

Risk-mitigation plan to restart condo development in Colorado

Much has been said, published and discussed about the lack of multifamily ownership housing construction in Colorado during recent years. Many plans, proposals and efforts have been made, and continue to be made, to address legislative and related solutions to break loose the logjam in construction for such housing. The main culprit seems to be the state of our construction defect laws in Colorado.

What to do in the meantime, where supply is extremely low and demand appears extremely high at most all pricing levels? Aware that there is likely an entitlement period before actual construction can begin and the market window is limited, some entrepreneurial developers are taking the leap, but doing so pursuant to carefully designed mitigation plans as a part of the overall project plan that is intended to create a quality project and, at the same time, also avoid or lessen exposure to liability. Nothing is perfect and the extent of protections afforded by such mitigation plans are not assured. With this in mind, we can explore some of the ideas that have been generated by those in the business as a means to hopefully provide some measure of comfort to these brave souls.

The main themes in these plans seem to include, in addition to the normal pursuit of quality projects, disclosure, transparency, peer review, communication and responsiveness.

Let's look at an overview of the process of pursuing a condominium development in Colorado.

■ **Planning Stage.** The conversion of existing rental product is one aspect of this issue, and some developers are pursuing this avenue with a view to carefully allocate the risk, where possible, in the agreement to purchase (PSA) the existing property. The specific allocations would address, for example, the major elements of the property that would be retained and used in the conversion, and those that would be redeveloped or added by the conversion developer. More standard PSA provisions in the purchase of existing product, such as the "As is Where Is" provisions, would need to be restructured where possible to account for this allocation.

Some developers are planning projects whose size (e.g., under 20 units) and/or ownership structure (e.g., townhome/lot structure with little/no common areas vs. condominium with attendant HOA) allows the project to be at least partially exempt from the state statutes governing common interest communities, including condominiums. Such statutory exemptions allow for more realistic protections for the developer to be built into the project's governing and sale documents. When little or no common elements or homeowner association involvement is needed, the risk of exposure is reduced.

Others are now pursuing larger projects but with a more in-depth planning, contracting, disclosure and communication approach to head off concerns of unit buyers before, during and following the unit purchase process. This latter plan attempts to start earlier and more comprehensively to incorporate a "best practices on steroids" approach to the project, and the process of designing, developing, marketing and selling the units is much more inclusive.

■ **Project Team.** When looking at the life cycle of the development of a condominium community, there are many phases that require careful planning and management in order to be sure that the project and developer are not being inadvertently "set up" for exposure to litigation claims. The first element that will advance the protection of the developer will be the selection of the qualified project team, including the legal, survey, design, construction, financing, title and property insurance, peer review, HOA management and accounting talent. The reputation, experience and successes that can be shown and assured in the process of retaining the project team is meaningful regarding the ability to implement a risk-mitigated development plan. This step and process should not be taken lightly and best practices would suggest that price alone for these team members should not be the driving determinative; value is the issue, certainly in the context of risk mitigation as well as the success of the resulting project.

■ **Project Documentation.** The structuring,



James M. Mulligan
Senior real estate partner, Snell & Wilmer LLP, Denver

negotiation and execution of appropriate documents for the project also can further mitigate exposure to liability, both in terms of form and substance. Initial contracts that can be subject to a "best practices on steroids" approach that anticipate a condominium regime include the acquisition contract for the desired property, the title insurance contract, the condominium regime governing documents (e.g., the Declaration and HOA documents and initial budget), the design and construction contracts, specifically including the nature and extent of insurance contracts, the financing documentation for the project financing, and the remaining project documentation anticipated by these main contracts that allows for the initial purchase of the property, if not already owned, and the design and construction of the desired project. Each of these contracts deals with provisions that will impact the allocation of risk and liability in the property and the project, and should be structured and negotiated with this allocation firmly in mind.

■ **Project and Unit Financing.** The market for financing condominium projects and units is narrow and likely more costly where it exists. At both the project and the unit level, the underwriting of each by lenders has become challenging as we recover from the recent recession, again enhanced by the current state of the law regarding construction defects. Careful thought to the allocation of risks among the various players in the project (borrower, guarantor, builder, insurance company, lender, etc.), and the affirmed value and makeup of the submitted collateral, will be of enhanced interest to the lenders. Lenders, in addition to justified market studies, review of provisions in the project documentation and presale requirements, will be looking for more equity in the project as well as to the balance sheet of the borrower/guarantor/contractor and the nature and extent of insurance coverage in the face of the risks associated with potential litigation that could tie up the collateral value of the property during the pendency of any litigation.

■ **Project Construction/Insurance.** In addition to the normal matters to be covered in a contract with the general contractor, the issue of risk allocation, normally addressed in conjunction with an insurance policy and with an appropriate peer review program, becomes exacerbated by the construction defect litigation issue. The availability and cost of insurance for condominium projects is a key and challenging issue. Where available and where the cost is manageable in the context of project feasibility, this becomes a defining issue with regard to the allocation of risk. In today's condominium market, various forms of "wrap" insurance are looked to in order to mitigate and shift risk in the appropriate circumstances. An owner-controlled insurance program is an insurance policy held by a property owner during the construction or renovation of a property, which is typically designed to cover most all liability and loss arising from the construction project (subject to certain exclusions). A contractor-controlled insurance program is similar to an OCIP except that the general contractor or construction manager sponsors the insurance program. Sometimes even a combination of an OCIP and CCIP have been formed on a loss sensitive basis where both owner and general contractor share in the savings or additional cost if losses are higher than expected on the primary insurance program, which usually includes workers' compensation and general liability. There also has been a developer-controlled insurance program, which may or may not include WC, but provides GL, umbrella and excess liability mainly for the protection of construction defect claims.

Also in this context, an advanced and comprehensive "peer review" program that provides another set of eyes on the major elements of the project's process assists with the risk-management



Michael Strand
Real estate associate, Snell & Wilmer LLP, Denver

program that is devised for the project.

■ **Project Marketing.** Timely disclosure, including appropriate disclaimers, and communications are paramount to marketing condominium projects to the consuming public. Assuming a larger project, the Interstate Land Sales Full Disclosure Act and its attendant registration or exemption requirements suggest an earlier and more comprehensive consideration of the issues that will need to be addressed in the marketing of the project and the contents of all of the advertising and marketing materials. This also will apply to the unit purchaser documentation, from the governing documents mentioned above, the reservation agreement, the unit purchase agreement and the buyer's handbook through the consumer selection process, the closing documentation and the owner's handbook, and inclusive of the post-closing warranty and callback response program. State and municipal laws should be reviewed for any supplemental or specific requirements regarding the marketing, sale and ownership of such projects.

■ **HOA Operations & Transition.** As with other aspects of the project, the transition of control of the HOA from the developer/declarant to the third-party consumer/unit owner is important at many levels and if done correctly, both in substance and in process, this transition is actually a time where the relationship between the developer and the HOA can be an enhanced partnership rather than adversarial. Here again, timely disclosure, appropriate disclaimers, transparency and communications should guide the process from the very beginning, and be anticipated in the design of the governing documents for the project. Proper use of a third-party management agent, for example, in establishing and managing the HOA and its budget, resulting assessments, recordkeeping and audit sensitive procedures from the beginning allows for third-party verification and assists to mitigate the direct risk to the developer. Involving the consumer/unit owner early can be done without losing control where necessary for construction, marketing and completion purposes.

■ **Unit Sales, Closings and Warranties.** Heeding the continued need for disclosure and communications emphasized in the project marketing section above will assist in the process of contracting and closing on the sale of the units and the attendant risk allocations that are involved. Although state law has limited the ability to contract away the liability for implied warranties of habitability, for example, if all of the disclosures and disclaimers are properly made and acknowledged, and a warranty and callback program is instituted from the beginning, then there is ample opportunity to work through issues that may arise regarding claimed or possibly legitimate issues as they arise. The old saying of "an ounce of prevention" applies here, and being sure that a communication program regarding issues and realistic response time with the unit owner, both before and after closing, will be a solid first step to allow mitigation of risk. Always have the unit buyer sign off all the way through the process regarding such disclosures and callbacks is a necessary first step toward such a plan.

There is no sure bet, but addressing the obvious in a careful and complete manner helps. Utilizing best practices during each and every step of the way allows for, if nothing else, an adequate case for a defense against any frivolous or overstated claim of defect. This article is space-limited and therefore incapable of covering any one or more of the above categories of risk in depth. However, this overview is intended to begin to allow one to understand that levels of risk mitigation are available in these projects, if planned and implemented in the proper manner. More to come as this market cycle unfolds and teaches us the value of continuing mitigation efforts.▲