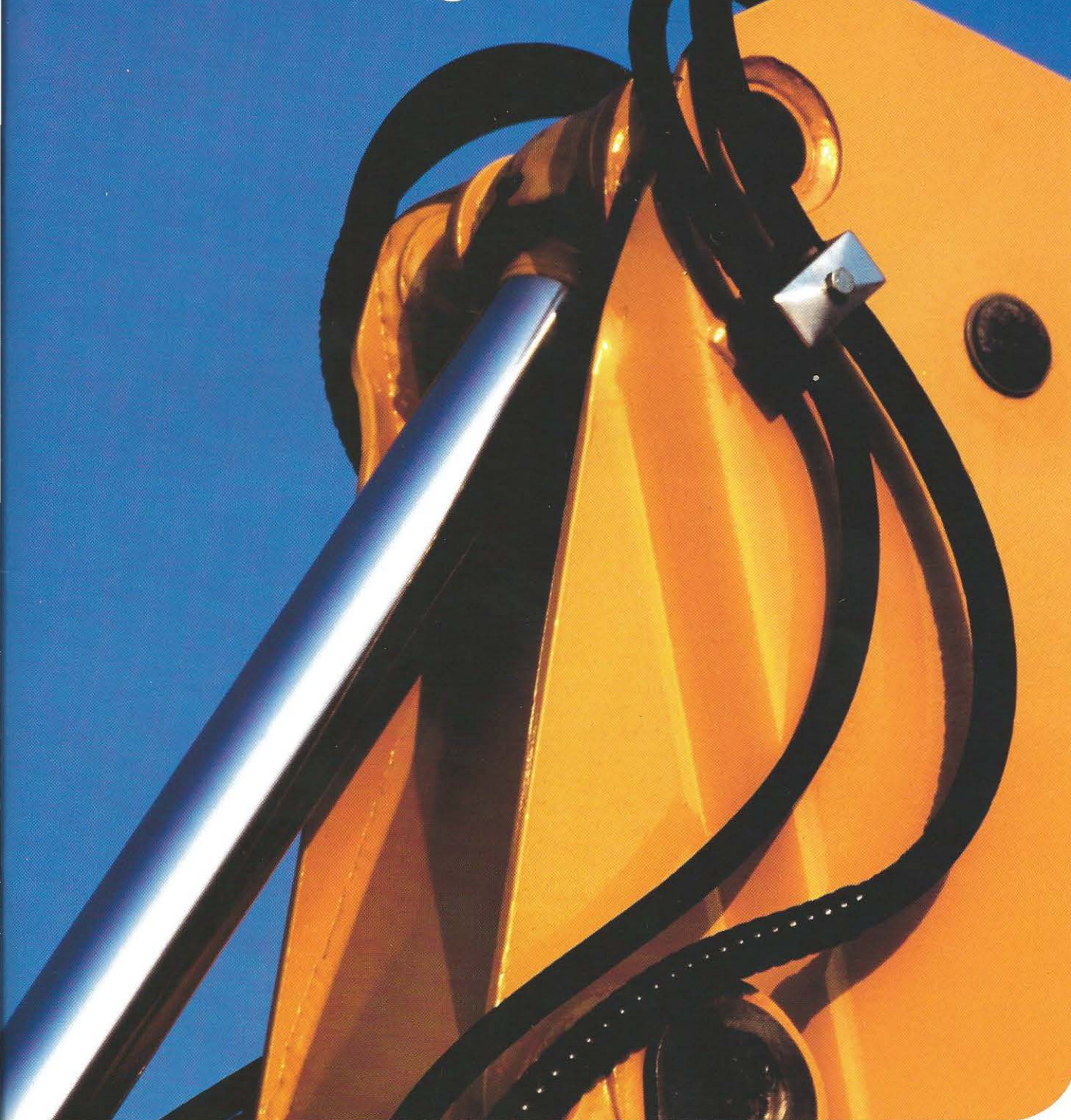


January
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2012

Construction

Accounting and Taxation



Condominium Issues

Working Capital—Revisited

Exiting Affordable Housing Partnerships

2013 Tax Increases



CONSTRUCTION

As demand for this type of housing increases, construction and accounting professionals should familiarize themselves with the issues that can arise related to the development, ownership, and oversight of condominiums.

ISSUES AT CONDOMINIUMS

JUANITA FERGUSON

According to economic indicators, the real estate industry is slowly beginning to recover from the state of depression that has characterized the last two years.¹ With the increased demand for dense housing, construction and accounting professionals can expect clients to have questions related to the development, ownership, and oversight of condominiums. Regardless of whether condominiums are designed for residential, commercial, or mixed-use, there are a variety of issues affecting the various stakeholders in the condominium market. Understanding construction issues related to condominiums will make it easier to navigate through the myriad of situations that can and do arise regularly in the management of condominiums.

Whose interests are at stake?

The developer. This is the party responsible for the overall construction and initial management of the condominium. Prior to forming a condominium association and installing officers for the association, the developer typically maintains control of all affairs related to the condominium. Until a certain number of units are sold, the developer controls whatever type of condominium association may exist and has the right to designate individuals as members of the

association's board of directors. However, once ownership reaches a certain level, the developer relinquishes control, and the condominium association self-governs with an autonomous election of unit owners to become board members and manage the affairs of the association.

An obvious goal of a developer is to sell units in the condominium. However, any condominium developer wants to ensure that risks are minimized when acquiring land on which to build and sell individual condominium units. While attempting to sell individual units, a developer could confront conflict by seeking to ensure there are sufficient reserves on hand for the routine affairs of the condominium. During the time a developer is in control of the board, it can determine the amount of monthly assessments for maintenance that will be levied against unit owners. The developer's interest in making the purchase of units attractive may cause it to impose unusually low assessments to increase sales. If there are insufficient funds for the management of the condominium at the time the developer cedes control to an autonomous board of directors, then the developer may be responsible for replenishing the reserve up to a certain

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percentage of the budget of the association on a noncumulative basis.

The condominium unit owner. An owner of a condominium unit does not own the entire condominium complex. Instead, the unit owner owns his or her own unit outright and shares ownership of the rest of the complex with all other unit owners. A unit owner of a condominium will likely be interested in his or her rights in the event that repairs are needed for the unit. In all likelihood, the individual unit owner will rely upon his or her condominium owners association to remedy construction issues related to the construction of the common elements of the unit. Even if construction is limited to the owner's individual unit, the governing documents for the condominium will likely require written approval from the association prior to an owner undertaking structural repairs.

The condominium owners association. Often referred to as a COA, the condominium owners association is comprised of all unit owners and generally elects individuals from its membership to serve on the board of directors. The board of directors is responsible for the management of the affairs of the association. The powers and duties of the COA are set forth in the governing documents of the condominium, commonly referred to as the declaration and bylaws of the condominium or condominium instruments. Although a COA is generally comprised of owners of units that are a part of the condominium, the board of directors is initially selected by the developer for the condominium.

To avoid having to defend against claims that it is not acting in the best interests of all unit owners, a COA can be characterized as dedicated and perhaps even overly cautious in executing its responsibilities under the condominium instruments and the laws of the jurisdiction where the condominium is located.

Insurers. Insurers provide various types of coverage to the COA and individual unit owners, including but not limited to title and general liability insurance.

Irrespective of whether the insured is a developer, individual unit owner, lender, or COA, in the event that a claim is made under a policy of insurance, insurers will be judicious in responding to potential claims. If bonding companies are a part of any insurance coverage, they may require sufficient guarantees prior to obligating resources for the respective condominium or the individual units.

The ABC's of constructing condominiums

Prior to breaking ground on a condominium, a developer must acquire land. Once the land is acquired and prior to the commencement of construction, the developer may require the contractor to provide some type of an indemnity bond for the project. This will protect the developer from any type of financial loss that may occur due to the actions or failure to act of the contractor during the term of the project. In some cases, the insurer could require the developer to provide indemnification against loss during the construction of the condominium.

Insurers may also seek bonds from developers in order to issue individual policies of insurance to unit owners. Agreeing to indemnify an insurer in order for the insurer to issue title policies respecting the units is often seen as an incentive that is provided by a developer. Typical language included in an indemnity bond obligates the developer to agree to indemnify the insurer from all loss, damage, cost, charge, liability, or expense, including court costs and attorney's fees that it may sustain, suffer, or be put to under its policy or policies of title insurance or otherwise, to the extent related to any lien or right to a lien for services, for labor material furnished, or imposed by law, whether or not the lien is shown in the public records.

Mechanic's liens are a prime example of potential financial loss that could invoke coverage under an indemnity bond. Consider the scenario where the developer fails to make payment to a general contractor, or the general contractor fails to pay its subcontractors. The lien claimant then files mechanic's

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liens against the property on which the condominium is built. In the event that the lots for individual condominium units have been sold by the time that the lien claimant performs work, the financial interests of individual unit owners are affected immediately. Those respective unit owners will, in all likelihood,

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file claims with their respective title insurers under title insurance policies. Coverage is triggered due to the existence of liens

for services, labor, or material filed against the subject property by the lien claimant. Barring an exception or an exclusion of the respective title insurance policies, title insurers defend unit owners and lenders named by the lien claimant as parties in any litigation to enforce the liens.

If the developer agrees to indemnify the insurer, the insurer could then demand that the developer either make immediate payment to the lien claimant in order to satisfy the lien or that the developer bond off the lien in order for construction to continue while the lien claim is resolved. The amount of potential claims could be great, depending upon the number of individual units in the condominium.

A developer, in issuing an indemnity bond, potentially obligates itself to the title insurer for all fees and costs incurred in the defense of every covered owner and mortgagee made a party to any litigation who may make a claim under their respective title policies. It also undertakes to bond off any mechanic's lien by agreeing that if any claims or liens are filed in the land records, it will satisfy or dispose of the liens without delay to the satisfaction of the indemnitee (i.e., the title insurer).

Given the potential for individual claims that could be made, in addition to issuing an indemnity bond as each unit is sold, a developer could be required to issue affidavits agreeing to indemnify and hold an insurer harmless of and from any and all loss, cost, damage, and expense of any kind including attor-

ney's fees, which the insurer may suffer or incur on account of mechanics' liens filed for work done prior to the date of each closing. The insurer would then issue title insurance policies in reliance on the agreements to indemnify each unit individually.

The interests of all unit owners and, should they exist, their respective mortgagees, are not necessarily aligned. Therefore, the developer could be obligating itself to indemnify for any loss incurred as a result of the actual mechanic's lien claims but also for those costs associated with defending any litigation due to construction contracts entered into by the developer.

Defining relationships between the unit owner and the COA on construction issues

The condominium instruments contain most of the answers. Regardless of whether any of the members of the COA have backgrounds in construction, when questions arise, interested parties must look to the governing documents and the applicable state law. Governing documents are also known as condominium instruments. It is a collective term referring to the declaration, bylaws, plats, and plans of a condominium. It also includes any exhibits, schedules, or certifications that may accompany a declaration or bylaws and that may be recorded simultaneously with other key documents, thereby making it an integral part of a particular condominium instrument.

Most, if not all, jurisdictions have statutes that govern the creation and ownership of condominiums. The actual creation of a condominium occurs with the filing of a declaration. The declaration is the legal document that actually creates the condominium under the applicable state law. Bylaws are also drafted for the purpose of explaining the internal management of the condominium, how officers are elected, and how meetings are conducted. Rules relating to condominium ownership are governed by the enabling statute of the jurisdiction where the condo-

minium is located, the terms of the condominium declaration, and, if applicable, the COA's bylaws.

The declaration will define what comprises a condominium unit. A condominium plat is attached to the declaration and filed within the land records with the declaration. Typically the boundaries of each unit are defined as the interior unfinished surfaces of exterior perimeter walls, the middle of interior demising walls, flooring, ceiling/attic below a certain number of feet above a finished floor, the doors and windows of a unit, and any wallboard, plaster, paint, tile, or wallpaper that may exist. All spaces, interior partitions, other fixtures, and improvements within the boundaries of a unit are generally considered a part of an individual unit.

Maintenance responsibilities are divided between the unit owners and the COA. A COA is responsible for the operation, maintenance, repair, improvement, and replacement of the common elements. Unit owners are responsible for the maintenance and repair of those portions of their unit that are not accessed by any other unit owners or that do not benefit the other units. To defray maintenance and construction costs, each unit owner is assessed by the COA and contributes financially to cover his or her share of the common expenses. The assessment is a dollar amount paid each month by each condominium owner to cover a proportional share of the common expenses of the property. These expenses typically include but are not limited to gas, sewer, water, electricity for common areas, trash removal, lawn cutting, snow removal, hallway cleaning, insurance for common areas, professional management, parking lot maintenance, legal and audit fees, and short- and long-term reserves for repairs to the condominium. The COA also purchases insurance coverage with condominium assessments. The condominium form of ownership in real estate succeeds because unit owners agree to cooperate in the maintenance of common elements.

The COA is responsible for making repairs to the common elements of a condominium. There are two types of

common elements—limited common elements and common elements. Limited common elements are reserved for use by at least one but fewer than all of the unit owners in the condominium. Examples of limited common elements include balconies, roof decks, storage areas, and parking spaces. Any questions about what makes up the limited common elements of a condominium can best be answered with a review of the declaration and an examination

of the declaration plat. Other examples of limited common elements are any air conditioning or heating units, chutes, flues, ducts, wires, conduits, bearing walls, bearing columns, and other fixtures located within or outside the boundaries of a unit that serve only that unit or are allocated solely to that unit. Fixtures that are designed to serve a single unit but that are nonetheless located outside of the unit's boundaries may be deemed limited common elements allocated exclusively to a single unit.

Common elements are those portions of a condominium used by all the unit owners. Common elements include everything that is not a part of an individual unit or a limited common element. In addition to the land on which the condominium is built, most condominium common elements include items such as foundations, roofs, slabs, perimeter walls, boiler rooms, corridors, laundry rooms, common stairs, building lobbies, trash areas, utility rooms, and water mains.

The condominium instruments should describe accurately what constitutes common and limited common elements. However, if the condominium's governing documents are ambiguous about the definitions of the common elements, the unit, and/or the limited common elements, those appointed or elected to the COA will likely have to propose the necessary amendments to the condominium's bylaws to ensure that any uncertainties are eliminated. Otherwise, the potential for disputes to arise between individual

TO DEFRAY MAINTENANCE AND CONSTRUCTION COSTS, EACH UNIT OWNER IS ASSESSED BY THE COA AND CONTRIBUTES FINANCIALLY TO COVER HIS OR HER SHARE OF THE COMMON EXPENSES.

unit owners and the COA will increase in the event that repairs are needed and it becomes necessary to apportion costs and to obtain insurance to cover the costs for those repairs.

Upgrades and repairs are opportunities to review condominium instruments

It is inevitable that either the common elements or the individual units of a condominium will be subject to repairs or renovations during ownership and management of the individual units. For example, if the interior and exterior of an individual unit is damaged as a result of a fire at the unit, then the unit owner notifies the COA. For the unit owner, the obvious concerns are the repair of the unit as well as accessing funds to repair the unit. For the COA, concerns include responding to the unit owner's concerns, assessing the potential liability for the condominium, and minimizing disruption on the lives of any other unit owners whose interests may be affected as a result of the damage.

While executing its duties under the applicable bylaws, the COA, and particularly the members of the COA who investigate and respond to requests for repairs, should be particularly careful to keep written documentation of their actions. Any uncertainty about the apportionment of duties between the COA and the individual unit owner requires careful examination of the condominium instruments, as those documents will provide most, if not all, of the answers that the parties need to resolve any issues related to who has responsibility to make and pay for the repairs.

Who gets to have the final say?

The condominium instruments usually dictate the terms by which repairs are made to the common elements and the individual units of a condominium.

Any changes to a unit that affect other units usually require the prior approval of the COA. If common elements are affected by construction at an individual

unit, a unit owner will likely have to secure the approval of the COA prior to undertaking any repairs to an individual unit. Also, if any modifications at the unit are something other than cosmetic and affect the structural integrity of the unit, then the COA must generally approve in advance of repairs being made to the unit.

Payment for repairs will usually invoke insurance coverage and trigger disbursements of condominium assessments from the COA to the unit owner in need of repairs. A unit owner may, and should, purchase additional insurance to cover damage to his or her individual unit. Often, the bylaws will provide that additional insurance may be purchased by the unit owners through the same insurance company used to purchase insurance for the common elements. Additionally, when insurance proceeds are issued, the COA often appoints certain members to act as trustees over the insurance proceeds to ensure that payments are made to unit owners for work performed in furtherance of repairs to the common elements or the individual units.

Despite the fact that the repairs may be confined to a single unit, tensions may arise between a unit owner and a COA during the planning and the actual progress of repairs to a unit. The COA has a fiduciary duty to ensure that any construction or modifications to the condominium is done in a workmanlike manner and that any proceeds earmarked for the construction are available to be provided for payment. However, if construction is confined to a single unit, the unit owner is often the party contracting with a contractor for the repairs to the unit. Nonetheless, if payment, either in the form of assessments or insurance proceeds, is held by the COA, conflict may result due to the COA's dual role of safekeeping proceeds for the unit owner while repairs are being made and simultaneously monitoring the work on behalf of the COA.

The COA can generally require a unit owner to provide certain documentation regarding contracts for construction at a unit. Such documentation may include:

- A copy of the contract between the owner and the contractor performing the repairs at the unit;



ANY CHANGES TO A UNIT THAT AFFECT OTHER UNITS USUALLY REQUIRE THE PRIOR APPROVAL OF THE COA.

- A copy of the contractor's scope of work for repairs to the unit;
- A copy of the contractor's license to perform the repairs at the unit;
- Written evidence that the contractor is bonded to perform the necessary repairs at the unit;
- Copies of any and all permits obtained to perform the repairs at the unit;
- A timeline by which the work will commence and will be completed;
- A schedule of when payments are to be made in order for the proceeds to be paid to the unit owner as the work progresses;
- Invoices for the completed work for which payment is sought, including detailed descriptions of the work completed;

- Proof that work is approved by the appropriate regulatory authorities if inspections are required of the construction.

While any type of construction at a condominium can have significant consequences for the various stakeholders, understanding the affected parties' expectations and gaining an increased understanding of the local laws and the condominium instruments is invaluable in minimizing potential conflict and making condominium management a more rewarding experience. ■

NOTES

- ¹ This article is not intended to provide specific legal advice but, instead, a general commentary regarding legal matters. You should consult with an attorney regarding your legal issues, as the advice will depend on your facts and the laws of your jurisdiction.