

PUBLICATION

Blindsided by the Interstate Land Sales Full Disclosure Act? There May be Hope for You Yet.

November 5, 2009

Summary: *Many residential developers have been caught off guard by purchasers alleging claims under the Interstate Land Sales Full Disclosure Act (ILSA). Although the various methods of complying with the act should always be explored prior to commencement of a project, even a developer that initially disregarded ILSA may have defenses under the act, depending on the facts and circumstances.*

At the peak of the housing bubble in 2006, most developers were not overly concerned with obscure federal consumer protection laws from the 1960s. However, as the market has deteriorated, buyers have scrambled to find any excuse to get out of their contracts, and many developers have gotten an education – the hard way – about the Interstate Land Sales Full Disclosure Act (ILSA).

ILSA is a federal statute, enacted in 1968, that governs the pre-construction sale or lease of property in certain types of large-scale developments. The act prohibits the sale or lease of real property unless: (i) the property has been registered with HUD and an ILSA-compliant property report has been provided to the buyer prior to contract execution; or (ii) one or more of the exemptions from the statute are met.¹ Violation of the act can result in criminal or civil penalties including revocation of the contract at the option of the buyer,² fines of up to \$10,000 and imprisonment of five years or less.³ Developers would therefore be well advised to carefully consider the risks of non-compliance with ILSA before they begin pre-construction sales on a project.

The reality in today's market, however, is that it is already too late for most projects, and the majority of avenues for ILSA compliance have already been closed off to most developers that got caught holding the bag when the market imploded. By the time you are hit with a lawsuit or a demand for rescission under the act, your only hope is either to reverse-engineer an exemption from the act or to cross your fingers and hope that the buyer's attorney isn't paying attention. This article will briefly summarize several of the strategies developers can use to avoid liability under ILSA, even if no ILSA-compliance analysis was conducted during the initial stages of the project.

As mentioned previously, compliance with ILSA can only be achieved by either registering the project with HUD and providing each buyer with a property report prior to contract execution or meeting the requirements of one or more exemptions from the statute. Due to the expensive and time-consuming nature of HUD registration, many developers elect to forego the registration process and rely on one or more exemptions set forth either in ILSA itself, or the regulations and guidelines promulgated by HUD pursuant to the authority granted to it in the act. Because ILSA would require that HUD registration be completed before the applicable sales contract is signed, a developer that gets blindsided with an ILSA claim will necessarily need to look to the exemptions from the statute for relief.

The most obvious exemptions from ILSA are those exemptions based on the number of overall units in the development. In particular, Section 1702(a) of the act provides a complete exemption⁴ from the act for developments of less than 25 units. In addition, Section 1702(b)(1) creates a partial exemption⁵ for developments of less than 100 units that are not otherwise exempt (in other words, units that qualify under another exemption do not count for purposes of measuring the 100 units under this exemption). Ironically, because improved properties (those for which construction is already completed at the time the sales contract

is signed) are completely exempt from ILSA,⁶ a developer who has undertaken a project without complying with ILSA may suddenly fall within the exemption in the event that less than 100 units remain subject to sales contracts (and therefore exempt under Section 1702(b)(1)) and the remaining units are already complete (and therefore exempt under Section 1702(a)(2)). Yet another partial exemption can be found at Section 1702(b)(2) for developments in which no more than 12 units are sold in any 12-month period. Although there are additional considerations for determining whether a developer qualifies for these exemptions, developments with approximately 100 units or less or developments in which sales have been extremely slow, may well have a legitimate argument for exemption.

A particular transaction may also be exempt from ILSA based on the nature of the buyer. For example, Section 1702(a)(7) of the act provides a complete exemption for sales to persons who either purchase the property for purposes of construction, or for the purpose of resale or lease of the property to persons engaged in the construction business. Also, Section 1710.14(a)(3) provides a partial exemption for sales to persons who are engaged in a bona fide land sales business.⁷ Sophisticated and opportunistic brokers, contractors and investors may therefore find themselves out of luck if they seek to avail themselves of ILSA's remedies.

Finally, if a buyer exercises its right of rescission under the act, or if a buyer files suit claiming a violation of ILSA, the developer should pay close attention to the limitation periods set forth in Sections 1703(c) and 1711 of the statute. Section 1703(c) requires that, if a property report was required to be provided to the buyer (i.e., the developer was not exempt), but no report was provided, the buyer may revoke the contract within two years from the date of the contract. In addition, Section 1711 requires that any action for a violation of the HUD registration and property report requirements must be brought within three years from the date the buyer signs the contract.⁸ Any action for a violation of the "anti-fraud" provisions must be filed within three years from the date the buyer discovers or should have discovered the violation.⁹ To the extent a buyer simply waited too long hoping for the market to recover prior to exercising his or her remedies under ILSA, the buyer may therefore discover that his or her claims are barred by the applicable statute of limitations.

As a matter of practice, it is always advisable to consult a knowledgeable attorney prior to commencement of a real estate project. However, even if a distressed project is already well on its way to completion, experienced legal counsel may be able to navigate the project through the maze of ILSA exemptions and bring reluctant buyers to the closing table. Baker Donelson's Real Estate group represents developers across the country in connection with all aspects of ILSA claims and compliance. Our experience includes not only the structuring of transactions to ensure compliance with ILSA, but also the defense of developers against suits brought by purchasers seeking rescission, damages and other remedies under the act.

1. 15 U.S.C. § 1703(a).

2. 15 U.S.C. § 1703(c).

3. 15 U.S.C. § 1717.

4. Section 1702(a) of the statute provides eight "complete exemptions" from ILSA, which exempt the developer not only from the HUD registration and property report requirements of Section 1703(a)(1), but also from the "anti-fraud" provisions contained in Section 1703(a)(2). A thorough analysis of the "anti-fraud" provisions is beyond the scope of this article, but in general the "anti-fraud" provisions prohibit actual fraud by the developer, and require that if the developer has made representations regarding roads, utilities or amenities for the project, those representations must be included in the sales contract. Unlike the "complete exemptions" at § 1702(a), the statute also provides a number of "partial exemptions" at § 1702(b), which exempt the developer from the HUD registration and property report requirements, but do not exempt the developer from the "anti-fraud" provisions.

5. See FN 4, *supra*.

6. § 1702(a)(2).

7. A person engaged in a "bona fide land sales business" is further defined in the HUD Guidelines as a party that plans to sell the property in the normal course of business (HUD Full Disclosure Act Exemptions, available at <http://www.nls.gov/offices/hsg/ramh/ils/ilsexemp.cfm>) (last visited September 8, 2009).

8. § 1711(a).

9. § 1711(b).

