

REAL ESTATE LITIGATION E-UPDATE

LUCE FORWARD
Luce, Forward, Armstrong & Bernstein LLP

www.luce.com

Volume III No. 2

May 17, 2004

Apartment to Condominium Conversion Liability Exposure and Methods to Minimize the Risks

Builders and speculators are rapidly converting apartments to condominiums as land for development becomes scarce or unreasonably priced. However, many condominium converters incorrectly believe their liability exposure is less than a builder of new condominiums, reasoning that since they did not perform the original construction, they cannot be held liable for construction defects.

This article explores a converter's liability exposure. Each theory of liability is explained in practical terms. The article concludes with methods the converter may employ to minimize the liability exposure.

Negligent Conversion. All persons and businesses are held to a standard of care in performing their daily activities. In legal terms, a breach of the standard of care is referred to as "negligence." For condominium conversions, this means that a converter may be held to a standard of care in undertaking the conversion from apartments to condominiums.

For example, in *Orange Grove Terrace Owners Association v. Bryant Properties, Inc.* (1986) 176 Cal.App.3d 1217, a condominium homeowners' association filed suit for, among other theories, negligent conversion of apartments to condominiums. The court found that a jury could determine the conversion was negligent:

[W]e deem it appropriate to note that if the defendants undertook to repair roofs, and in doing so negligently determined that patching, rather than replacing would suffice, the jury could reasonably determine that the roof repairs were negligently performed. (*Id.* at 1223.)

What this means as a practical matter is that the converter can be held liable for negligently performing the conversion. This is especially true where the converter is a sophisticated builder or contractor, which arguably may be held to a higher standard of care in performing the conversion. In other words, a sophisticated builder could not look the other way to an obvious defect in the building such as a code violation.

Violation of Statute. Numerous and complex statutes apply to the conversion of apartments to condominiums. A violation of a statute may impose liability by itself, legally referred to as "negligence *per se*." While it is beyond the scope of this article to discuss all statutes applicable to conversions, two examples are discussed below.

California Civil Code Section 1134 obligates the converter to inspect each unit and the common areas and to disclose all substantial defects or malfunctions in the "major systems." Major systems are defined, but not limited to, the roof, walls, floors, heating, air conditioning, plumbing, electrical systems or similar components. Thus, the failure to perform an adequate inspection or make adequate disclosures may result in liability.



Roger C. Haerr
Partner

rhaerr@luce.com
phone: 619.699.2564
fax: 619.645.5329

LUCE FORWARD REAL ESTATE LITIGATION E-UPDATE

Apartment to Condominium Conversion Liability Exposure and Methods to Minimize the Risks

By Roger C. Haerr

Page 2

The converter must always consult local counsel to determine applicable municipal or county codes. For example, County of San Diego Code of Regulatory Ordinances, Zoning and Land Use Regulation Section 81.110, requires conversions, in certain instances, to be brought into conformance with various building codes. Thus, if a converter acquires a building which was not constructed to code, it may be exposed to liability.

Fiduciary Duty. When forming and turning over a homeowners' association to the condominium buyers, the converter stands as a fiduciary in relation to the association. (*Raven's Cove Townhomes, Inc. v. Knuppe Development Co.* (1981) 114 Cal.App.3d 783.) Thus, the converter and its employees who serve as directors on the association board may not make decisions for the association that benefit their own interests at the expense of the association and its members. (*Id.* at 799.)

As a practical matter, this means that the converter must act in the highest good faith toward the association and avoid any conflicts of interest. In this regard, the plaintiffs' bar often focuses on the adequacy of maintenance reserve budgets in arguing that the converter looked after its own interests, rather than those of the association.

Nondisclosure. The developer of new condominiums may be less exposed to nondisclosure claims because it can control the quality of the product it builds. By contrast, a converter buys a building that, in some cases, may have been built decades before by others. In such cases, the converter would have no control over the quality of construction. Nevertheless, like all sellers of real property, the converter must disclose all facts which may materially affect the buyer's decision to purchase the condominium.

Under the circumstances, a prudent converter cannot turn a blind eye to the condition of the existing building. If there are obvious problems, such as evidence of water damage or mold, which would put an otherwise sophisticated builder or converter on notice of problems, the converter may have a duty to investigate further. Otherwise, the converter may be exposed to claims of negligent misrepresentation because of representations the converter made which it did not have a reasonable ground for making.

Nondisclosure and fraud claims have other implications to the converter. Intentional misrepresentation claims may result in the imposition of punitive damages. Moreover, most misrepresentation claims are not covered by insurance.

Construction Defects. The good news is that a converter is generally not liable under traditional theories for construction defects arising out of the original construction of the units, subject to two major exceptions. First, liability for the cost to make repairs to construction defects may be independently imposed based on the alternative theories of liability discussed above. Second, a converter may be held liable for alterations and improvements it made to convert the apartments to condominiums.

As a practical matter, a converter's alterations and improvements may be inextricably intertwined with factual issues concerning the adequacy of the original construction. For example, attaching new plumbing fixtures to old, defective plumbing lines may result in an argument that the converter should have known that the plumbing system was defective when it installed the new fixtures. In other words, this means that the converter may be forced to defend its improvements at trial because of the factual question of who was responsible for the defective condition, the original construction or the later improvements? Either way, the converter is left defending more than its own share of the work.

The foregoing is not intended as an exhaustive discussion of conversion liability. Rather, this is an introduction to the concepts of liability that a converter needs to understand. Having discussed the risks of liability, the article now turns to a discussion of measures a converter can undertake to mitigate its liability exposure.

Due Diligence. The legal and statutory obligations discussed above impose a significant burden on the converter during the investigation of any property for conversion. Accordingly, the converter should engage in a heightened level of due diligence to determine the true condition of the property and improvements. Among other things, a converter should consider hiring a plaintiffs-oriented architectural expert to conduct visual and destructive testing. By doing so, the converter may determine before it purchases the building the same information a plaintiffs' lawyer would find out when the association decides to sue. The difference is that the converter will have the information before it exercises the decision to purchase. Moreover, the cost of making repairs may be considered in negotiating the purchase price, rather than having the converter assume an unknown risk.

LUCE FORWARD REAL ESTATE LITIGATION E-UPDATE

Apartment to Condominium Conversion Liability Exposure and Methods to Minimize the Risks

By Roger C. Haerr

Page 3

The converter will also want to hire an experienced consultant to review and summarize maintenance logs for the apartments, keeping in mind that tenants may not hold their landlord to as high of a standard as a condominium purchaser will hold the converter. In particular, the converter will want to properly analyze all water complaints, as they may indicate systemic water intrusion or concealed mold problems.

Documenting the Conversion. Obviously, it is essential that the converter maintain, on a permanent basis, records of all work performed during the conversion. Photographic and video records make for particularly compelling evidence in subsequent disputes and can be very cost effective where the work is no longer visible without destructive testing. Such visual records can be of great assistance to litigation counsel.

Contractual Protection. To the extent possible, the converter will want to put itself in the shoes of the seller of the building with respect to rights the seller has against parties responsible for the original construction. Thus, the converter should attempt to obtain assignments of any contractual rights the seller has against the designer and builder of the property. To the extent possible, the converter should ask for indemnities for construction defects, repairs or other matters discovered prior to closing.

Under California law, the benefits of an insurance policy are not generally assignable. Nevertheless, superior protection may be afforded by simply becoming a named additional insured on any policies of insurance the seller or original builder hold. This may not be possible if the policies have already expired or the building was built many years earlier.

At a minimum, the converter should have its own liability insurance. Obtaining insurance in this marketplace is increasingly difficult. Accordingly, the converter should consult experienced brokers and counsel to obtain the best coverage available. Consideration should also be given to purchasing stand alone mold coverage.

Association. The converter will need the assistance of experienced counsel in preparing the necessary common interest documentation and complying with Department of Real Estate regulations. Among other things, counsel will consider ensuring that the conditions, covenants and restrictions and association by-laws place affirmative obligations on the association to adequately maintain the building and common areas following turnover. In particular, the converter will want to ensure that the reserve study is adequate and that the reserves are fully funded to sufficiently cover anticipated long-term maintenance expenses, especially if the building is several years old. Keep in mind that one of the prime motivations in bringing a lawsuit is to fund the cost of maintaining an aging building which neither the association nor the condominium owners can afford.

The converter and its counsel will also want to discuss the myriad of risk mitigation measures which may be employed to reduce liability, including ownership structure, entity formation, and contract drafting and review. Given the rapid changes in California law, particular attention should be paid to alternative dispute resolution, especially arbitration under the Federal Arbitration Act.

Homebuyer Protection. The converter and experienced counsel will want to consider and prepare a purchase agreement which can survive an attack by a disgruntled buyer that the contract is unconscionable. The converter and its counsel will also consider the necessary disclosures, document retention policies, and dispute resolution alternatives.

In particular, the converter should consider hiring experienced personnel to run any warranty programs or having any warranty administered by third parties. Either way, the converter must effect quality assurance programs to ensure that the homebuyers remain satisfied customers.

Of course, each case is different and must be evaluated on its own merits and that the general principles discussed above may not apply in any particular case. The foregoing was not intended as an exhaustive checklist on ways a converter can minimize its liability. Instead, this article was intended as an introduction to ideas a converter should consider to minimize its liability exposure. It goes without saying that the best liability protection is getting counsel experienced in conversion involved early in the process.

Roger Haerr is a partner in the Real Estate Litigation Practice Area. He can be reached at rhaerr@luce.com or 619.699.2564.