Felhaber Larson Fenlon & Vogt
A Professional Association – Attorneys at Law

REAL ESTATE REPORT

Issue 9 Spring 2007
Published by the law firm of Felhaber, Larson, Fenlon & Vogt, P.A.

FUNDING RECONSTRUCTION PROJECTS USING SPECIAL ASSESSMENTS

A common interest community (a "CIC") is a term used to describe a condominium, a townhome community, or a cooperative. When a CIC ages, the association of the owners of units may undertake a major reconstruction project to maintain the physical integrity of those portions of the CIC which the Association is obligated to maintain. Such projects may include re-roofing, re-siding, window replacement, asphalt and concrete replacement, or the like. If the Association has not built-up adequate funds in its capital reserve account, from the regular assessments paid by the CIC unit owners to fund the cost of the improvements or repairs, the Association must consider other funding options.

One common option selected by Associations is to levy a special assessment against the units within the CIC. This article will address issues relating to the levying of a special assessment and financing options that a CIC may consider in order to facilitate payment of the special assessment by unit owners.

Authority to Levy the Special Assessment

The Association must first determine whether it has the authority to levy against the units in the CIC a special assessment to pay the project costs. That authority will be derived from either the governing documents of the CIC (which generally include a declaration of covenants, bylaws, and articles of incorporation), and the relevant statutes.

The Minnesota Common Interest Ownership Act ("Act") applies to condominiums, planned communities and cooperatives created on or after June 1, 1994 (which was the effective date of the Act); and to condominiums, planned communities and cooperatives that were created prior to June 1, 1994, but which have amended their governing documents for the purposes of opting into coverage by the Act. It is not uncommon to find in the governing documents for older planned communities not subject to the Act restrictions on the authority to levy a special assessment. The governing documents may also regulate the basis for allocation of the special assessment among the units in the CIC. Thus, an Association must carefully review its governing documents to determine whether there are limitations on the levy of special assessments. Often, the governing documents of the CIC describe the procedures to be followed in declaring a special assessment. For example, the governing documents may require a certain percentage of the owners of the units in the CIC to approve a special assessment.

If the special assessment is approved, the Board must set the date that the special assessment is to be paid and whether the special assessment will be due and payable by the unit owners in one lump sum or in installments. That decision may be based on a number of factors. For example, the Association may have opted to effect the project in stages as the special assessments are paid or the Association may borrow funds to pay the cost of the project and use the special assessment to repay the loan.

Payment of the Special Assessment

In levying a special assessment, the Association must consider the ability of its unit owners to pay the special assessment. Sufficient time between the announcement of the special assessment and the date it is payable must be provided to allow unit owners to arrange to pay their special assessment. Some unit owners may be able to pay the special assessment in full on the date it is due. Others may require time to obtain financing.

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In setting the amount of the special assessment, the Association must allow for some delinquencies in the payment of the special assessment by unit owners and for the interest expense the Association will pay should the Association borrow funds for the project cost.

Deferred Payment Option

If the Association elects to borrow funds and permit unit owners to pay their special assessments over time, the Association must consider how to comply with Minnesota's usury limitations and the federal Truth-in-Lending disclosure requirements.

In Minnesota, interest that may be charged to an individual person pursuant to a written agreement is limited to 8% per annum, unless one of the numerous statutory exemptions applies to the limitation. Unfortunately, none of the statutory exceptions apply to a typical residential CIC. The courts, however, have created a judicial exception to the statutory usury limitations, which is referred to as the "Time Price Differential." The Time Price Differential applies where a creditor (the Association) provides a choice of paying an obligation (the special assessment) either in full as a "cash price" or in installments as a "time price." The difference between the aggregate payments over time and the "cash price" would constitute "finance charges" for purposes of federal Truth-in-Lending requirement disclosures, but would not be deemed to be interest for purpose of the Minnesota usury limitations. Thus, the Association can provide a finance charge with an effective rate in excess of the 8% usury limitation under the time price differential.

The federal truth-in-lending regulations obligate lenders and others involved in extending credit to consumers to provide consumers with specified information so the consumer may make an informed decision in obtaining credit. In addition, if the credit involves taking a lien on the consumer's residence, the consumer is to be provided with a right to rescind their agreement to take the offered credit.

Early Payoff Options

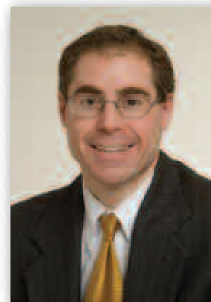
If the Association provides for payment of the special assessment in installments under the time price differential approach that involves an effective financing rate in excess of 8%, the deferred payment agreement between the Association and the unit owner may provide for early pay off opportunities.

To preserve the time price differential arrangement to permit the higher financing rate, however, the Association may not simply use the financing rate to establish a payoff based on the payoff date and an amortization of the special assessment. Rather, the Association should consider selecting a target date in the payment period and use it to establish the early payment amount that saves the unit owner the finance charges that would have otherwise been payable. The Association may also consider requiring payment if the unit owner sells the unit in the CIC before the special assessment has been paid. Such arrangements may actually benefit a unit owner as they would not be required to indicate the special assessment in the disclosures they provide to prospective purchasers related to payments due the Association.

The early payoff option may provide the unit owner the incentive to find alternative (and presumably more attractive) financing to allow the unit owner to take advantage of the early pay off discount.

In Conclusion

Before considering the special assessment option, the Association must analyze restrictions on its authority to levy the special assessment, the capacity of unit owners to pay the assessment, financing terms third party lenders may provide, the coordination of special assessment payments by unit owners with such financing, and compliance with usury and Truth-in-Lending requirements. Preliminary planning is critical if the Association is going to be successful in levying and collecting the special assessment and in achieving the reconstruction and financial goals of the Association.



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PROPOSED MINNEAPOLIS CONDOMINIUM CONVERSION ORDINANCE

The Proposal:

Title 12, Chapter 250 of the Minneapolis Code of Ordinances regulates condominium conversions in the city of Minneapolis (the "City"). Currently, there is a proposed amendment to this ordinance that calls for the addition of multiple provisions, including one titled "Affordable Housing Protections." This proposed provision states that "if the average rents in a building within twelve months prior to the notice [of intent to convert] are at or below one-twelfth of 30% of 50% of the area median income adjusted by size (1.5 persons per bedroom), including all utilities," then the declarant must "make a commitment" to meeting one of three conditions in order to proceed with the conversion. *Proposed ordinance 250.130*.

The First Condition

A "buy-in" requirement. This condition requires that "at least fifty-one percent of the bona fide tenants in occupancy of all units in the building or group of buildings or development on the date [of giving notice] have executed and delivered a purchase agreement . . . to the declarant."

The Second Condition

An "affordable housing fee" requirement. This condition states that the declarant shall pay "an affordable housing fee not to exceed ten percent of the sales price of each unit." The fee increases to twenty percent if the entire building is rent subsidized prior to conversion. The fee cannot be based on a sales price "lower than 100% of the appraised value of the unit as a condominium at the time of conversion." If the units are sold at a price below the appraisal level, the fee is still based upon 100% of the appraisal value. The fee is due immediately upon the closing of each unit and will be placed in the affordable Housing Trust Fund of Minneapolis to be used "solely to finance needed permanently affordable low and moderate income housing to help meet the City's housing goals and policies." Failure to pay the fee may subject the declarant to criminal penalties.

The Third Condition

An option to "retain affordable units" in the building. To meet this condition, the declarant "shall offer for sale to a nonprofit or public body twenty percent of the units of each converted building of ten or more units and such nonprofit or public body will make those units available to households earning fifty percent or less of the [Metropolitan Median Income]." The time period in which the units must remain available for sale is sixty days following the close of the original sixty-day option to purchase period set out under section 250.50. Additionally, the units must remain affordable for a minimum term of fifteen years. The designated units may be used for rental and/or ownership as long as the use occurs on the project site. This option is not available if the converted building has fewer than ten units or if no nonprofit or public body purchases the units.

The City's Authority for the Amendment:

Minnesota Statutes Chapter 515B, known as the Minnesota Common Interest Ownership Act ("MCIOA"), is the authority for common interest communities created within Minnesota on and after June 1, 1994, unless an exemption applies. Sections 515B.4-105 and 515B.4-111 of MCIOA set forth the authority and requirements for converting property into common interest community ("CIC") property. Municipalities, however, may impose their own regulations on conversion property so long as such action does not conflict with MCIOA.

Section 515B.1-106(a) of MCIOA states that "a zoning, subdivision, building code, or other real estate use law, ordinance, charter provision, or regulation may not directly or indirectly prohibit the common interest community form of ownership or impose any requirement upon a common interest community . . . or upon any part of the common interest community conversion process which it would not impose upon a physically similar development under a different form of ownership." However, Section 515B.1-106(c) of MCIOA provides an exception to this rule when a city determines, following a public hearing, that there is "a significant shortage of suitable rental dwellings available to low

and moderate income individuals or families." If a city meets this exception, MCIOA authorizes it to "prohibit or impose reasonable conditions upon the conversion of buildings occupied wholly or partially for residential use to the common interest community form of ownership." The City, relying on information from the Department of Housing and Urban Development, the 2000 Census and the 2005-2009 Minneapolis Consolidated Plan, made such findings and included them in proposed section 250.05.

Pros & Cons:

The benefits of the ordinance would ostensibly be to ensure that affordable housing is not significantly depleted or wiped out by condominium conversions. According to the City's findings, "at least 283 affordable units were converted between 2001 and 2005, or 23% of the total conversions in that time period." Without the proposed "conditions," the opportunities for affordable housing could diminish as more and more apartment buildings go through the condominium conversion process. The hope is that the proposed conditions will help make available more housing options for low to moderate-income tenants, either in the form of ownership or as rental units.

On the other hand, despite the good intentions behind the proposal, the downside could include a chilling effect on condominium conversions. It is unusual for more than 15% to 20% of the building tenants to purchase units in any conversion situation. Low to moderate-income tenants may face difficulties in meeting down payment requirements and securing financing to purchase the units. Realistically, the "buy-in" requirement may turn out to be a difficult, if not impossible, condition to meet.

The "affordable housing fee" option requires a sizeable financial contribution from the seller. The declarant may only receive eighty to ninety percent of the unit sales price after paying the fee. This economic burden may also deter future condominium conversions.

The third option of "retaining affordable units" seemingly places the least economic burden on the seller. Although it appears reasonable, if there is not a nonprofit or public body willing to purchase twenty percent of the units, the declarant will be forced to meet one of the other two conditions.

Conclusion:

The City's goal of maintaining affordable housing is both noble and justifiable. Only time will tell if the City's good intentions and the restrictive requirements of the proposed ordinance put the kibosh on the future of condominium conversions.

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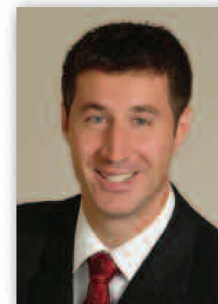

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Jon M. Hopeman

Governor Pawlenty Appoints Jon Hopeman to Board

Governor Tim Pawlenty appointed Felhaber Attorney Jon Hopeman to The Board on Judicial Standards. The Board on Judicial Standards investigates allegations of misconduct by Minnesota judges and referees and recommends discipline to the Minnesota Supreme Court, including censure, suspension, retirement or removal of judges.

INTERSTATE LAND SALES ACT: A PRIMER FOR DEVELOPERS

The Interstate Land Sales Act (the "ILSA") restricts a developer from selling residential property within a development or subdivision without first registering the development or subdivision under the ILSA, except in the case of so-called "exempt transactions." The registration process administered by HUD is time-consuming and costly; therefore, an exemption under the ILSA is of significant importance. Furthermore, a purchaser of property in a nonexempt transaction from a developer who has not registered under the ILSA has the option to revoke their sales contract at any time within two years after the date of the contract. Other remedies for violation of the ILSA include disgorgement of related profits, fines, injunctive relief, and criminal prosecution for willful violations.

There are a significant number of exemptions under the ILSA. Some of the less common statutory exemptions include the following:

1. The "single family exemption" which exempts the sale of lots in certain typical subdivisions that are limited to single-family residential use;

2. The "intrastate exemption" which exempts the sale of lots in certain subdivisions sold exclusively to residents of the state in which the property is located; and

3. The "Metropolitan Statistical Area exemption" which exempts the sale of lots in certain subdivisions located in a Metropolitan Statistical Area to persons residing in the same such area.

Each of these exemptions is quite narrow in scope and typically has limited application to sizable condominium projects.

One of exemptions under the ILSA that has broader application is the so-called "100 lot exemption." Under this exemption, the sale of property is exempt from the registration requirements of the ILSA if the development or subdivision contains fewer than 100 units, exclusive of units that are otherwise exempt under other statutory exemptions to the ILSA. In determining the number of units within the project, include all units within related projects that are marketed pursuant to a "common promotional plan" and any garage stalls or storage areas created as separate units within the CIC.

It should be noted that the 100 lot exemption is only a "partial" exemption from the ILSA in that a development qualifying for this exemption is still subject to the antifraud provisions of the ILSA. As a result, sales personnel should be advised accordingly and purchase agreements used for the sale of units under the 100 lot exemption should include language which warrants to the buyer that all utilities, common element roadways, and other amenities have been or will be completed.

The other common exemption is the "improved property" exemption or the "two-year rule", which exempts the sale of completed units and units that are not complete but will be completed within a period of two years from the date of the purchase agreement. The form of purchase agreement used must expressly obligate the seller to complete the unit purchased within the two year period. In addition, the purchase agreement cannot prohibit or limit the purchaser's remedies if the seller does not complete the unit within two years, except in the case of pre-sale contingency clauses conditioning completion of construction within a stated period of time generally not to exceed 180 days.

Certain of the ILSA exemptions can be used contemporaneously. The most common application of this approach is that the 100 lot exemption and the two-year rule can be applied in combination to exempt a project containing 100 or more units in certain instances. However, it is important to note that the determination of whether a project is exempt (under single or multiple exemptions) is made on an all or nothing basis. For example, the sale of more than 99 units in transactions not covered by another available exemption has the effect of nullifying the 100 lot exemption for all prior and future sales within the project. As a result, developers of projects containing in excess of 99 units must assure themselves that all units in excess of 99 will be sold in exempt transactions (for example, the two-year rule) or risk the consequences of noncompliance with the ILSA.

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Determination of the applicability of the ILSA requirements are project-specific and should be made only after a thorough analysis of the project is completed. Some considerations in making this determination are the size and nature of the project as well as construction and marketing timetables. If a determination is made that filing under the ILSA is not required and any of the exemptions discussed above are utilized, the developer must maintain conscious and vigilant monitoring of construction timetables and sales and marketing efforts with respect to the project in order to comply with the ILSA exemption requirements.

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Felhaber Hires New Attorneys

Felhaber Larson Fenlon & Vogt is pleased to announce that **Barbara Kristiansson** and **Nauni Manty** have joined the firm. Ms. Kristiansson practices in the areas of estate planning and probate. Ms. Manty focuses her practice on bankruptcy and commercial litigation.

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