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A Primer on the Developer's Obligations to a New Association

By Matthew A. Drewes, Esq.

Unit owners and property managers face a lot of new responsibilities when the developer of a new association (also known as the "declarant") transfers control to the owners. Not the least of these new worries is accounting for and managing the financial condition of the association. To do this properly, it is important to start with at least a general understanding of the developer's financial obligations. This article briefly outlines those responsibilities, some common oversights by developers, and the association's rights when the developer leaves insufficient money behind.

Apples and Oranges: What Are We Supposed to Have?

Often people are unfamiliar with the way association funds are categorized, leading to much of the initial confusion. Understanding these concepts means the difference between comparing apples to apples, or apples to oranges. An association's funds break down into two primary components: (1) The operating funds, which are the vendor fees and other expenses that should be covered entirely by the regular monthly assessments; and (2) The reserve funds, which are required by statute to be set aside for the replacement of all components the association is obligated to replace (the components a given association is required to replace will depend on the type of association and should be identified in the association's declaration). The developer's responsibility to fund these two categories differs, and can also vary depending on the schedule the developer follows for the completion of construction and the date the association passes its first assessment. There are, however, some general rules that should be followed.

The developer generally "controls" the association (meaning the directors it selected will retain a majority of the seats on the board of directors) for a period of months and often years while it builds and sells units. When a sufficient percentage of units have sold, the developer is required to turn over this control to the homeowners. During the period of declarant control, however, the developer can use its control of the association's board to set the amount of the monthly assessments for operating expenses. The developer also decides, at least initially, how much money will be set aside each month for the buildup of the reserve fund.

A Bite out of the Apple: The Alternative Operating Assessment

The regular monthly assessments that are to be used to pay the operating expenses do not start until the association (as controlled by the developer) approves and passes the first assessment. The developer can thus decide when to begin monthly assessments, and can set the amount of the assessments at whatever level it wants. After that assessment, the Minnesota Common Interest Ownership Act, or "MCIOA," permits a developer to pay a 25% alternative assessment for each unit it owns that is not "substantially complete." The developer would have to reserve that right within the declaration.

Under MCIOA, "substantial completion" means the date on which a "certificate of occupancy" is issued. A savvy developer will therefore try to pass the first assessment as early as possible so homeowners start to pay a portion of the operating expenses, but it will also try to delay reaching "substantial completion" on unsold units, to take full advantage of the alternative assessment. Developers also sometimes

seek to take advantage of the language in MCIOA that states an assessment obligation does not begin until the unit is "created," leading to another factor that is subject to interpretation.

Paying only 25% of monthly assessments may seem like a boon for the developer, but it's not entirely that simple. First, a surprising number of people do not realize that prior to the passage of the initial assessment, the developer is required to pay all of the association's operating expenses. Also, there is a requirement that any shortfall in the operating budget of the association be covered by the developer within 60 days of the transfer of declarant control. The developer may pay less than individual owners in the short term, but if there are unpaid bills for things like lawn service and snow removal at the time declarant control is transferred, the developer has to cover the shortfall.

The Core of Association Longevity: The Reserves

The developer's alternative assessment right is also restricted to the operating portion of the assessment. The developer may not take a discount on the reserve funds due on the units it owns. Reserve funds need not be paid on a particular unit, however, until the unit itself or any building within the unit is "substantially complete." This again benefits a developer who stalls the final inspection to delay the issuance of a certificate of occupancy, and thereby delaying the date of "substantial completion" under MCIOA. Nevertheless, it is the developer who sets the first budget of the association and therefore it is the developer's responsibility to set a reasonable and adequate reserve assessment so there is enough money in place after 20 years to replace the association's roofs, for example. This obligation is intensified by the heightened duty owed by those members of an association's board of directors who are appointed by the declarant, under MCIOA.

The Seeds of a Dispute: How Money Troubles Start

A developer knows its units will be more appealing to buyers if assessments are low. It will also have an interest in minimizing any assessments it might have to pay while its units sit on the market, so initial assessments are frequently set lower than is practical for the long-term health of an association. It is also common for a developer to try to collect from the association for early operating expenses it incurred, or to fail to pay all the reserves it should. It is therefore important to ensure that all financial information has been provided to the association and that assessments are set at the proper levels to fund current and future expenses.

A shortfall in operating expenses should be relatively easy to spot, and MCIOA makes it clear the developer should pay the difference. Note that MCIOA provides that this determination should be made using an accrual method of accounting, so an expense incurred before the transfer of declarant control is still an obligation that the declarant needs to ensure is satisfied. The tougher call is when the developer has under-funded the reserves. This is not something that is likely to appear based upon a casual review of the association's budget or financial statements. A determination of the adequacy of an association's reserves requires the review and analysis of the life expectancy of the building materials used in areas that the association must later replace. A qualified reserve analyst, engineer, or contractor should be retained to perform this evaluation.

Righting the Apple Cart: Getting the Finances Back on Track

A good place to start at the time of turnover of declarant control is to hire an attorney and/or an accountant experienced in the area of community association law, to help walk the newly-elected homeowner board through the process. In addition to making sure adequate funds are on hand, there are numerous documents that the developer often fails to deliver to homeowners. Many of these documents, including financial statements, audits and building plans are critical for evaluating whether the association is starting off on the right financial foot. An attorney can assist in securing and interpreting these documents to get the association up and running as quickly and efficiently as possible. Establishing fast and effective collection procedures should be an early priority as well, whether that means pursuing the developer or individual unit owners.

All of the above steps should be undertaken as soon as possible, and there is much more to do. While a developer and/or its originally-appointed board of directors may be liable for insufficient reserves or missing funds, the association has a decreased chance for recovery if too much time passes before the oversight or omission is discovered. An association is much more likely to resolve these problems, through negotiations or in court, if they are caught sooner, rather than later. If you have even a basic grasp of the above concepts, you are much better off in approaching the daunting task of taking over control of your association from the developer.

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