

The Interstate Land Sales Full Disclosure Act: An Overview

by Adam K. Feldman

This article provides an overview of the Interstate Land Sales Full Disclosure Act, explaining why the Act is especially relevant in today's real estate market.

Many real estate practitioners have heard of the Interstate Land Sales Full Disclosure Act (Act),¹ but most probably do not fully appreciate the relevance of the Act in today's troubled real estate market. The Act's significance has taken on new meaning, as an increasing number of contract purchasers look for ways to terminate real estate purchase and sale agreements (contracts) and obtain a refund of their earnest money deposits. As a result, litigation seeking rescission of contracts under the Act has increased exponentially over the last couple of years. Legal malpractice claims arising under the Act also have risen dramatically over the same time frame. Given the current economic recession, both of these trends should be expected to continue for some time.

This article provides an overview of the Act, focusing particularly on the two exemptions to the Act most often relied on by developers, and discusses recent case law interpreting these exemptions. The article also presents the advantages and disadvantages of registering a project under the Act, as opposed to relying on one or more exemptions, and discusses the penalties for failure to comply with the Act. The process for registering a project under the Act is not discussed in detail in this article, but both the process and requirements for a registration are explained at great length in the regulations interpreting the Act.²

Overview of the Act

Unless an exemption applies, the Act requires the registration of all subdivisions with the Secretary of the U.S. Department of Housing and Urban Development (HUD).³ The Act defines a "subdivision" as:

any land which is located in any state or in a foreign country and is divided or is proposed to be divided into lots, whether contiguous or not, for the purpose of sale or lease as part of a common promotional plan.⁴

Though once a heavily contested issue, it is now well-accepted that condominium projects constitute subdivisions and are subject to the provisions of the Act.⁵

A "common promotional plan," as used in the context of the definition of a subdivision, is a:

plan, undertaken by a single developer or a group of developers acting in concert, to offer lots for sale or lease; where such land is offered for sale by such a developer or group of developers acting in concert, and such land is contiguous or is known, designated, or advertised as a common unit or by a common name, such land shall be presumed, without regard to the number of lots covered by each individual offering, as being offered for sale or lease as part of a common promotional plan.⁶

A developer registers with HUD by filing a statement of record.⁷ The statement of record includes two principal components: a property report that is given to a purchaser prior to execution of a contract (Property Report) and additional information about the subdivision that is submitted to, and kept on file by, HUD.

The purpose of the Act is to provide consumers basic information about the property prior to execution of a contract. Such information includes the proximity of the project to community facilities (such as schools and hospitals), whether the obligations of the developer have been secured, and additional information that might be relevant to a purchaser when deciding whether to purchase a property. Further, the purchaser is provided a seven-day right of rescission after signing the contract, should the purchaser change his or her mind after execution of the contract.

Exemptions

Registration under the Act is not required if the subdivision falls within one of the eight exemptions that except the subdivision

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from all provisions of the Act (Full Exemptions)⁸ or one of the eight exemptions that except the subdivision from only the registration requirements under the Act (Partial Exemptions).⁹ The difference between the Full Exemptions and Partial Exemptions is that projects qualifying for a Partial Exemption still must comply with the anti-fraud provisions of the Act.¹⁰

The exemptions from the Act are self-operating and do not require a determination or approval from HUD to be relied on by a developer. A developer nonetheless may request an advisory opinion from HUD that confirms whether, based on the information provided by the developer, the subdivision meets the requirements of a specified exemption. Requesting such an opinion adds costs and takes time. HUD typically has a thirty-day review period (during which the developer would not want to execute any contracts that rely on the exemption). Furthermore, HUD may ask for a local opinion on state law, so legal practitioners should be aware of this before requesting an advisory opinion on behalf of their clients.¹¹

A developer whose subdivision does not meet all of the requirements of an exemption may request a finding of substantial compliance from HUD that would entitle the developer to rely on the exemption. Though useful, such substantial compliance findings may be sought only prior to undertaking sales in a subdivision, and may not be sought after noncompliance with the strict requirements of an exemption are discovered.¹²

As mentioned above, there are sixteen exemptions (eight Full Exemptions and eight Partial Exemptions). The following two are the most relevant to this article and are the most commonly used.

Improved Lot Exemption

This also is known as the “Two Year Exemption” and is the most commonly used Full Exemption. It exempts:

the sale or lease of any improved land on which there is a residential, commercial, condominium, or industrial building, or the sale or lease of land under a contract obligating the seller or lessor to erect such a building thereon with a period of two years.¹³

Completion of the home or unit is determined at the time the unit or home is ready for occupancy and has all necessary and customary utilities extended to it.¹⁴ Note that because the two-year requirement is individual to each contract, it is possible in any given project for some contracts to qualify for the exemption and for others to fail based on the length of time it takes to develop the applicable lot or unit.¹⁵

HUD takes the position that, for an uncompleted subdivision to qualify for the Improved Lot Exemption, the contract must absolutely and unconditionally commit the developer to complete the unit within two years from the date the contract is signed by the purchaser.¹⁶ The two-year completion obligation can be extended only for acts of God, *force majeure*, or any other delay that is a legally permissible defense to a contract action in the jurisdiction governing the contract.¹⁷ HUD defers to local law in determining whether the two-year completion obligation may be extended by such *force majeure* type defenses.¹⁸

Legal practitioners must be careful in drafting the *force majeure* extension language in a contract attempting to rely on the Improved Lot Exemption, because if even one portion of the *force majeure* clause is unenforceable under state law, the entire contract will not be exempt.¹⁹ Because most developers use form contracts, this would mean that every contract technically could lose its exemption. Suggested sample language for a typical *force majeure* clause is as follows:

Seller will substantially complete construction of the Unit, in the manner specified in the Agreement, by a date no later than two years from the date Purchaser signs this Agreement, subject only to delays caused by matters that are legally recognized as defenses to contract actions pursuant to the laws of the state of [fill in state name here]. If any delays caused by matters that are legally recognizable as defenses to contract actions pursuant to the laws of the state of [fill in state name here] occur, Seller has the option to extend the estimated time of completion for such time as the enumerated delays have occurred.

Contracts relying on the Improved Lot Exemption cannot allow nonperformance by seller, absent some purchaser default. Con-

tracts that allow seller to breach at will are not enforceable because the two-year completion obligation is not an obligation in reality.²⁰ Contracts that allow the seller to cancel are not enforceable for the same reasons, because they would make the completion obligation illusory. Therefore, a financing contingency in a contract relying on the Improved Lot Exemption should be drafted to be exercised only by the purchaser and not by the seller.²¹ The rationale is simple: federal regulations state that the failure of the purchaser to obtain construction financing will not relieve the seller of the obligation to build.

Moreover, with respect to title objections, the seller cannot be allowed to cancel a contract because the seller is not willing to resolve an exception to title found unacceptable to a purchaser. However, the contract does not need to obligate the seller to cure any title objections raised by the purchaser.

With respect to a casualty event, the seller cannot cancel an agreement if the property is destroyed during the construction period. The contract can provide that seller will notify the purchaser in writing if loss or damage occurs and make a recommendation as to whether the home or unit should be rebuilt but, ultimately, the purchaser's consent must be required to cancel the contract.

Contracts relying on the Improved Lot Exemption may contain a presale contingency that permits the developer to terminate all of the contracts it has executed by a date certain if a specific number of units or lots have not been put under contract. In no event may this contingency period extend beyond 180 days from the date the first contract is signed, or, in a phased project, 180 days from

the date the first purchaser signs the first contract in each phase.²² Note that unlike the two-year completion obligation, this presale contingency period is tied to the date the first contract is signed, so each contract is not subject to its own 180-day period. Additionally, if a developer waits to commence construction until the end of the presale contingency period, such contingency also can effectively limit construction time to eighteen months.

The seller cannot limit a purchaser's right to seek specific performance of the contract on seller default. Also, depending on the jurisdiction, the seller may not impose limits on the purchaser's other remedies in the event of seller default. HUD has made clear in its guidelines that contracts that have attempted to limit or eliminate specific performance as a purchaser remedy on seller default do not qualify for the exemption; otherwise the contract would not have a real completion obligation.²³

Florida courts have gone further and have held that contracts that do not allow the purchaser the remedy of damages for seller default do not qualify for the Improved Lot Exemption, holding that this also makes the completion obligation illusory.²⁴ The law varies from state to state as to whether limiting damages affects the obligation to complete the unit. HUD takes the position that only specific performance cannot be limited, but defers to state law on the issue of damages.²⁵

100 Lot Exemption

This exemption applies to the sale or lease of lots in a subdivision containing fewer than 100 lots.²⁶ It also is commonly referred

to as the “99 Lot Exemption” for this very reason. It is important to note that condominium units are considered lots under the Act.²⁷ Generally, storage spaces and parking spaces are not considered lots.²⁸ However, Colorado is an exception to this general rule, concluding that parking units are lots under the Act.²⁹

The 100 Lot Exemption is the most commonly relied on Partial Exemption and usually is used when the developer cannot commit to the two-year completion requirements of the Improved Lot Exemption. Only lots that are sold or offered for sale under a common promotional plan must be counted.³⁰ However, lots that are exempted under a Full Exemption may be excluded (as described below).

The 100 Lot Exemption is not automatic; to satisfy the anti-fraud provisions of the Act, the contract must contain express language that discloses to purchasers which utilities and recreational amenities the developer agrees to complete.³¹ If a contract that relies on the 100 Lot Exemption does not contain this language, the contract will not be exempt because it will violate the anti-fraud provisions of the Act.

Stacking Exemptions

Developers can, and often do, stack exemptions under the Act. The term “stacking exemptions” refers to using one exemption in connection with another exemption such that all contracts are collectively exempt from the Act. Two exemptions that cannot be stacked are the 100 Lot Exemption and the 25 Lot Exemption (which is not discussed in this article; it is a Full Exemption that

applies to the sale or lease of lots in a subdivision containing fewer than twenty-five lots).³² The most common stacking exemption used by developers is stacking the 100 Lot Exemption with the Improved Lot Exemption.

A developer may stack the 100 Lot Exemption with the Improved Lot Exemption when the developer does not wish to guarantee that the first contracts can be completed within the two-year period, as required under the Improved Lot Exemption. So, the developer can take the first ninety-nine units or homes under binding contracts that contain the language necessary to qualify for the 100 Lot Exemption. Then, after the ninety-ninth unit or home is under a binding contract, the developer will switch to contracts that rely on the Improved Lot Exemption for the remainder of the unsold units or homes.

It is essential that the legal practitioner coordinate this process with the developer and/or the developer’s marketing team. If the developer or its marketing team takes more than ninety-nine units or homes under contracts that rely on the 100 Lot Exemption, then the entire exemption will be lost and all of the contracts relying on the 100 Lot Exemption will be ineffective, thereby entitling any of those purchasers to seek rescission of their respective contracts under the Act.³³

Challenging Stacking

A recent case has called into question the entire notion of stacking exemptions. In *200 East Partners, LLC v. Gold*,³⁴ the Florida Court of Appeals rejected the concept of stacking the 100 Lot Exemption with the Improved Lot Exemption, despite an advisory opinion from HUD specifically authorizing such action.

The case involved a 115-unit development, in which the developer planned to place the first ninety-nine units under contracts complying with the 100 Lot Exemption and the last sixteen contracts complying with the Improved Lot Exemption. The court accepted the finding of the trial court that, at the time the Golds executed their purchase and sale agreement, the contract language applying to the first ninety-nine units failed to obligate the developer to complete the remaining sixteen units within two years.³⁵ The court refused to interpret HUD guidelines to permit a developer to wait until the sale of a unit in excess of the first ninety-nine to qualify for an exemption for the remaining units, and found unpersuasive HUD’s advisory opinion letter permitting the stacking of the exemptions.³⁶

Recent Eleventh Circuit Case Law

The recent downturn in the real estate market has resulted in litigation involving the Act increasing substantially in the last two years. The vast majority of this litigation has centered on condominium developers’ reliance on the Improved Lot Exemption, with the greatest number of cases coming from the 11th Circuit, of which most are from Florida.

In a victory for developers and lenders, in *Pugliese v. Pukka Dev., Inc.*,³⁷ the U.S. Court of Appeals for the Eleventh Circuit reversed a lower court decision and re-established a longstanding interpretation of contracts claiming a Partial Exemption under the Act. At issue was whether contracts that relied on Partial Exemptions to the Act must include certain provisions generally believed to apply only to contracts for registered projects (Required Disclosures). Courts and HUD, which administers the Act, had taken the posi-

tion that no contract that qualified for a Full Exemption or a Partial Exemption from the Act had to contain the Required Disclosures.

Holding against established precedent and an opinion letter issued by HUD, a federal trial court in Florida had determined that developers relying on the 100 Lot Exemption must include the Required Disclosures in their contracts; developers that did not include the Required Disclosures in their contracts would be subject to rescission rights by purchasers for up to two years after execution of the contract by the purchaser.³⁸ That opinion appeared to open rescission rights not only under outstanding contracts, but also in contracts that already had closed. As expected, litigation seeking rescission of outstanding contracts relying on a Partial Exemption greatly increased. Developers, construction lenders, and legal practitioners who had relied on the enforceability of contracts seeking the 100 Lot Exemption or another Partial Exemption were concerned.

The Eleventh Circuit reversed, holding that any contract that is exempt under the Act (regardless of whether the developer is entitled to a Full Exemption or a Partial Exemption) does not have to contain the Required Disclosures.³⁹ The *Pukka* case is one of dozens of recent decisions interpreting the scope of exemptions to the Act. Though *Pukka* has generated the most publicity, practitioners would be well-advised to periodically review the new case law interpreting the Act and its exemptions.

Registering vs. Relying on Exemptions

Having a better understanding of the Act and some of its exemptions, the analysis of the legal practitioner should turn to whether a developer client should register a project or rely on an exemption to the Act. There are a variety of considerations to be evaluated when discussing with a client whether to register the project with HUD or to rely on one of the Full Exemptions or Partial Exemptions, or whether to stack exemptions. The advantages to registering a project versus relying on an exemption(s) are discussed below.

Advantages of Registration

The Act is a consumer protection statute; as a result, exemptions have been narrowly construed by the courts. The Improved Lot Exemption, in particular, has been hotly contested and litigated, and, as discussed above, there are several potential pitfalls when drafting a contract that can invalidate the Improved Lot Exemption.

Registration provides a developer with more control over the terms of sale and the power to limit contractual remedies. For example, a contract for a registered project does not have to commit to a certain timeline for delivery of the unit. The contract can limit the remedies of specific performance and damages on seller default, and can provide the seller with the right to terminate the contract if the purchaser is unable to satisfy the financing contingencies, if casualty to the project improvements occurs, or for any number of other reasons. In addition, the developer can include in the contracts additional seller contingencies, such as longer pre-sale contingency periods than are permitted under the Improved Lot Exemption.

Although registration may be extensive from a due diligence standpoint, it is not unduly burdensome and often is useful for a

developer. Registration is based on the mere disclosure of existing facts about the project backed by basic documentation, not a long list of new substantive standards to be met. Furthermore, much of the required information already may have been gathered in connection with state registrations, depending on where the project is located and will be marketed. As noted above, under the Act, developers of registered projects are to provide purchasers with a Property Report in advance of the purchaser signing the contract.⁴⁰ The Property Report often provides detailed information on the project, which may reassure purchasers and lenders.

Registration is a complete defense to most claims of noncompliance with the Act. The most common claims seeking to attack a registered project are claims of fraud or misrepresentation in the Property Report⁴¹ or failure to deliver the Property Report in advance of the execution of the contract by the purchaser. Lawsuits attacking exemptions are increasingly common, whereas lawsuits attacking registrations are not. Developers may spend as much in legal fees in compliance efforts with one or more of the exemptions (and subsequently defending attacks from disgruntled purchasers and their attorneys) as they would have spent registering the project in the first place.

Registration removes the possibility of a purchaser using or attempting to use the Act's two-year rescission option if the seller fails to comply with the provisions of the Act, regardless of

whether title has transferred—for example, for improperly relying on an exemption.⁴² A Florida court has allowed post-closing rescission in one case even beyond the two-year period.⁴³ In a difficult real estate market, registration helps sales stick by removing the strong threat of rescission from purchasers and their attorneys.

Registering under the Act may allow the developer to use exemptions from certain state registrations. It also may allow the developer to use short forms of registration in states that allow the developer to include the HUD registration, along with a shorter form of information.

Advantages of Relying on Exemptions

There are several disadvantages to registering a project versus relying on an exemption. These are discussed below.

Registering a project requires increased time, legal expense, and management/staff attention. The developer client may prefer that this attention be focused on sales and marketing efforts to entice purchasers into signing contracts. The registration process typically takes a minimum of sixty days. During that time, the developer can accept only nonbinding reservations from potential purchasers.⁴⁴ In instances where registration is undertaken after sales have begun, registration requires the disclosure to HUD of information on prior sales in the subject project that were made without the benefit of compliance with the Act.

Property report disclosures may expose facts and circumstances about the project that the developer would rather not show prospective purchasers or lenders, such as:

- 1) the identity of developer's affiliates, the names of their projects, and whether such other projects are subject to the Act;
- 2) the developer's financial ability to assure completion of construction of the project;
- 3) the degree of risk to which purchasers could lose their deposits;
- 4) the developer's thin capitalization; and
- 5) the operating loss to date of the developer entity.

Also, the information about the developer contained in the additional information section of the registration that is given only to HUD could become available to purchasers by virtue of a Freedom of Information Act request.

When defending an exemption, the developer does not have to prove compliance with the Act; the developer only has to defend against the specific allegations of noncompliance. Suits for misrepresentation and omission of material facts under the Property Report are fully authorized by the Act, so registration does not render the developer completely immune from lawsuits or attacks by purchasers.⁴⁵

Under the Act, when the deed is to be delivered to the purchaser more than 180 days after the purchaser has signed the contract and in the event of purchaser default, in addition to the other Re-

quired Disclosures, the seller must give purchaser a twenty-day notice and right to cure default, and the seller may retain only up to 15 percent of the purchase price or actual damages, whichever is greater (regardless of the amount of the deposit),⁴⁶ along with the other Required Disclosures. Contracts for a project relying on a Full Exemption or a Partial Exemption do not have to contain the Required Disclosures.⁴⁷

If the project is registered, the developer must give prospective purchasers a seven-day rescission period after delivery of the Property Report and execution of the contract. Therefore, it is essential for the practitioner to discuss these advantages and disadvantages with the developer at the inception of the project and before commencing sales and marketing efforts. The outcome of the decision by the developer client of whether to register or rely on an exemption will affect, among other things, how contracts are drafted and how sales and marketing efforts are coordinated with prospective purchasers.

Failure to Comply

Failure to comply with the Act by failing to register, misrepresenting or omitting material facts in a Property Report, or incorrectly relying on an exemption(s) for which the developer did not qualify can result in rescission of the contracts by purchasers, including possible post-closing rescission, monetary fines of up to \$1 million, and criminal penalties.⁴⁸ It is possible that failing to register a project when required will be a black mark in HUD and state registration applications for future projects by the developer or an affiliate. In today's economic recession, that is too great a risk for developers to take. Therefore, it is imperative that real estate practitioners are knowledgeable with the requirements of the Act to ensure that their clients' projects comply with the Act.

Conclusion

The Act was relatively unknown when the real estate market was expanding and rescission by purchasers was not a concern. Now, it is used by an increasing number of purchasers and practitioners as a means to rescind otherwise enforceable contracts. Counsel to developers and lenders should carefully scrutinize contracts in development projects to ensure the enforceability of such purchase agreements and compliance with either the registration requirements of the Act or with an exemption to the Act. Developers' counsel should have detailed discussions with their clients before deciding whether to register a project or rely on an exemption to the Act. The ultimate success of a project could depend on it.

Notes

1. 15 U.S.C. §§ 1701 *et seq.*
2. See 24 C.F.R. §§ 1710 and 1715.
3. See 15 U.S.C. § 1703(a)(1).

4. See 15 U.S.C. § 1701(3).
5. See *Giralt v. Vail Village Inn Assocs.*, 759 P.2d 801 (Colo.App. 1988).
6. See 15 U.S.C. § 1701(4).
7. See 15 U.S.C. § 1703. See also 15 U.S.C. §§ 1705 and 1706 (setting forth the information required to be included in the statement of record).
8. See 15 U.S.C. § 1702(a)(1) to (8).
9. See 15 U.S.C. § 1702(b)(1) to (8).
10. See 15 U.S.C. § 1703.
11. See Supplemental Information to Part 1710: Guidelines for Exemptions Available Under the Interstate Land Sales Full Disclosure Act, 61 Fed. Reg. 13595 (1996), the Interstate Land Sales Registration Division, U.S. Department of Housing and Urban Development (Guidelines) Appendix A, Part IV(b), available at www.hud.gov/offices/hsg/ramh/ils/ils_exemp.cfm.
12. See *id.* at Appendix A, Part VII.
13. See 15 U.S.C. § 1702(a)(ii).
14. See Guidelines, *supra* note 11 at Appendix A, Part IV(b).
15. *Id.*
16. *Id.*
17. *Id.*
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.*
22. See 24 C.F.R. § 1710.5.
23. See Guidelines, *supra* note 11 at Appendix A, Part IV(b).
24. See *Samara Dev. Corp. v. Marlowe*, 555 So.2d 1097 (Fla. 1990).
25. See Guidelines, *supra* note 11 at Appendix A, Part IV(b).
26. See 15 U.S.C. § 1702(b)(ii).
27. See *Winter v. Hollingsworth Properties, Inc.*, 777 F.2d 1444 (11th Cir. 1985).
28. See *Trotta v. Lighthouse Point Land Co.*, 551 F.Supp.2d 1359 (S.D.Fla. 2008).
29. See *Giralt*, *supra* note 5.
30. See Guidelines, *supra* note 11 at Appendix A, Part V(a).
31. See 15 U.S.C. § 1703(a)(2)(D).
32. See Guidelines, *supra* note 11 at Appendix A, Part V(a).
33. *Id.*
34. See *200 East Partners, LLC v. Gold*, 997 So.2d 466 (Fla.App. 2008).
35. *Id.*
36. *Id.*
37. See *Pugliese v. Pukka Dev., Inc.*, 550 F.3d 1299 (11th Cir. 2008).
38. See *Pugliese v. Pukka Dev., Inc.*, 524 F.2d 1370 (S.D. Fla. 2007).
39. See *Pukka*, *supra* note 37.
40. See 15 U.S.C. § 1703(b). See also 15 U.S.C. § 1707 (setting forth the requirements of the Property Report).
41. Claims of fraud or misrepresentation in the Property Report are difficult to prove. The remedy is damages, which must be proven by the purchaser, as opposed to the remedy of rescission if the developer erroneously relied on an exemption.
42. See 15 U.S.C. § 1703(c).
43. See *Engle Homes, Inc. v. Krasna*, 766 So.2d 311 (Fla.App. 2000).
44. See Guidelines, *supra* note 11 at Appendix A, Part III(a).
45. See 15 U.S.C. § 1703(a)(1)(C).
46. See 24 C.F.R. § 1710.105(d).
47. See *Pukka*, *supra* note 37.
48. See 15 U.S.C. §§ 1709, 1717, and 1717a. ■