Real Property and Financial Services Section
Hawaii State Bar Association

Newsletter

October 1992

Letter From The Chair

If there is a proportional relationship between the regulation of a particular human activity and that activity's role in the survival and perpetuation of our species, then one might argue that the sale of condominiums is more critical to the future of human kind than the disposal of nuclear waste and the practice of obstetrics.

Each year our legislature enacts a number of laws which are then grafted onto Chapter 514-A. In this issue, Nancy Grekin and Mark Hazlett discuss the provisions of Act 50, which was signed into law April 29, 1992. The Act included significant revisions and additions to the owner-occupant pre-sale process. Next year the Real Estate Commission is expected to issue comprehensive new rules and regulations regarding the development, sale, and management of condominiums.

Our Annual (Breakfast) Meeting will be held on Wednesday, November 25, 1992, 7:30 a.m., at the Plaza Club. Harold Matsumoto, Director of the Office of State Planning, our guest speaker, will discuss the five-year boundary review. In addition, new members of the Board of Directors will be selected at this meeting, so please attend. Section members will be receiving ballots shortly.

Also, don't forget the Hawaii State Bar Association's Bar Convention on November 24th and 25th, 1992 at the Hilton Hawaiian Village. This year our section, in conjunction with the Hawaii Institute for Continuing Legal Education will present the next installment of our Real Estate Manual, Hawaii Conveyance Manual III. Copies of the manual will be available at the program on Hawaii Conveyance Law at the Bar Convention on Tuesday, November 24, 1992 from 8:00 A.M. to 12:00 noon. The editors and authors of the manual have worked hard to produce this volume and have provided an exemplary service to our members.

William J. Deeley
Chair, Real Property &
Financial Services Section
Hawaii State Bar Association ■

Act 50 Blues: Owner-Occupant Overkill

By Nancy N. Grekin and Mark A. Hazlett

Over the past fifteen years few areas of commercial law have seen as much legislative activity as the Condominium Property Act, Chapter 514A, HRS. In some years as many as a dozen acts have been passed amending an already complex law. Many of these amendments have been intended to address governance or management problems in large residential projects and have produced unintended and often unfortunate complications for mixed-use, resort and commercial projects. Indeed, the condominium law has seen more amendments since 1980 than the entire Uniform Commercial Code (Chapter 490, HRS).

The legislative complexity is reflected in the Real Estate Commission's checklists for various condominium documents which are submitted as part of a project registration. The bylaws checklist lists nearly 100 mostly statutorily-mandated items, far more than are required for corporate bylaws under Chapter 415, HRS. This list has been subject to annual change and has resulted in greater legal and compliance costs, as well as costs of delay, all of which must be passed on to apartment purchasers. For small projects, legal costs may easily exceed several thousand dollars per unit. For existing projects, continuing compliance costs are incurred.

While more legislative restraint may have been demonstrated in recent years, perhaps in recognition of past excesses, the legislative impulse to tamper with the condominium law is still strong. The Legislature has wrestled for some years with the conflicting policy goals of encouraging rental housing and affording prospective owner-occupants special opportunities to purchase. This year a new law, Act 50, has sweepingly amended Hawaii's owner-occupant presale laws and may create a range of new problems for developers, lenders, escrow companies and other parties involved in condominium development. Some background is necessary to understand these changes and their likely consequences.

In 1980 the Legislature adopted Part VI of the Condominium Property Act which required developers to publish an "owner-occupant pre-sale notice" at least twice during a specified period prior to filing for a public report. The purpose of the notice was to give prospective owner-occupants the opportunity to purchase units in the project, and the developer was required to offer at least 50% of the residential units to prospective owner-occupants. Buyers who contacted the developer following publication of the notice were placed on a reservation list, and were required to sign affidavits of intent to become owner-occupants. During the first 10 days following issuance of a public report, the developer could offer the owner-occupant units only to buyers on the reservation list.

The 1980 owner-occupant statute was a response to a practice which had developed during the strong real estate market of the late 1970's. Developers sold desirable units in their condominium projects to friends and associates, prior to construction, who in turn resold them at substantially higher prices, sometimes in back-to-back closings following completion. Also, in some cases

rental properties were converted to condominium status with units sold to investors before existing tenants or other prospective owner-occupants could purchase. It was hoped that the pre-sale notice would provide prospective owner-occupants with the opportunity to acquire condominium units at more favorable pre-construction prices which might have been otherwise acquired by investors for rental use or speculative resale. Ironically, the procedure also meant that the least sophisticated purchasers made their initial decisions to purchase without the availability of a public report. A further consequence of the statute was to frustrate use of the condominium laws for certain small projects, including rental housing. Families or close groups of investors owning and seeking to refinance, restructure ownership or improve properties have sometimes used the condominium law for estate planning, financing or other legal structuring purposes where no sale of units was contemplated, yet local lenders often require registration (to protect their interests in the event of foreclosure) and the registration law mandates sale of one-half of the residential units to owner-occupants even though the owners do not wish to sell.

The statute also required lenders to act on owner-occupant loan applications within a specified time period, now 45 days, even though condominium documents for a project typically are not in final form available for lender review at that stage and even though the Equal Credit Opportunity Act generally requires lenders to take action to disapprove a completed application within thirty days. The authors are unaware of any cases in which claims have been asserted against lending institutions under the law.

The 1980 statute foreshadowed a reversal in the real estate market caused by the rise in interest rates in the early 1980's, and the owner-occupant pre-sale notice often became an irritating and expensive formality for condominium developers who now had few interested owner-occupants.

By the late-1980's real estate markets had again reversed. With the rapid increase in real estate prices, lower priced or "affordable" units in certain projects, sometimes required as a condition of land use reclassification, attracted enormous interest among owner-occupants willing to camp for hours at the developer's sales office in the hope of being placed on an owner-occupant reservation list. Developers of several projects in a few well publicized incidents faced huge crowds with no fair method of compiling a reservation list. In addition some buyers who signed owner-occupant affidavits clearly did not intend to occupy the units, but presumably hoped to resell at higher prices following completion. While some real estate developers may have viewed these events as a means of publicizing large multi-phase projects by developing demand for small initial increments of affordable units, genuine problems did arise in some cases. Ironically, some of these projects were single-family home subdivisions and not condominium projects.

Act 50 was adopted in response to these perceived problems of false affidavits and excessive demand for certain affordable projects. The measure was introduced in the Legislature in 1991 and held over to the Regular Session of 1992. The Real Property and Financial Services Section presented testimony at the 1991 session and some improvements were made. Unfortunately, in the 1992 Regular Session, the matter was considered only in conference committee and the Section was unable to present testimony as to the remaining desirable technical amendments. Act 50 was signed into law on April 29, 1992. The Commission has since found that Act 50 does not apply to projects with presale notices "properly" published prior to that date. This article discusses three of the most significant changes and additions to the owner-occupant pre-sale process: (1) the addition and effects of the owner-occupant affidavit which must be reaffirmed and recorded at closing; (2) a requirement that the pre-sale notice be submitted to the Commission for its review and approval 30 days before publication; and (3) a lottery system for compiling the owner-occupant reservation list.

Affidavit of Intent to Become an Owner-Occupant

Before the adoption of Act 50, prospective owner-occupants were required to execute a simple affidavit which stated that they intended to occupy the unit for 365 days following closing, as a condition to being placed on the reservation list. Making a false affidavit was deemed perjury (a Class C felony), but the statute provided that the affidavit was not deemed false if extenuating circumstances rendered the buyer unable to occupy the unit as an owner-occupant. Despite the potential criminal penalties, it was believed that false affidavits were common, and there was little or no enforcement.

Act 50 was an attempt to strengthen the affidavit requirement, and to provide penalties for false affidavits which would discourage making them. The committee reports which preceded Act 50 suggested that the new requirements would be "self-enforcing."

Act 50 requires that a prospective owner-occupant execute a lengthy form of affidavit prescribed by the Commission. The Commission issued an announcement on September 25, 1992, which included new forms for public report filings, and a revised form of affidavit which must be used. The Commission has advised in a June 1, 1992 release on Act 50 that the affidavit must be personally executed a[illegible] attorney-in-fact signatures are not vali[illegible] While this requirement may prevent fraud and address past abuses, persons traveling, military on overseas orders, hospitalized persons, and, perhaps persons with legal guardians may, for practical purposes, be precluded from participation at this stage. The entire affidavit must be "reaffirmed" at closing, and the reaffirmation recorded either separately or in the conveyance document. Commission staff have advised informally that only owner-occupants on the reservation list or participating in the lottery are subject to the affidavit and reaffirmation requirements, although the statutory definition of owner-occupant is not so limited. Later buyers, including prospective owner-occupants who reserve or purchase units after the effective date of the public report are not subject to the requirement. The affidavit remains in effect for 365 days following closing, and during that period the affiant is absolutely prohibited from selling the unit. The required seven-page Commission form contains some 13 separate representations by the buyer.

Notices and penalties have been included to discourage false affidavits. After obtaining a loan commitment and for 365 days after closing, an affiant is required to notify the Commission if he or she decide not to become, or to cease being, an owner-occupant. An owner-occupant can also be required to verify owner-occupancy upon request of the Commission. If the owner-occupant fails to provide the verification, he or she is subject to a fine equal to the profit on the (presumed) sale (if there was one). Penalties for violation of other provisions include a fine of the greater of $10,000 or 50% of the net proceeds of an unpermitted sale. Developers, their agents and employees and real estate licensees are affirmatively required to notify the Commission of any violation or attempted violation and are also subject to these penalties for non-compliance.

The requirement that the affidavit be reaffirmed and recorded raises numerous problems. Under the original version of Part VI of the Condominium Property Act, an affiant was deemed not to have made a false affidavit if hardship circumstances arose, and the buyer was permitted to cancel the contract during the first 10 days after issuance of the final public report if extenuating circumstances prevented the buyer from occupying the unit. Because the affidavit was not recorded, nothing prevented or discouraged resale during the first year, even if hardship circumstances did not exist.

Act 50 significantly amends these provisions. The recorded affidavit now prohibits any sale during the first 365 days, re-

gardless of extenuating circumstances. The hardship exception is now contained in the enforcement provisions, and permits the Commission to consider whether extenuating circumstances exist before prosecuting a suspected violation. There is no express procedure for an owner-occupant to obtain a prior ruling whether a proposed sale will be considered a violation of the affidavit. Thus, even a seller facing extenuating circumstances takes the risk that the Commission may determine that the circumstances did not justify the sale. Since the sale is a violation of a restrictive covenant, buyers from owner-occupants may be reluctant to close, and the buyer's title policy may contain an exception for the effects of violation, an encumbrance which the buyer may not be required to accept. In addition other parties (the original developer, its agent and all real estate licensees) have an affirmative duty to report the possible violation even though they believe there are legitimate extenuating circumstances.

Act 50 also requires purchasers who cannot reaffirm at closing to rescind their contracts. This mandatory rescission requirement has broad consequences.

First, purchase contracts of owner-occupants who signed an affidavit prior to issuance of the first public report will be subject to cancellation until closing. This is of concern to construction lenders, as well as developers, because condominium construction loans are often not funded until the developer has enough binding contracts to pay off the loan with the sale proceeds. Act 50 may cause lenders to refuse to accept or to discount owner-occupant contracts subject to reaffirmation for purposes of meeting pre-sale requirements. Senior loan officers at local banks and savings institutions have expressed grave concern over this new construction lending risk. Projects directed at investor buyers will not feature this risk.

Second, the nominal penalty for failing to reaffirm an affidavit at closing, apart from frustrating construction financing, is likely to encourage speculation by ostensible owner-occupants. If a sales contract is not reaffirmed at closing the developer is permitted to retain only the greater of 5% of the deposit or actual damages. As actual damages may be extremely difficult to ascertain or prove (particularly at closing before the damages can be calculated based on resale), it is likely the 5% of deposit standard may be widely used for this purpose. Many project sales contracts require only a $5,000 or $10,000 deposit until preclosing. This means purported owner-occupants may be able cancel at preclosing for a nominal amount ($250 or $500 in many cases) without further penalty. Worse, these cancellations may occur after a two-year or longer development period during which the buyer has speculated on the appreciation of an asset which may have a value of one thousand times or more the theoretic penalty. Apart from the harm to third parties, this result invites speculation, particularly for projects in the earlier stages of development.

Third, Act 50 seems to assume that all projects will be oversubscribed with prospective owner-occupants. The Commission has informally indicated that rescission will be required regardless of whether there are back-up buyers. But in projects where there are no back-up buyers, the required rescission may have a contradictory effect and reward speculation by permitting the person who merely hoped to resell the opportunity to avoid his or her contractual obligation at the expense of the developer, its lenders, its brokers and other innocent third parties.

Numerous unanswered technical questions exist pertaining to rescission and resale procedures. If a couple divorces, a spouse or co-buyer dies or receives military orders, a single buyer marries, a tenancy change is made, must the contract be cancelled or must the contract be closed? Can reaffirmation occur after such a change in circumstances? Must third parties report the changed circumstances as possible violations? If a contract is cancelled may the unit be sold by the developer for a higher price? Does it matter with respect to resale at a different price if there is a backup reservation? Does it matter if the next buyer is an owner-occupant not on the reservation list or an investor? What if the buyer later requests to change the apartment purchased or to materially change amenities in the apartment?

Commission staff have also advised that the statutory duty to rescind cannot be waived by an owner-occupant who fails to reaffirm but closes anyway. It is not clear how the closed transaction might be affected under these circumstances. The act of closing should constitute an implied reaffirmation, and the transaction should not be affected when intent is otherwise clear.

There are a number of possible solutions to these problems which would preserve the intent of Act 50. At a minimum the Commission could provide an informal process for an owner to obtain the Commission's consent or approval of a sale necessitated by extenuating circumstances during the first year. If a recordable approval were provided it should eliminate exceptions in the buyer's title policy and permit the affidavit to be removed from the record.

Further, rather than requiring rescission in all cases where owner-occupants cannot reaffirm (including where there is no back-up buyer), the statute could require rescission only if there are back-up owner-occupant buyers on the original reservation list prepared to close. The question whether the original price must be offered should also be answered. If there are no other buyers, then the making of the false affidavit causes no harm, and the "punishment" for the buyer should be to require performance under the contract. This should also allay lender's concerns because in either circumstance, there would likely be a buyer.

Owner-Occupant Pre-Sale Notice

Prior to the adoption of Act 50, the pre-sale notice had to be published initially 15 days before filing for a public report. No approval of the notice was required, though the Commission could and did reject published notices filed with the public report materials which did not comply with the statute. This necessitated republication and delay and effectively sanctioned developers for incorrect notices.

Act 50 requires that a copy of the pre-sale notice be filed with the Commission at least 30 days prior to its publication. Filing for the initial public report must be made within 60 days thereafter. Notices for neighbor island projects must now be published not only in a newspaper with general circulation in the State, but also in a newspaper with general circulation in the county in which the project is located.

The apparent purpose of the new pre-filing process is to avoid the problems resulting from improper notices, but the result will be that all projects are now delayed at least one additional month, not just those with defective notices.

Although the statute does not state that the Commission is to "approve" the notice (it refers only to "filing" the notice), the Commission staff have made clear that comment upon the notices is to be expected and that it views the waiting period as necessary to provide it the opportunity to do so. Indeed, the Commission has requested that developers submit the notices more than 30 days before publication thus delaying the project even further, to give it adequate opportunity to comment.

Three issues have arisen regarding the timing of the filing which the Commission has not yet addressed. First, can the developer publish the notice when 30 days have passed even if the Commission has not commented? Second, if the Commission has commented before the 30 days have passed, can the notice be published immediately (the Commission has intimated that the answer to this question is "no"; however, the matter may be further reviewed)? Finally, if the developer is unable to file for the public report within 60 days after the notice is first published, must the notice be resubmitted to the Commission again 30 days prior to publication?

Developers have now had some experience with submitting notices to the Commission, and have been requested to comply with a puzzling variety of additional requirements. Commission staff have requested that applicants not use the term "offer to sell" as the Commission staff believes that such an offer made by an unlicensed developer violates Chapter 467 (the real estate broker licensing law). The "B" symbol must be inserted after the name of the broker. Staff have also requested that developers include the precise days and hours when owner-occupant reservations will be taken although this is not required by the statute, so that prospective owner-occupants will know when and for how long reservations have already been taken. Developers are also being required to resubmit the notice with the suggested or requested changes either red-lined or shown using the Ramseyer method. Additional information has been suggested, such as the number of bedrooms and baths in each unit, although not required by statute. Each submission and resubmission is taking a week to ten days for review and comment.

Given the administrative and legal complexity and the time delay, the value of the entire owner-occupant pre-sale procedure may be seriously questioned. If a policy of preference for owner-occupant buyers is to be retained, a far simpler alternative would be to require the developer to publish a statutory notice that a public report has become effective, followed by a short period during which only owner-occupants could purchase designated units. This would also ensure owner-occupants had reviewed a public report at the time their decision to purchase was made.

If the pre-sale procedure is to be retained, prior review by the Commission of the pre-sale notice should be made optional or advisory. Developers not getting the prior review would more clearly proceed at their own risk but would not incur present delays. Alternatively, the Commission could adopt a prescribed form of pre-sale notice so that no prior review is necessary. The statute might also be amended to clarify that the Commission's approval of the form of the notice is required, but permit publication whenever it is obtained, with an absolute time limit of 30 days following filing. Any such solutions would help to ensure that owner-occupants have an adequate opportunity to purchase, while avoiding additional delay and administrative effort.

Lottery System

Act 50 added an optional lottery method of determining the reservation list in order to alleviate the problems developers of affordable projects were experiencing in compiling the reservation list.

Act 50 permits developers to determine whether they will have a lottery or chronological reservation system. The system to be used is announced in the pre-sale notice. If the lottery system is chosen, prospective owner-occupants contact the developer to be placed on the reservation list, and must still execute the owner-occupant affidavit, but the order in which the reservations are received is not used to determine the buyer's place on the reservation list. Instead, the developer is permitted to hold a public lottery "conducted in such a manner that no prospective owner-occupant shall have an unfair advantage" to select those who will be placed on the reservation list. Within 30 days after the lottery, those on the list have an opportunity, in the order in which they appear on the list, to select a unit. All interested buyers on the reservation list remain as back-up buyers in the order in which their names were selected in the lottery.

It has been suggested that the lottery could be used by developers as a means to shorten the owner-occupant reservation period by holding the lottery soon after publication of the notice (as early as a day after the second publication) and lessen the number of sales subject to the reaffirmation/rescission problem. Owner-occupants reserving units after the lottery presumably have no special rescission opportunity at reaffirmation.

Conclusion

The Act, while well-intentioned, certainly will lengthen the time and expen of developing a condominium. Other unfc tunate and ironic consequences of Act 50 may be to discourage developers from selling to prospective owner-occupants, at least during the pre-public report period, to make construction financing of condominiums more difficult and to encourage speculation and false affidavits.

While developers in the past have used presale notices for marketing purposes, it can be expected that some developers sensitive to the new rescission risks will attempt to run obscure notices and defer aggressive marketing to owner-occupants until the expiration of the pre-sale period. A last irony of Act 50 is that with the decline of foreign real estate investment in Hawaii and adverse tax law changes for U.S. investors in the mid-1980's, there is a relatively weak investor market for new condominium units and, thus, little new rental housing. The State and the counties are each pursuing strategies to encourage such developments. Lack of investment in housing rather than excessive speculation may be the greater present problem. The difficulties posed by Part VI of the Condominium Property Act need immediate legislative attention; however, burial rather than emergency surgery may be appropriate in the light of current circumstances. Un then it will remain a trap for unwary deve. opers, lenders, real estate salespeople and their counsel. ■

The next issue of the newsletter will be published January 31. Please contact Deborah Chun, Nancy Grekin or Mark Hazlett before December 31 if you are willing to contribute an article or information on this or any other matter of interest to members of the Section. This and other articles in the newsletter reflect the view of the authors rather than official positions of the Real Property and Financial Services Section.

Real Property and Financial Services Section
Hawaii State Bar Association
136 Union Mall, PH 1
Honolulu, HI 96813