

Real Estate Title Insurance & Construction Law

Representing HOAs and Condominiums in Transition During A Challenging and Difficult Time

Must be respected and handled with care

By David J. Byrne

Transition is a word that carries with it great significance. It describes the process by which control, together with responsibility for that communities' common elements and/or facilities, is transferred from a developer to owners. There are considered two parts of transition: (a) transition of control; and, (b) transition of responsibility. Transition of control involves the gradual process by which owners of lots, homes, interests, etc., assume control over the association's governance. Once owners assume control, the owners have the power to make all decisions that up to that point had been made by the association, albeit controlled by the developer. This 'transfer' is governed by both New Jersey's Condominium Act, N.J.S.A. 46:8B-1 et seq. (the "Act"), and New Jersey's Planned Real Estate Development Full

Disclosure Act, N.J.S.A. 45:22A-21 et seq. ("PREDFDA"), together with the contents of the particular association's declaration, master deed and/or bylaws. The act applies only to condominiums, while PREDFDA applies to almost all residential community associations, including condominiums.

Transition of responsibility involves the process by which the association assumes maintenance, repair and/or other responsibilities over the common elements and/or property, and by which it is determined whether the developer paid assessments and other funds to that association with respect to unsold units, in development, in accordance with PREDFDA. The goal here is to ensure, before the owners assume these obligations into perpetuity, that the developer improved and/or constructed the project correctly, and contributed funds in accordance with New Jersey law. The association engages independent consultants, including architects, engineers and accountants to aid it in these determinations. The transition process is complex, involved and time consuming,

but is perhaps the most important time in the history of a community association. Aside from the act and PREDFDA, it may involve New Jersey's Municipal Land Use Law and New Jersey's New Home Warranty and Builders' Registration Act, N.J.S.A. 46:3B-1 et seq. ("HOW"). The onset of a troubled real estate market and challenging economy has forced associations and their counsel to be focused on a developer's financial duties, as well as on divided loyalties and the value of early transitions.

Developer's Financial Obligations

In just the past few years, several large, well-known developers have filed for bankruptcy. While a community association's rights and obligations vis-a-vis any such bankruptcy are worthy of a separate article, two concepts can be addressed briefly. First, there is no doubt that a developer must contribute financially to an association during the development period. See, N.J.A.C. 5:26-8.6. While there are varying interpretations of this PREDFDA regulation, and of the formula it purports to create, it sets forth the unquestionable obligation to fund, at least to some extent. Once the association makes a "common expense assessment, that assessment shall be assessed against the units individually owned and under development in proportion to the benefit derived by the unit from the items included in the budget." This is known in the industry as a developer's "benefits

Byrne is a Shareholder & Co-Chair of the Community Association Group of Stark & Stark in Lawrenceville.

derived" obligation. These amounts are assessments, and if unpaid by financially troubled developers, should be collected just as any other unpaid assessments. Importantly, though, in New Jersey, these amounts constitute "secured" debt, and thus are more easily recovered in any developer bankruptcy, once they are included in a recorded assessment lien. *See*, with respect to condominiums, N.J.S.A. 46:8B-17. To truly protect an association from the consequences of a developer bankruptcy, counsel should advise that association to ensure developer units owned and under development are assessed, that payment of same is demanded and that any unpaid assessments be "secured" via a recorded lien.

Developer's Fiduciary Duty

At the inception of an association, it is only individuals appointed by that association's developer that serve on that association's board of trustees. As homes and/or units sell, control of the association is gradually transferred. While using slightly different language, both the act and PREDFDA dictate the terms of the transfer.

Both the act and PREDFDA, however, empower the developer to retain one seat on that board so long as "there are any units remaining unsold in the regular course of business." While developers and their appointed board members rightfully focus on the economic realities, such as the need to finish homes and/or units and sell and close them, they must also ensure their appointed members of the board meet their fiduciary duties to the association and its members. While employees of developers, appointed to the board, may have a fiduciary duty to those developers, they also have such a duty to the association and its members. Further, members of an association board must "discharge their duties in good faith and with that degree of diligence, care and skill which ordinary prudent persons would exercise under similar circumstances in like positions." N.J.S.A. 15A:6-14. PREDFDA demands that an association "exercise its powers and discharge its functions in a manner that protects and furthers the health, safety and general welfare of the" association's residents. A condominium is charged with the maintenance of the common elements and the "assessment and collection of funds

for common expenses and the payment thereof," along with various other duties. N.J.S.A. 46:8B-14. Members of an association's board "appointed by the developer shall be liable as fiduciaries to the owners for their acts or omissions."

An association and its board owe a duty to its members. "The Association's Board of Directors has a fiduciary obligation to its members similar to that of a corporate board to its shareholders." *Kim v. Flagship Condominium Owners Ass'n*, 327 N.J. Super. 544, 550 (App. Div. 2000). The overriding framework of the Act and PREDFDA require an association to act as a fiduciary and make decisions "for the protection of the whole [condominium] and each of the constituent owners." *Billig v. Buckingham Towers Condo.*, 287 N.J. Super. 551, 563 (App. Div. 1996). This existence of fiduciary duty carries the possibility of suits for damages allegedly arising from breaches of such duty. *Glen, Sec. 1 Condo. Ass'n. v. June*, 344 N.J. Super. 371, 380 (App. Div. 2001). The New Jersey Supreme Court has specifically held that breaches involving the enforcement of bylaws and rules and regulations are considered under the umbrella fiduciary duty of the association's board. *Thanasoulis v. Winston Towers 200 Ass'n*, 110 N.J. 650, (1988); and *Papalexou v. Tower West Condominium*, 167 N.J. Super. 516 (Ch. Div. 1979).

The dual duties and divided loyalties carried by developer-appointed board members sometimes manifest themselves in conflicts of interest. For instance, and just one example, when faced with a financially troubled developer that fails to pay assessments as required by N.J.A.C. 5:26-8.6(b), a board whether that developer controls, or just maintains one (1) seat on that board, has a duty to demand payment and record liens against the developer's unsold units. In such an instance, a developer-appointed board member is faced with violating his duty to the association by failing to secure a debt in the face of a possible bankruptcy, or violating his duty to his employer, the developer, by outright acting to encumber that employer's real property with a lien. New Jersey's Non-Profit Corporations Act, N.J.S.A. 15A:1-1 et seq., provides guidance to developer-appointed trustees in the face of conflicts and divided loyalties. See N.J.S.A. 15A:6-8a.

Further, PREDFDA affords to devel-

opers the ability to minimize their liability arising from the serious and burdensome fiduciary duty they maintain while controlling and/or serving on the board. A developer can "surrender control" prior to the time set forth, so long as the "owners agree by a majority vote to assume control." N.J.S.A. 45:22A-47b. Developers and their counsel should also note that even aside from doing an early transition, the retention of the final seat while units and/or homes are being sold, but after 75 percent have been sold, is voluntary. Conflicts faced by developers as they control and serve on the boards of the associations they create are only exacerbated during challenging economic times, as homes and/or units sell more slowly and control of the board, and the developer's financial obligations, linger and linger on.

Built into both the act and PREDFDA are limitations on the powers of an association, freed from developer control, but in which unsold homes and/or lots remain. These limitations should provide some comfort to developers that seek to minimize liability by either seeking an early transition, or not electing to retain a seat on the board while its last homes and/or units are sold. PREDFDA provides that an association when "controlled by the owners shall not take any action that would be detrimental to the sale of units by the developer, and shall continue the same level of maintenance, operation and services as immediately prior to their assumption of control, until the last unit is sold." The act is even more specific, by prohibiting the following actions unless approved "in writing by the developer": (1) Assessment of the developer as a unit owner for capital improvements" and/or "(2) Any action by the association that would be detrimental to the sales of units by the developer." N.J.S.A. 46:8B-12.1c. Trial courts asked to relate the "veto" provisions of both the act and PREDFDA have, however, ruled that the "veto" rights, in relation to a condominium, set forth in the Act constitute the "ceiling" of developer rights following transition.

In the end, these challenging and difficult times in the real estate market and the economy overall must be respected and handled with care by associations and legal counsel. If handled correctly, efficiently and assertively, these times can also be an opportunity. ■