Litigation Involving The Developer, Homeowners Associations, and Lenders

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I. DEVELOPER LIABILITY

A. Introduction

Developers can be exposed to liability, either to a homeowners' association ("HOA") or to individual home or unit buyers, under a variety of legal theories. The theories of liability range from breach of contract to fraud. In some instances, developers may face liability for violating various state or federal statutes. Undoubtedly, the three areas of a developer's activities that create the greatest potential for liability are as follows: (1) construction, (2) marketing, and (3) sales.

B. Liability To Purchasers For Home Or Unit Defects

A developer often acts as the builder of homes and/or condominium units in the planned community. If the developer assumes the role of builder, it is potentially liable for home or unit construction defects in the same manner as any other "builder" of a home would be.

1. Liability for Breach of Implied Warranties

With regard to the sale of new homes, the vast majority of states now recognize that the developer-builder impliedly gives to each purchaser of a home or unit two implied warranties. The first type of implied warranty is known as the warranty of habitability. The warranty of habitability requires that a home or unit be safe, sanitary, and otherwise fit for human habitation. The second type of implied warranty is the warranty of good workmanlike construction. This warranty requires that a home or unit will be constructed in compliance with local or state building codes and with non-defective, high quality materials. Pursuant to the warranty of good workmanlike construction, the developer-builder warrants that the home or unit is free from latent defects of a substantial nature caused by a failure to construct the home in a skillful manner.

2. Liability for Breach of Express Warranties

Today, most contracts pertaining to the construction of a new home or unit include express warranties made by the developer-builder to the purchaser. An express warranty is a promise, made by the developer to the purchaser of a home or unit, whereby the developer makes certain express promises as to the quality or fitness of the home or unit. If the express warranty is breached, the purchaser can hold the developer-builder liable for damages in an amount sufficient to permit the purchaser to remedy the construction defects. In some instances, the breach of an express warranty may entitle the purchaser to rescind the sale contract. Normally,

express warranties are limited to the original home or unit purchaser and cannot be relied upon by subsequent purchasers. Some express warranties provide that, in the event of a dispute between the developer and the purchaser, the matter is to be sent to binding arbitration.

3. Liability Based upon Common-Law Fraud
If a developer-builder expressly misrepresents the characteristics or quality of a home or unit, it can be held liable for damages to the purchaser under a theory of fraudulent misrepresentation. Similarly, the developer-builder can be liable to a purchaser for failing to disclose defective conditions which a reasonable and prudent purchaser would wish to know about before buying a home or unit.

4. Liability Based upon Negligence
In some jurisdictions, purchasers and/or HOAs may have a viable cause of action for negligence against the developer pertaining to the design and/or construction of a home, unit, or the HOA's common areas. To be successful against the developer under a negligence theory the plaintiff would essentially have to demonstrate that the developer negligently created a defective or unsafe condition. Typically, a negligence cause of action would arise from the developer's failure to properly design a structure or by the developer's use of substandard construction materials.

5. Liability Based upon Breach of an Implied Warranty to Develop in a Good and Workmanlike Manner
Courts around the nation have held that developers impliedly warrant that the development, together with the development's amenities and common areas, are designed in a good and workmanlike manner. Pursuant to this warranty, the developer is under an affirmative obligation to exercise reasonable care and prudence with regard to all aspects pertaining to the planning and development of the new residential community. Today's developers are deemed to be more than mere sellers of raw land.

6. Developer's Liability under Deceptive Trade Practices Act
Most states have enacted what are generally known as deceptive trade practices acts. These acts prohibit unfair or deceptive practices in the conduct of any trade or commerce. If a developer misrepresents the purported quality or fitness of the home or unit, or deliberately fails to construct the home or unit in accordance with the agreed upon plans and specifications, the developer could face liability for deceptive and unfair trade practices.

Most state deceptive trade practices acts permit the plaintiff to seek treble damages and attorneys fees.

C. Liability Of A Developer For Misrepresentations Concerning The Amenities
In order to market a new development, developers will often focus their advertising efforts on the type of the amenities that the development will have. Amenities can consist of recreational amenities, such as tennis courts, picnic areas, and swimming pools, or more fundamental things such as water and sewer availability, parking lots, and roads. Home or unit buyers have a right to rely on representations made to them as to the quantity and quality of the amenities. Where a developer makes false promises as to type, quality, or quantity of amenities which will be available to residents of the development, this will entitle purchasers to sue the developer pursuant to either a breach-of-contract or fraud theory.

D. Developer's Liability Under Federal Law

1. A Developer's Potential Liability under CERCLA

A developer can face possible liability pursuant to the federal Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA"). CERCLA was enacted, in 1980, to address environmental and public health problems created by the improper disposal of hazardous substances. The Environmental Protection Agency (EPA) is authorized to sue those who created the environmental hazard as well as current owners and operators of the property upon which the improper disposal occurred. A developer who owns property contaminated as a result of the improper disposal of hazardous substances thereon is liable for clean-up costs even though the developer did not participate in the improper disposal.

2. A Developer's Potential Liability under RICO

RICO is the acronym for "Racketeer Influences and Corrupt Organizations". RICO derives from the Organized Crime Control, Act of 1970. Developers who deliberately make misrepresentations about a planned community in promotional literature sent via the United States mail, or who make misrepresentations pertaining to the planned community via telephone, radio or television, could find themselves subject to a RICO suit by disgruntled purchasers. If a RICO claim is successful, the plaintiff can be entitled to treble (triple) damages, costs of the suit, and reasonable attorneys' fees.

3. A Developer's Potential Liability Under The Interstate Land Sales Full Disclosure Act

The federal Land Sales Full Disclosure Act ("ILSFDA") forbids the use of false, deceptive and misleading advertising claims made with regard to the unimproved subdivided lots offered for sale through means of interstate commerce. The ILSFDA permits purchasers to recover damages for actions deemed in violation with the requirements of the ILSFDA.

II. LIABILITY OF HOMEOWNERS' ASSOCIATION

Like a developer, a HOA and its directors can face potential liability to home or unit purchasers under a variety of legal theories. Many lawsuits against a HOA and/or its directors arise from an alleged breach of fiduciary duty. In the context of a HOA, the term "fiduciary duty" broadly means the duty to act fairly and reasonably in all actions affecting home and unit owners. Accordingly, HOAs and their directors cannot act in an arbitrary and capricious manner toward individual home or unit owners nor can they single out certain home or unit owners for disparate or discriminatory treatment. The "fiduciary duty" also requires that HOAs and their directors must operate the association's business and financial affairs with ordinary care, skill and prudence.

A HOA is normally charged with the duty and responsibility to keep common areas in a state of repair and maintenance. If this duty is breached, and some one is injured or killed as a result of the unsafe condition of the premises, the HOA can be sued for damages in the same manner as any other premises owner or occupant. Similarly, if a failure to maintain the common elements results in damage to the property of a home or unit owner, the HOA can be liable based upon its neglect of the common elements.

III. LENDER LIABILITY

Lenders who loan money to developers can, in some instances, be liable for construction defects and/or misrepresentations pertaining to the development. If a lender's role in the development is simply that of a lender, the courts have generally concluded that the lender is not liable for construction defects and/or is representations pertaining to the development and its amenities. However, a lender can face liability, for construction defects and/or misrepresentations, if the developer has actively participated in the decisions pertaining to the planned development. Similarly, the lender can be liable for construction defects and/or misrepresentations in situations where the lender has (1) foreclosed on the development property, (2) taken title thereto, and (3) begins to hold itself out as the developer. The lender who becomes actively involved in a development could also face potential liability under the Interstate Land Sales Full Disclosure Act, RICO, and CERCLA.

IV. STANDING TO MAINTAIN AN ACTION FOR CONSTRUCTION DEFECTS AGAINST DEVELOPER

A. Standing Of A Homeowners' Association To Maintain An Action For Construction Defects Against The Developer

One cannot bring a lawsuit against another unless he or she has standing to sue. "Standing to sue" means that the party bringing suit has a sufficient stake in an otherwise justiciable controversy to obtain a judicial resolution of the controversy. The requirement of standing is met if it can be said that the plaintiff has a legally protectible and tangible interest at stake in the litigation. Some courts have taken the position that a HOA has no standing to sue a developer for construction defects, unless the HOA has an ownership interest in the defective property or is given the express authority to sue by virtue of state statute.

Generally, if the HOA is suing the developer for defects in the common areas owned by the HOA, or directly under its control, the HOA is deemed to have standing to sue. However, most courts have concluded that the HOA has no standing to sue a developer for construction defects affecting only individual home or unit owners.

B. Standing Of Individual Unit Owners To Maintain Action For Construction Defects Against Developer

As a general rule with regard to condominium regimes, there is no question but that an individual unit owner has standing to assert a claim against a developer due to the defective condition of his or her individual unit. There is a split of authority as to whether individual unit owners can sue for defects in the common areas under the control of an HOA. Some jurisdictions would permit individual unit owners to bring suit against the developer for defects in the common areas, while other jurisdictions have held that HOAs have the exclusive right to bring suit for defects in the common areas of the condominium.

C. Class Actions

A class action provides a means pursuant to which one or more individuals may sue as representatives of a large group of persons who are interested in the outcome of a legal controversy. Class actions are particularly useful where members of the class are so numerous as to make it impracticable to bring them all before the court as party-plaintiffs.

Not surprisingly, class actions are often utilized with regard to lawsuits brought against HOAs or developers on behalf of numerous unit owners.

D. Defenses A Developer Can Assert As To Suits Brought By HOAs Or Individual Home/Unit Owners Based Upon Alleged Construction Defects

1. Statutes of Limitations
A statute of limitations prescribes the time limitations within which a cause of action must be brought. A cause of action will be barred if not brought within the applicable statute of limitations. Different causes of actions often have different limitations periods. The applicable statutory limitations period, within which a particular type of claim must be brought will vary from state to state.

2. Statutes of Repose
While a statute of limitations dictates the timeframe in which a plaintiff may bring suit after a cause of action accrues, a statute of repose totally extinguishes a cause of action after a fixed period of time regardless of when the cause of action accrues. Usually, a statute of repose begins to run upon the completion of the work or the delivery of a product.

3. Avoidable Consequences/Mitigation of Damages Defense
A failure to mitigate damages is an affirmative defense available to a developer in an action brought by a HOA to recover for construction defects in a condominium project.

Pursuant to this doctrine, a HOA which suffers a loss has a duty to make a reasonable attempt to mitigate its damages. If the HOA fails to make a reasonable attempt to mitigate its damages, the developer will not be liable for damages which could have been avoided by reasonable prudence and care.

V. NECESSITY OF COMPETENT LEGAL COUNSEL TO REPRESENT DEVELOPERS AND HOAS

Competent legal representation of a community association will go a long way toward supporting a smooth and seamless turnover of control from the developer-appointed directors to the homeowner-elected representatives.

The attorney of the developer is involved in drafting the governing documents and the sales documents, registering the community, as required by various federal, state, and local laws and ordinances, processing sales, and otherwise counseling the corporate entity which is responsible for the actual development and, possibly, the construction of the project.

The attorney for the developer should encourage the developer to fulfill its contractual obligations and to respond promptly to punchlist items and owner inquiries. The attorney should also follow up on any compliance issues related to construction and development.

It is not appropriate for the attorney for the developer to also represent the community association. There is too much potential for conflict of interest, as the rights and concerns of the owners diverge from the business interests of the developer.

All association directors, on pre- and post-transition boards, have a fiduciary duty to the membership. That duty requires a director to place the interests of the association and its members ahead of the director's personal interests. Some state laws hold developer appointed directors to a higher standard of duty and care and attach significant personal liability to breach of that duty.
Prior to transition, the association attorney must make sure that the association board meets the

documentary and statutory requirements for regular and special member board meetings, keeping of minutes, maintenance of financial records, rosters, and so on. And beyond the procedural and legal requirements, there are steps to be taken to lay the groundwork for the eventual transition of the association. The association attorney should encourage the developer-board to involve the owners in the governance process.

Step 1: Communication. The association attorney should make sure meeting notices are posted or distributed to all owners. Working with the professional manager, the attorney can assist in the creation of a newsletter or other type of regular communication between the board and the owners. Working with the accounting professional, the association attorney can make sure that legally required financial statements are produced and distributed, and that the financial records are kept in accordance with applicable laws.

The flow of information bears a direct relationship to the degree of membership satisfaction. Both the attorney for the developer and the attorney for the developer-controlled association should encourage the developer to be available to the buyers and owners, as the sales and build-out progress. When the owners feel that the developer's representatives are available to them and are willing not only to listen but also to be responsive, the owners develop more confidence and trust in the transition process.

Step 2: Gradual Evolution of Self-Government. The attorney for the developer should produce an initial set of documents which include the appointment of a committee made up of nondeveloper owners, perhaps at the point at which 50% or so of the dwellings have been sold. The committee would attend board meetings and could be used to assist the developer-board in operating the association, enforcing the documents, developing rules, and the like.

The association attorney can assist the committee members in understanding the governing documents, the rights and responsibilities of the individual owners, and the respective roles of the developer, the board, the manager, and the owners. Such a committee could also assist with annual meetings and could help with the orientation of new owners and residents.

The committee can also be used to provide experience in governance for eventual nondeveloper board members. The association attorney should train committee members regarding the scope of board authority, the duty to maintain the common property, and statutory and documentary procedural requirements.

As time for turnover of the association draws near, this group can become the Transition Committee.

How do you know when it is time for the developer to turn over control? The turnover date may be dictated by state law, or it may be set forth in the governing documents at a specific date, or it may be triggered by reaching a certain percentage of sales. At the turnover meeting, the association attorney can preside and facilitate the election of the nondeveloper directors. The attorney would also assist in the organizational meeting of the board at which the association officers are elected.

Because the association attorney does not represent the developer, he or she is in a position to answer questions and educate the owners on the legal aspects of transition.

Once the owners other than the developer have taken over governance responsibilities, the association attorney's obligation is to guide the board through the process of preserving and protecting the legal rights of the association and its members.

As part of the board's fiduciary duty to maintain, repair, and replace common property, the board should arrange for a professional inspection of any property for which it is responsible. A report from a professional architect or engineer will bring to light any construction issues. In addition, it can serve as a basis for short- and long-term planning for the maintenance of common property and the establishment and funding of reserve accounts.

The association attorney would be involved in reviewing and negotiating the contract and, then, in reviewing the report working with the architect or engineer, and the developer in addressing the issues raised.

The professional community association manager can assist in the evaluation process, working with the board and the association attorney to collect owner surveys, and coordinating repairs and access to the common property for contractors, if work has to be done.

In addition, the board has a duty to protect the common funds. It would be appropriate for the association attorney to recommend that the posttransition board engage the services of an accounting professional to review the association's financial records. Some state laws require a final report or an audit to be produced by the developer at the time of transition.

There may also be working capital accounts and reserve account funding issues. The developer may owe assessments or other charges. Again, the attorney should review the contract for the accounting professional, as well as the final financial report.

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