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Conversion Conundrums - Challenges of Handling CD Claims on Projects Built as Apartments Later Converted to Condominiums

During the recent fluctuations in the residential housing markets across the country there have been numerous residential development projects which may have been initially operated as apartments and later converted to condominium units. This trend will be most prevalent for the projects built around 2007 which may have initially been intended for sale but were placed on the rental market as an alternative during the economic downturn. Conversely, as the demand for condominium units increased beyond the available inventory, some older apartment complexes have also been converted to condominiums to meet the housing demand in certain areas which are more densely populated. All projects which began as apartments and are converted later to condominiums have a unique project history raising various challenges when addressing defect claims in subsequent litigation.

The first phase of any litigation or claim review involves understanding the defect claims involved and knowing the project history which is very different from most residential developments. This will assist greatly with conducting key investigation and discovery relating to the evaluation of defect claims and overall liability for defendants in these cases. Understanding the project use, background of occupancy and local rules and ordinances which may apply as well as the progression of construction will be critical in following the addressing the liability issues peculiar to these types of projects. Additionally, it is important to understand the construction and design process and criteria to investigate the defect claims and separate out those which are not recoverable as part of the pre-conversion conditions. Finally, the applicable insurance and risk transfer options are much different for conversion projects and will often involve several overlapping issues. The summary provided is intended to explain each phase of the conversion process and spot the key legal issues and insurance issues to consider in handling disputes on conversion developments.

Most states as well as local municipalities impose strict regulations on condominium conversions. The courts have consistently treated condominium conversion regulation as a proper exercise of local police power. The regulations are upheld so long as “reasonably related” to the legitimate governmental purpose of maintaining a “healthy rental housing inventory.” (See, *Griffin Development Co. v. City of Oxnard* (1985) 39 Cal.3d 256, 264-266).

The regulatory requirements for development projects generally involve several steps. All California conversions are subject to approval under the State Subdivision Map Act. Once final approval issues, rental tenants are entitled to extensive written notice at various stages of the map submission as set forth in California Government Code §66427.1. There are also numerous local requirements. Some municipalities have limits on the amount of units that may be converted in a given calendar period (Berkeley). Others require the developer to generate replacement rental units (Oakland, West Hollywood). San Francisco requires that each affected tenant be given a right of first refusal to purchase the unit at a price no greater than that offered to the general public, and that 40% of the tenants actually exercise that right. San Jose imposes strict limits on rent increases after issuance of a permit to convert. Many cities require the landlord to provide relocation assistance to tenants, and tenants over a certain age in San Francisco and Oakland are entitled to a lifetime lease and cannot be required to vacate. Additional requirements are imposed on the conversion of residential hotels by many cities. Depending on your location, the plan for handling renters may begin long before filing a tentative tract map application.

In addition to complying with local requirements for existing renters, condominium conversions are subject to approval requirements imposed by state law. In California, there are several steps which are simultaneous with the tenant notice requirements especially if an owner intends to create five or more condominium units. The typical procedures require the filing of several documents with the Bureau of Real Estate, formerly the Department of Real Estate. An application for a tentative tract map approval must be filed with the applicable jurisdiction. The local planning agency reviews the application, holds a public hearing, and grants approval. Appeals may be filed and heard within each jurisdiction. The Developer then files a public report and complies with all conditions of the tentative tract map to receive a final map.

The Developer will also need to use the information from its inspections for the disclosure process which will occur at the time of the sale of the condominium units and also will be useful for conversion work to be performed by applicable design professionals and contractors. As with any undertaking along this process, due diligence is required and all inspections must be performed with an understanding and appreciation that the units will be sold to the public as part of the conversion.

The construction considerations on conversion projects are numerous. Buildings created to be apartments, and converted to condominiums at some later date represent the highest risk for defect issues. Typically, they will have lower quality systems and materials than a newer building. In addition, there are likely code violations in terms of structure, mechanical systems, and items like ADA compliance for common areas. Noise control is one of the more expensive aspects of new condominium construction, but when an existing apartment building is converted there is frequently no effort made to upgrade that portion of the project. The primary imperative for the developer is to upgrade the finishes to improve curb appeal.

As part of the conversion process, a property condition assessment (PCA) is normally carried out. There are various standards, the most established being one promulgated by the American Society for Testing and Materials (ASTM E2018, Standard Guide for Property Condition Assessments). Relevant statutes

require disclosure *(CA Civil Code 1134)* and penalize failure to disclose "substantial defects or malfunctions" of what are considered to be "major systems" including (but of course not limited to) roof, walls floors, heating, air conditioning, plumbing and electrical systems. In addressing potential litigation, it is important to understand what a report created using the ASTM standard actually addresses.

ASTM E2018 is necessarily vague. In part, this is because it covers all building types and only runs 21 pages long. At best, it provides a framework for investigation and documentation. The section on "enhanced due diligence" for multifamily buildings is less than a page, and the definitions of terms takes up 3 pages. By way of comparison, the rather notoriously ambiguous ASTM E2112 "Standard Practice for Installation of Exterior Doors, Windows and Skylights" runs 88 pages long. The standard also promotes a 2-stage process for report generation, where one individual (or group) performs the visual inspection, and a second individual performs quality control and report generation. One side effect of this effort at quality control is that good and bad report can be virtually undistinguishable. Uncovering deficiencies in a PCA can require significant time and effort.

The PCA process involves review of existing documentation, including as-built drawings of the project (if they exist and assuming they can be relied upon), maintenance and repair records (if they exist, and ditto), and a visual inspection of <u>easily</u> accessed portions of the building. There is no verification required of the drawings or repair records, no destructive testing, and in the case of multifamily residential buildings "residential occupants do not need to be interviewed unless appropriate and with the consent of the owner or user." This is significant, because the triggers for future litigation tend to revolve around "quality of life" issues. Noise complaints especially figure prominently, but this is an area that the ASTM standard does not address.

The lack of any destructive testing is also significant. If (and when) there is litigation brought by the new owners, deficiencies that were not visible to the entity conducting the PCA <u>will</u> be uncovered. The disclosures made to the condominium purchasers can shortcut some of these, but there are issues (such as ADA accessibility) which are absolutely triggered by any significant work on the project. Similarly, life-safety issues are difficult to sidestep (particularly in common areas, or portions of a structure that have recognized safety concerns such as decks). It is a very good idea for developers to make a thorough investigation of the conditions at the time of purchase and conversion to make sure any defect issues are identified and addressed.

The legal issues for developers which create a basis for conversion liability are significant and include several theories of liability for recovery including Negligence, Negligent Misrepresentation, Failure to Disclose Conditions, Breach of Warranty and Fraud. Most cases filed will also include a claim for strict liability for the converter, but this would likely to be limited to the areas of new work, rather than the entire project depending on the facts. The Title VII/SB 800 Right to Repair Statue in California expressly states it does not apply to condominium conversions.

Another source for the legal standards outside of California for condominium claims is set forth in the **The Uniform Condominium Act** which was originally passed by the uniform law commissioners in 1970 and was substantially revised in 1980. It (or laws substantially similar to it) is the law in Alabama, Arizona, Louisiana, Maine, Missouri, Nebraska, New Hampshire, New Mexico, Pennsylvania, Rhode Island, Texas, Virginia and Washington.

In California, the legislature has chosen not to jettison the previous statutory framework that had been adopted, originally as the Condominium Act, and then as the Davis-Stirling Common Interest Development Act. However, there may be certain provisions that will provide guidance to the California legislature when it considers modifying the Davis-Stirling Common Interest Development Act. Furthermore, case law in other parts of the country is often used as precedent for deciding common interest development cases in California. When reviewing these cases, one must understand that the statutory framework in the jurisdiction of each case may dictate a result that would be different in California, because California has a different underlying statutory framework.

The insurance applicable to conversion projects will be different than traditional cases and may include general liability insurance for the original construction and OCIP (Owner Controlled Insurance Program) for the conversion itself. Depending upon the timing and nature of the claims, obtaining the entire history of the insurance, contractors, contracts and enrollment information will be essential to handling these matters. In comparing the overlaps in insurance for the different phases of the project, there will also be different types of exclusions, self-insured retentions and deductibles which may apply and must also be determined. The timing of the contracts will also affect risk transfer components of the case including determining applicable indemnity provisions and contract requirements.

Here are a summary of key California cases which may be relevant to conversion cases:

- *Griffin Development Co. v. City of Oxnard* (1985) 39 Cal.3d 256 – conversion regulations are legitimate exercise of police power and constitutional.

- *Drake v. Martin* (1994) 30 Cal.App.4th 984 – subsequent purchasers do not have right to rescind based on developer's failure to comply with Subdivided Lands Act (former law)

- *Orange Grove Terrace Owners Association v. Bryant Properties* (1986) 176 Cal.App.3d 1217 – Association has standing to sue developer for damage to common areas caused by negligent acts of developer prior to formation of association.

- *Sandy v. Superior Court* (1988) – since action against converter was time barred, converter's cross claim against architect also barred.

- *Greenman v. Yuba Power Products* (1963) – manufacturer strictly liable and liable for breach of warranty if product defective and causes injury.

- *Kriegler v. Eichler Homes* (1969) – developer of home strictly liable for defective heating system.

- *Shapiro v. Hu* (1987) 188 Cal.App.3d 324 – vendor who sells property "as is" not liable for breach of contract for defect not observed prior to sale.

- *Raven's Cove Townhomes v. Knuppe Development* (1981) – HOA Board of Directors owes fiduciary duty to association and individually liable.

Overall, these cases involve a much deeper level of investigation and also greater complexity coordination, discovery and resolution efforts often conducted on a tiered level which can be best handled by grouping the original contractors, the conversion contractors and/or applicable repair contractors to reach a resolution of the entire action.