by Frank A. Lombardi, Esq.

Developer Loans

"Well, Surprise, Surprise, Surprise!"

Usually, when I speak or write about the benefits of association loans, it concerns those loans made to associations by specialty lenders. The proceeds can be used to fund any number of capital improvement projects as the condominium's building and grounds start and continue to deteriorate. Further, these loans can most times be a welcome alternative to a special assessment. Today's discussion, however, is not about loans from banks, but from developers.

Specifically, I recently addressed a new board of directors for a condominium association that had just transitioned from developer control. From what I gathered from the board, during the transition meeting, the developer gave the unit owners copies of the "financials" for the first three years of operation, and indicated that he had advanced his own monies to the association to cover operational shortfalls. So, then, rather than raise the monthly assessments during the three-year sale period, he lent the association the money and upon his departure, politely requested that the loan be paid back. No worries, the developer says, you can pay me back over five years, and oh, one more thing, I won't be doing the final asphalt coat on the driveways and roadways until you commit to paying the loan back. Though I am dating myself, some of you will remember Jim Nabors's character, Gomer Pyle, famously saying: "Well, surprise, surprise, surprise!"

Is it Legal and Legitimate?

One of the first concerns I have about this "loan" is whether or not it is legal. Under the statute, RIGL 34-36.1-3.02 (a) (17), and further, under most condominium bylaws, an association may borrow money. Under the statute, an association must be formed once the first unit in the project has been sold. While technically, the association had been formed and thus had powers to borrow, a board had not been formed as the developer was as they say, the chef, cook, and bottle washer and was calling the shots. Under Rhode Island law, during this pre-transition period, acting as an association, the developer had a fiduciary duty to the unit owners. In my opinion, as a fiduciary, he had an obligation to disclose to each unit owner that a) there was a budgetary shortfall and b) rather than specially assess the unit owners as permitted by the declaration, he would be advancing funds to be paid back at a later date with specific terms and conditions.

My second concern was whether the amount of the advancement/loan was for a legitimate purpose. In other words, were the funds used to cover unanticipated expenses, i.e. snow removal during an unusually harsh winter? Also, were the funds used for operational expenses, i.e. grass cutting for units declared and part of the association, or were they used for developer related expenses, i.e. initial lawn installation? Was the insurance figure in the budgets for the condominium's master policy, which would be an association expense? Or, was it for insurance covering buildings while under construction, i.e. builder's risk, which would be a developer expense? If the expenses were developer related, then the board would have no obligation to pay this supposed loan back.

Unrealistic Projections and Expectations

Even if we can determine that the advance was valid and that the actual expenses advanced were for the condominium's operational issues and not developer related, the developer would still not be out of the woods yet. My third concern here would be whether the developer knew or reasonably should have known that the budget estimates stated in his Public Offering Statement were unrealistic and unreasonably low so as to lead a potential buyer to believe that the condo fees would be lower than they should be. This is a practice commonly called "low balling." If the estimates were in fact set unreasonably low and the buyers reasonably relied on them before purchasing the units, then although the expenses and advances were legitimate, an argument could be made that the buyers were damaged by the difference between the amount quoted and the actual amount. It would be no surprise then if the set off for the damages was that amount advanced/lent.

My fourth and last concern would be the developer's holding out the possibility that unless a commitment to pay back the loan is made by the post transition association, then the final build-out work (asphalt) would not be completed. In response, before the issues become ramped up into a lawsuit by the association for construction defects, breach of fiduciary duty, etc., with a developer's counterclaim for monies lent, unjust enrichment, etc., I would suggest that the best course of action would be to indicate that the board will consider paying the amounts advanced back over an extended period of time provided the developer can prove that the expenses were legitimately for the association and not developer related. I would thereafter politely, but firmly, remind the developer that there must be no nexus between paying the loan back and doing the finish work promised. Unfortunately, sometimes polite reminders do not work.

What's comforting here though is that the Rhode Island Condominium Act is at its heart a consumer protection act, and, as such, if the expenses were illegitimate, if in fact there was low balling to increase sales, and/or if there was a subtle form of extortion by setting conditions upon what was supposed to be an unconditional obligation to complete the asphalt work, then the developer would be facing punitive damages if the association should prevail at trial. When faced with this set of facts, the judge may in fact cite Gomer Pyle's other famous saying: "For shame, for shame, for shame." Whenever I hear a judge say something like that, chances are that the developer will not leave the courtroom a happy camper. CM

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