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Developing An Interstate Land Sales Compliance Strategy: A State Land Sales Law Perspective – Part II

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This article continues the discussion started in Part I¹ regarding the impact that the Federal Interstate Land Sales Full Disclosure Act² (“ILSFDA”) and state land sales laws have on a real estate developer’s marketing and sales program for residential subdivided land and condominiums.

As discussed in Part I, many states regulate the marketing and sale of out-of-state projects to their residents. State regulation is separate from, and in addition to, regulation under ILSFDA (each such state is referred to herein as a “Closed State”). Part I of this article provided an overview of state land sales laws, including how state jurisdiction is triggered; exemptions; compliance requirements; and penalties for non-compliance. The purpose of Part II is to highlight one of the most commonly used exemptions from registration under ILSFDA, the “Improved Lot Exemption,” and to discuss how different Closed States treat projects that qualify for the Federal Improved Lot Exemption.

I. The Federal (ILSFDA) Improved Lot Exemption

One of the most commonly used

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ILSFDA exemptions is the “Improved Lot Exemption.” Under ILSFDA, if a unit or lot is sold complete with a residential dwelling or pursuant to a contract obligating the seller to complete the unit or home on the lot within two years of the date the purchaser signs the contract, the sale is exempt from ILSFDA³. A unit or home is deemed complete when it is physically habitable and usable for the purpose for which it was purchased or leased. In many jurisdictions this is evidenced by the issuance of a Certificate of Occupancy for the unit or home.

Developers that comply with the requirements of the Improved Lot Exemption obtain a full statutory exemption from ILSFDA. A transaction that is fully exempt from ILSFDA is exempt from all provisions of ILSFDA, including registration



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and ILSFDA’s anti-fraud provisions⁴. Exemption under ILSFDA, however, does not mean the same project will be exempt from a Closed State’s land sales laws. As discussed in Section III below, some state land sales laws include an exemption similar to the Improved Lot Exemption and other states do not.

II. Common Pitfalls Of The Improved Lot Exemption

Although seemingly straightforward, the Improved Lot Exemption is narrowly tailored and requires strict adherence to its requirements. Failure to comply with the requirements of the Improved Lot Exemption can lead to the invalidation of the exemption, in which case all of the sales made in reliance upon the Improved Lot Exemption will no longer be exempt. If the protection of the Improved Lot Exemption

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is lost, each sales contract entered into in reliance upon the exemption may be canceled at the option of the purchaser for two years after the purchaser signed the sales contract, which right will survive closing on the sales contract. In addition to the foregoing rescission rights, failure to comply with the Improved Lot Exemption may result in civil monetary penalties, criminal actions if the violation is willful, and opens a developer up to potential class actions.

A critical step to complying with the Improved Lot Exemption is proper drafting of the home or unit sales contract. The following summarizes fundamental contract issues that should be considered by any developer intending to rely upon the Improved Lot Exemption. The discussion below focuses on contracts for the sale of homes or units (collectively "homes") that are to be completed after the purchaser signs the sales contract.

A. Obligation to Deliver

The contract must contain an absolute obligation by the selling developer to complete and deliver the home to the purchaser within two years of the date the purchaser executes the contract. In a multi-phased condominium, the obligation to build within two years does not require completion of the entire project within the two-year period, only completion of the phase in which the unit is to be located.

B. Default and Remedies Provision

1. *Specific Performance.* A contract may not negate the purchaser's right to specific performance, although such right need not be specifically stated in the contract.

2. *Damages.* It is unclear whether or not the limitation of certain types of damages would be acceptable to state courts. The U.S. Department of Housing and Urban Development ("HUD"), the federal agency charged with enforcing ILSFDA, defers to state contract law to determine whether a limitation on remedies at law (damages) will undermine or negate the developer's obligation to complete the home within two years. The risk of limiting a purchaser's ability to seek damages for failure to deliver in two years is that a court may find that the limitation undermines the developer's unconditional obligation to deliver the home and therefore negates the Improved Lot Exemption.

C. Force Majeure Clauses

The inclusion of force majeure clauses which allow for non-performance or delays in completion of a home beyond the two-year period are acceptable if the cause for such delay is a recognized defense to contract actions under the laws of the jurisdiction in which the project is located. Thus,

state law will determine whether and, if so, to what extent force majeure provisions may condition the obligation to build within two years and, thus, whether the contract complies with the requirements of the Improved Lot Exemption.

An overly broad force majeure provision may nullify the Improved Lot Exemption. A force majeure provision in a contract for sales pursuant to the Improved Lot Exemption should be limited to legally recognized contract defenses under the laws of a project's situs state.

D. Contract Contingencies

Any provision that gives the developer the option to cancel the contract (other than a properly drafted 180-day pre-sale provision in the sale of a multi-unit development¹) poses the risk of the contract not satisfying the two-year delivery obligation under the Improved Lot Exemption. For example, a contract may not include a financing contingency provision that allows the developer to cancel the contract if the purchaser does not obtain financing. To minimize the risk of running afoul of the Improved Lot Exemption requirements, contingencies in the contract should be limited to those that allow the purchaser to cancel the contract.

III. Improved Lot Exemptions Under State Land Sales Laws

Exemption from ILSFDA does not mean that the project will also be exempt from the land sales laws of any Closed State. The laws of each target market state must be examined. Some states mirror the ILSFDA provisions regarding the Improved Lot Exemption while other states do not recognize any exemption for the sale of a home that is completed or required to be completed by the developer. The below discussion provides examples of states that do and states that do not recognize the Improved Lot Exemption under ILSFDA and is not intended to be a comprehensive analysis of how all Closed States treat projects that qualify for the federal Improved Lot Exemption.

A. Mirroring ILSFDA's Improved Lot Exemption

Closed States, such as Illinois, Kansas, North Dakota, Pennsylvania, South Carolina, and Utah provide an exemption from their state land sales laws for projects that qualify for the Improved Lot Exemption under ILSFDA. In many of the Closed States that offer an Improved Lot Exemption that mirrors the ILSFDA exemption, the exemption is self-determining. There are a few states, however, such as Illinois and Pennsylvania, in which the developer must either apply for or file notice of intent

to use, the state's improved lot exemption.

As a result of lobbying efforts by certain industry leaders and organizations, there have been recent changes to some states' laws to amend certain states land sales laws to adopt an exemption that is the same as or similar to the Improved Lot Exemption under ILSFDA. For example, effective August 1, 2007, North Dakota amended its land sales laws to include an exemption similar to the Improved Lot Exemption under ILSFDA. Similarly, the Connecticut legislature, on April 30, 2008, voted to adopt an amendment that will exempt from Connecticut's land sales laws sales that qualify for the Improved Lot Exemption under ILSFDA, which amendment is anticipated to go into effect on October 1, 2008.

B. States That Have Not Adopted ILSFDA's Improved Lot Exemption

States such as Arizona, California, New Hampshire, New Jersey, Ohio, and Rhode Island do not recognize an Improved Lot Exemption. Thus, a project that is exempt from ILSFDA pursuant to the Improved Lot Exemption must comply with the land sales laws of these Closed States before a developer may offer or sell homes within such Closed States.

Understanding federal and state land sales laws, how they relate to each other and to a particular project and how to comply with both is the first important step in developing an effective land sales compliance strategy. Implementing a land sales compliance strategy early on in the development process is important to protecting a developer against the potentially devastating repercussions of violating ILSFDA or state land sales laws.

¹ Published in the April 2008 issue of The Metropolitan Corporate Counsel, Vol. 16, No. 4.

² 15 U.S.C. §1701, et seq. For a thorough discussion of ILSFDA please see our article "U.S. Land Sales Laws: Complying With The Federal Interstate Land Sales Full Disclosure Act," published in two parts, Part I in the April 2006 issue of The Metropolitan Corporate Counsel, Vol. 14, No. 4, and Part II in the May 2006 issue of The Metropolitan Corporate Counsel, Vol. 14, No. 5.

³ 15 U.S.C. §1702(a)(2).

⁴ See our article on ILSFDA referenced in footnote 2 above for a discussion of partial statutory exemptions, which provide an exemption from registration under ILSFDA but not from ILSFDA's anti-fraud prohibitions against the use of unlawful or misleading sales practices and the inclusion of certain contract provisions in sales contracts.

⁵ C.F.R. §1705.5. The Federal Regulations, promulgated pursuant to ILSFDA are found at C.F.R. §17001.1, et seq. (1991).