courts have interpreted this requirement to prohibit the builder-seller from limiting the purchaser’s right to seek specific performance or damages as a result of a breach of this obligation. See *Markowitz v. Northeast Land Co.*, 906 F.2d 100, 104 – 105 (3d Cir. 1990) (stating that contract must not allow nonperformance by seller at seller’s discretion with regard to exemption under §1702(a)(2)); *Marco Bay Associates v. Vandewalle*, 472 So.2d 472, 474 (Fla.App. 1985) (stating that courts have construed §1702(a)(2) to require unqualified and unconditional guarantee to complete building within two-year period and that any contract provision limiting purchaser’s right to affirm contract and seek damages or specific performance is fatal to exemption). If the purchase agreement does not contain the required provisions to qualify for an exemption, then the exemption is not available, regardless of how long it takes to complete construction of the home or unit. This exemption is the most commonly used exemption for builders of single-family homes, townhomes, and low-density condominium projects, particularly those in the suburbs, because in these situations it is relatively easy to deliver a home or condominium unit within two years after the date that the purchaser executes the purchase agreement. However, if the builder-seller decides to abort the project or change the development plan and needs to terminate purchase agreements, it may have a difficult time doing so because the purchaser is required to be given the right of specific performance and the builder-seller cannot simply take a position that it has defaulted and that its only obligation would be to return the purchaser’s earnest money, which is what many purchase agreements that do not qualify for this exemption provide.

The issues become more significant in the case of a high-rise condominium building. Often the builder-seller begins a sales program before construction begins and seeks to satisfy a presale requirement imposed by its construction lender before it can open its construction loan and begin construction of the building. High-rise buildings often take from 18 months to two years to construct. Depending on how long before construction begins the purchase agreements are entered into, the timing of a high-rise condominium building will make it difficult to qualify for the two-year exemption. In these situations, the best approach, if the builder-seller has time, would be to register with HUD. However, as mentioned above, many builders do not have time to wait until their registration with HUD has been completed and, as a result, attempt to qualify unit sales for the two-year exemption. HUD permits delay in completion of the unit for causes that are legally recognized as defenses to contract actions under local laws. Thus, a builder may have

some leeway if the builder is unable to complete construction due to things like material shortages, labor disputes, war, or other causes that fall within the category of force majeure.

If a particular transaction does not qualify for an exemption and is not registered with HUD, the builder-seller may be subject to private administrative and criminal sanctions, including the right to rescind the contract, injunctive relief, fines of up to \$10,000, or five years in prison. 15 U.S.C. §1717.

There are benefits to registering with HUD. There is no limit on the time for completing a home unit after the purchaser signs the purchase agreement. Thus, for instance, in a high-rise condominium project that is registered with HUD, the builder-seller can agree to deliver units three or four years after the date of the contract without violating the ILSFDA. Also, once a development is registered with HUD, the home purchase agreement can limit the remedies of the purchaser in the event of a default by the seller. Generally, the purchase agreement limits the remedies of the purchaser to a return of the earnest money or a return of the earnest money plus interest or liquidated damages of a modest amount. Also, under HUD's regulations, the purchase agreement must provide that if the purchaser defaults under the purchase agreement and does not cure the default within 20 days of receipt of seller's written notice of the default, the seller can retain as damages up to the greater of (a) 15 percent of the purchase price or (b) the actual damages incurred by the seller. 24 C.F.R. §1710.558(b)(3)(iii).

An entity considering acquiring a partially completed project, especially if it would become the seller under outstanding unit purchase agreements, needs to determine if the project was registered with HUD (and if so, whether the developer strictly complied with HUD's regulations concerning distribution of the HUD property report including collecting signed acknowledgements from each purchaser) or if it is attempting to operate under an exemption from filing.

X. REPRESENTING THE DEVELOPMENT PLAN TO THE PUBLIC

A. [3.36] In General

In a planned development, the developer may find it necessary to change the development plan as required by market conditions. To preserve and maintain maximum flexibility, it is important that the developer not make representations to purchasers or prospective purchasers that would limit this flexibility. Arguably, covenants, restrictions, and easements that bind the real estate or contract rights that bind the developer may be created from representations made by the developer or its agents in sales brochures, maps, scale models, newspaper advertisements, and oral statements. Although there are few reported cases directly on point, it appears that the courts are prepared to hold developers to representations made in their sales efforts. *See Siegel v. Levy Organization Development Co.*, 153 Ill.2d 534, 607 N.E.2d 194, 180 Ill.Dec. 300 (1992); Jan Z. Krasnowiecki, *Townhouses with Homes Associations: A New Perspective*, 123 U.Pa.L.Rev. 711 (1975).

B. [3.37] Unit Owner Lawsuit

A developer who has made representations to the public that the planned-unit development will be built according to a particular plan and who later either changes or abandons the plan may be faced with a lawsuit by disappointed unit owners. A lawsuit may include actions for an implied contract based on representations made, an implied covenant running with the land owned by the developer, misrepresentation, or fraud. Among possible remedies, an owner could seek injunctive relief, monetary awards for damages, or rescission of the purchase contract of the unit.

C. [3.38] Suggested Precautions

To avoid the possibility of a lawsuit, the developer should make no representations concerning the development plan without coupling the representation with a clear disclaimer. Salespeople must be cautioned to speak in terms of what the developer “currently” plans to build and to add that the development plan is subject to change because of market conditions and that the purchaser cannot expect the developer to complete the planned-unit development as currently planned. In addition, if in marketing units the developer uses a scale model or pictorial representation of the PUD as planned, a clear and unambiguous statement should be included that there is no obligation on the part of the developer to complete the PUD as shown.

XI. [3.39] SECONDARY MORTGAGE MARKET

At several points in this chapter, reference is made to the requirements of the secondary mortgage market and how it influences the formulation of the development plan. See, *e.g.*, §3.30 above. A brief description of the secondary mortgage market and its requirements follows.

The secondary mortgage market is a shifting complex of governmental and quasi-governmental agencies and entities as well as institutional investors. Currently, the major investors in the secondary mortgage market are the Federal National Mortgage Association (FNMA or Fannie Mae), a federally chartered, publicly held corporation; the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), a federally chartered corporation whose shareholders are member banks of the Federal Home Loan Bank Board; and various mortgage banking operations, insurance company pension funds, and other institutional investors that buy and sell home mortgages or securities backed by pools of home mortgages.

Lenders generally have regarded loans on units in condominiums and planned-unit developments to be more risky, if not simply more trouble, than loans on detached, single-family homes that are not part of a condominium or PUD. One way to maximize the availability of end-loan financing is to conform the condominium or PUD documentation to the requirements of the secondary mortgage market. This enables the end lender to sell the mortgage loans it originates, rather than to hold them in its portfolio, or to shift some of the risk of the loans to entities that insure or guarantee loans.

Usually, investors in the secondary mortgage market purchase only mortgages that satisfy certain specific requirements. Since home ownership is a goal that the federal government actively supports and encourages, a number of federal or federally related programs have been developed to encourage the purchase of home mortgages by investors:

a. The Federal Housing Administration, a part of the Department of Housing and Urban Development, insures home loans that satisfy its requirements. An investor is encouraged to purchase FHA-insured home loans or securities backed by a pool of loans that includes FHA-insured loans because if an FHA-insured loan goes into default, it can be assigned to the FHA in return for cash or debentures of the federal government, thus substantially reducing the investor's risk.

b. The Department of Veterans Affairs (VA) is a federal agency that guarantees a substantial portion of a home loan to a veteran who satisfies its requirements. An investor is encouraged to purchase VA-guaranteed loans or securities backed by a pool of loans that includes VA-guaranteed loans because if a VA-guaranteed loan goes into default, the VA will stand behind its guaranty and, in many cases, will purchase a defaulted loan for cash. The VA will guarantee loans secured by lots in a PUD and condominium units. The VA does not guarantee co-op share loans.

c. Freddie Mac is an investor that purchases conventional loans (other than those that are FHA-insured or VA-guaranteed) that satisfy its requirements. Freddie Mac purchases loans from savings and loan associations, banks, and certain mortgage bankers. Freddie Mac will purchase long-term, fixed-rate loans, and various adjustable rate mortgages (ARMs) on lots in a PUD and condominium units. Freddie Mac does not purchase co-op share loans.

d. Fannie Mae is an investor that purchases from qualified sellers/servicers FHA-insured loans, VA-guaranteed loans, and conventional loans that satisfy its own requirements. Conventional loans purchased by Fannie Mae include long-term, fixed-rate loans, GEMs, and various ARMs. Fannie Mae will purchase loans secured by lots in a PUD and condominium units. Fannie Mae will purchase co-op share loans.

FHA, VA, Fannie Mae, and Freddie Mac all have requirements that must be satisfied before they will insure, guarantee, or purchase a loan, as the case may be, on a condominium unit. Although all of these entities previously had similar requirements that needed to be satisfied before they would insure, guarantee, or purchase loans on non-condominium units, they currently do not have such requirements, but it is possible that such requirements may be reinstated in the future.

It is possible to draft a set of condominium documents that satisfies the legal requirements of the FHA, VA, Fannie Mae, and Freddie Mac. Although the FHA, VA, Fannie Mae, and Freddie Mac currently do not have a uniform set of standards for condominium projects, there are a number of basic issues that concern them all, including:

Workability. The documentation must establish a workable project and, in particular, must set forth clearly responsibility for maintaining all portions of the project. The documentation must

provide a logical and workable means of allocating expenses incurred by the association and collecting assessments from unit owners.

Budgeting. The budgeting procedure must be clear, and the budget must include adequate reserves (usually minimum of 10 percent of the overall budget) for the replacement and major repair of the common areas of the project and funding for insurance coverage and deductibles.

Assessments. Assessments must be mandatory, and nonpayment of an assessment must result in a lien against the defaulting owner's unit. No more than 15 percent of the total units may be more than 30 days in arrears in the payment of assessments.

Priority of Mortgage Lien. With only a few exceptions, the lien of the holder of a first mortgage on a unit must have priority over the association's lien for unpaid assessments.

Developer's Reserved Rights. The reserved rights of the developer must be reasonable and must relate to the legitimate interests of the developer in constructing the project and selling the units. A long-term recreational facility lease is generally not acceptable to the secondary mortgage market. Also, a long-term management agreement or any contract that appears to involve self-dealing by the developer will be scrutinized closely. The developer will not be permitted to retain control of the association beyond a reasonable period of time, which is generally not later than when 75 percent of the units have been sold or five (and in some cases seven) years after the declaration is first recorded, whichever comes first.

Add-On Rights. If the developer reserves the right to add additional property to a residential association, the improvements on the added property should be of the same style, construction, and quality as the property currently being administered by the association. This requirement is intended to ensure that the maintenance costs of all units will be similar and that no one unit owner will be required to subsidize the cost of maintaining other units that may require a greater amount of maintenance than his or her unit. Also, the developer may have to limit its power to add property to the condominium to a reasonable period of time, which may vary depending on the character and size of the project. Further, the method the developer chooses to implement his or her add-on rights may affect his or her quota for the owner-occupancy rate or the limits on FHA concentration levels.

Phasing a Single Structure. Building-by-building add-on phasing is not typically a problem for the secondary mortgage market. Difficulties arise when a developer phases a single building structure into several phases in which a floor or groups of floors are added in as a legal phase. Although this type of vertical phasing is permitted under the Illinois Condominium Property Act as discussed at §3.32 above, it is not favored in the secondary mortgage market. Particularly, Fannie Mae has determined that one building equals one legal phase. There may be some flexibility if a project is approved through its Project Eligibility Review Service (PERS) but not through the traditional lender-delegated review processes. Vertical phasing is acceptable under FHA guidelines if certain criteria are met such as phasing done in groups of five floors or more, completion of common areas and facilities, issuance of at least a temporary certificate of occupancy, and obtaining a completion bond.

Right of First Refusal. Originally, a declaration containing a right of first refusal in favor of the association upon the sale of a unit was not generally acceptable to the secondary mortgage market. These rights, rarely exercised by an association, created a problem just by their mere presence in the declaration. Effective January 1, 2010, P.A. 96-228 added §22.2 to the Illinois Condominium Property Act as a possible solution to the problem. 765 ILCS 605/22.2. Section 22.2 provides: “[i]n the event of a sale of a condominium unit by a unit owner, no condominium association shall exercise any right of refusal, option to purchase, or right to disapprove the sale, on the basis that the purchaser's financing is guaranteed by the Federal Housing Authority.” In addition, FHA guidelines now permit a right of first refusal “unless it violates discriminatory conduct under the Fair Housing Act regulation 24 CFR 100.” See HUD Mortgagee Letter 2009-46B, V(3).

Amenities. The amenities of a project, such as recreational facilities, must not be a financial burden to the existing units in the project. If the project documentation permits later annexation of additional property and if the existing units cannot support the amenities, then a secondary mortgage market entity may approve the project but require the developer to post adequate security to guarantee that the cost of maintaining the amenities will be paid until a sufficient number of units exist.

Presale Requirement. Generally between 50 percent and 70 percent of the units in a project must be under contract for sale before a mortgage on a unit will qualify for insurance or guarantee by or sale to an entity in the secondary mortgage market. The harsh effect of the presale requirement may be mitigated by breaking a large project into phases. Also, if the project is an add-on project, the presale requirement may be applied on a cumulative basis as phases are added to the project.

On November 6, 2009, the FHA issued Mortgagee Letter 2009-46A (available online at www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-46aml.pdf), which temporarily reduced the presale requirement to 30 percent for a new construction project assigned an FHA case number between December 7, 2009, and December 3, 2010. Per Mortgagee Letter 2009-46A, valid presales require (a) copies of sales contracts and evidence of a mortgagee willing to lend, (b) evidence a unit has closed and is occupied, or (c) a builder's certificate and spreadsheet evidencing that (a) or (b) is true.

Owner Occupancy Requirements. The secondary mortgage market will not approve a project if too many units are owned by nonresidents or investors. Generally, if more than 49 percent of the units are owned by nonresidents, the secondary mortgage market entities will not insure, guarantee, or purchase loans in the project. There are some exceptions for second homes and bank-owned (REO) units. Owner-occupancy limits are also affected by the type of phasing chosen by a developer. For example, under FHA guidelines, the owner-occupancy ratio applies to the number of presold units only when the developer is in its initial marketing phase, proposed, or still under construction.

FHA Concentration Levels. FHA will not assign a new case number to a new loan once a condominium development reaches a 30-percent concentration level of units subject to FHA-insured mortgages. FHA Mortgagee Letter 2009-46A temporarily increased the concentration level to 50 percent between December 7, 2009, and December 3, 2010. In some other cases, the

concentration level will be increased to 100 percent when a project is fully completed, 100 percent of the units have been sold, no entity owns more than 10 percent of the units in the project, the budget contains adequate reserves, the association has been turned over to the owners, and the owner-occupancy ratio is 50 percent. This exception is only available for established condominium projects, not for new construction or conversion projects.

Commercial Space. Generally, the secondary mortgage market will limit the amount of space in a mixed-use building that may be designated as commercial to 20 to 25 percent of the total floor area.

Investor/Single Entity Ownership. No single entity may own more than 10 percent of the units in the project. The 10-percent limitation on single ownership applies to all owners except the developer during the initial marketing of a new condominium. It does apply to a developer, however, if the developer subsequently rents vacant and unsold units.

Although unit loans secured by lots in PUDs and condominium units are widely traded in the secondary mortgage market, loans secured by the shares of a co-op unit owner in his or her co-op association have not yet gained wide acceptance in the secondary mortgage market. Fannie Mae has a program under which it will purchase loans made by lenders to owners of co-op units that are secured by a pledge of the owner's stock in a cooperative association and his or her leasehold interest in the unit. In addition, the FHA will insure loans secured by a pledge of a co-op unit owner's stock in his or her cooperative association.

The foregoing briefly outlines some of the major issues with which the secondary mortgage market is concerned. To obtain project approval of a PUD from a particular entity, it will be necessary to compare the documentation for the PUD to the legal requirements of the entity. As of this publication, FHA, VA, Fannie Mae, and Freddie Mac do not require project approval of non-condominium projects. The secondary mortgage market is in a state of flux, and it is possible that this could change and that at some time in the future the secondary market once again will require approval of documents for non-condominium projects.

XII. CONSIDERATIONS WHEN ACQUIRING TITLE TO A PARTIALLY COMPLETED PROJECT

A. [3.40] In General

The continuing depressed housing market has resulted in a number of stalled projects for sale, many of which are in various stages of workout or foreclosure. A lender or other party interested in acquiring a partially completed project needs to conduct a thorough due-diligence investigation to determine the status of the project, including what rights may and should be assigned to them and what obligations they may be inheriting.

Sections 3.41 – 3.43 below provide a summary of documents that should be reviewed and issues that should be considered by a party contemplating taking over a partially completed project.

B. [3.41] Suburban Projects

Entitlements. An interested party should review annexation and development agreements, applicable zoning and subdivision ordinances, recapture agreements, easements, cost sharing agreements, and other recorded documents. Be aware that many rights and obligations may “run with the land.” If certain rights and obligations do not run with the land, the acquiring party should determine if it needs or wants to acquire such rights and, if so, what needs to be done to acquire them and what obligations come along with them.

Bonds/letters of credit. Often surety bonds or letters of credit are posted by the developer as security for the completion of subdivision improvements required under the entitlement documents. It should be determined whether such bonds or letters of credit exist and, if so, whether they are sufficient to complete the required work. The acquiring party needs to determine if it will be required to replace the security or if the municipality will call the security and complete the work. If the security is called, a determination needs to be made whether the party standing behind the security will have a defense to the call and, if it does the work, whether it will have recourse against the acquiring party.

Homeowner and condominium documents. An interested party should review the declaration, bylaws or operating agreement, articles of incorporation or articles of organization, other association corporate or LLC records, rules and regulations, cost-sharing or other agreements that bind the association, budgets, bank records, financial statements, and real estate tax bills. These documents should be reviewed to determine the rights and obligations of the developer (or declarant), including, *e.g.*, status of control of the association, subsidy issues, obligations to complete common areas and amenities, status of conveyance of common areas to the association or governmental bodies, real estate tax liabilities with respect to common areas, real estate tax issues including tax divisions, obtaining the \$1 assessment treatment for common areas, and other exemptions available to the developer such as model home exemptions. As discussed in §3.32 above, non-condominium declarations often are drafted so that the developer or declarant pays the shortfall between income and operating expenses instead of paying assessments on units owned by the developer or declarant. The acquiring party may want to accept an assignment of the rights of the developer or declarant in order to have the same option, provided that the acquiring party understands the obligations that go along with becoming a successor developer or declarant. Consideration must be given to the economic situation of the association, particularly if control has been turned over to the owners. An important part of due diligence is meeting with the managing agent and board of directors for each association to determine if they have any claims against or issues with the developer. It may be appropriate for the acquiring party to attempt to negotiate an agreement with an association to resolve issues discovered in due diligence.

SSA issues. In recent years, municipalities, at the request of developers, established special service areas (SSAs) to finance the construction of certain public improvements that will serve a development, such as storm water management facilities, sanitary sewer facilities, roads, streets, sidewalks, erosion control measures, wetland mitigation, public park improvements, etc. The municipality issues tax-exempt bonds to pay for the public improvements with the bonds being repaid over a period of 27 – 30 years by way of a line item on the real estate tax bill (SSA tax) for each lot or unit in the development. A number of partially completed projects are subject to such

SSA taxes. A typical annual SSA tax may range from \$1,500 – 2,500 per lot or unit, regardless of whether the lot is improved with a dwelling unit, and this amount typically increases by 1.5 or 2 percent per year. This could be a significant burden for an acquiring party and will affect the marketability of the unsold lots. Currently, many SSA bonds are selling for significant discounts. An acquiring party should consider purchasing the SSA bonds at a discount and retiring a portion of the bonds and releasing the portions of the project that the acquiring party owns from the annual real estate tax burden and thus improving the value and marketability of that property, while leaving the bonds and the real estate tax obligation on the existing homes that were sold by the previous developer or developers.

Interstate Land Sales Full Disclosure Act. HUD issues should be considered, including whether the project was registered with the Department of Housing and Urban Development (and if so, whether the developer strictly complied with HUD’s regulations concerning distribution of the HUD property report, including collecting signed acknowledgements from each purchaser) or qualifies for an exemption from registration under the Interstate Land Sales Full Disclosure Act. If the project was registered with HUD, then periodic filings are necessary to maintain the registration.

Financing unit or lot sales. Other issues to consider are the availability of end-loan financing for the lot or unit purchasers and whether secondary mortgage market approvals been received. As discussed in §3.39 above, it has become significantly more difficult to obtain end loans on condominium units. As a result, many builders avoid creating condominiums whenever possible.

Environmental issues. Environmental issues could have a significant impact on the ability to obtain financing and the cost of development and insurance and may create expensive and time-consuming obligations for the acquiring party, such as obligations to create or mitigate wetlands, complete environmental remediation work, and obtain revisions to flood maps.

C. [3.42] Mid-Rise or High-Rise Buildings and Mixed Uses

Mixed-use structures and mid-rise and high-rise buildings, typically located in urban settings, have many of the same issues described in §3.41 above. Zoning, condominium regime documents, end-loan financing, and the other issues described above all need to be considered. In addition, a party acquiring a mid-rise or high-rise building or mixed-use development also needs to consider whether the building should continue to be marketed as a condominium or converted to a rental project. Under the Condominium Property Act, a building can be removed from the Act with the consent of 100 percent of the owners and their lenders. Sections 15 and 16 of the Act provide the procedures for the sale of the entire condominium to a purchaser who then would own all of the units and would be able to remove it from the terms of the Act. Under the Act, such a sale requires an affirmative vote of at least 75 percent of the owners, but the Act contains additional provisions that could make this option unworkable, particularly if there are a large number of units closed.

Ownership structure/cost sharing. As discussed in §3.29 above, the commercial space in a mixed use building is often carved out of the condominium and owned separately from the

condominium. An acquiring party needs to understand the relationship between the condominium association and the commercial property owner, particularly with respect to cost sharing, easements, and access rights.

If the condominium is set up as an add-on condominium, the acquiring party needs to understand what portion of the building has been added to the condominium. The declarant-developer is required to pay assessments with respect to each unit it owns in the condominium. The declarant-developer also may be obligated to pay a share of certain costs incurred by the condominium association that benefit unadded portions of the building, such as costs associated with utilities and elevator maintenance.

Governing documents. The governing documents, including the condominium declaration and any reciprocal easement or cost-sharing agreement, will need to be reviewed to understand rights and obligations relating to permitted uses; cross-easements and access; maintenance; costs sharing; remedies; restrictions on parking, signage, and leasing; rights of the declarant-developer; timing of the turnover of control of the association; and amendment provisions.

Interstate Land Sales Full Disclosure Act. HUD issues should be considered, including whether the project was registered with the Department of Housing and Urban Development (and if so, whether the developer strictly complied with HUD's regulations concerning distribution of the HUD property report, including collecting signed acknowledgements from each purchaser) or qualifies for an exemption from registration under the ILSFDA. If the project was registered with HUD, then periodic filings are necessary to maintain the registration. The ILSFDA does not require the registration of commercial units. The relationship between the commercial and residential space and the rights of the commercial unit owner, however, may need to be discussed as part of the disclosures required under the ILSFDA.

Financing unit or lot sales. In addition to the secondary mortgage market issues described in §3.39 above, a party acquiring a mixed-use development needs to consider the ratio of the commercial area to the residential area in the building and the method for adding on units, as they relate to secondary mortgage market financing issues. Owner occupancy and pre-sale requirements must be considered so that future purchasers will qualify for loans to be sold to or insured by the secondary mortgage market. While selling to investor purchasers may help achieve a pre-sale requirement, such sales may have a negative impact on the owner-occupancy ratio. Similarly, selling a block of units to a single purchaser will jeopardize the available financing for other purchasers, as neither the Federal Housing Administration nor Federal National Mortgage Association will insure or purchase loans on units in a condominium if one entity owns more than 10 percent of the units in the condominium.

Real estate taxes. The recording of the condominium declaration and plat will cause the automatic division of the building and land for real estate tax purposes. If units are added to a condominium over a period of two years or more, several divisions will take place. The tax liability of the developer (and commercial owner) will need to be determined for unsold units and unadded portions of the building. A party acquiring a mid-rise, high-rise, or mixed-use building should determine whether there are existing proration or re-proration agreements with purchasers in place and whether escrows have been established for the payment of real estate taxes when due.

Affordable housing. The developer may be selling some units in a building as affordable by either selling a unit (1) at a reduced price with restrictions on resale value and qualification requirements for subsequent purchasers or (2) subject to a second mortgage that will need to be paid off at the time the unit is sold. Furthermore, if affordable units are sold to an entity for leasing to low-income tenants, secondary mortgage market issues may arise that affect owner-occupancy rates and single entity ownership limits. Also, the budget should be reviewed to determine whether efforts have been made to keep assessments allocated to “affordable” units affordable.

Fair Housing Act. The federal Fair Housing Act, 42 U.S.C. §3601, *et seq.*, (as well as other federal, state, and local laws) is in place to, among other things, assure a real estate market free from discrimination based on race, color, gender, religion, handicap, family status, and country of origin. One of the most common issues in condominium governance involves requests for accommodation by residents with disabilities. When possible, the association should make reasonable accommodations for residents with disabilities. These requests often involve parking spaces.

Earnest money. Section 24 of the Condominium Property Act requires that purchasers’ deposits (excluding those for extra work) be held in segregated escrow accounts. 765 ILCS 605/24. An account must be interest bearing if the deposit will be held for over 45 days. If there is a refund of the earnest money or a default under the contract, the interest earned follows the distribution of payment of the earnest money. The funds held in escrow pursuant to §24 are not subject to attachment by any creditor of the purchaser or of the developer or by the holder of a lien against any portion of the property such as a construction mortgagee or mechanics lien holder. Unlike condominium sales, there is no statute that governs the deposits of earnest money in non-condominium projects. Developers often spend this money during the construction process. If the money is not spent and is placed in escrow, the escrows may not provide the necessary protections against liens of the developer’s creditors. In either case, a successor developer should examine any existing accounts and require an assignment of the developer-seller’s rights to the accounts.

D. [3.43] Representing the Construction Lender in a Troubled Project

Generally, a lender considering foreclosure or deed in lieu of foreclosure will need to go through the same analysis and due diligence as a third party considering acquiring the project. Many lenders made loans on large projects without a full understanding of the project or its development plan, and many of the development plans for projects that are in default are seriously flawed. In some cases, it may be necessary for the development plan to be restructured before another entity resumes development activities. Such restructure may include amending the project documentation to correct defects in the documentation. It also may include renegotiating the annexation and development agreements. Because of the potential liabilities that may follow the ownership of the project, the lender should take title to the real estate in a limited-liability company established to hold title to the project.

If there is construction in process and there are sales pending, the lender should determine what needs to be done to protect the unfinished improvements and how to deal with the

purchasers until a replacement developer can be hired or the project can be sold. In some situations, the lender should consider offering end loans to potential purchasers as a way to facilitate sales.

The lender also needs to determine how to deal with the existing associations and whether they have been turned over or are still subject to developer control, paying particular attention to subsidy and assessment obligations. Lack of funding for reserves and working capital and other budget shortfalls are common problems that need to be evaluated and dealt with. The lender may want to consider requiring the developer to turn over control of the association prior to accepting a deed in lieu of foreclosure with respect to the project so the lender will be in a position to negotiate with a board that can effectively bind the association as opposed to a developer-controlled board whose actions are more likely to be challenged later. If the lender takes over a project that has an association that has not yet been turned over, it may need to appoint individuals to serve on the board until the association is turned over.

If the lender has posted letters of credit to ensure completion of subdivision improvements, it needs to determine if the municipality intends to call the letters of credit and, if so, may want to negotiate a settlement before the call is made.

If the project is subject to a special service area ordinance and bonds were issued to finance the installation of subdivision improvements, it should be determined if there are sufficient funds in the SSA trust to fully complete the work or if additional funds will be needed to complete the work. If an SSA is in place, the lender should evaluate the effect that the SSA taxes will have on the value of the project and may want to consider purchasing the bonds at a discount, as discussed in §3.41 above.

The lender should review its mortgage title insurance policy to determine if it has claims against the title insurance company. If a construction escrow was used to disburse funds and insurance was obtained for each disbursement, the lender may have coverage over mechanics lien claims. If there is limited or no coverage over mechanics lien claims, the lender should be prepared to negotiate and settle those claims.

XIII. [3.44] DISTRESSED CONDOMINIUM PROJECTS

P.A. 96-174 (eff. Jan. 1, 2010) amended the Illinois Condominium Property Act by adding §14.5, entitled “Distressed condominium property.” 765 ILCS 605/14.5. This legislation was passed in response to a multitude of problems such as the blight and hazards of distressed condominium projects, reduction in the values of the remaining units, lost tax revenues, and loss of apartments to the rental market. Customary municipal building code enforcement mechanisms cannot solve the problems of such projects. Distressed condominiums often lack a functioning board to enforce assessment collections and effectuate building repairs. As a result, such condominium projects are at risk of being demolished.

Section 14.5 provides procedures for determining if a particular projected is distressed: (a) 50 percent or more of the units are not occupied by parties with legal rights; (b) the structure has serious building code violations; (c) 60 percent or more of the units are in foreclosure or have

been in the last 18 months; (d) the recording of more units on the parcel than physically exist; (e) essential utilities to the parcel or 40 percent of the units have been terminated (or have been threatened to be terminated); or (f) at least 60 percent of the units are delinquent in the payment of property taxes. Section 14.5 provides further procedures for addressing these concerns, including the appointment of a receiver to manage and conserve the property or to sell the condominium property. The court may appoint a receiver and, after notice and a hearing, may declare that the property is no longer viable as a condominium. If such determination is made, the property shall be deemed owned by all of the unit owners as tenants in common based on their former undivided interest in the common elements; liens affecting any unit shall be deemed attached to each undivided interest in the property. An appointed receiver has broad powers including securing the premises, executing leases, collecting rents, procuring insurance, employing third parties, paying taxes, maintaining or disconnecting utilities, making repairs, holding reserves, and other powers granted by the court.

XIV. [3.45] CONCLUSION

A developer that considers the issues raised in this chapter should be able to formulate a development plan that will create a workable planned-unit development and allow the developer to exercise the type of control and flexibility necessary to ensure the success of the PUD under continually changing market conditions.

A lender, investor, or developer that considers the issues raised in this chapter before committing to acquire a partially completed project should be better able to make an informed decision as to whether it wants to acquire the project and how it will deal with these issues if it does acquire the project.