



## Association Not Creditor of Declarant at Time of Illegal Transfer of Funds

*Luria v. Board of Directors of Westbriar Condominium Unit Owners Association*, No. 080515, Va. Supr. Ct., Feb. 27, 2009

**Developer Liability/Risks and Liabilities/Warranties:** The Virginia Supreme Court reversed a circuit court ruling that a developer breached his fiduciary duty to a condominium association as a creditor because of a failure to show that the developer had actual notice of structural defects.

Jon Luria is a real estate developer in northern Virginia. In 1996, he began construction of The Westbriar Condominium in Fairfax, Va., a four-building condominium that contained 244 units. Luria held title to the condominium property through two limited liability companies and a corporation that managed development of the property. Each of these entities served as declarants of the condominium project.

During construction of the project, Luria did not honor general and administrative costs as provided in agreements he made with lenders, and he made a series of improper transfers and draws of funds from the various declarant entities. He used an alternative to stucco or siding on the exterior of the buildings, Exterior Insulation and Finish System, and hired a reputable certified contractor to install it. Installation was certified after its completion in compliance with Fairfax County building regulations.

On June 8, 1999, the project architect, Christian Lessard, sent Luria a letter identifying 10 problems with construction discovered during his substantial completion walk-through, two of which related to the exterior finishing system. He suggested that a moisture meter be used to verify that there were no moisture problems behind the exterior surface. Subsequently, Lessard and Luria executed an indemnification agreement that provided that Luria would indemnify Lessard from any liability arising from Luria's failure to correct the problems enumerated in Lessard's letter.

In October 2000, Lessard provided Luria with a field report that itemized various problems with individual units. Three items related to the exterior finishing system. The report recommended flashing and caulking the system and suggested that Luria hire a "water proofing engineer" to verify all flashing applications.

In July 2002, control of the Westbriar Condominium Unit Owners Association passed to the unit owners. Afterward, the association hired an engineering firm to conduct a warranty inspection for the purpose of, "identifying structure defects," as defined by the Virginia Condominium Act ("Act"). The firm's report detailed several defects, and noted that the exterior finishing system was in poor condition. The estimated cost of repairs recommended in the report was \$3,730,000. By letter dated March 12, 2003, the association notified Luria of the defects within the scope of the statutory warranty. The association's engineering consultants conducted a follow-up inspection to specifically address the problems with the exterior finishing system and prepared a supplemental report. The supplemental report noted that the defects were "systematic and comprehensive" and recommended that the system be "completely removed and replaced."

In May, the association sued the declarants, Luria, and Ellen Luria and others, alleging that the defendants had constructed the buildings with major structural defects and that Luria used the declarant entities he controlled to fraudulently avoid obligations owed to the association as creditor.

The association's motion for judgment included six counts. Counts II, IV and VI were dismissed. The court entered judgments against the declarants (Count I) and Jon and Ellen Luria (Count VII, alter ego liability), concluding that they breached the Act's statutory warranty provision and assessed damages against them in the amount of \$5,813,416.

Count III of the association's motion alleged that by making improper transfers and distributions for his own benefit, Luria breached his fiduciary duty to the association as a creditor. Count V alleged that the improper transfers constituted illegal distributions by the declarants.

The court held a bench trial and issued an opinion letter awarding judgment against Luria on both counts, relying on *Marshall v. Fredericksburg Lumber Company*, 162 Va. 136, 173 S.E. 553 (1934). In *Marshall*, the Virginia Supreme Court found that "where there are existing creditors of a corporation, the stockholders will not be permitted, as against those creditors, to withdraw the assets of the corporation without consideration . . ." In its opinion, the trial court stated that Luria's conduct fell within the conduct contemplated and prohibited by the court in *Marshall*.

The court stated that the weight of the evidence showed that by virtue of information Luria received on-site and from his

experience in construction and development, he knew there were problems regarding installation of the exterior finishing system. In making its determination, the court stated that it relied upon Lessard's letter, the indemnification agreement and Lessard's field report.

Based on its determination that Luria was on notice of serious defects from the use and installation of the system, the court adopted the position that the association was a creditor of the declarants from the time when the first unit was sold in 1998. It further concluded that Luria's withdrawal of declarant assets constituted self-dealing and was a breach of the fiduciary duty he owed to the association as a creditor of the declarants. It ordered him to refund the sum of \$3,484,363.40. It used the same analysis in awarding the association identical relief against Luria under Count V for illegal distributions by the declarants. Luria appealed, and his appeal was granted only as to the issue of the duty owed to a potential statutory warranty claimant under Counts III and V.

In his appeal, Luria argued that the courts had never imposed upon the managing member of a limited liability company a fiduciary duty to a third part creditor. He also argued that the association was not a creditor of the declarants because he did not have actual notice of any potential statutory warranty claim. He contended that the circuit court erred as a matter of law in finding that the legal right to assert a claim in the future creates a fiduciary duty.

The association argued that the court properly imposed liability upon Luria, asserting that it was a creditor because Luria had knowledge of defects that would support a claim for breach of statutory warranty and that notice of a statutory warranty claim. In this case, it was not possible because the declarants controlled the association prior to the transfer of control to the unit owners.

The court considered that whether the association was a creditor was dispositive in resolving the appeal because its status triggered both the creation of fiduciary duty and liability under *Marshall*. The Virginia Supreme Court has held that potential tort claimants can be considered creditors if the punitive debtor has adequate notice of the claim. In this case, the circuit court failed to require a showing of actual notice of the structural defects to support its conclusion that the association was a creditor of the declarants in 1998. The "should have known" standard implicitly applied by the court was an erroneous legal standard. The circuit court erred in finding that the association, as a potential statutory warranty claimant, was a creditor of the declarants at the time transfers were made to the developer because the evidence did not show that the developer had actual notice of the units' structural defects. Accordingly, its judgment on Counts III and V was reversed.

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