From Developer to Owners

A 13 Point Plan for Successful Transition

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As construction and home ownership continue to be a growth industry in New Jersey, one issue that will be faced by more and more HOA members is the transfer of power from community developers and sponsors to the new homeowners who will actually be living in the community. Though not everyone reading this article will agree with everything in it—or even anything in it—few would disagree that the power transfer is not always an easy or entirely transparent process. It can, however, be made much easier if both the outgoing developers and incoming new board members observe the following helpful points:

Point One

It's best to transfer common property before control of the board passes to unit owners in large or slow selling projects. It's a mistake for both the developer and the unit owners to postpone the transfer and/or acceptance of the common property by the association until after 75 percent of the units have been sold and the unit owners assume control of the governing board. This is especially true when there is a significant time lapse due to either the size of the project or the slow rate of sales. Under those circumstances, I would much rather see a sponsor-controlled board permit the minority unit owners to select an independent engineer—at the expense of the association—to inspect the completed portions of the common property and to negotiate the extent of the remedial work with the sponsor. That work should be subject to an express written agreement that there is no waiver of any legal rights by either the association or the sponsor pending turnover of control of the board to the unit owners.

Although this approach may not be feasible in every circumstance, it encourages the separation of construction defects from maintenance problems and helps to isolate the responsibility for each type of problem. It also eases problems of proof for both sides, should formal proceedings ultimately be instituted. The approach encourages cooperative rather than adversarial solutions with respect to any physical problems that may exist, but most importantly, it allows the developer to look to its subcontractors to remedy defects while they are still on the job, and while monies have been retained under their contracts. Some developers of large projects have included similar "early transition" provisions in their governing documents—and the current version of New Jersey's Uniform Common Interest Ownership Act (UCIOA) also includes a mechanism for transition.

Point Two

Independent association counsel should be appointed shortly after the first transition election when 25 percent of the units have been conveyed. It is usually beneficial to both the developer and the unit owners to appoint independent counsel at this point, especially where the transition period is expected to be an extended one.

The presence of independent counsel should significantly increase the comfort level of the new unit owner-board members and help build communication between them and the sponsor. Selection of the independent counsel should be done by the unit owner board members to maximize trust and confidence between the unit owners and the attorney, which will hopefully result in a continuing, positive relationship throughout transition and afterward, when the unit owners take over full control of the board.

Point Three

Active, involved managing agents can be very helpful in achieving a successful transition. Managing agents can play an extremely constructive role in transition by giving the unit owner board members some perspective on the dynamics of transition, the importance of communications, and the pitfalls of litigation.

A newly-formed HOA would do well to avoid a manager with a passive approach, or who is not concerned beyond the politics of what is best for him- or herself when contract renewal time rolls around. It's not unheard of for managing agents to refer professionals to an association whose primary qualification is that they refer business back to the manager, rather than actually being the best qualified for the job. Issues like this more often than not wind up costing the newly-transitioned HOA money in the long run, and can create a host of unnecessary problems.

Point Four

Remember that engineering inspection reports are not intended for litigation purposes. The primary purpose of an engineering report commissioned by an association at the outset of transition is for the board to obtain professional assurance that the physical condition of the property is satisfactory, and to identify deficiencies that need to be addressed. The report's other main objective is to discharge the board's fiduciary duty to ascertain the physical condition of the property before it is accepted for maintenance—not to serve as a springboard for litigation or settlement negotiation against the developer.

Given this perspective, a clean report by a qualified engineer is the best result for both sides. Naturally, where there are construction problems, these reports should serve as a vehicle for promoting constructive dialogue with the developer regarding what remedial work may be appropriate or necessary.

Point Five

Canned engineering reports may do more harm than good in transition negotiations. Canned engineering reports, as well as overly judgmental ones, tend to raise questions about their technical credibility. The other side will address a more factual, individually tailored report more seriously—which is better for both sides of the transition equation.

It's also important to separate maintenance problems from construction problems. To homogenize them in the same report can foster the notion that most of the problems are maintenance-related, and therefore not the responsibility of the developer—which is clearly not always the case.

Also, the engineering report should not contain either patently unreasonable or peripheral items that could hang both parties up on detail and detract from the importance of the significant ones, negatively impacting the entire report's credibility. Try to cull out these items before submitting a report to the other side, and focus on the important items. The others usually disappear anyway—if and when the primary issues are resolved.

Point Six

Don't be too quick to give a formal engineering report to the other side. Engineering reports can be trouble for either side if they are not judiciously prepared and reviewed by counsel before being finalized. Nothing can destroy the credibility of a report more completely than obvious mistakes caused by carelessness, boilerplate document construction, stretching of the facts, or inadequate homework.

In addition, an overly candid report or one that says too much can prejudice one's client, even in the absence of litigation. Consider having the engineers

for each side prepare summary reports covering the major defects, although notes can be made and maintained by the engineers themselves. The summary report can be used as a basis for initial discussions to see if a basic agreement can be reached on the major issues between the clients and their technical consultants. Otherwise, too many details may stand in the way of reaching agreement on the important issues.

Point Seven

Experience in both the HOA transition process and in court is an absolute must when choosing a law firm and other professionals to help your board navigate the power transfer. In choosing a professional consultant in connection with a transition negotiation, it's important to obtain assurance from your attorney that the consultant's report and individual testimony will stand up in court. An experienced adversary will know—or will quickly learn—about the weaknesses of each, and will exploit them during the settlement negotiations and the time of trial.

Be on guard against being penny-wise and pound-foolish in this area—it's far less expensive to do your homework and hire the right person for the job than it is to have to hire a second professional if the first turns out to be inadequate. (Not to mention the prejudice that may have occurred to your case as a result of the wrong initial choice.)

Point Eight

Informal communications between professional consultants can be effective and economical. Consider having the engineers and the accountants for both sides talk to each other early in the transition process. If they are professional in their approach, it should enhance communications, eliminate spurious claims and minimize professional fees for both sides.

Attorneys tend to be adversarial by nature, and therefore communications through attorneys do not necessarily promote constructive dialog. It is a good idea however, to have a written understanding between the attorneys as to the ground rules and the fact that none of the discussions between the other professionals can be utilized in subsequent litigation.

Point Nine

Punch lists from unit owners can impede successful transition negotiations. The compilation of a unit owner punch list can be a deterrent to a successful transition negotiation—especially with respect to individual units. Punch lists unduly raise the expectation level of the individual unit owners and make it more politically difficult for the governing board to reach a fair and reasonable settlement with the developer.

Furthermore, an HOA may not be empowered to settle unit claims, and the unit owners should not be led to believe otherwise when it is clear that any knowledgeable developer will reject unit claims that are not pervasive as a matter of course. As for an alternative to a punch list, a questionnaire prepared by the engineer related to specific physical aspects of the common elements may be a useful tool in helping the engineer identify any construction problems that may exist. Care should be exercised to make certain that its purpose is not misunderstood.

Point Ten

The process of transition differs substantially between conversion projects and new construction projects. One significant difference has to do with the sponsor's obligations as to the common property. In the case of conversion, the sponsor's warranties are relatively limited, and generally the property is sold in an "as is" condition. In addition, deficiencies in the engineering report required for conversions do not necessarily give rise to a claim by the sssociation, as the Planned Real Estate Development Full Disclosure Act (PREFDA) expressly limits the standing to assert damage remedies to purchasers who have placed reliance upon the disclosure information.

In new construction, there are warranties that run not only to the original purchasers—as in the case of conversions—but also to the association under the Homeowner's Warranty Act and related warranty plans, as well as those required by the Department of Community Affairs in connection with PREDFDA registration.

Point Eleven

Don't sue developers personally or indiscriminately. The combative instincts of some attorneys tend to encourage the inclusion of principals and/or the directors and officers of the developers as defendants in community association litigation, even when their potential liability appears to be highly speculative or even nonexistent. Suing developers personally should never be a reflex action, because nothing can make a developer stonewall an association quicker than to name him as an individual defendant. If there is either the hope or potential for future settlement dialogue, the potential for that settlement may be diminished significantly—if not extinguished altogether—by a personal attack. Instead, the association may be faced with the aggravation and expense of years of litigation.

Point Twelve

Community Association insurance is unique, and changes to policy should be approached cautiously. Automatically changing insurance agents or carriers once control of the board rests with the unit owners is not necessarily appropriate, although a review of insurance coverage is encouraged. The review of coverage, rates and quality of service should be a periodic and ongoing process—especially in an uncertain marketplace. Insurance should not be treated as political patronage, especially if the existing agent is knowledgeable and provides good service.

Point Thirteen

Consider enlisting the aid of the Department of Community Affairs (DCA) in the transition process if there are substantial problems and the developer is unresponsive or negligent. The DCA is playing an ever-increasing role in the enforcement process, and can sometimes be helpful to an association when sales are still going on by requiring the developer to meet his obligations under the development's Public Offering Statement or the transition provisions of the Condominium Act or PREDFDA regulations. The Department is especially responsive to delinquencies by sponsors in their common expense payments or reserves, as well as construction defects which have the potential to seriously threaten the health, safety or welfare of the unit owners. That said, the DCA's involvement should never be assumed to be automatic, and their response has a lot to do with the nature of the complaint.

In conclusion, I have attempted to raise a number of issues that concern me about the developer-to-owners transition process in New Jersey's new developments and HOAs. Different professionals will naturally have differing opinions on the most important aspects of the process, and may feel that this list is redundant—or incomplete. What I hope to do is to provoke some thoughts about the transition process that could be vitally important to future transitions, as well as to our community associations in general. ■

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