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Distressed RE: special challenges for troubled mixed-use condos

While many real estate developments are struggling, condominium projects, particularly mixed-use projects in which construction has been recently completed or is nearing completion (“projects”), face uniquely tough challenges. Those seeking to invest in or acquire such projects (“successors”) should first determine the cause of the distress, which may range from the credit crisis, as many developers are unable to qualify for construction advances under existing loans and have difficulty securing permanent financing to pay off construction loans, to factors such as terminations and defaults by residential buyers and the scramble for retail tenants. To accomplish a successful transition, successors must understand the challenges involved in operating mixed-use condominiums and the obligations associated with the roles of owner, developer, declarant, seller, landlord, association member, association board member and/or property manager.

Repositioning the project as another type of use and ownership, such as apartments for rent, hotel, vacation interests for sale, or a senior living facility, may be a viable alternative, particularly in projects where few or no residential closings have occurred. If commercial units retained by the developer have significant value, another option may be withdrawal of those units from the condominium scheme. Otherwise, the successor will be facing owners with varying and sometimes conflicting interests as well as an owners’ association, which the successor may not control.

Evaluation of the legal structure of the project and the governing documents will be critical.



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Are the documents and the project compliant with the Colorado Common Interest Ownership Act (“CCIOA”) and with other applicable requirements? Do the documents adequately address the basic questions of control, management and cost allocation related to different areas of the project? Will the voting allocation and common expense liability provisions actually work? Is restructuring or amendment possible at the current stage of development and, if so, would it be beneficial? For example, a single association structure that does not include careful voting allocation and class provisions is fraught with the potential for disputes between differing uses. The successor may wish to pursue amendments to the documents in order to address class issues, including board appointment provisions, or may seek to revamp the legal structure and instead form a master association for the project with subassociations corresponding to each use type. Ownership and control of areas that will be shared by different types of users is another matter that is often ripe for modification. Are such areas common elements, part of a management unit, or part of a commercial unit that is subject to easement rights? More discrete provisions can also have a significant impact on the successor. For example, do the documents pre-

vent the association board from making or changing rules that might restrict commercial uses?

Another critical issue is the scope of the reserved declarant rights and whether such rights should be transferred to the successor. Depending upon the nature of the project, its stage of development and the voting power allocated to the successor, the successor’s ability to proceed with its plans may depend on what rights the original developer has reserved. The successor will need to carefully weigh its desire for the flexibility and control associated with declarant rights against the corresponding obligations and potential liabilities, since successors taking assignment of the declarant’s rights also succeed to most of the obligations and liabilities imposed on the declarant by CCIOA and the declaration. Such matters should also be weighed in structuring the acquisition. The successor might consider buying the existing loan in order to insulate itself from certain types of obligations. Most successors could avoid declarant liability by electing to hold declarant rights “solely for transfer,” but this election must be affirmatively made prior to transfer of title. On the other hand, a foreclosing lender that intends to exercise such rights will need to ensure that they are not terminated by foreclosure.

The successor will need a plan for the unsold units and will need to understand the obligations associated with ownership of those units. Most financially significant is the successor’s obligation to pay association assessments on such units. Successors may be able to insulate themselves from liability for past-due assessments by structuring the

acquisition in a manner that takes advantage of CCIOA’s protections for parties taking title through foreclosure or deed in lieu of foreclosure.

With respect to the residential units, will the successor take assignment of all presale contracts, together with (hopefully) escrowed earnest money and/or will the successor continue to offer residential units for sale? If so, the successor should be cognizant of the termination and rescission rights of buyers as well as warranty and other continuing obligations of the seller. The successor will also need to understand possible registration requirements, including subdivision developer registration in Colorado, out-of-state registration requirements related to purchasers and marketing in other states, registration or exemption under the Interstate Land Sales Act (“ILSA”) and, if vacation interests are offered, securities and/or timeshare registration requirements.

It is always a challenge to successfully integrate diverse uses in a single building, but it becomes even more so in an economically troubled project. In seeking buyers or tenants for commercial units, the successor will need to understand any use restrictions based on zoning, project documentation and any restrictions in any existing leases. Even in the absence of use restrictions, compatibility with the residential uses will need to be considered, and the successor should evaluate whether any assurances regarding uses may have been given to residential buyers. These issues can be resolved and these challenges can be met with careful planning and appropriate advice.▲