

# BURDMAN & WARD

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**Law in Hand**

### **Keys to the City: Problems & Solutions When Dealing with the Developer During Transition**

This is the first of a two part series discussing important issues that arise during the transfer of control from the developer to the homeowners of a recently constructed common interest development. The first part focuses on some of the problems that can arise before, during and subsequent to working with the developer during this transition period.

#### **The Developer Transition Process**

Common-interest developments have often been likened to small "cities," with their own form of government (the homeowner's association), infrastructure (streets and curbs), and even entertainment facilities (clubhouse, pool). When a change of ownership takes place from developer to owners, the transition process can be daunting.

In most common interest developments, the developer forms the homeowners association during initial construction. In doing so, an attorney drafts the "governing documents" for the association (i.e., the Covenants, Conditions & Restrictions, By-laws, and Articles of Incorporation), which set forth the rules for handling day-to-day business in the community. Because the developer still owns newly-built unsold units, the first board of directors is usually selected by the developer. The board members proceed to conduct the newly-formed association's business while units are sold to individuals. The developer-selected board continues to control the association until a certain number of new unit owners are prepared to take over the project (usually a simple majority).

The rules for making a proper transfer of ownership to an owner-controlled board of directors can be found in the governing documents as well as California statutory and case law. Problems arise when the rules are bent, broken, or neglected and often, these problems are preventable. Here are some common examples of issues that could arise when you are being given the "keys to the city", and what you can do to prevent them from causing bigger problems down the road.

## **Budget and Reserve Concerns** ("We've got *how much* in our operating budget?")

One of the more serious problems that arise out of ownership transfer concerns the inadequate transfer of funds to perform routine or extended maintenance. Developers must act under the strictest duty of care in providing the newly formed association with an adequate budget and properly funded reserves. When they fail to do so, associations relying solely on homeowner assessments may find it terribly difficult to afford to perform routine maintenance tasks, including hiring a landscape contractor or paying the common area lighting bill.

Reserves were a primary focus of a landmark California case in the late 1970's called *Raven's Cove Townhomes, Inc. v. Knuppe Development Co.* In *Raven's Cove*, the developer failed to fund reserves or implement an operating budget. When the homeowners discovered common area landscaping problems and moldy, decomposing exterior siding from defective construction, they were unable to perform even the slightest of repairs since no operating budget or reserves were created. The court determined that the developer breached its fiduciary duty to the association by failing to fund the reserves and prepare a budget.

Associations should be wary of receiving budgets from developer-run boards that appear unreasonable. The best practice is to always get a professional opinion from a reserve specialist before completing the transfer of ownership. Similarly, the California Department of Real Estate publishes reserve guidelines meant to assist developers and budgetary consultants. It is worth the small charge for these materials.

Additionally, financial problems can result if the developer, while still in control of the project, uses association fees or assessment funds to pay for maintenance items that were actually the developer's responsibility. Reserves should be earmarked for the inevitable repairs and replacement of major items, such as roofs, fencing, driveway/walkways, and exterior siding, that will be needed down the road. They should **not** be used for "clean up" or punch-list type items that fall under the developer's umbrella of construction costs. Be wary of accounting methods employed by the developer and their agents, and if anything looks improper upon review, consult with an accountant and attorney.

## **Construction Documents**

Proper maintenance lies at the very foundation of what an association board member must perform. Quite often, the homeowners will accept transfer from the developer without obtaining all the important documents that allow them to make informed decisions about maintenance. These documents can include all building plans, the condominium plan (if applicable), architectural plans, civil or drainage plans, and "as-builts"-- drawings that show in detail the lay of the land and the condition of the project at transfer.

Without these documents, the newly-formed board may find it difficult to pinpoint proper maintenance items or even locate common area improvements that fall under the association's maintenance responsibility. Also, there have been instances when the as-built plans showed that the builder failed to follow the construction plans--perhaps a walkway was forgotten that should have been installed, or a building was placed in a different location.

Bottom line: make sure you spot check all major construction systems--including roofs, siding, foundations, electrical, plumbing, landscape, concrete flatwork, and drainage--with a licensed

professional during the transition. Make any appropriate demands on the developer based on the expert's recommendations.

### **Other Documents**

Examples of other important documents to take inventory of include:

1. Originally recorded governing documents
2. Original board minutes and membership roster
3. Tax records and financial statements
4. Insurance policies (including general liability, board certifications to the certified public accountant), and audit materials
5. Initial operating budget and reserve studies performed from inception
6. Performance bonds
7. Warranties and vendor contracts

Each of these documents is crucial to allowing the newly formed board perform its day to day operations and satisfy their fiduciary obligations to the association. Review them before the transition period ends. If some of these are missing at transfer, *ask for them!*

### **Walking the Property**

Speaking of as-builts, it is a very good idea to consult them as you do the initial walk-through. In much the same respect as new home buyer, the newly formed board of directors should always create a punch-list of the improvements that are built poorly, installed incorrectly, or simply forgotten. This is best accomplished with the help of an independently licensed contractor or engineer.

It is worth incurring consultant fees to pre-emptively address construction defect concerns. At the very least, this may avoid the hassle of possibly having to pursue the developer a few years down the road for the same problems. A simple roof inspection or window test prior to accepting control of the property could save the association bundles in time and expense by having notable problems corrected immediately.

### **Performance Bonds**

What happens if you find items that require attention that are part of a subdivision maintenance bond? If you have already released the performance bond prior to making a thorough examination and determining whether components are working properly, you may be out of luck. Bond money is there to insure the project will be safe and habitable at turn-over. If it isn't, the board should **not** release the developer from the bond until each of the items are corrected.

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