NORTH CAROLINA BAR ASSOCIATION
SEEKING LIBERTY & JUSTICE

REAL PROPERTY

Published by the NCBA's Real Property Section Section Vol. 30, No. 2 December 2008 www.ncbar.org

The Chair's Comments

Robert W. Allen

As you know, our state is experiencing a tremendous increase in the number of foreclosures. The Real Property Section of the NC Bar Association is joining with the North Carolina Commissioner of Banks (COB) and Legal Aid of North Carolina (LANC) to assist homeowners facing foreclosure. Recently, our legislature enacted the State Foreclosure Prevention Project to be led by the COB. On Nov. 1, 2008, the COB began the process of reviewing thousands of loans in an effort to reduce the number of foreclosures in North Carolina. To conduct these Red Flag Reviews, the COB needs help. In addition, LANC needs attorneys to help homeowners facing foreclosure to re-negotiate loans.

I am writing to ask for your help and for your commitment to participate in this project. Training sessions were held in November and earlier this month to teach attorneys and paralegals how to undertake a Red Flag Review and to prepare attorneys to negotiate with lenders on behalf of borrow-

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Inside This Issue:

Happy Anniversary!

A Look Back on the First Ten Years of the North Carolina Planned Community Act

By Brian S. Edlin

This January will mark the 10th anniversary of the effective date of the North Carolina Planned Community Act, N.C.G.S. §47F-1-101 et sec. ("the Act"). S.L. 1998-199 (S.B. 801) began as a bill recommended by the Real Property Section of the North Carolina Bar Association and was based on the Uniform Planned Community Act promulgated by the National Conference of Commissioners on Uniform State Laws.

Introduction

It is important to note first why the Act was needed in the first place in order to appreciate all the changes it has undergone in the past 10 years. The main purpose of the Act was to help planned communities move away from the common law doctrines associated with restrictive covenants in older communities and to recognize modern planned communities' fundamental differences with traditional residential subdivisions which look little like their modern day counterparts. For instance, under older restrictive covenants, often times there were no provisions for assessments; haphazard enforcement of the various use restrictions and no corporate structure within which to operate the community. However, in today's modern day planned communities, particularly with respect to larger subdivisions, there are detailed covenants, bylaws, and articles which all specify exact measures to be taken with respect to collection of assessments, enforcement of restrictive covenants, architectural control, and general corporate governance of the community.

In short, the Act was an attempt by the General Assembly to catch the law up to the reality of modern day real estate development in North Carolina.

Legislative Changes

There have been several pieces of legislation over the past 10 years impacting planned communities, two of which have involved fairly significant amendments to the Act. Some of these amendments were in response to appellate decisions, and some of these amendments were in response to other concerns raised by homeowners in various parts of the state. For instance, S.L 2004-109, ("the 2004 Amendment") was, in part, a response to a Supreme Court decision handed down in 2003. In **Wise v. Harrington Grove**, the Supreme Court fixated on the phrase "subject to" in N.C.G.S. §47F-3-102 which statute specifically provides a laundry list of powers to community associations. Under the **Wise** holding, pre-1999 communities could only avail themselves of the powers set forth in N.C.G.S. §47F-3-102 if they opted into the Act or their governing documents specifically authorized the particular power. In other words, the Supreme Court interpreted the phrase "subject to" to basically mean "only if" the association's governing documents allowed these powers. Obviously, the General Assembly disagreed that the Supreme Court interpreted the General Assembly's intent correctly, and in the 2004 Amendment, the General Assembly righted the wrong by the Supreme Court and modified N.C.G.S. §47F-3-102 to strike the "subject to" language in the statute and replace it with "unless the Articles of Incorporation or Declaration expressly provides to the contrary." This new language

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VOL. 30, NO. 2 DECEMBER 2008

Published by the NCBA's Real Property Section

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ers. The reviews are expected to take less than one hour for each. Our great hope is that members of our section will agree to undertake more than two Red Flag Reviews and will be willing to handle some of the negotiation cases with LANC after they complete the training.

Foreclosures impact all of us, either directly or indirectly. This project offers an opportunity for all of us to help our fellow citizens in a meaningful way. Please make a commitment to help with these Red Flag Reviews.

If you have questions about the program, please feel free to call (704-377-8350) or e-mail (*rallen@rbh.com*) me. Thank you for your consideration of this worthy project. ■

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clearly evidences the intent of the General Assembly to apply these powers to pre-1999 communities, unless the particular governing documents for the community in question, expressly disallow the use of these powers. Of course, these powers would include only those that the General Assembly specifically *intended* to apply to pre-1999 communities-which powers are found in Subsections 1-6 and 11-17 of N.C.G.S. §47F-3-102.

S.L. 2005-422 ("2005 Amendment") made changes to both the Act, as well as, the Condominium Act, N.C.G.S. §47C-1-101 *et sec*. The changes to the Act in the 2005 Amendment were clearly aimed at providing additional safeguards and protections for homeowners who live in planned communities. For instance, among other changes, the statute was amended to require that the association publish the name and addresses of officers and board members within 30 days of their election; requiring board meetings of the association be open at regular intervals and provide an opportunity for homeowners to attend such board meetings; preventing the foreclosure of a lien which solely secures fines; capping the dollar amount of uncontested foreclosures of regular assessments collection matters; limiting financial payments by the board to a member of the association's executive board or a relative of the executive board; and adding certain restrictions on the display of American flags and political signs. In short, while the 2004 Amendment was aimed at clearly restoring the powers called into question by the Wise holding, the 2005 Amendment was geared more towards installing additional limits on community associations' powers.

Judicial Interpretation of the Act

There have been at least a dozen cases which have either directly or indirectly dealt with various provisions of the Act. In large part, these cases tend to focus on fines, foreclosure rights, standing and constitutional issues with respect to retroactive application of the Act to communities in existence before its enactment in 1999. Interestingly, **Wise** is still repeatedly cited in a slew of appellate court decisions, even though the main holding has been eviscerated due to the modification of the language in the Act by the General Assembly in the 2004 Amendment. Perhaps the most interesting cases are the cases which challenge the applicability of the Act to pre-1999 communities. The question of whether retroactive application of the Act impairs vested contract rights of homeowners has been the subject of much discussion in various scholarly articles in publications in North Carolina. For instance, *Webster's Real Estate Law in North Carolina* devotes an entire chapter to the Act, and in its fifth edition, the point is made that it remains to be seen whether the application of such powers to pre-1999 communities infringes on the constitutional rights of homeowners in earlier communities.

This question presented in *Webster's* was answered by the North Carolina Court of Appeals case in **Reidy v. Whitehart**. In that case, a pre-1999 community imposed a fine against the homeowner and the homeowner brought suit against the association alleging various constitutional violations including impairment of contract. The homeowner's main argument was that the homeowners' procedural and substantive due process rights were violated with the fine process and the application of the fining provisions in the Act to this pre-1999 community impaired a vested contract right of the plaintiff homeowners. The Court of Appeals disagreed, rejected the substantive and proce-

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dural due process arguments, and dismissed the impairment argument on the grounds that the fining mechanism in the Act was merely a means to enforce restrictions the parties had already agreed to abide by, rather than an unconstitutional impairment of contract. Incidentally, both the North Carolina and U.S. Supreme Courts refused to hear the Reidy's appeals in this case. In short, the application of the Act to pre-1999 communities, as contemplated by the General Assembly, does not offend the North Carolina or U.S. Constitutions and practitioners would be well served not to make such arguments unless they are prepared to overturn current judicial precedent.

In February of 2008, the Court of Appeals handed down a decision in **Riverpointe v. Mallory** which reversed a Superior Court's refusal to foreclose a lien which secured fines that had been levied against a homeowner in a subdivision in Mecklenburg County. As a result, it seems apparent that based on the **Whitehart** and **Mallory** case, the fining provisions in N.C.G.S. §47F-3-102 and N.C.G.S §47F-3-107.1 are here to stay unless amended by the General Assembly.

Our appellate courts have not been completely enthusiastic to move beyond the old common law with respect to restrictive covenants of modern day real estate developments which prompted the enactment of the Act in the first place. For instance, in **Creek Pointe v. Happ**, the Court of Appeals was faced with the issue of whether a homeowners association had standing to sue for injunctive relief and monetary damages against a homeowner who had put up a fence that blocked a road in the subdivision that all residents in the community had a right to access. The trial court granted the defendant's motion to dismiss, dismissing all claims of the association against the individual homeowner based on lack of understanding. The Court of Appeals discussed Subsection 4 in N.C.G.S. §47F-3-102, which section allows an association to "institute, defend or intervene in litigation." The Court of Appeals held that "[the Act] does not automatically confer standing upon homeowners associations in every case and that questions of standing should be resolved by our courts in the context of the specific factual circumstances presented with reference to the principles of law and equity as well as other North Carolina statutes." The Court of Appeals then went on to analyze the **Hunt v. Washington State Apple** case and the three prong test used to determine organizational standing and found that at least a portion of the claims brought by the association (those claims alleging injury to the association itself) were improperly dismissed and remanded the case for further proceedings. In other words, our appellate courts have not necessarily interpreted the Act to automatically extend standing to a community association. Instead, our appellate courts will look to the common law with respect to analyzing questions of standing.

Although our appellate courts have not embraced the Act with open arms, our appellate courts have certainly been willing to affirm the constitutionality of the Act as it applies to pre-1999 communities and recognize the powers of such associations with respect to the foreclosure of liens secured by fines, as evidenced in the **Whitehart** and **Mallory** cases.

When we look back on the last 10 years of legislative changes and case law interpreting the Act, it is uncertain what the Act will look like 10 years from now. Just as Delaware provides a consistent uniform body of law for corporations which make the rights and obligations of shareholders relatively predictable for Delaware corporations, the Act does provide a framework for the governance and operations of modern day communities in North Carolina which can be equally useful to homeowners and their boards. As such, it is an invaluable reference for both individual homeowners and their governing boards of directors in efficiently and effectively managing the day to day affairs of the modern day real estate development. ■

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Scheduling of Construction Loans

By Troy Crawford

Everyone is familiar with the recent rash of lien filings that have swept across the state the last several months as the new housing market has dramatically slowed. While small and newer builders were the first to feel the pinch as spec houses sat unsold and carrying charges escalated, several regional builders and developers have recently made newspaper headlines as they drain their cash reserves. Steve Brown, in a prior article published in 2006, details the historical basis for the lien statutes, and more importantly, the steps a practitioner can take to limit his client homebuyer's risk. A copy of the article may be found on our website at *www.nc.invtitle.com* Click on Resource Center, Newsletters, Archives Click on the article "Mechanics' Liens Revisited: Concepts Every Attorney Should Understand."

Since his article, we have seen numerous claims arise related to homes that are either abandoned during construction or remain unsold for so long the construction lender forecloses. Under N.C. Gen. Stat. 44A-10, "A claim of lien on real property . . . shall relate to and take effect from the time of the first furnishing of labor or materials at the site of the improvement by the person claiming the claim of lien on real property." In order to protect our lender's priority position, owners obtaining construction loans are required to sign lien waivers stating that materials have not been delivered and work has not started. Additionally, lenders will frequently require affidavits of non-commencement or other forms to verify that their security instrument is in a first lien position.

While it can be challenging for a certifying attorney to verify that a builder or homeowner is not deceitful in executing affidavits, one source of liability that can be minimized is reducing the 'gap' between the execution of the lien waiver and the recording of the security instrument. It is imperative that the closing attorney get to the courthouse before the yellow machines show up at the job site. This need is further enhanced with the tightening construction industry – previously busy suppliers and subcontractors had 'time off' between jobs but now are trying to get to the job site (and get a portion of the loan draw) as soon as possible.

We recently had a claim where a lot purchase and construction loan closed at 2:00 p.m. in the attorney's office, but did not record until 11:00 a.m. the next day. In the interim, construction allegedly began in full force, with a couple different subcontractors claiming they were on the job site first thing in the morning. The builder drew-out the construction loan, but failed to fully pay many of his subcontractors, including those that claimed to have started working the next day. In order to establish priority, we were reduced to comparing field notes of material suppliers to the time stamp on the recorded deed of trust to establish priority.

In addition to showing an example delay in recording can cause, a more detailed examination of the example illustrates another area of avoidable exposure – deeds and lien waivers prepared by the counsel for the developer/seller or the developer themselves. In our example, both the deed and lien waiver provided to the closing attorney were dated and notarized the day before closing. Therefore, the date of lien waiver was two days before construction began and provided no useful evidence in debunking what we perceived to be generous start dates of the subcontractors or providing a source of subrogation for our loss. As most developers are sophisticated parties with outside legal counsel, inspection of the seller documents is critical for the closing attorney to look at the effective date of the Seller's documents.

While there are many causes for the recording delays, construction loans are usually not as prone to late arriving wires or ridiculous lender funding requirements that stall recording. Setting a closing time that accommodates timely recording and a careful examination of Seller documents prepared outside of the closing attorney's office will go a long way to keeping a construction lender in proper priority position. ■

CRAWFORD, A RALEIGH NATIVE, ATTENDED NCSU WHERE HE RECEIVED A BACHELOR OF SCIENCE IN CIVIL ENGINEERING (1997). CRAWFORD EARNED HIS JD FROM CAMPBELL UNIVERSITY IN 2000. A FOUNDING PARTNER OF CRAWFORD, CHRISTOPHER & JOHNSON, PLLC, CRAWFORD NOW WORKS WITH INVESTORS TITLE. CRAWFORD IS A MEMBER OF THE REAL PROPERTY SECTION OF THE NCBA. HE CAN BE REACHED AT *TCRAWFORD@INVTITLE.COM.*

Proposed 2008 Formal Ethics Opinion 13 – Audit of Real Estate Trust Accounts by Title Insurer

The North Carolina State Bar asked the Real Property Section of the North Carolina Bar Association to comment on Proposed 2008 Formal Ethics Opinion 13, Audit of Real Estate Trust Account by Title Insurer. A copy of the proposed opinion is set forth below. The Real Property Section Council, *after significant discussions with a joint ad hoc committee (discussed below)* voted to support the proposed opinion. The Real Property Section Council believes that one of the best ways to instill confidence in consumers and lenders that our system works is to protect their interests. This opinion is one component of that goal by allowing attorneys to work with third parties in reviewing, reconciling and auditing their real estate trust accounts.

Background

The fraudulent conversion of funds associated with real estate transactions in North Carolina has reached an unprecedented level. Parties to the transactions, the State Bar's Client Security Fund, and title insurers are suffering losses due to fraudulent conversion of funds deposited into real estate trust accounts.

In North Carolina, the handling of a residential real estate closing is the practice of law. Therefore, in the overwhelming majority of closings, the funds are disbursed through the closing attorney's trust account. Although title insurance offers some protection for the lender and the borrower, title insurance does not cover all the losses or every situation involving fraudulent conversion of closing funds. In some circumstances, the loss is borne, in whole or in part, by one of the parties to the transaction. Often the only recourse for the injured party is the Client Security Fund which caps each award of damages at $100,000, an amount sometimes far less than the loss experienced by the injured party.

Lenders usually require closing protection coverage in the form of a closing protection letter before the lender will disburse its loan proceeds to an attorney's trust account. In issuing a closing protection letter, the title insurer agrees to reimburse the lender and the buyer/borrower for, among other things, actual loss or damage on account of the fraud or dishonesty of the attorney handling the lender's funds.

In the current economic downturn, losses to title insurers under their closing protection coverage to lenders and borrowers/buyers have far exceeded the calculations upon which title insurance premiums are based. In light of the amount of losses title insurers have experienced due to fraudulent use of closing funds, title insurers are seeking ways to verify whether funds from real estate closings are being disbursed and accounted for properly. One verification method which is used by title insurance companies in other states is the option to request a voluntary audit of an attorney's real estate trust account or a review of the attorney's trust account reconciliation reports to ensure the safety of the funds and to protect the interests of those whose funds are placed in the account.

The Opinion History

Earlier in 2008, the Real Property Section and the North Carolina Land Title Association formed an ad hoc joint Loss Prevention Committee in an effort to work together to put in place measures to help reduce future fraudulent conversion of closing funds. The joint committee has met *and/or talked* with representatives of the North Carolina Bar Association, the North Carolina State Bar, Lawyers Mutual Liability Insurance Company, the North Carolina Department of Insurance, and others in an effort to come up with a solution to this problem. The Real Property Section spent a considerable amount of time weighing the concerns of all parties.

The joint committee recommended the North Carolina Land Title Association submit an ethics inquiry to the State Bar to ensure that an attorney's cooperation with a title insurance company desiring to conduct such an audit would not present an ethical problem for the attorney.

From this ethics inquiry, the State Bar issued the proposed draft ethics opinion which is reprinted below. The State Bar then requested comments from the Real Property Section on the proposed ethics opinion. At its last quarterly meeting held on November 3, 2008, the Real Property Section Council voted to support the proposed opinion. The Real Property Section Council agreed with the reasoning of the proposed ethics opinion that an attorney's agreement to allow a title insurance company to audit the attorney's real estate trust account does not represent an ethical problem for the attorney. *The Real Property Section Council believes that the proposed ethics opinion will help maintain the integrity of the closing process in North Carolina and that by lending our support to the measure, the Council hopes to demonstrate our belief in both the effectiveness of our self-policing policy and our approved attorney system.* ■

Want to write an article for the Real Property Section newsletter? Have a good idea for an article? Please contact Trent Jernigan, editor of the Real Property Section newsletter at: Trent E. Jernigan, Womble Carlyle Sandridge & Rice, PLLC, One West Fourth Street, Winston-Salem, NC 27101, (336) 721.3664, (336) 726.8082 (facsimile), *tjernigan@wcsr.com*.

NORTH CAROLINA BAR ASSOCIATION
SEEKING LIBERTY & JUSTICE

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North Carolina Lawyers Saving Homes

A Foreclosure Prevention Project of the North Carolina Bar Association Foundation and the Real Property Section – Red Flag FAQs

Do I have to attend the CLE training in order to volunteer?

Yes. At this time, the NC Banking Commission requires training attendance.* They are looking at other means providing training.

Will I have to meet with clients?

No. Your participation with the Red Flag Review program is limited to reviewing files accessible online through a secure site from the NC Banking Commission.

How will I be assigned cases?

The NC Banking Commission's staff will regularly post matters for review by its volunteers. You will also be periodically reminded that there are matters available for your review.

Will I have to travel outside my area?

No. The Red Flag Review matters will be handled in the privacy of your home or office. You will not meet with clients, homeowners, banks or their attorneys.

What about confidentiality?

The NC Banking Commission will ask you to sign a confidentiality agreement before handling any matters.

Do I have to handle two matters in exchange for the complimentary CLE tuition?

Yes. Your CLE tuition was complimentary based upon your agreeing to handle two Red Flag Review matters from the NC Banking Commission.

Who do I call if I have problems with my password to access Red Flag Review matters?

You should contact Will Corbett at *wcorbett@nccob.gov* or 919-733-0577 to let him know that you are having problems.

What do I do if I wish to discontinue participating with this project?

Please contact Michelle Cofield at *mcofield©ncbar.org* or 800-662-7407 to discuss this matter.

What if I want to handle a loan modification negotiation or an actual foreclosure?

Please contact Legal Aid of North Carolina's Mortgage Foreclosure Project at *johnniel@legalaidnc.org*.

I'm not an attorney. Can I participate?

Yes. Non lawyers (e.g. mediators, paralegals and law students) may help with Red Flag Reviews. Loan modification negotiations and actual representation at foreclosures are open for NC licensed attorneys only. ■