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# Applying Condominium Unit Escrow Deposits Towards Construction Costs: Proceed with Caution

October 2019 • [Chelsea Marx](#) and [Kyle Blackmer](#)

While residential condominium development still has not reached its pre-Great Recession levels, it is growing (albeit slowly). This type of project presents an interesting source of capital for developers in the form of earnest money deposits by condominium unit purchasers while the condominium project is under construction (“Deposits”). To decrease their cost of capital and to help fill their capital stack, a developer may consider applying Deposits toward the cost of construction prior to the closing of the sale of the applicable condominium units. That developer would also likely expect that those applied Deposits will count towards the developer’s equity for purposes of obtaining a construction loan. Developers and their construction lenders considering this application of Deposits should proceed with caution because it might be against the law, irrespective of what the underlying purchase and sale agreement says. It could result in a purchaser’s right to cancel the purchase contract and developer liability for damages and attorney’s fees, and possibly even punitive damages. As residential condominium development continues its resuscitation, it is important that developers and lenders be aware of this issue.

This article (A) summarizes the three approaches states take with respect to applying Deposits towards construction costs prior to the closing of the sale of the purchaser’s unit, and (B) offers recommendations for developers and lenders.

A. Three Approaches: (1) Prohibition, (2) Conditional Use, (3) No Prohibition.

Generally speaking, states take one of three approaches to regulating a developer's ability to apply Deposits towards construction costs prior to the closing of the sale of the purchaser's unit.

### **Approach #1: Prohibit the application of Deposits towards construction costs.**

Fourteen states, including Texas, Illinois and Washington, prohibit the application of Deposits prior to completion of the project by requiring that Deposits be held in escrow until closing on the unit, default under the purchase contract, or it is refunded to the purchaser. This approach follows the Uniform Common Interest Ownership Act ("UCIOA") and the Uniform Condominium Act ("UCA"). As a general proposition, the restriction applies to any reservation or purchase deposit made in connection with either a condominium unit in a new development or whenever a seller is required to deliver a public offering statement.

### **Approach #2: Conditionally allow the application of Deposits towards construction costs.**

Fifteen states, including Florida, Michigan, Ohio, and New Hampshire, allow the conditional application of Deposits towards construction costs. The conditions vary from state to state. Some states allow Deposits to be applied towards construction costs if the unit is being sold for a certain price or if the purchaser has a particular income. Other states allow a Deposit to be applied towards construction only for prescribed construction costs, if the Deposit is bonded, or if the purchaser expressly agrees to it in the purchase contract.

### **Approach #3: No express restriction on the application of Deposits towards construction costs.**

Lastly, twenty-one states, including Colorado and California, have not enacted any statutory regulations regarding the application of Deposits towards construction costs.

## **B. Recommendations: Do Your Research, Draft Documents Accordingly, and Don't Expect/Allow Deposits Contributed to Construction Costs to Count Towards the Satisfaction of HVCRE's 15 Percent Capital Contribution Requirement.**

Fortunately, the chances of running afoul of applicable law with respect to the application of Deposits towards construction costs can be mitigated.

The first step is doing the research. Developers and their lenders should research the laws of the state in which the project is located. We also recommend considering the possibility that in addition to the laws of the state where the project is located, the laws of the state where a purchase and sale agreement is executed may apply to a

particular Deposit and restrict its application. For example, under both the UCIOA and the UCA, the prohibition on the use of Deposits applies not only to condominium units located in the state, but also to any contract for the disposition of a condominium unit signed by any party in that state. However, at this time very few states have enacted a similar provision. Consequently, if a developer anticipates a significant number of out-of-state buyers from a particular state, consider researching the escrow deposit laws of that state.

After conducting that research, draft the form purchase and sale agreement and financing documents accordingly. For example, many states permit the application of Deposits towards construction costs so long as the executed purchase and sale agreement includes statutorily prescribed language. To address restrictions on the application of Deposits imposed by foreign law, consider the following. If the project metrics support it, and the escrow deposit laws of the state where the project is located are accommodating, a developer may require that all buyers or those from a problematic state execute their purchase and sale agreements in the state where the project is located. Assuming a construction lender is willing to allow the application of Deposits towards construction costs, Lenders should also draft their loan documents to prohibit the application of Deposits that, under applicable law, cannot be so applied. Guidance from the Federal Deposit Insurance Corporation states that Deposits applied to construction costs cannot count towards a developer's satisfaction of the 15 percent capital contribution requirement imposed by the so-called "high volatility commercial real estate" rules. Loan documents should likewise clarify the same.

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950 Seventeenth Street, Suite 1600, Denver, CO 80202  
Phone 303.825.8400 | Fax 303.825.6525 | [ottenjohnson.com](http://ottenjohnson.com)