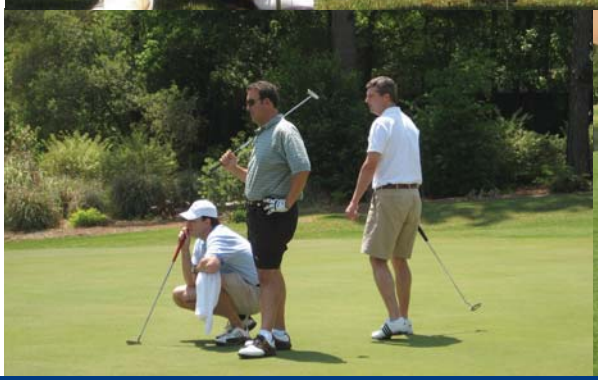
THE DEFENSE LINE

S.C. Defense Trial Attorneys' Association

IN THIS ISSUE:

- Analysis of the Crossman case
- Limits on the duty to warn in SC products liability law
- Judicial profile of the Hon. Henry M. Herlong, Jr.
- PAC Golf Tournament information
- Upcoming SCDTAA events



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April 14, 2011
Spring Valley Country Club

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ARTICLE

Restricting Restrictive Covenants

by Douglas W. MacKelcan

Restrictive covenants often create tension between the personal property rights of individual property owners and the interests of those same property owners in providing common services and protections to enhance the value of their neighborhood or condominium. What is an unreasonable restraint on the use of property to one property owner can be a necessary safeguard to another. Recent legislative developments and case law in South Carolina illustrate this tension and the challenges property owners associations, and their lawyers, face when determining how they govern themselves.

Transfer Fees

The hot topic in community association law for the past few years has been deed-based transfer fee covenants. Pending South Carolina House Bill H.3095, which would amend South Carolina Code Section 27-1-70 to prospectively prohibit transfer fees, defines a transfer fee covenant as:

> A provision in a document, whether recorded or not and however denominated, which purports to run with the land or bind current owners or successors in title to specified real property located in this State, and which obligates a transferee or transferor of all or part of the property to pay a fee or charge to a third person upon transfer of an interest in all or part of the property, or in consideration for permitting this transfer.

According to the Community Association Institute ("CAI"), a national organization that provides education and other resources to its more than 30,000 members, including volunteer and professional community leaders and managers, over half of CAI's member organizations rely on transfer fees as a way to generate revenue for their community association. While every property owners association has different restrictive covenants, all associations have limited options for generating revenue. The primary sources of revenue for property owners associations are annual and periodic assessments paid by the existing property owners. Depending on the association, these assessments pay for everything from security to maintenance and repair of common elements to providing recreational facilities, programs and staff. Transfer fees, which generally range from one quarter of a percent to one percent of the sale price of the property, have provided community associations a new revenue source, but they have been met with considerable opposition. Those in favor of the ban on transfer fees cite the burden the additional fee places on an already difficult real estate market and the public policy interest in promoting the free use and alienation of property.

The Federal Housing Finance Agency ("FHFA") began efforts in August 2010 to ban property transfer fees; however, it recently backed off of the proposal due in part to its potentially broad reach and negative impact on property owners associations. CAI and the community associations who rely on transfer fees for revenue have fought against Bills such as the one pending in South Carolina and the FHFA proposal due to the ever increasing costs of providing community services and the challenges associations face in collecting assessments when many properties have gone into foreclosure. Proponents of transfer fees in South Carolina appear to be losing the battle to those against it because Bill H.3095 passed almost unanimously in the House.

South Carolina House Bill H.3095 would only impact those transfer fee covenants not already recorded, thus, those associations that have already established a transfer fee covenant, either at the inception of the association or through an amendment to its governing document, would still be able to impose the fee. However, in addition to its impact on new communities and condominiums, the Bill would prevent existing communities and condominiums from amending their covenants to collect transfer fees.

Based on its overwhelming support in the House, it appears that this Bill will become law in South Carolina sometime in the near future. What is less clear is whether this is an isolated effort from the legislature specific to transfer fees, or whether it will lead to more legislation restricting the rights of community associations to establish and enforce restrictive covenants.

Two Step Analysis When Seeking to Prohibit the Use of Property

Although the transfer fee issue is one with such an impact and interest level that it developed into a legislative matter, the vast majority of controversies involving restrictive covenants are unique to a particular community. Typically, a condominium or

Continued on next page

ARTICLE CONT.

community developer creates and establishes the covenants in a governing document, such as a Master Deed or Declaration of Covenants and Restrictions, and files the document with the RMC office in the county in which the community or condominium is located. When a lot, home or condo is sold by the developer, it is done subject to the Master Deed or Declaration of Covenants and Restrictions, and it creates a contractual duty on both parties to follow the covenants identified in the governing documents. Every subsequent property owner, whether purchased from the developer or from a subsequent owner, is bound by the same restrictions that run with the land.

As one would expect, issues arise over time that were not anticipated by the developer and are not expressly addressed in the governing document. In such cases, the association or an individual property owner look to the Court for a determination of the language of the document as it relates to the particular issue, usually in the form of a declaratory judgment action. When interpreting governing documents, courts generally follow traditional rules of contract interpretation and make a legal determination as to the meaning of the documents as it relates to the specific issue presented. In addition, issues arise that were anticipated and addressed by the developer but a particular property owner or group of owners disagrees with the rule or the way the Board of Directors of the association has decided to interpret it. The South Carolina Supreme Court, in *Buffington v. T.O.E. Enterprises*, 383 S.C. 388, 680 S.E.2d 289 (2009), addressed the way Circuit Courts must handle cases that involve the interpretation of a restrictive covenant and request to enjoin a particular use.

In *Buffington*, residential landowners in the Forest Acres subdivision in Easley, South Carolina sought a declaratory judgment that neighboring landowners (T.O.E. Enterprises) operating a car dealership were in violation of the neighborhood's restrictive covenants and an injunction prohibiting commercial operation. The restrictive covenants in place provide that, "[n]o lot shall be used except for residential purposes," but the covenants only apply to 62 of the 110 lots in the subdivision. T.O.E. Enterprises' Toyota dealership borders the subdivision and is not subject to the restrictive covenants. However, it purchased four lots within the subdivision to provide additional parking for expansion of the dealership. The trial court found that three of the four lots were subject to the restrictive covenants as a matter of law; and, therefore could only be used for residential purposes. Further, the trial court ruled that T.O.E. Enterprises failed to show it was entitled to use the three (residential) lots for commercial purposes under an equity theory or that a change of conditions existed to warrant the release of the restrictive covenants. The trial court issued an injunction prohibiting Petitioners from using the land for commercial purposes, and the Court of Appeals affirmed the trial court.

Before the Supreme Court, T.O.E. Enterprises argued that the Court of Appeals erred in holding that the equities favored the enforcement of the restrictive covenants, while the residential property owners argued that a court is not required to balance the equities in deciding whether to enforce restrictive covenants, and, even if it was, equity required enforcement in this case. Although the Supreme Court ultimately affirmed the trial court's injunction against T.O.E. Enterprises, preventing the commercial activity on the residential lots, the Supreme Court disagreed with the Court of Appeals in determining that the trial court is required to balance the equities of enforcement of the covenant once it finds that the restrictive covenant has been violated. This distinction, while consistent with precedent, is important for practitioners because it requires preparation of arguments on two fronts – legal arguments related to the interpretation of the language of the restrictive covenant and equitable arguments supporting or opposing enforcement of the covenant.

In the *Buffington* opinion, the Supreme Court provides some guidance as to what factors might have tipped the scales of equity in favor of ignoring the restrictive covenants and refusing the injunction. It appears that had the lots been used for commercial purposes in the past, or had the residential owners waited until T.O.E. Enterprises was further along in the development process before opposing the use, the Court might have been more inclined not to enforce the use restriction. However, despite T.O.E. Enterprises having spent over $700,000 on improving the land, the Court found that financial loss in purchasing and improving the land was not enough to overcome T.O.E. Enterprises' notice of the covenants at the time of purchase. Further, the residential owners brought suit as soon as development of the lots began; thus, T.O.E. Enterprises had no argument that the right to enforce the covenants had been waived.

Although the injunction prohibiting commercial activity on the residential lots was upheld in Buffington, by requiring the equitable analysis of enforcement of the covenant, the Court places an additional burden on community association leaders to ensure that the enforcement of the covenants meets the fairness test, in addition enforcing their restrictive covenants as written. While time will tell whether Courts will refuse requests to enjoin certain property uses that violate the language of restrictive covenants on equitable grounds, *Buffington* appears to indicate a potential weakening of the ability of community associations to enforce restrictive covenants.

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