Passing the Torch from the Developer to the Homeowners:

The Transition of Association Control without Litigation

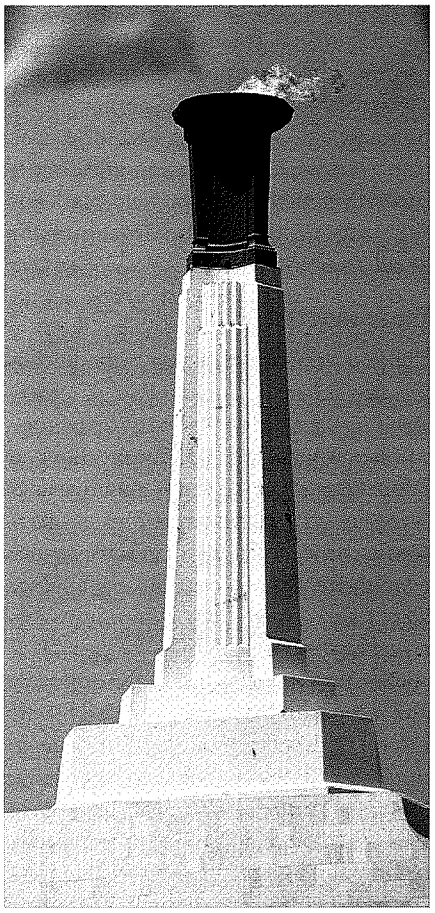
By Jo Anne P. Stubblefield

With a solid understanding of the nature of the homeowners' association and the transition process, developers can avoid litigation.

Gone are the days when the typical developer/builder created small subdivisions of single-family homes with public streets and no amenities. Today's consumers demand landscaped entranceways, open space, parks, playgrounds, and other recreational amenities— "lifestyle" communities that define who they are or who they want to be. Homeowners want to be assured that their neighbors share similar values and a common interest in maintaining the community as a desirable place to live. They are concerned about "the neighborhood" and protecting property values. They want programs and activities that bring neighbors together and create a true "sense of community."

Developers have responded to these consumer demands by developing "highly amenitized" communities with a wide variety of common areas and facilities. They impose protective covenants and restrictions on the lots to control architectural design and use and to make certain that homes and lots are maintained in a neat and attractive condition. They create lien rights to ensure that each owner pays a fair share of the cost of maintaining and operating the common facilities and enforcing the covenants.

The key to making it all work is the creation of an entity—a condominium or homeowners' association—that owns and maintains the common areas when the community is sold out and administers and enforces the covenants after the developer/builder exits from the project. But with new entities come a new source of litigation. Added to the traditional lawsuits between homeowners and builders over defects in home construction are new lawsuits



brought by homeowners' associations that challenge developers over everything from defects in common areas to mismanagement of the association.

Developers increasingly find themselves caught between a rock and a hard place. They recognize the need to create a homeowners' association that will administer the product they are selling, yet they fear that they are creating a monster that will one day attempt to devour them. The more complex the product, the greater is the risk that buyers' expectations will remain unfulfilled, thereby increasing the opportunities for dispute. At no time are such disputes more likely to arise than when the devel-

oper prepares to turn over control of the association to the homeowners and the homeowners begin to understand their newly inherited responsibilities.

Is litigation between the developer and the homeowners' association inevitable? While it may seem that way to a developer in the final stages of the transition process, it need not be the case. With a solid understanding of the nature of the homeowners' association and the transition process, careful design and implementation of the development plan, and the proper attitude, the developer can avoid litigation.

The Association

The first step in recognizing and minimizing the potential for conflict is understanding the nature of the beast that the developer is creating. A condominium or homeowners' association is a unique entity. Although typically organized as a nonprofit corporation, its character derives from the recorded covenants that apply to all of the property in the community governed by the covenants.

The covenants establish the authority and responsibilities of the association with respect to the community and the property owners. Typically, they create and define two roles for the association. The first is a *business* role arising from the responsibility for maintaining and operating the community's common areas and facilities and providing services to owners and their property. The second is a *governmental* role arising from the authority to levy assessments to fund common expenses, the power to regulate use, conduct, and activities within the community, and the power to enforce the covenants and regulations that govern the community.

The covenants "run with the title" to the property in the community; in other words, they are binding on all present and future owners of such property whether or not the owners consent to be bound. Each property owner automatically becomes a member of the association upon taking title to property in the community and must remain a member as long as he or she owns such property. The covenants make no provision for "opting out" or resigning such membership should the owner become displeased. The only way for an owner to terminate his or her membership—and the obligations that go with it—is by transferring the property to a new owner, who then automatically becomes a member of the association and assumes the privileges and obligations of membership.

It is important to understand that transition is not a single event but rather a systematic means of transferring control of the association.

The association is administered by a board of directors that generally has the authority to exercise all of the powers of the association except in limited areas where the governing documents specifically require a membership vote. The board's authority is constrained by the fiduciary duties owed by each director to the members: a duty of undivided loyalty, a duty to avoid self-dealing and conflicts of interest, and a duty to exercise the care of an ordinarily prudent person in like circumstances, which requires that the director be informed and exercise diligence and care. These duties are interwoven with and influence many a conflict between developers and homeowners as the transition process unfolds.

The Transition Process

It is important to understand that transition is not a single event but rather a systematic means of transferring control of the association. The process begins when the first lot or home is sold and continues throughout the period of development and sale. Depending on the size of the community and market demand, the process may take months or years.

The recorded covenants and the association's organizational documents (i.e., its articles of incorporation and bylaws) typically reserve to the developer the right to appoint a majority of the directors on the association's board until a substantial percentage—often 75 percent or more—of the total lots or homes planned for the community have been sold. At that time, control of the board passes to the property owners, who are then entitled to elect a majority or all of the directors.

In communities where it may take several years to develop and sell all of the lots or homes (and in some states where dictated by statute), it is common to "phase in" owner participation on the board of directors, allowing the owners to elect an increasing number of directors (but less than a majority) as development and sales progress. At a designated time, control passes to the owners, after which they may be entitled to elect a majority or all of the directors, with the developer often retaining the right to appoint a minority of the directors until it has sold its remaining inventory of lots or homes in the community. This type of "phased transition" facilitates the process of identifying and training future leaders to take over when control passes fully to the owners.

During the period of developer control, the developer typically assumes a paternalistic role to ensure that the community develops and operates in accordance with the development plan. Homeowners, particularly when new to the community, are often more than willing to accept the developer in its paternalistic role; in fact, they often grow accustomed to the benefits of paternalism. However, the longer they have to wait to assume control, the greater the chance that they will behave like unruly teenagers, demanding independence and control while continuing to expect the financial support and benefits of living under their parents' roof.

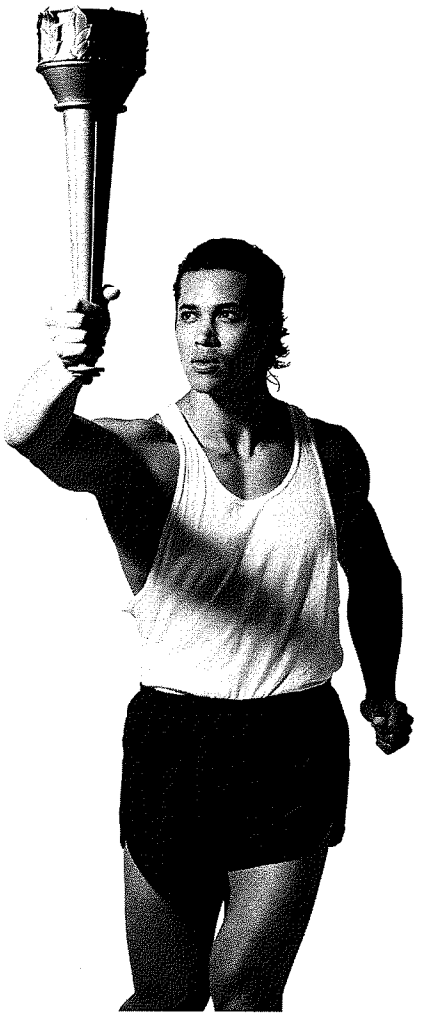
Just as the quality of a parent-teenager relationship depends on the ground-

work laid during the childhood years, the quality of the developer's relationship with the homeowners depends on the manner in which the developer educates, trains, and earns the respect of the homeowners during the transition process. The developer cannot prepare the homeowners to assume association responsibilities unless it is willing to involve them in the process. The owners need to be given standards and see them enforced. They need to know that there are limits to what the developer can and should be expected to do. Perhaps most important, they need an opportunity to learn by participating before they have to assume complete responsibility.

Passing the Torch

The time for the developer to step down and turn over control of the association to the owners is set forth in the governing documents of the community and, in some cases, is dictated by state law. Typically, it is triggered by either the sale of a stated percentage of the homes or lots planned for the community or a specified date, whichever occurs first. The developer may also have the right to turn over control earlier than otherwise required, and there are many reasons why it may wish to do so. Sooner or later, one of these events will occur, and the right to control will *automatically* pass from the developer to the owners.

The developer can help the homeowners prepare for the transition by ensuring that the developer-controlled board of directors nominates and elects homeowner representatives to serve on the board of directors several months before the developer's control is scheduled to terminate. This arrangement will give the individuals who eventually serve as the new board an opportunity to attend board meetings, familiarize themselves with operations, and work with the existing board to guarantee a smooth transition of the association's business and financial matters. The developer should also make certain that the association's books and records are complete, in order, and



ready to turn over to the new board on the turnover date.

The board or the homeowners may wish to request the appointment of a transition committee to assist in the final stages of the transition process; such a request is optional unless required by the documents. If appointed, the transition committee should include representatives of the developer, the owners, and the association manager to facilitate the flow of information, provide balance, and ensure credibility. The role of the committee should be clearly defined, and it should be understood that the committee has only such authority as the board delegates to it. Its responsibilities might include arranging for a financial audit of the association's books and a legal audit of the governing documents, contracts, and operations; an insurance review; a physical and structural evaluation of the common area facilities and improvements; and a personnel and human resources evaluation.

A transition committee should not be appointed too early in the process because it will have little to do until the last several months. The longer committee members sit and think about their role, the greater is their tendency to feel the need to justify their existence. Moreover, they often fall prey to a power and greed syndrome and make unreasonable demands on the developer as they seek to fend off charges that they are doing nothing. In addition, the opportunity for divisiveness, disagreement, and turnover among committee members grows with each passing day.

Unfortunately, many homeowners view the turnover date as a deadline by which all claims and potential claims against the developer must be identified, raised, and resolved—as if the owners had the ability either to refuse to accept control or to postpone or delay the turnover in order to "punish" the developer. Likewise, many developers think it is appropriate, if not standard practice, to demand that homeowners release all claims and potential claims they may have against the developer as of the turnover date—as if the developer had the ability to refuse to turn over control until such a release is delivered. These misconceptions have unnecessarily given rise to many hostile transitions.

It is understandable that homeowners are eager to raise their claims and see them resolved while the developer is still actively involved in the community. Even though the statute of limitations for filing claims against the developer may not have expired, owners fear that the developer will dissolve or disappear upon the sale of its remaining inventory. One way to reduce homeowner concerns is to establish trigger events or dates that fall well before the developer has sold out, thereby fostering the assumption that the developer will be around for whatever period is necessary to complete the development and sale of its remaining inventory.

Homeowners' anxieties can be further allayed if they understand that the deadline

under the applicable statutes of limitations for filing any claims of the association against the developer is independent of the turnover date, except in those jurisdictions where the statute of limitations dates from when the homeowners assume control of the board. Those jurisdictions recognize that a developer-controlled board has a conflict of interest that may make it unwilling to seek out or reveal information or file a claim against the developer. Thus, some jurisdictions establish a deadline after the turnover date to give homeowners ample opportunity after they assume control of the board to discover the facts giving rise to the claim and to file suit on behalf of the association if appropriate.

Assuming that the statute of limitations is not about to expire and the developer is not likely to disappear any time soon, the homeowners would generally be better off to wait until they gain control of the association to undertake any investigation they feel is needed. At that point, the board will have the resources and assessment power of the association at its disposal and will be able to act on behalf of the association, rather than as just a group of concerned homeowners, to raise, negotiate, settle, or otherwise resolve any claims the association may have against the developer.

From the developer's perspective, demanding or requesting a release before the turnover date may seem prudent. However, the developer who makes such a request is more than likely asking for trouble. When asked to sign a legal document releasing their rights, a perfectly content group of homeowners will inevitably become suspicious of the developer, hire an attorney to advise them, and begin forming ad hoc committees to look under every rock in the community for possible claims, eventually presenting the developer with a list of demands that they want met before they sign anything.

The list of demands is likely to include any number of items that are totally unexpected, irrational, and irresolvable, along with numerous "nuisance" items thrown in to provide for negotiating room. A fairly congenial relationship can quickly deteriorate into hostilities as each side becomes entrenched in its position. The developer eventually realizes that the developer-appointed board has a conflict of interest that would likely invalidate any release it might authorize on behalf of the association. Furthermore, there is no way the developer will obtain releases from all of the homeowners even after satisfying all the listed demands; thus, the developer remains open to lawsuits brought by those who refuse to sign the release. Accordingly, the developer refuses to address any of the demands while the homeowners, now stirred up like a next of hornets, file suit.

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Minimizing the Risk of Litigation

There is much that the developer can do to minimize the risk of litigation. The first step is to understand the source of the problems. The developer must then incorporate and consistently apply risk management techniques to project planning and implementation.

Association claims tend to fall into three primary areas. Representations made by the sales and marketing staff orally and in advertising materials, brochures, property reports, newsletters, zoning documents, and plats are often the source of expectations that, when unfulfilled, give rise to claims against the developer. Buyers often perceive unrealized expectations as defective construction and add them to claims of actual defects in construction. Perhaps the greatest number of claims tend to be related to association operations, including financial issues arising out of budgeting, assessments, and reserve funding as well as allegations of breach of duty to maintain, insure, or take appropriate enforcement action. Another major group of claims relates to amenity ownership, operation, and disposition, including everything from what is to be provided and who is entitled to use it to issues of maintenance, operation, and the rights of the association to own or acquire it.

In seeking to minimize the risk of claims, developers find that there is no substitute for well-drafted documentation and warranties that are clear, concise, and understandable by a layperson. Selective but thorough and consistent use of disclosures and disclaimers in written documentation, marketing materials, and displays helps limit opportunities for misrepresentation and misunderstanding while conveying candor and building trust and confidence among buyers. Document provisions should clearly and conspicuously reserve to the developer rights of access to inspect and correct as well as rights to modify the development plan. The documents should be unambiguous in discussing the developer's other rights and obligations as well.

The developer should also adopt a program of education and ongoing training of its sales and marketing staff, managers, employees, and agents at all levels to ensure that they are well versed in the development plan and the commitments the developer is and is not willing to make. Sales staff should be trained to market at the product level and to avoid overselling. Those responsible for management of the association should be thoroughly familiar with the duties and constraints imposed by the governing documents and trained to conduct themselves accordingly.

Active supervision and quality control measures are critically important to managing risk. They go hand in hand with customer service; when problems are discovered or complaints lodged, responsiveness is the key to building respect, loyalty, and a satisfied customer base.

The importance of managing the association business in a businesslike manner cannot be overemphasized. Developers must

recognize the association as a separate entity and manage it as such, keeping full and accurate books and records. The books must report monies received and expenditures made by or on behalf of the association. The records should include minutes of board and membership meetings that accurately and completely reflect actions taken, decisions made, and the basis for each.

There is probably no better way to minimize the developer's risk of a suit over mismanagement of the association or breach of duty than to involve homeowners in the decision-making process through participation on committees and the board of directors. Not only does the presence of homeowners force the developer to run the association by the book, but homeowners are also much less likely to be suspicious or critical of decisions or actions in which they or their representatives have had a hand.

Resolving Disputes When They Arise

When disputes arise between the developer and homeowners, too often they quickly deteriorate into a lawsuit. The tendency to rush to court results in part from fear, in part from both sides' lack of understanding of the cost of litigation, and, unfortunately, in part from litigation attorneys who tend to be more interested in litigating than in resolving the dispute. If the matter is to be resolved without litigation, both sides need to understand and overcome these influences.

Association boards often operate under the misconception that they have a duty to sue and that they may be held personally liable to members for breach of duty if they do not sue. In fact, the courts have held that there is no duty to sue. Under the "business judgment rule," the courts generally do not attempt to second guess or interfere in a board's decision-making process so long as

- the actions of the board fall within the scope of the powers granted to it under the governing documents and are rationally related to the purposes for which it was formed; and
- the directors are informed, act in good faith, disclose potential conflicts, avoid self-dealing, and act in a manner that they rationally believe to be in the best interest of the association.

If litigation is to be avoided, developers must understand that the successful transition of an association from developer to owner control requires both sides to work together as partners in the process.

In making a decision to sue or not sue, the board—according to the business judgment rule—is authorized to exercise its judgment in evaluating a potential claim, the likelihood of prevailing, and the cost to cure versus the cost of recovery, among other things. Furthermore, most association boards maintain directors' and officers' liability insurance, which would defend board members sued on the basis of decisions they have made. If the board lacks the confidence to make the decision on its own, it can always present the facts as well as the pros and cons of litigating to the members for a membership vote on the issue.

Associations that must deal with a rapidly ticking statute of limitations are often advised to protect their rights by filing suit against the developer if they have not had an adequate opportunity to investigate and substantiate the potential claims. But the developer and the association can avoid the rush to court by entering into a tolling agreement, whereby they agree to toll the statute of limitations for a specified period of time. In this way, the association has an opportunity to investigate the claims and, if necessary, to attempt a negotiated resolution of the dispute. If the choice is between definitely being sued or perhaps not being sued, the developer has nothing to lose but time by offering to enter into a tolling agreement. And that time may be well spent.

Throughout the process of attempting to resolve a dispute, the developer must allow business, not emotions, to drive resolution of the conflict. Tempers and egos must be kept in check. Every effort must be made to maintain productive lines of communication so that settlement remains an option. The developer must understand the politics—"people factors" and emotions are often the most important elements in resolving disputes. The developer and its attorney must have a mutual understanding that the goal is to resolve the dispute, not to win the fight.

If litigation is to be avoided, developers must understand that the successful transition of an association from developer to owner control requires both sides to work together as partners in the process. The developer must take the lead in fostering collaboration by establishing and maintaining proper documentation, by providing education and training to its own staff and to the owners, by earning the respect of the homeowners, and by providing guidance as the owners assume control. Developers must understand the areas of potential dispute and exercise diligence in adopting and implementing a plan to minimize the risk of conflicts. If and when conflicts arise—and they will—the developer needs to understand the tangible and intangible costs of litigation, work rapidly and conscientiously to resolve the dispute without litigation, and overcome the desire to "win" at any cost. ■

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