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Update

REAL ESTATE/TRANSACTIONAL LAW

"LOUIE, I THINK THIS IS THE BEGINNING OF A BEAUTIFUL FRIENDSHIP": AVOIDING TRANSITION MISTAKES IN COMMUNITY ASSOCIATIONS

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Transition is, by definition, a movement or evolution from one form, stage, or style to another. In the condominium or community association context, transition describes the two-part process by which control of an association, together with responsibility for the common property, is transferred from a developer to the unit owners.

The first step in transition involves the unit owners assuming control of the association's governance (signified by occupying a "majority" of seats on the association's board), which allows the owners to make all decisions that up to that point were made by the developer. This "transfer" is governed by New Jersey's Condominium Act, N.J.S.A. 46:8B-1, New Jersey's Planned Real Estate Development Full Disclosure Act, N.J.S.A. 45:22A-21 ("PREDFDA"), or both, as well as the association's declaration/master deed and bylaws. The second step in transition involves the association assuming the responsibility for the common property. The goal here is to ensure, before the unit owners accept these obligations in perpetuity, that the developer improved and/or constructed the project correctly, properly managed the association and contributed funds in accordance with New Jersey law.

Transition can be both a complex and time consuming process, but it is perhaps the most important time in the formation of a community association. Understanding common problems that may arise between an association and its developer is half the battle to completing a successful transition and avoiding future litigation. And while no association or transition is the same, developers should be aware of several common transition mistakes.

1. "What we've got here is… failure to communicate."

Failing to communicate with the unit owners is quite possibly the biggest and most costly mistake a developer can make during the entire transition process. This is often the favorite complaint of unit owners – both before and after transition occurs – and for good reason. Communication is the key to addressing unit owner concerns, issues and misconceptions and educating the owners about the association's role and operations. Whether it is holding monthly meetings, distributing a newsletter, promptly responding to calls and requests for information, or meeting individually with unit owners to address problems, taking a proactive role can make the process go smoothly and, more importantly, save time and money over the course of the transition.

2. "These aren't the droids you are looking for…"

For our purposes, the old Jedi mind trick applies to the documents, plans and other information that must be provided to the association pursuant to both the Condominium Act and PREDFDA. At the outset of transition, communication with the new unit owner board and management regarding these documents is essential as the turnover of these contracts, budgets and financials, and insurance information will guide the initial operations of the association. Moreover, as transition progresses, it is imperative for the association to be provided with all of the plans, as-builts and specifications in order to engage an independent engineer to conduct a transition inspection. Again, all of these documents must, by law, be turned over to the association within sixty days from when the unit owners take control of the board. So, rather than creating an adversarial situation from the start, the developer should be proactive in the exchange of this important information.

3. "Greed, for lack of a better word, is good."

While this mantra may be true in some circumstances (at least according to Gordon Gekko), a developer must be vigilant in safeguarding the association's financial position and be aware of and document any and all contributions to the association in accordance with the Condominium Act and PREDFDA. This goes in the ounce of prevention category (along with turning over the relevant documents upon termination of developer control). It is important that the initial budget sets the association's common assessments at a level high enough to fund the association's maintenance and capital reserves. Equally as important is to conduct annual audits, keep a clear segregation of association funds, and to document payments, including reserves, for when the transition progresses. Otherwise, the developer is inviting financial claims by the association regarding expenditures and an accounting of assessments paid on unclosed units.

4. "I'm gonna make him an offer he can't refuse."

The developer should consider the option of early turnover of control of the association's board and common property to the unit owners prior to the statutorily mandated period (when seventy-five percent of the units have been sold), especially when a significant period of time has elapsed from the creation of the association. This is important for two reasons. First, it allows the unit owners to engage an independent engineer to inspect the completed portions of the common property, which would encourage the separation of construction defects from maintenance issues and help isolate responsibility for each problem. Second, it facilitates cooperation in resolving any construction issues at an early stage, rather than in a later adversarial situation, and allows the developer to look to subcontractors (if applicable) to remedy any defects while they are still on the job. While this "early transition" is not practical in all associations, it should be considered for larger or potentially problematic developments.

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"LOUIE, I THINK THIS IS THE BEGINNING OF A BEAUTIFUL FRIENDSHIP": AVOIDING TRANSITION MISTAKES IN COMMUNITY ASSOCIATIONS *(continued)*

5. "Send lawyers, guns and money."

Independent association counsel should be retained shortly after the first transition election (after twenty-five percent of the units have been conveyed). Involving independent counsel at this early stage will be beneficial and increase the comfort level of the unit owners as well as foster communication with the developer to facilitate and resolve any outstanding issues. Moreover, allowing the unit owner board members to select counsel knowledgeable in condominium and community association transition will maximize trust and confidence between the unit owners on the board and hopefully result in a lasting relationship throughout transition when the unit owners take over control of the board.

6. "Round up the usual suspects."

One of the most important decisions a developer will make is the engagement of a professional property management company. As with independent counsel, at this early stage it will be highly beneficial to bring in management who is well versed in transition to demonstrate that the developer controlled board functions independently from the developer. Again, this will increase the comfort level of the unit owners as well as foster communication with the developer to facilitate and resolve any outstanding issues. One final note regarding management companies that are a subsidiary of or closely affiliated with a developer; often due to the close corporate relationship, these firms are not an effective shield against liability, which may be imputed to the developer for the management company's improper discharge of duties.

7. "Toto, I've a feeling we're not in Kansas anymore."

For many unit owners who are appointed or elected to their boards, this may be the first time serving in such a capacity. Often times, this leads to being overwhelmed with transition issues and, like Dorothy, involves the sneaky suspicion that they might be in an unfamiliar place. Competent management and counsel should be able to allay a lot of these fears; however, it has also been common practice for associations to engage independent engineers and accountants to address transition-related issues. Specifically, these professionals will be inspecting the property and the books, essentially probing whether the association has any potential claims – either construction or financial – against the developer. As discussed above, the best course of action the developer can take is to cooperate with the unit owners and their professionals in providing any requested documents or information.

8. "Houston, we have a problem."

Aside from lack of communication, nothing can raise the ire of unit owners more than little things like failing to address punch list items or not properly maintaining or landscaping the common property. Not only do these relatively minor issues annoy the unit owners, but they also affect the ever-important "curb appeal" of the new community. Punch lists are effective ways to identify issues that need to be addressed, but developers should be wary of endorsing punch lists (especially with respect to individual units), which may be a deterrent to a successful transition negotiation. With respect to landscaping, these issues consistently come up during association meetings as evidence that a developer is not responsive or does not attend to the community's concerns. Again, in the ounce of prevention category, addressing these issues early in transition will prove beneficial throughout the process.

9. "If you build it, he will come."

It is imperative that from the first closing through transition, the developer maintain and enforce the exterior and architectural standards set forth in the association's governing documents. This issue arises in almost all condominium and community associations at some point during transition, many times when a unit owner alters a fence, patio or (shudder to think) decides to paint his front door pink. The unit owner (invariably) fails to submit an exterior change application and/or seek approval from the board or the architectural standards committee. While competent management will often resolve many of these issues before they become major problems, the developer should pay close attention to enforcing the association's covenants and restrictions while in control of the board.

10. "Surely you can't be serious!" "I am serious… and don't call me Shirley."

You mean that the municipality is required to pay an association for lighting, and trash and snow removal? With some caveats, yes. As all developers know, but often fail to pass on to the unit owners once transition occurs, the Municipal Services Act, N.J.S.A. 40:67-23.2, provides that a municipality must either provide to an association certain services or reimburse the cost of those services, including snow removal, collection of trash or recyclables, and the lighting of roads.

Moreover, municipalities may, as part of a properly adopted development agreement, delegate to a developer the obligation to provide or pay for the municipal services until such time as the developer's control of the board is turned over to the unit owners. So why not let the association know that they are entitled to these services and/or reimbursements? The sooner the association is turned over to the unit owners, the sooner the developer will be relieved of this expense. And again, communication and a knowledgeable property manager will ease this aspect of transition and, by alerting the unit owners of this law and assisting with the necessary information to facilitate the municipality providing either services or reimbursement, another common transition mistake can be avoided.

"Louie, I think this is the beginning of a beautiful friendship."

Transition by nature lends itself to becoming an adversarial process if the developer allows it to be. While knowledge of these common problems discussed above will not guarantee a smooth transition, by being aware of and properly addressing these common pitfalls early in the process, a developer may be able to prevent transition from becoming a nightmare.

For more information concerning transitions in Community Associations or other Community Association concerns, please contact Jonathan H. Katz, Esq. at 609.989.5036 or jkatz@sternslaw.com.

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