Change Order

Published by the Construction section of the North Carolina Bar Association • Section Vol. 26, No. 3 • May 2012 • www.ncbar.org

Have We Seen the End of the Pre-Sale and How Will Developers Get Their Condo Projects Built?

Article Date: Tuesday, May 08, 2012

Written By: Scott A. Miskimon, Wayne K. Maiorano & Toby R. Coleman

A recent federal court decision from the Western District of North Carolina threatens to eliminate the ability of developers and lenders to rely upon pre-construction sales of condominium units as the lynchpin for construction financing for residential condominium projects. In *Berkovich v. The VUE-North Carolina*, LLC, 2011 U.S. Dist. LEXIS 123049, No. 3:10-cv-618-RJC-DSC (Oct. 14, 2011 W.D.N.C.), the court held that the purchasers could rescind a pre-construction sales contract and receive a refund of their earnest money deposit when the contract did not technically comply with the Interstate Land Sale Full Disclosure Act, 15 U.S.C. § 1701 *et seq*. (commonly referred to as "ILSA"). ILSA regulates the sale of subdivided land that is marketed and sold through interstate commerce. While ILSA provides the purchaser with several remedies when the developer fails to comply with the act, it gives the purchaser a unilateral right to rescind a non-compliant purchase contract for two years from the date the contract was executed.

Sellers Beware

The purchasers in *Berkovich* contracted to buy a penthouse unit in a 51-story condominium project in Charlotte known as The VUE. In December 2008, they paid $145,485 as an earnest money deposit towards the $1.283 million purchase price. In October 2010, nearly 22 months later, the purchasers sent a "Notice of Cancellation of Contract" to the developer, invoking ILSA's two-year revocation option. The purchasers then sued the developer when it refused to return their earnest money deposit. In their suit, the purchasers alleged that the contract did not contain a recordable legal description of the condominium as required by ILSA. The contract described the condominium unit to be purchased as follows:

> BEING all of that Unit 5102 of the VUE Charlotte, a Condominium, as described in the Declaration of Condominium (the "Declaration"), recorded in Book _____, Page _____ in the Office of the Register of Deeds for Mecklenburg County, North Carolina, as shown on the plat and plans for the Condominium recorded in Unit File No. _____ in the Office of the Register of Deeds for Mecklenburg County, North Carolina; TOGETHER with the percentage interest in the Common Elements appurtenant to said Unit, as set forth in the Declaration.

Because the contract's legal description did not contain the condominium declaration's recording information, the purchasers contended that it did not comply with the general recording requirements under North Carolina law. Further, the purchasers argued that the purported legal description was "not in a form acceptable for recording by the appropriate public official responsible for maintaining land records in the jurisdiction in which the lot is located" as required by ILSA.

North Carolina law requires that the legal description of a condominium unit include the name of the condominium, the condominium declaration's recording data and the identifying number for the unit; or, it must otherwise comply with the general requirements of North Carolina law concerning the description of property. Pursuant to North Carolina law, before a condominium unit is created, the developer must record a declaration that legally establishes the condominium building and identifies all the units. This cannot occur until the condo building is substantially completed.

In *Berkovich*, the developer had not yet completed the condominium building at the time the purchasers entered the pre-sale contract. Instead, construction was not projected to be complete until December 2011—fully three years after the contract was signed. Therefore, the purchasers' unit had not yet come into legal or factual existence, and thus, no description could be recorded at the time of contracting. In the lawsuit, the developer acknowledged that the legal description was not yet recordable and that the unit purchased had not yet come into legal existence. However, the developer argued that it had provided the purchasers with the form of the legal description and considerable detailed information regarding the location of the unit, which should be sufficient under applicable law.

The *Berkovich* court disagreed and concluded that the property description in the contract was inadequate under ILSA. Therefore, the court entered judgment in favor of the purchasers, permitting them to rescind the pre-sale contract and recover their earnest money from the developer.

The Interstate Land Sale Full Disclosure Act

ILSA was originally enacted to aid land purchasers swindled into buying undevelopable swampland and inaccessible desert property. Among other things, ILSA provides that a purchaser has a two-year right to revoke his contract and obtain a refund of all money paid if the contract lacks certain provisions. 15 U.S.C. § 1703(d). In particular, ILSA's Section 1703(d) provides that the contract may be revoked if it does not provide "a description of the lot which makes such lot clearly identifiable which is in a form acceptable for recording by the appropriate public official responsible for maintaining land records in the jurisdiction in which the lot is located." Over the years, ILSA's scope has been expanded judicially to govern contracts for certain condominium developments. While the sale of condominium units is not expressly included within the language of ILSA, courts have consistently applied it to such sales. *See, e.g.*, *Ndeh v. Midtown Alexandria*, LLC, 300 Fed. Appx. 203 (4th Cir. 2008).

ILSA's Section 1703(d)—as currently interpreted by the courts to apply to condominium sales—thus poses a quandary for lawyers, developers and bankers seeking to assess the enforceability of pre-construction sales contracts for condominiums in North Carolina. In a state where (i) condominium declarations cannot be recorded prior to construction, N.C.G.S. § 47-C-101, and (ii) condominium lot descriptions cannot be recorded unless they contain the declaration's recording data, N.C.G.S. § 47C-2-104, should ILSA be read as making *every single pre-construction contract revocable*? Or should the interpretation of ILSA's revocation remedy be practically interpreted in line with the disclosure requirements of North Carolina law, so that pre-construction sales contracts are binding in cases where the purchaser is provided with a proposed property description (with the recording information for the declarations left blank) and the proposed declarations?

The *Berkovich* decision adopts a textualist approach to ILSA, and holds that ILSA's right of revocation applies to all pre-construction contracts. It waives off arguments that such an interpretation is impractical and even "nonsensical," holding that Congress wanted purchasers to have the protection of being able to record their lot descriptions. 2011 U.S. Dist. LEXIS 123049 at 14-15. "Where this protection is unavailable, section 1703 instead gives purchasers the right of revocation for two years." Id. at 16.

It is noteworthy that the Berkovich court's interpretation of ILSA conflicts with that of the Middle District of Florida in *Taplett v. TRG Oasis (Tower Two)*, 755 F.Supp.2d 1197 (2009 M.D. Fla.). In an almost identical fact pattern under Florida law, the court in *Taplett* held that a pre-construction condominium sales contract was not revocable because the developer had effectively met its ILSA obligations by providing the purchaser with sufficient information, including the proposed lot description and declarations, even though the declaration with the description had not been recorded. The *Taplett* court's interpretation was consciously practical: "To penalize a developer for giving the entire document rather than a mere identifying reference (required so the same document could be found) would be absurd." *Id*. at 1205.

Potential Fallout From Berkovich

The real estate industry has been hard-hit during and after the 2008-2010 recession. This is particularly true for the residential sector. It has become increasingly more difficult to obtain financing for projects. Lenders have traditionally required, and developers have relied upon, condo unit pre-sales to secure financing and to start projects. After the *Berkovich* decision, such pre-sale contracts in North Carolina may no longer be considered binding, essentially turning them into option contracts, and therefore making financing condo projects far more difficult.

While purchasers have not been immune to harm in the wake of the downturn, there is an increasing trend for purchasers to take advantage of ILSA as a tool to avoid their contractual obligations under a pre-sale purchase agreement. (More than half of the reported decisions interpreting the provisions of the 42-year-old law have been issued in the last five years.) ILSA suits like *Berkovich* appear to be a manifestation of buyer's remorse prompted by the decline in the market price of the condominium unit or the purchaser's inability to obtain financing to complete the purchase, resulting in purchasers seeking to cancel or invalidate pre-construction sales contracts on various ILSA grounds. *See, e.g., Bacolitsas v. 86th & 3rd Owner*, LLC, 2010 WL 3734088 (S.D.N.Y. Sept. 21, 2010) (purchaser entitled to rescind contract because property description in sales contract failed to comply with ILSA); *see also Boynton Waterways Inv. Associates, LLC v. Bezkorovainijs*, 2011 WL 2694522 (Fla. Dist. Ct. App. July 13, 2011) (court determined that ILSA is not meant to supersede nor guarantee state law recording obligations in holding that failure to record declarations of condominium prior to sale of unit did not violate ILSA where state law did not require such recordation).

Regardless of whether the non-complying aspect of the contract was obvious to the purchaser, the result of the *Berkovich* decision shifts the entire risk and burden to the developer. By doing so, the *Berkovich* court allowed a mere technicality to trump the practicality of condominium project development and the limitations imposed by state law. The court did so irrespective of the fact that there was no showing of harm or prejudice to the purchasers or intent to mislead or defraud on the part of the developer.

The *Berkovich* decision challenges long-standing industry practice and marks a potentially significant shakeup of North Carolina condominium law. The North Carolina Condominium Act, N.C.G.S. § 47C-1-101 *et seq*., requires extensive disclosures when offering condominiums for sale to the public, but clearly contemplates that there will be pre-construction contracting. *E.g*. N.C.G.S. § 47C-4-103 (requiring developers to disclose proposed declarations if they have not been recorded). Developers and lenders have long assumed that pre-construction sales contracts are binding, provided that developers comply with the North Carolina Condominium Act's various disclosure requirements. As a result, developers have often provided pre-construction buyers with thick pre-offering disclosures that include, among other things, the planned condominium's proposed declarations. *Berkovich* undermines this practice by holding that, even with detailed information and disclosure of the proposed declarations, no pre-construction contract can be made binding until the declarations are recorded—something that cannot occur under North Carolina law until construction is substantially complete.

If the *Berkovich* decision were to be widely followed, the decision would render pre-construction sales of condominiums an unreliable mechanism for developers and lenders to determine the viability of a contemplated condominium project. During the real estate boom of the previous decade, construction lending for condominium projects was often made contingent on a certain amount of pre-sales. Coming out of the downturn, lending practices have become more onerous. Ultimately, by creating uncertainty about whether pre-construction sales contracts are binding, the decision could drastically alter construction financing for condominium projects and stymie condominium development. Likewise, in light of North Carolina's recording requirements, the *Berkovich* court's rigid application of ILSA handicaps condominium construction in North Carolina by creating a nearly insurmountable obligation for developers. Such an interpretation places North Carolina at a significant disadvantage as compared to other states with differing recording requirements.

At the time this article was prepared, the *Berkovich* decision had not been appealed. When interviewed shortly after the court's decision, the developer suggested it intended to appeal. Assuming that an appeal may still be feasible, it is unclear whether the decision will be upheld. Even if the *Berkovich* decision remains unchanged, it is one federal court's interpretation of this issue. Other federal and state courts in North Carolina are not required to follow this decision. However, absent Congressional action to amend ILSA to exclude condo unit sales from its ambit, or judicial action reinterpreting the act's applicability to such sales, the *Berkovich* decision will be relied upon by purchasers seeking to rescind their contracts and likely will be seen as instructive by other courts when addressing this issue. Accordingly, uncertainty and risk remains. While the lending environment may be improving, lenders do not like uncertainty. Therefore, developers and practitioners must consider carefully the implications of the *Berkovich* decision when trying to develop condominium projects. •

Scott Miskimon is a partner in the Real Estate Development Group at Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan, L.L.P. where he concentrates his practice in commercial litigation and real estate litigation matters. He is the co-author and editor of North Carolina Contract Law. He can be contacted at smiskimon@smithlaw.com.

Wayne Maiorano is a partner in the Real Estate Development Group at Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan, L.L.P. where he concentrates his practice in all aspects of construction law and real estate development matters. He can be contacted at wmaiorano@smithlaw.com.

Toby Coleman is an associate in the Real Estate Development Group at Smith, Anderson, Blount, Dorsett, Mitchell & Jernigan, L.L.P. He can be contacted at tcoleman@smithlaw.com.

This article also appears in the upcoming edition of the NCBA Real Property Section's newsletter.

Reprinted with permission by the North Carolina Bar Association.