The Elephant in The Title Report

BY MATTHEW FOGT

Recorded development declarations, and the rights and restrictions they afford and impose on property and third parties, were a key due-diligence obstacle in several recent acquisitions of land and broken projects. We'll differentiate between development declarations, which govern the development phase of a project and typically terminate upon the conveyance to an end user, and association CC&Rs, which govern the long-term use and maintenance of a community. Understanding how development declarations work is essential to analyzing and underwriting potential acquisitions. An incomplete or inaccurate understanding can result in overpayment, unanticipated costs and delays or not being able to develop the property as anticipated.

Development declarations and association CC&Rs typically look identical on a title report and even upon a quick glance at the documents. We have even seen seasoned real estate professionals shrug off development declarations as "just CC&Rs." However, these declarations are often the key document governing the development of a property and dictating the input for a pro forma schedule and budget. Association CC&Rs, on the other hand, have much less of an impact on the development phase and instead impact the end user.

Things to Look For: Development declarations typically include construction deadlines, transfer restrictions, off-site improvement obligations, use controls, intensity restrictions, design-review requirements, marketing fees and profit-participation obligations. Failure to satisfy these requirements can result in penalties, damages or losing the property to the master developer.

While these documents or associated subordination agreements typically include lender protections, many of the most onerous provisions of these survive a foreclosure. The lender protections typically protect the lender only between the time of the foreclosure and a sale to an unrelated third party. Thus, a buyer who acquires an encumbered site through foreclosure, or from the bank following the foreclosure, often must begin complying with applicable requirements.

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Verify Rights of the Beneficiary: The rights of the alleged benefited property owner should always be verified to ensure the party still has enforcement rights. Most development declarations are drafted to benefit only the master developer, or its assignees, so long as those parties own the benefited property. Under such a scenario, the master developer may no longer be able to enforce its rights to the extent it no longer owns the asset. Also, if the benefited rights have been assigned to another party, the assignment should be analyzed to verify compliance.

Resolving Issues: We advise our buyer clients to negotiate a solution with the benefited property owner, typically the master developer (or, as is often the case, a succeeding lender or purchaser from such lender), during due diligence or at a minimum prior to the close of escrow, in order to better understand and plan for the costs and impacts from a development declaration. Most distressed sellers or banks will allow such communications from a prospective buyer, and a master developer generally welcomes the opportunity to resolve outstanding issues. If a solution cannot be reached prior to the due diligence deadline, a resolution of the known issues relating to the development declaration can be made a closing condition. Failing to speak with the benefited property owner until after the closing adds unnecessary risk to the acquisition process. ■

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