

RESERVE PLANNING AND CONSTRUCTION DEFECT LITIGATION

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What's the Problem?

Many associations are confronted with conflicting priorities when their associations are facing the unfortunate challenges of construction defects at their association. The board, and owners, are concerned about the integrity and value of their homes, yet the business of running the association still needs to be addressed. This means the job of being a board member, or a manager, of an association in these circumstances becomes much more complicated.



What does "success" look like?

Physically, the objective is to restore the association to "properly constructed" condition. To accomplish this, board decisions will be measured against these three things:

- 1) Their primary responsibility, which is to protect, maintain, and enhance the assets of the association.
- 2) The Business Judgment Rule, which requires their decisions be made:
 - In their area of authority and power
 - In the best interests of the association (duty of loyalty), and
 - After reasonable, prudent inquiry
- 3) In accordance with applicable State Laws

The key is for the Board to assemble a strong Construction Defect legal team (the prudent decision, according to the third principle of the Business Judgment Rule), able to handle the case competently so the board can continue to focus on the big picture of running the association without getting bogged down in the details of the Construction Defect case.

Why are Reserve Studies an issue?

Reserve Studies are prepared in accordance with National Reserve Study Standards, which stipulate that components should be presumed to have been "properly constructed". So while the Construction Defect legal team addresses the resolution of

the property's current physical problems, the Reserve Study continues to help the association plan responsibly for the future. This means it continues to be wise to set aside contributions, on an ongoing basis, for future Reserve expenditures (not upcoming Construction Defect reconstruction). Separate between the two.

What is the Construction Defect Process?

Interview, evaluate, and retain a capable and experienced Construction Defect team. Expect a period of Investigation, while keeping an "eye on the clock" of Statute of Limitations or State of Repose. After that comes the Litigation phase, which often leads to settlement rather than trial. Finally comes Reconstruction, when the property is restored to "properly constructed" condition. The process often takes years. So a strong Construction Defect team is key, helping the board meet their objective to continue to run the affairs of the association throughout this possibly extended process.

The process is often managed with the Construction Defect team advancing funds for experts during the investigation process, and working on a contingency (not getting paid until the case is settled, when they receive a set percentage of the award). Other options, or hybrids, involve one or more of the following: spending some Reserves, raising homeowner assessments, or levying one or more special assessments.

How are Reserve Studies Affected?

Some "Remaining Useful Life" expectations may be significantly extended because the next "repair" will be accomplished as part of the Construction Defect settlement. Similarly, some "Remaining Useful Life" estimates may be adjusted to work around, or with, planned Construction Defect reconstruction projects. All these adjustments will affect the size of the association's ongoing Reserve contributions, allowing the association to remain on-target to have sufficient funds for the timely repair and replacement of Reserve components.

It is important that associations not neglect periodic Reserve Study updates (or their Reserve contributions based on those updates, which are often 15-40% of an association's total budget!), as taking their eye off that responsibility will significantly increase their chance of future special assessments. It is not good to go from Construction Defect turmoil to special assessment turmoil a few years later, or invite legal challenges if periodic Reserve Study updates are not accomplished as required by your State Law!

Note that while most associations only perform one "Full" Reserve Study (performing Update With-Site-Visit or Update No-Site-Visit Reserve Studies thereafter). If the Construction Defect reconstruction process was significant, another "Full" Reserve Study may be appropriate after reconstruction has been completed. At least, that may be a good time for another fresh With-Site-Visit update.

What Helpful Hints pave the way to Success?

- 1) Remember the big picture of running the association. Construction Defects will be a dominant subject for a period of time, but it does not need to be at the expense of other matters at the association.
- 2) Remember how your decisions throughout the process will be measured:
 - Did you Protect, Maintain, and Enhance the assets of the association?
 - Did you follow the Business Judgment Rule?
 - Were you compliant with all applicable State Laws?)
- 3) Pursue an Improved Future: for yourself, all the owners, and the association. Keep your “eye on the prize”. It may be a lot of work now, but it will be worth it, and association members are relying on the Board to execute the process well.
- 4) Communicate often and candidly with the Owners: making sure to discuss communication content with your Construction Defect Team to avoid waiving attorney client privilege and jeopardizing your case and ultimate recovery.
- 5) Maintain Good Documentation: a hallmark of an effective board, but especially so in these circumstances... what you decided, when, and why, how much it cost, etc.
- 6) Encourage Owner Patience: See #3 above. It’s going to be ok! It’s not as bad as it seems! This too will pass!
- 7) Assemble a Strong Team: Back to where we started, this is a complicated and important time in the association’s history. Selection of a capable and experienced Construction Defect legal team is the strong start that will lead to a successful finish.



For additional Resources see:

www.ReserveStudy.com

www.BurgSimpson.com



You can view the recorded webinar by clicking on this link:

<https://youtu.be/ji1SPQ-N4Wc>

AUDIENCE QUESTIONS

Q: Please list the typical construction defects to look for.

Joe:

- Water Intrusion through the Building Envelope (stucco, siding, brick, stone, roof, window, etc.)
- Inadequate Grading/Drainage
- Foundation & Structural Movement
- Inadequate Fire Rated Assemblies (walls, floors, ceilings)
- Inadequate Sound Rated Assemblies (walls, floors, ceilings)
- Improperly Installed Asphalt/Pavement and Concrete Flatwork

Q: Do you ever mention in Reserve Study reports "potential defects"? If you did that would probably "start the clock" on the notice of claim, correct? Would you just notify the manager separately?

Robert: As a Reserve Study professional, if we see something odd, we notify our property contact. Our observations are not authoritative, as we are budget generalists, not forensic experts.

Q: How does an association deal with construction defects which are deteriorating rapidly or are life safety issues without having to wait a year or more for settlement funds in order to resolve?

Joe: These types of issues can be addressed through temporary or emergency repairs during the construction defect lawsuit. However, in most instances the Association's construction defect attorneys need to give advance notice to the Defendants' attorneys and give the Defendants an opportunity to observe and document the conditions, before, during, and after the repair. The cost of temporary/emergency repairs usually need to be paid by the Association and sought as damages in the defect lawsuit.

Q: What national trends are you seeing when it comes to association construction defect cases? Would you say the number is generally increasing?

Joe: The number of construction defect claims appears to be increasing, likely spurred on by several straight years of new housing growth following the Great Recession. We

continue to see legislatures across the country considering construction defect litigation, often in favor of developers and builders. A 2017 report by Community Associations Institute (CAI), titled, "Protecting Homebuyers and Homeowners from Construction Deficiencies in Condominiums and Preserving Property Values Survey," provides a national survey on construction defects and their impact on homeowners and community associations.

Q: Is it a common issue for an association to neglect unrelated assets during defect litigation, and what is the cause and ultimate consequence of such neglect?

Robert: That common neglect was one of the driving issues prompting this webinar. We wanted to guide associations towards keeping the business of the association successfully moving forward, not getting critically distracted on construction defect issues. The association successfully moves forward when it has a strong team in place, and is reminded of their obligation to "protect, maintain, and enhance" all the assets of the association (not just the ones in construction defect litigation).

Q: How do you hold the developer accountable given that he controls the Board? Our developer has left our HOA with about \$200k in unplanned expenses, premature and grossly underfunded expenses, or loss of assets because they had to be removed.

Joe: First, review the Association's governing documents and/or your state's common interest community laws (many states follow at least portions of the Uniform Common Interest Ownership Act) for guidance as to notice and enforcement steps that can be taken. The Association's general counsel or outside counsel with expertise in community association law should be consulted. Due to the Developer's conflict of interest, he/she/it may be required to recuse himself/herself/itself from all Association board decisions regarding these matters. Alternatively, consider establishing a stand-alone committee of non-Developer board members or unit owners to pursue the necessary actions. A letter requesting that the Developer turn over control of the Association to the unit owners may be warranted as an initial, non-confrontational step in attempting to resolve issues like this.

Q: How can a Board collect from a Community Member who willfully caused significant damage to common area?

Loura: First, I would recommend you review your community's governing documents as it is common for them to contain provisions that allow an association to impose a

“reimbursement” assessment against an owner who causes damages to common area after providing the owner with notice and an opportunity for a hearing. If your documents are silent on this issue, the association could file a lawsuit against the owner seeking a money judgment for the damages caused under a theory of negligence.

Q: How do I find out the Statute of Limitation on construction defects for State of Wisconsin?

Joe: The most reliable source for each state’s Statute of Limitations is the state statutes themselves. These can often be found on state websites. An Internet search of “Wisconsin construction defect statute of limitations” should lead you to basic information, including identification of the applicable statute sections. Because application and analysis of statutes of limitations and related statutes of repose can be complicated and often depend heavily on very detailed factual scenarios, we recommend contacting an attorney experienced with construction defect litigation in your state to provide advice, and never assume you can no longer bring suit until you have an attorney fully analyze all of the facts

Q: Should the Board build in a claim consideration to cover the litigation costs within the lawsuit?

Joe: Reasonable litigation costs are often awarded to the prevailing party in a construction defect lawsuit, either by statute, court rule, or, in an association’s case, the governing documents. These costs are typically presented to the judge or arbitrator after trial/arbitration by way of a motion with supporting documentation.

Q: Who would pay for the temporary housing that may be needed throughout the reconstruction process?

Joe: Although there may be situations in which temporary housing would not be recoverable, typically the Defendants would be liable for this expense as part of the cost of repair if temporary housing is necessary in the Association’s experts’ opinion to facilitate the repairs.

Q: Could construction defect litigation apply if the club house and office (owned by developer) and guard house (owned by third party), all of which are not yet owned by association, but are later purchased by the association during or after turnover?

Joe: Yes, although the association probably could not successfully pursue construction defect claims for these buildings if the association is aware of defects at the time it takes ownership. The association would, however, have valid claims for latent defects (fault in the property that could not have been discovered by a reasonably thorough inspection before the sale).

Q: In order to know any pre-existing construction defect before turnover in Florida, how would a Reserve Study be paid for if developer is not obligated to have a Reserve Study/funding?

Robert: Many associations commission a “Transition Study” (not a Reserve Study), which is an independent inspection and analysis of construction quality and completeness. That is a responsible first step for the association to take while the developer is still engaged with the property (and available to fix/resolve any issues that were found). Such a report is paid with association funds.

Q: It a proper use of reserve funds to pay for upgrades of items not included in the current study?

Robert: Items should appear in the Reserve Study if they pass the National Reserve Study Standards four-part test (association responsibility, with a limited Useful Life, a predictable Remaining Useful Life, and above a minimum threshold cost of significance). There is no requirement that the asset be replaced identically. Natural upgrades (such as replacing a B&W camera system with a color-digital system, for example) are appropriate.

Q: As treasurer I've insisted on a Reserve Study. Any delay in maintenance due to litigation hopefully will be included in the repairs. Does the Reserve Study and reserve contributions become “frozen”, and then get adjusted once needed repairs have been identified and prioritized?

Robert: A Reserve Study helps guide the association’s repair and replacement decision-process, guides the association towards having sufficient funds to accomplish those projects, and serves as an effective communication tool to the homeowners. Reserve

Studies prepared in the midst of construction defect investigation or litigation should reflect the current condition of the common areas, projections for what projects will be accomplished, when, and with what funds (no need to set Reserves aside now for something soon to be replaced with settlement funds). This becomes a valuable document to the association. It is then good to perform a fresh “With-Site-Visit” update or a “Full” Reserve Study after settlement and reconstruction, to reflect the actual condition, timing, and materials used in the recent reconstruction.

Q: I'm curious to know what our owner assessments will be in ten years based on the current Reserve Study. Can future monthly dues be calculated based on the Reserve Study?

Robert: While Reserve Studies look 20 years or more into the future, they are fundamentally one-year recommendations, in need of updating on an annual basis because their value and accuracy drops significantly with the passage of time. Reserve contributions are an important component of an association’s annual budget (often 15-40% of the total), and Reserve contribution trends should be reflected in Operating Budget expectations for future years. It is best practice to presume that your overall owner assessments will increase annually at approximately the rate of inflation, perhaps even a bit more.

Q: We have metal gates and railings that are scheduled for painting this year, but lawyers have asked us to hold off. How should a Reserve Study adjust for that?

Robert: Let’s presume that painting has a Useful Life of 5 years. If the best expectation is that painting will be accomplished in two years as part of reconstruction (it is foolish to paint something now that will shortly be removed and replaced, or paint over something that currently is key evidence!), the Reserve Study should show a Remaining Useful Life of 7. In that way it will reflect the expectation that it will be painted in two years with settlement funds, and then painted five years after that with Reserve funds.

Q: Presently our Reserves are 80% funded. Every month, the Board is adding \$\$ to the Reserve account to fund it at 100%, following the Reserve Study guidelines. This creates a big burden to owners, whose fees keep increasing yearly. In the future, would it be better if the Reserve Study showed the range of contributions that would yield a range of different outcomes (70%, 80%, 90%, 100%, etc.)?

Robert: The majority of your Reserve contributions go towards paying for repair and replacement. Only a small fraction of your Reserves “builds margin”, as in strengthening your Reserve Fund from 80% to 100%, so the difference in Reserve contributions between the two will be relatively small. It may be a good question to ask your Reserve provider to calculate the difference between contributions directed towards being 70% or 100% Funded, so you can make an informed decision. While the 70% level is considered “strong” Reserves, 100% Funded is a fiscally responsible target, where the board can claim they are funding Reserves so that their Reserve cash balance offsets existing common area deterioration.

Q: Should the Reserve Study Component list be updated for items that are included in the CD Litigation after the litigation is started, or should you wait until the Litigation is resolved through arbitration to update the Component list- specifically for Remaining Life of a component that was identified by a Construction Defects engineering firm that provided evidence in the case?

Robert: It is prudent to update your Reserve Study on a regular basis, to keep the association “on track” financially with respect to its major common area repair and replacement obligations. For this reason, many states have maximum intervals between Reserve Study updates. Waiting years to update the Reserve Study significantly increases the association’s special assessment risk, as we found in this study. So yes, it is a good idea to update your Reserve Study during possibly lengthy construction defect litigation, using best estimates, to prevent the association creating future problems for itself (special assessments or deferred maintenance).

Q: A component’s remaining useful life was not specifically identified in the engineering report, just that there were defects that would reduce the Normal Life. In other words, what should you use for a remaining life in this situation?

Robert: This question is best asked of someone on your construction defect legal team, as that component may be combined as part of the reconstruction schedule for a group of assets. Another idea is to request permission to speak with the author of the engineering report, in order to gain some insights.

Q: How often, in your experience, will an attorney work on a contingency basis and include the costs of preparation (engineering fees etc.), as implied during the webinar, and what would be a normal contingency percentage?

Joe: This may vary from state to state depending on how attorney fees and litigation costs are regulated, but in our experience most competent Association construction defect attorneys offer a contingency fee arrangement and advance the litigation costs through its resolution. Contingency percentages are limited in some states (e.g., Florida), but where not limited normal contingencies are typically one-third of the final recovery.

Q: What if you don't get enough funds for reconstruction, or if litigation is unsuccessful?

Joe: In either situation, with respect to repairs, an Association would then need to consider a special assessment and/or obtaining a loan to fund the necessary repairs.

Q: What do you do with "extra" funds, if any, that aren't used in reconstruction?

Joe: The Association's governing documents should be reviewed, as they may dictate where "extra" funds go. If not, the Association should consider using some or all of these funds to strengthen the Reserve fund, bringing reserves up to an adequately or closer to adequately funded level.

Q: Are there indicators of "slam dunk" CD success vs risky litigation?

Joe: There is no "slam dunk" litigation. The riskiest construction defect litigation is that where the passage of time before the lawsuit is filed makes the statutes of limitations or repose potentially fatal to the Association's case. In addition, where the primary Defendant(s) is defunct or has inadequate assets or insurance to pay a judgment obtained by the Association, the successful lawsuit becomes a hollow victory.