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CREC-approved contracts: Tips & traps – owners' associations

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This is the 13th in a series of 17 or so articles that come from some years of experience using the Colorado Real Estate Commission-approved contracts for purchase and sale of real estate for commercial real estate transactions. Previous articles addressed the buyer's name, the seller, the property, water rights, ordering the title commitment, owner's extended coverage, making title objections, off-record matters, special taxing districts and ordering and reviewing the new improvement location certificate or new survey. This article addresses owners' associations.

Section 7 of the contract, based on its caption, deals with "owners' associations" but in fact the section is applicable only to property located within a "common interest community," most of which have some kind of an owners' association. **Trap:** *A common interest community that is exempt from the Colorado Common Interest Ownership Act, often referred to as "CCIOA," may not have an owners' association, making it difficult to comply with §7.* The term "common interest community" is not defined in the contract, but presumably refers to that term as used in C.R.S. 38 33.3 103(8), the definitions section of CCIOA. The essence of the definition of a common interest community under CCIOA is real estate with respect to which a person owning a portion (i.e., a "unit") is required to pay for real estate taxes, insurance premiums, maintenance or improvement of other real estate. Residential real property in newer suburban communities is commonly located in a common interest community, as are all condominiums, but it is not unusual to have other commercial real property located in one as well. There also is reference to a "declaration," which presumably refers to the term as defined in C.R.S. 38 33.3 103(9), which defines it as "any recorded instrument, however denominated, that creates a common interest community." The term "association" is defined in C.R.S. 38 33.3 103(3), with reference to C.R.S. 38 33.3 301, and is the entity, most commonly a nonprofit corporation, of which owners in a community are automatically members and which governs the community.

Ownership of real estate in a common interest community has its hazards as indicated by the disclosures the seller must give to the buyer in §7.1 of the contract (in all caps and bolded) if the property is located in one (similar to the disclosures required for special taxing districts discussed in the 10th article in this series). The disclosures mandated by C.R.S. 38 35.7 102(1) include that if the property is located in a common interest community, the owner is required to be a member of the association and will be subject to its bylaws and rules and regulations; the declaration and other documents will impose financial obligations on the owner; the obligations are subject to a lien that might allow the association to sell the unit to pay the debt; and the documents might also prohibit the owner from making changes to the property without an architectural review. It advises the buyer to investigate the financial obligations and read the declaration, bylaws and rules and regulations.

Under C.R.S. 38 35.7 102(2)(b) the seller is obligated either to provide, or authorize the association to provide, to the buyer, upon request, all of the community's governing documents and financial documents as listed in the most recent Colorado Real Estate Commission-approved form of the contract. Failure to comply exposes the seller to "actual damages directly and proximately caused by such failure plus court costs" (C.R.S. 38 35.7 102(2)(b)). The seller can assert as a defense, however, that the buyer had actual or constructive knowledge (which, by definition, would include knowledge of all provisions of the recorded association documents) of the facts and information required to be disclosed (C.R.S. 38 35.7 102(2)(a)).

The contract implements the provisions of these statutes, including the disclosures and listing in detail what information the buyer is required to receive (§7.4). The "association documents" to be provided include certain identified "governing documents" (e.g., declarations, articles, bylaws rules and regulations, minutes, and, in what seems to be a rather random inclusion, "party-wall agreements") and "financial documents" (e.g., balance sheets, income and expense statements, budget, reserve study and unpaid assessments). **Trap:** *As to minutes of the owners' meetings, only the minutes of the most recent annual meeting are required, while a buyer would be prudent to get the minutes of any special meetings as well, along with minutes from several preceding years.* Special meeting minutes might be very important, especially recent ones in which an emergency or crisis might have been addressed or revealed. Often, the historical minutes reveal problems the association has had in the past, as well as matters it has deferred into the future and which the buyer might find very relevant to its due diligence. **Trap:** *As to directors' minutes, only the minutes from meetings during the past six months are required to be given to the buyer, which gives the buyer only a very short history of the association.* The existence of a dysfunctional board, for example, is not necessarily discoverable by looking only at the minutes of the past six months, especially if the board is so dysfunctional that it stopped meeting more than six months ago. **Trap:** *Requiring only the "most recent" financial documents does not allow the buyer to see any historical trending.* In a commercial transaction, a buyer typically asks for financial information from at least the past three years. **Tip:** *The buyer should ask for the right to receive any additional information concerning the association the buyer reasonably requests, recognizing that it won't get any information the association is not required to provide to the seller.* **Tip:** *The buyer also should ask for a representation and warranty that the information provided*

is true, accurate and complete (at least to the seller's knowledge). At a minimum, such a requirement should encourage the seller to be diligent and not just provide the possibly outdated information the seller put in its file when it purchased the property.

The buyer's rights following its review of the association documents is binary: Accept them as is or terminate the contract (§7.4). **Trap:** *There is no procedure for objection and resolution for association documents as there is for title documents.* **Trap:** *The buyer's right to terminate may be "based on any unsatisfactory provision in any of the association documents, in buyer's sole subjective discretion" (§7.4).* The buyer need not be reasonable, but the termination must be in good faith under §29. **Trap:** *Is the poor financial condition of the association an "unsatisfactory provision in any of the association documents"?* Might the seller argue that the buyer may not terminate the contract if that is the stated reason? The contract termination must occur before the "association documents objection deadline," a date chosen by the parties. In a rather convoluted provision, the buyer gets an extension to 10 days after receipt of the association documents (but not later than the closing), if the association documents were not delivered by the agreed-upon "association documents deadline." **Trap:** *Section 7.4 does not clearly allow the buyer to terminate the contract if it does not receive the association documents by the association documents deadline.* The clause can be construed to require the buyer to wait until closing and, if it has not received the association documents by then, deliver the buyer's notice to terminate. Equally troublesome is that the clause could leave the seller hanging until closing when the buyer finally gives its notice of termination.

A clause at the end of §7.4, puts an interesting twist on the buyer's right to terminate. It waives any right to terminate under §7.4 of the contract after the applicable deadline, "notwithstanding the provisions of §8.6 (right of first refusal or contract approval)." Presumably the quoted clause is intended to say that a waiver of the right to terminate under §7.4 does not eliminate the buyer's right to terminate under §8.6. Connecting §7.4 and §8.6 in this way makes sense, since it is not unusual for association documents (especially for an older condominium) to contain a right of first refusal and it should be clear the buyer may terminate under both provisions. **Trap:** *Section 7.4 does not address a similar problem that arises if any of the association documents are title documents or off-record matters.* Does a waiver of the right to terminate the contract under §7.4 prohibit the buyer from objecting or terminating the contract under §8.4 as to any of those association documents? Does the failure to object or terminate the contract under §8.4 as to any of those association documents, prohibit the buyer from terminating the contract under §7.4? **Tip:** *The buyer would be wise to add a provision that allows it to terminate the contract under each of §7.4, §8.4 and §8.6 independently and regardless of any overlap.*

Section 15.3 of the contract addresses certain fees that may be charged by the association upon a transfer of the property, including the cost to produce a "status letter" regarding assessments due, any "record change fee," including any "ownership record transfer fee," and, in §15.5, any "private transfer fee." **Trap:** *As the words used in §§15.3 and 15.5 are not defined in CCIOA and are not likely to be the same words used in the association documents, the parties need to figure out what is intended as to each item.*

Section 16.3 addresses the proration of assessments. A number of issues that might be the subject of dispute between the seller and the buyer are addressed in these provisions and any of a number of disputes might arise when the buyer and seller endeavor to apply them. Current regular assessments and dues paid in advance are credited to the seller. "Cash reserves held out of the regular association assessments for deferred maintenance" are not credited to the seller unless the governing documents provide otherwise. **Trap:** *In order to properly affect the intent of this clause, the parties need to know how the reserves are accounted for by the association and customize the clause accordingly.* For example, the cash reserves might not be "held out." They might not be solely for "deferred maintenance." The governing documents may have a rule that applies unless the seller and buyer agree otherwise in the contract. **Trap:** *The clause that addresses an amount for reserves or working capital does not say how or by whom the buyer might become obligated for reserves or working capital.* Again, making this clause work so it affects the parties' intention requires an understanding of how the reserves or working capital are treated by the association. For example, the seller may have deposited an amount with the association that is still held in reserve; in that case, the buyer might be willing to reimburse the seller for that amount. If that amount has been spent by the association, however, and the fruit of the expenditure is reflected in the purchase price, the buyer might not want to reimburse the seller. **Trap:** *The word "assessed" in §16.3 is not defined in the contract or in CCIOA, and can cause disputes.* For example, how do the amounts get allocated under §16.3 if the association simply "bills" the unit owners. If the association's board resolves to start billing the unit owners sometime in the future, is the amount "assessed" when the board's resolution is passed or when the billing starts. The variations, of course, are endless.

Trap: *While §16.3 requires the seller to request that the association deliver a status letter to the buyer, it does not say what happens if the association does not do so.* The logical solution would be for the buyer and seller to agree to a post-closing adjustment once the association bills the buyer and, perhaps, have some money held in escrow to cover any amounts payable by the seller.

The final treatment of associations appears in §19, where the contract endeavors to address the role of the association (if there is one) with respect to the receipt of insurance proceeds, the maintenance or replacement of damaged property and any claims the seller might have for reimbursement from the association. **Tip:** *Given that the provisions of the contract regarding the association's fees, assessments, reserves and what happens if a casualty occurs depend heavily on how the association documents treat these matters, the buyer should consider a procedure under which it can adjust the provisions of the contract to fit the circumstances after it has reviewed the association documents. The procedure could mirror that used to address title matters.* ▲