The Interstate Land Sales Full Disclosure Act: The Devil's in the Details

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In 53 words filling one long sentence, the regulators in the Interstate Land Sales Registration division of the U.S. Department of Housing and Urban Development have captured the basic rule of the Interstate Land Sales Full Disclosure Act (15 U.S.C. §§ 1701-1720):

> Except in the case of an exempt transaction, a **developer** may not **sell or lease lots** in a **subdivision**, making use of **any means or instruments of transportation or communication** in **interstate commerce**, or of the mails, unless a Statement of Record is in effect in accordance with the provisions of this part. (24 C.F.R. §1710.3)

Pry the sentence apart, and one has the feeling of opening the proverbial can of worms. To get to the bottom of it, some definitions and tools provided by those same regulators are key. Those tools include the regulations at 24 C.F.R. §§ 1710.1-1710.635 (2008) and other information posted periodically at http://www.hud.gov/offices/hsg/sfh/ils/ilshome.cfm (the "HUD Web Page"), including the important Supplemental Information to Part 1710: Guidelines for Exemptions Available under the Interstate Land Sales Full Disclosure Act (the "Guidelines").

The exemptions from the Act are often the focus, quite rightly, of developers and their counsel in applying and complying with the Act. However, the exemptions are just the holes in the surprisingly wide net cast by the Act to regulate land sales. The terms highlighted below are the mesh of the net that may snag and tangle any real estate developer's project. This outline is intended as a primer for the concepts at the heart of the Act and its exemptions.

1. Exactly what is a "sale"?

A "sale" is defined as any obligation or arrangement for consideration to purchase or lease a lot directly or indirectly. Note, the terms "sale" or "seller" include in their meanings the terms "lease" and "lessor." (24 C.F.R.§1710.1) However, an exemption from the registration requirements of the Act is available for the lease of lots for a term not to exceed five years, provided the lease documents do not require the tenants to renew. (24 C.F.R. §1710.14; Guidelines, Part VI, paragraph (a)(2))

2. When does a sale occur?

The time of sale is determined when a purchaser signs a contract, even if the contract contains contingencies beyond the control of the seller.

The Guidelines explain the concept with a simple example carrying devastating consequences: If a developer uses a contract which states that the sale is contingent upon obtaining an exemption from HUD, a sale has occurred nonetheless, once the purchaser has signed the contract. (Guidelines, Part II, paragraph (e)) Having effectively completed a "sale," according to HUD's definition, without qualifying for an exemption and without registering, the developer in HUD's example would be subject to the sanctions and remedies available under the Act's enforcement and penalty sections.

In contrast to a sale contract, a reservation agreement that meets certain requirements may allow a developer to document a prospective buyer's interest in a lot without running afoul of the Act's prohibitions against signing a contract without an exemption or a registration statement in place. Specifically, the Guidelines define a "reservation" as "a non-binding agreement used to gauge market feasibility for a developer through which a potential purchaser expresses an interest to buy or lease a lot or unit at some time in the future." A transaction contemplated by a reservation agreement will fall outside the jurisdiction of the Act if the agreement meets these criteria:

(i) The developer must transfer any deposit from the interested person into an escrow account maintained by an independent institution having trust powers.

(ii) The deposit must be refundable in full at any time at the option of the potential purchaser.

(iii) The reservation must not ripen into a binding obligation to purchase a lot without an additional confirmation by the prospective buyer. In other words, the buyer must take some subsequent affirmative action, typically the signing of a sales contract, to create a binding obligation.

The Guidelines illustrate the limits of a reservation agreement by comparison to an option, which calls for a buyer's deposit of consideration that could be forfeited if the option were not exercised. In light of that feature of a deposit at risk, an option will not qualify as a reservation agreement excluded from the Act. (Guidelines, Part III, paragraph (a))

3. Who is a "developer"?

A developer is an individual or a business entity that, directly or indirectly, sells or leases, or offers to sell or lease, or advertises to sell or lease lots in a subdivision. (15 U.S.C. §1701(5))

Since offering or selling lots, rather than developing them through the process of planning, platting and constructing infrastructure improvements, is a criteria for determining who is a developer, the following players may meet the criteria of a "developer" under the terms of the Act:

(a) a bank offering lots obtained through a foreclosure;

(b) a corporation that acquires groups of lots in an existing subdivision for resale; or

(c) an individual who buys lots at a tax sale or an auction for resale to others.

(HUD Web Page: FAQ for Developers, "Full Disclosure Act Questions and Answers")

4. What does it mean, in the definition of a "developer," to sell or lease a lot "directly or indirectly"?

A. Is a developer potentially liable to a "remote" or "second generation" purchaser who took title from the buyer who bought directly from the developer?

At least some courts have answered, "no," holding that private causes of action under Section 1709 of the Act are limited to persons who directly purchase their property from a developer. Gibbes v. Rose Hill Plantation Dev. Co., 794 F. Supp. 1327 (D.S.C. 1992). *See also* Konopisos v. Phillips, 30 N.C. App. 209, 226 S.E. 2d 522 (1976) where the court explained, "Stated simply, this Act was designed to protect *purchasers* of real property and to fulfill that goal the Act establishes rigorous disclosure provisions and requirements. The logical beneficiary of that information is the seller's buyer and not the buyer's assignee; the latter having never dealt with the seller in the first place." 30 N.C. App. at 213.

More recently, a federal district court in Florida departed from the Gibbes and Konopisos rulings to hold that a buyer's assignee could indeed raise claims against the seller for violations of the Act, although notably, in this particular case, the court was dealing with an assignee (a limited liability company whose members were the original buyer and his wife) deemed essentially the alter ego of the original buyer. Trotta v. Lighthouse Point Land Company, LLC, 551 F.Supp.2d 1359, 1365 (S.D. Fla. 2008). On appeal, the Eleventh Circuit reversed the decision on other grounds in an unpublished opinion (No.08-14115, filed March 16, 2009). Still, the Trotta case probably holds lessons for both developers – to beware of contract assignees, and buyers – to beware of contract assignments for estate or tax planning reasons that may jeopardize the assignee's standing to challenge the contract seller for violations of the Act.

B. Is a principal in a position of ownership or control of a developer entity included in the Act's definition of "developer"?

The answer may be "yes," particularly if the court decides that holding the principal liable as a developer is necessary to carry out the purposes of the Act. In Kemp v. Peterson, 940 F.2d 110 (4th Cir. 1991), the Fourth Circuit heard an appeal from a lower court decision against a corporate developer's officers, directors and participating planners, found individually responsible for violations of the Act. The lower court had remedied those violations with orders requiring the defendants to deposit proceeds from subsequent lot sales in an escrow pending ultimate determination of the issue of liability, and an injunction requiring the defendants to submit periodic reports to a magistrate judge accounting for their personal and business expenses. The appellate court rebuffed the defendants' complaint that the district court's

accounting requirement was burdensome and intrusive, reasoning that a district court is authorized to issue all orders necessary to enforce its decisions issued in the exercise of its jurisdiction and its equity powers conferred by the Act.

Along similar lines, the Tenth Circuit had subjected officers and directors to liability under the Act in McCown v. Heidler, 527 F.2d 204 (10th Cir. 1975), stating,

> The 'developer' of a land sale plan is usually a corporate entity which, in a fraudulent scheme as here alleged, ends up defunct and offers no reserve for recovery to those persons defrauded; so, too, the end selling agent, when the development collapses financially, is often long gone or cannot respond pecuniarily. Indeed the actual selling agent may well be a creditor of the developer and an indirect victim of the fraud himself. The basic protection of the Act, to be meaningful, must be leveled against the fraudulent planners and profit makers for otherwise the Act would be pragmatically barren. No legislative enactment should be rendered ineffective to attain its purpose if such a construction can be avoided.

Id. at 207, citing SEC v. C.M. Joiner Leasing Corp., 321 U.S. 344, 350-351, 64 S. Ct. 120, 88 L.Ed. 88.

An equally dire but apparently deserving result for some particularly unrepentant principals of a swindling developer arose in U.S. Dept. of Housing & Urban Development v. cost Control Marketing & Sales Management of Virginia, Inc., 64 F.3d 920 (4th Cir. 1995). Exercising its administrative remedies under 15 U.S.C. §1714, HUD brought this action in federal district court against a developer corporation for failing to register its offering of vacant lots, to provide the required Property Report to prospective purchaser, to inform those purchasers of a two-year rescission right available because of the missing Property Reports, and to rescind sales upon demand. HUD also alleged that the developer used high-pressure, misleading marketing techniques. At the district court level, HUD won a preliminary injunction prohibiting the developer from further violations of the Act and freezing the assets of individuals acting for the developer. The district court also drew on its equitable powers to order the disgorgement of the developer's ill-gotten profits.

In the course of the proceedings, three of the principals filed bankruptcy petitions and then argued that their discharge in the bankruptcy action should bar entry of any order for the disgorgement of the profits from their sales in violation of the Act. The Fourth Circuit ruled in favor of HUD with these holdings:

(1) Although the filing of a bankruptcy petition would ordinarily act as a stay of pending judicial proceedings under 11 U.S.C. §362(a)(1), the stay did not apply to the commencement or continuation of an action by a governmental unit to enforce its police or regulatory power, under 11 U.S.C. §362(b)(4). Accordingly, the bankruptcy filing did not operate to stay HUD's action against these defendants.

(2) As discharge in bankruptcy is not to provide a shelter for wrongdoers, a Chapter 7 debtor may not discharge a fine, penalty or forfeiture that is payble to and for the benefit of a governmental unit, and that is not compensation for actual pecuniary loss, pursuant to 11 U.S.C. §523(a)(7). Here, HUD sought disgorgement of over $8,000,000 in profits. HUD based its claim on the amount lot purchasers had lost, and HUD's representatives disclosed an intent on the agency's part to use some or all of the recovery to repay the lot purchasers. Even so, since the final judgment ordered payment to HUD and not to the lot buyers, and as the lower court's order did not require HUD to disburse the money to any third parties, the Fourth Circuit interpreted Section 523(a)(7) of the Bankruptcy Code to rule that as long as the government's interest in enforcing a debt is penal, it does not matter that injured persons may receive, out of that debt, some compensation for their pecuniary loss. The order for the disgorgement of profits stood against the individual "developer" representatives.

C. How does the Act speak to the role of agents acting for, or in tandem with, the developer?

The Act defines "agent" as "any person who represents, or acts for or on behalf of, a developer in selling or leasing, or offering to sell or lease, any lot or lots in a subdivision…." (15 U.S.C. §1701(6))

To the relief of lawyers everywhere, that same section of the Act excludes from the definition of "agent" an attorney "whose representation of another person consists solely of rendering legal services."

The concept of "agent" is important because the provisions of 15 U.S.C. § 1709(a) allowing private causes of action for violations of the Act include an agent as a potentially liable party:

> (a) Violations; relief recoverable. A purchaser or lessee may bring an action at law or in equity against a developer or agent if the sale or lease was made in violation of [15 U.S.C. §1703(a), the statute's provision requiring registration of non-exempt offerings and compliance with anti-fraud protections]. In a suit authorized by this subsection, the court may order damages, specific performance, or such other relief as the court deems fair, just, and equitable.

A developer does not escape liability under the Act with the shield of a broker or other agent, as a party may be deemed to be selling "indirectly" to purchasers (and thus qualifying as a "developer") by conducting selling efforts through means other than direct, face-to-face contact with buyers. Bartholomew v. Northampton Nat'l Bank, 584 F.2d 1288 (3rd Cir. 1978).

A number of cases demonstrate that lending institutions may not lie beyond the reach of the Act. For example, a bank listed as "lead lender" in newspaper advertisements promoting a real estate management conglomerate was not summarily dismissed as a defendant in a lawsuit alleging violations of the Act, due to questions of whether the bank exceeded its ordinary course of operations to the extent that it should be deemed a "developer" or "agent" governed by the Act. Hammar v. Cost Control Marketing & Sales Management, Inc., 757 F. Supp. 698 (W.D.

Va. 1990). Similarly, a bank was forced to fight claims under the Act in circumstances where the bank agreed with a subdivision developer to purchase secured notes executed by subdivision lot buyers, based on the argument that the bank had an interest in the development going forward, and that the bank was holding itself out as a financial backer to attract prospective buyers to the project. Timmreck v. Munn, 433 F. Supp. 396 (N.D. Ill. 1977).

On the other hand, a credit corporation which granted loans to lot purchasers, but never engaged in advertising, development or sales activities, was held to not constitute a "developer" or "agent" under the meanings of the Act, and so the corporation escaped civil liability under Section 1709 of the Act (pertaining to the actions at law and in equity available to buyers and lessees for a developer's violations of the Act). Zachery v. Treasure Lake of Georgia, Inc., 374 F.Supp. 251 (N.D. Ga. 1974)

D. Are others in a developer's organization vulnerable to enforcement of the Act?

Taking a cue from the Timmreck and McCown decisions noted above, a district court held that a defendant who is neither a "developer" nor an 'agent' under the Act could still be liable *as an aider and abettor* under the Act. The court cautioned that not everyone who is tangentially connected to land developer guilty of committing fraud is a proper defendant under the Act. Instead, the remedies of the Act should be available against such party only if the defendant is a "classic insider" of the developer, providing "knowing assistance of or participation in a fraudulent scheme." The court stressed that this construction of the Act involves only minimal flexibility to better carry out the purpose of the statute, namely, "to prohibit fraud and protect purchasers of land which is part of a common promotional scheme." Rolo v. City Investing Co. Liquidating Trust, 845 F. Supp. 182, 220-221 (D.N.J. 1993) (citing Bartholomew, McCown, Timmreck and other cases)

5. What is a "lot"?

A "lot" is defined in the regulations as "any portion , piece, division, unit or undivided interest in land located in any State or foreign country, if the interest includes the right to the exclusive use of a specific portion of the land." (24 C.F.R. §1710.1) The Guidelines, echoing case law, go on to explain that the definition may include a cooperative unit, a campsite or a condominium. By extension, and notwithstanding the use of the word "land" in the definition, a "dockominium" could be considered a "lot" for the purposes of the Act.

With respect to a real estate interest that is classified as an undivided interest or marketed as a membership, the key in determining whether the interest is a "lot," as defined by HUD, lies in the right of the buyer or tenant to use the property repeatedly, on an exclusive basis (so that the owner or tenant could evict another person from using the property during the time allotted to the owner or tenant), for even a portion of the year. Accordingly, a membership that carries these rights allowing exclusive, repeated use of a particular parcel is included in the definition of a lot, according to the Guidelines. (Guidelines, Part I, paragraph (d))

Differing from the interests constituting "lots" as described above, undivided interests that do not bestow the right of exclusive use of a specific parcel falls beyond the jurisdiction of the Act. The Guidelines make the distinction with an illustration: A camping subdivision sold as 400 undivided interests to tenants in common, governed by a regime allowing the buyers co-extensive, non-exclusive rights to the use of all campsites on a first come, first served basis, but denying any buyer any exclusive right to repeatedly use or occupy any specific campsite, would *not* be covered by the Act. (Guidelines, Part III, paragraph (b))

The district court in the Trotta case mentioned above provided a common sense answer to a question that has plagued developers for some time: Does a storage or parking space mapped as a separate unit in a condominium project constitute a "lot" within the definition of the Act? Plaintiff Trotta claimed that his seller/developer failed to qualify for an exemption from the Act's registration requirements because the developer's condominium project included 67 dwelling units and 59 storage units, totaling more than the 99 units allowed under the exemption on which the developer had relied (found at 15 U.S.C. §1702(b)(1)). The plaintiff argued that the storage units should be considered "lots" under the Act because those units were designated for the exclusive use of each condominium owner. Trotta at 1362-1363.

With a common sense approach to the purpose of the Act, the court rejected the plaintiff's argument, reasoning,

> [A] development does not become meaningfully larger, in the sense that consumers are more likely to need regulatory protection from sophisticated sellers, merely because interests in storage places (or parking spaces) are sold along with residential units.

Id. at 1363.

6. What is a "subdivision"?

The Act defines a subdivision to mean any land, located in any state *or foreign country,* that is *divided or proposed be divided into lots*, *whether contiguous or not*, for the purpose of sale or lease as part of a *common promotional plan*. (15 U.S.C. § 1701(3))

Any number of lots, whether divided by the previous owner, divided by the current owner, or merely proposed to be divided, may constitute a subdivision. In a note important to anyone claiming an exemption based on the limited number of lots in the subdivision, the Guidelines clarify that the phrase, "proposed to be divided" refers not only to the developer's intention to subdivide land within the developer's project, but also the developer's intention to add additional land or units to the developer's project. (Guidelines, Part II, paragraph (g))

Note carefully, the reference in the statute and the regulations to lots, *whether contiguous or not,* blurs the conventional notions of the boundaries defining a subdivision -- and the method of counting the lots included. That number may be critical to a developer's effort to qualify for the Act's exemptions available to projects with fewer than 25 lots (15 U.S.C. §1702(a)(1)) or

fewer than 99 lots (15 U.S.C. §1702(b)(1)), and that developer may be surprised to learn that his successful projects scattered throughout a city or even larger area, taken together, might arguably amount to a single subdivision under the tests establishing a "common promotional plan," as explained below.

7. What is a common promotional plan?

A common promotional plan is any plan undertaken by a single developer or a group of developers acting together to offer lots for sale or lease. The Guidelines, drawing from the Act (15 U.S.C. § 1701(4)), list these factors to be assessed in determining the existence of a common promotional plan:

(a) The existence of a common promotional plan is presumed when a developer or a group of developers, acting together or linked by a thread of common ownership, offers lots which are contiguous or which are known, designated, or advertised under a common name.

(a) The number of lots offered is not determinative in a finding of a common promotional plan.

(b) Other characteristics considered in a finding of a common promotional plan include those listed below (but note, the presence or absence of one or more of these characteristics will not be conclusive):

(i) 10% or greater common ownership of the lots offered (;

(ii) the same or similar name for the lots;

(iii) common sales/leasing agents;

(iv) common sales/lease office facilities;

(v) common advertising; and

(vi) common inventory.

(Guidelines, Part II, paragraph (b))

For a developer, broker, investor, lender or any other party involved in a real estate development, the seven questions above provide an introduction to the Act and the pitfalls that may lurk in the details of the statute.

After all, 'better the devil you know than the devil you don't.