

## Beware: “Broken” Subdivision Pitfalls Will Linger for Years to Come: Top Ten Questions You Need to Ask



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We now see signs of hope on the horizon for the battered real estate market. But recovery typically happens in stages and there is no reason that this recovery will differ in that regard. At the initial stages of a recovery, sales of unsold inventory will increase. At the same time, projects which were “mothballed” as rentals pending the recovery will re-enter the market as for-sale residences. Many subdivision projects which were stalled when the recession began will be among the first to test the market. New projects will be further behind in the process depending on where they were in the entitlement or construction process when sales ground to a halt. Common interest subdivision projects which were left with a mix of homeowners and an active owners association, as well as unsold units that were vacant or leased, are often referred to as “broken” projects. These projects were often the most problematic at the heart of the recession and will continue to pose more challenges as they change hands and enter the retail market, often with sellers several steps removed from the original developer. What questions should be asked before an acquisition of the unsold homes through foreclosure or a bulk sale?

- 1. What property will be acquired?** A lender or bulk purchaser must understand which portions of the project are encumbered by the lender, which portions have been conveyed to owners or the owners’ association, whether all necessary easements are in place and whether it has control of any recreational facilities or amenities required to market or sell the balance of the project.
- 2. Will a Public Report be required to re-sell the property?** A foreclosing lender or bulk purchaser will need to evaluate whether a new public report is required or desirable due to changes in the project, or whether an exemption applies.
- 3. If required, how quickly can changes to the public report be processed with the DRE?** This depends upon the scope of changes required, but will range from 14 days for a minor amendment to more than 60 days for changes requiring budget review.
- 4. Will the lender be able to convey the balance of a condominium project to an apartment operator without violating the Subdivision Map Act?** If not, the lender will be forced to convey individual condominiums subject to the jurisdiction of the owners association and the purchaser will have to pay assessments, including reserves, even if renting the condominiums. If the project can be divided into “for sale” and “for rent” components, the lender or acquiring purchaser must determine who will control the recreational facilities, whether reciprocal easements are in place for use of the facilities, and how the maintenance and quality of the facilities will be assured.
- 5. Is a foreclosing lender obligated to pay assessments? Or, will sale to a bulk purchaser trigger assessments?** A lender or bulk purchaser is responsible for all assessments payable on units where assessments have commenced. Usually, the conveyance of a residence under authority of a Public Report triggers the payment of assessments. If the CC&Rs do not limit this trigger to individual sales, assessments may be triggered by sales to a bulk purchaser.

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- 6. What is the financial condition of the Association?** A foreclosing lender will extinguish pre-foreclosure delinquent assessments. But, if there is a budget shortfall, the association board members may have a fiduciary duty to levy a special assessment on all units, including the units the lender or bulk purchaser now owns.
- 7. What does the lender need to know about the governing documents and the project governance?** Some of the key issues to review include the following:

  - Can the Declarant’s rights be assigned to the new entity?
  - How long will Declarant control the Association?
  - Has the Association been properly formed and is it in good standing with the Secretary of State?
  - Has the Association asserted any claims against the developer?
  - Is the board of the Association or the management company aware of any outstanding issues at the project?
- 8. Can the original sales documents and sales program be used?** The lender or bulk purchaser must evaluate the sales documents and program to determine the following:

  - Were the requirements of applicable state and federal laws met? Were the appropriate registrations made or exemptions obtained?
  - What is the status of deposits? Will these be assigned?
  - Are there pending claims or arbitrations with defaulting buyers?
  - Do the sales or disclosure documents need to be revised?
- 9. What liability will the lender have for bonds posted by the original developer?** A foreclosing lender or bulk purchaser must review and understand the status of all of the bonds required by the DRE and whether it will be obligated to replace the bonds.
- 10. Is a lender liable for construction defect or other liabilities of the original developer?** Many of the activities that a foreclosing lender must take to complete development or marketing of the project may be outside of the scope of what are considered “lending” activities and if so, may not be protected by Civil Code 3434. A lender must also evaluate its liabilities under SB800. These issues may dictate whether the lender should take title as a single purpose entity and the appropriate liability insurance it should obtain.

**Conclusion.** The acquisition and disposition of a residential subdivision can create pitfalls for the unwary lender or bulk purchaser. A lender or entity acquiring such a project should ask the questions listed above before the deal is final.