

Transitioning Property Owner Association Control

Robert D. Burton
Armbrust & Brown, L.L.P.
100 Congress Ave., Suite 1300
Austin, Texas 78701

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Robert D. Burton, Partner

Armbrust & Brown, L.L.P.
100 Congress Ave., Suite 1300
Austin, Texas 78701
Phone: (512) 435-2300
Fax: (512) 435-2360
E-mail: rburton@abaustin.com
Website: www.abaustin.com

Areas of Practice

Real Estate
Condominiums
Community Associations
Condominium Development
Master Planned Community Development
Timeshare and Resort Development

State Bar Admittance: 1992
Texas, 1992

Education:

Tulane University, J.D. 1992, With Honors
Member, *Tulane Law Review* 1990-1991
Editor, *Tulane Law Review* 1991-1992 University of
North Texas, B.S., M.S. (Accounting)
Certified Public Accountant, Texas, 1989

AV Peer Review Rated by Martindale-Hubbell



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I. INTRODUCTION

It is a rare occurrence indeed to find a residential project developed within the past 20 years without a property owners association. Since 1990, the number of residents living in a community governed by a property owners association has increased by over 100%.¹

In almost all circumstances, the developer will cause the association to be created during the early stages of the development and will control operation and administration of the association until some point prior to the completion of sales². In large projects, developer control and administration can last for years, even decades³. However, the developer will eventually transition administration and control to the residents and/or non-developer owners.

Even if the developer has flawlessly administered the association, a poorly conducted transition can create the perception of mismanagement and increase the likelihood of claims against the developer. A proper transition of association control from the developer to residents can avoid the perception of mismanagement and may provide an opportunity to correct or remedy issues that might later give rise to claims.

Thought should be given to transition when the community governance documents are drafted.⁴ Specifically, consideration should be given to reserving the right to amend the documents in anticipation of changes in development plans and market events. The community governance documents should anticipate procedures to facilitate meaningful resident participation during the developer control period. The

developer should seek opportunities to encourage resident participation in certain aspects of the association decision-making process. The developer should also ensure that decisions and procedures are communicated to residents on a timely basis. Resident participation and good communication during the developer control period will pay dividends at transition.

II. THE TIMING OF TRANSITION

A. Condominium Associations

For land submitted to the condominium form of ownership⁵, Texas law provides for the *timing* of transition from developer to resident control.⁶ Within 120 days after the developer has conveyed 50% of the units that may be created⁷, at least 1/3rd of the Board members must be elected by non-developer owners. Within 120 days after the developer has conveyed 75% of the units that may be created, the developer control period terminates. Accordingly, for the condominium association, the developer usually participates in two transition meetings.⁸

Partly as a result of the two-stage transition process, but mostly as a result of the statutory disclosure requirements associated with the sale of a condominium unit⁹ and the administration of the

¹ Community Associations Institute, *Industry Data*, available at <http://www.caionline.org/about/facts.cfm> (Dec. 23, 2008).

² Developer control, or the developer control period, for the purpose of this article, means that the documents governing the creation and administration of the association, typically the deed restrictions, permit the developer to elect or appoint all or a majority of the board members. The board is responsible for the operation and administration of the association. Accordingly, during the period the developer appoints or elects a majority the board, the association is “controlled” by the developer.

³ This author represents one developer who is embarking on its third decade of association control, and another developer who estimates its control will extend beyond 2040.

⁴ Community governance documents include the community deed restrictions and the documents associated with creation and administration of the community association, i.e., articles of incorporation, bylaws, and associated rules and policies.

⁵ The developer who submits land to the condominium form of ownership is required to create a unit owners’ association prior to the conveyance of a unit. TEX PROP. CODE §82.101 (West 2008).

⁶ TEX PROP. CODE §82.103(c) and (d) (West 2008). The developer may reserve the right to appoint and remove all members of the condominium association board. §82.003(a)(22)(F).

⁷ Note that §82.103(c) and (d) uses the phrase “that may be created.” In a legally phased condominium project, the number of units initially created will be less than the number of units planned for the regime. When determining the period of transition, the practitioner should initially determine the transition date based on the maximum number of units the developer has reserved the right to create pursuant to the condominium declaration. Since the maximum number of units may change based on development plans, the date of transition may change.

⁸ If the developer reaches or expects to reach the 75% trigger date before it has held the initial transition meeting, it may be more practical to hold a single meeting at which the entire board transitions to resident control.

⁹ To avoid the 6 day right of rescission under §82.156(a), a developer will deliver a condominium information statement to each prospective unit purchaser. The condominium information statement includes a summary of the regime and the regime’s principal governance documents. See §82.153

condominium association¹⁰, the developer should expect an informed membership at each transition meeting.

B. Other Property Owners Associations.

For all other property owners associations, there is no statutory requirement for the transition from developer to resident control. Practitioners should consult the community’s governance documents to determine the *timing* of transition.¹¹

III. INITIAL DRAFTING CONSIDERATIONS

If you have the opportunity to prepare community governance documents, including certain provisions in the documents can pay dividends as the community approaches the transition to developer control.

A. Deed Restrictions

In most circumstances, the mechanism used to control the association will be set out in the deed restrictions. In Texas, the preferred method is to allocate votes to each owner, with a larger portion of votes allocated to the developer during development and sale, i.e., a “super-majority” of votes is allocated to the developer.¹²

Practitioners use different “trigger points” to shift control from the developer to the residents. The deed restrictions may terminate the super-majority votes allocated to the developer when the developer has conveyed a certain percentage of lots within the community or after a certain period of time. Whatever method is chosen, the transition point should be capable of determination based on easily ascertainable facts. If the land will be developed in phases and

for a description of the contents of a condominium information statement.

¹⁰ Specific statutory provisions address the payment and levy of assessments, *See* §82.112, financial statement audits, *See* §82.114(c), the keeping of association records, *See* §82.114, maintenance of insurance, *See* §82.111, and member meetings, *See* §82.108.

¹¹ On January 22, 2003, the Department of Housing and Urban Development released Mortgagee Letter 2003-2. Mortgagee Letter 2003-2 terminated FHA subdivision (i.e., “PUD”) approval as a precondition to the issuance of FHA secured mortgages. Prior to Mortgagee Letter 2003-2, one condition to PUD approval included transition of the property owners association to resident-control upon the conveyance of 75% of the lots.

¹² For the association created to administer a condominium regime, developer control of the board is determined by statute and based on the units owned by the developer rather than votes allocated to the developer.

portions of the land will be annexed into the deed restrictions over time, avoid using a provision that “recaptures” developer control based on land annexation.¹³ Instead, consider basing control on ownership of annexable land and terminate control either by a certain date or the date when the developer no longer owns any portion of the annexable land.

The decision whether to include a provision requiring resident participation on the board prior to the date of transition depends on the size of the development, local requirements¹⁴, and developer preference. Resident participation on the board prior to the actual transition to resident control can reduce the likelihood of disputes between the residents and the developer regarding association operations. Many of these disputes have their genesis in poor communication regarding association affairs. A resident representative usually results in better communication with resident members.¹⁵ Phased resident participation on the board can be accomplished by increasing the number of board members at certain stages of development.¹⁶ Of course, resident participation need not be formally incorporated into the deed restrictions. If the developer reserves the right to appoint or elect board members during the control period, the developer can elect or appoint a resident to the board at the appropriate stage of development.

Most deed restrictions provide for the creation of an architectural review authority to review and approve improvements to be constructed within the development. In many cases, the entity that exercises this authority is characterized as a committee of the board. So long as the developer appoints the board, the developer also has control over architectural review committee appointments. Since the developer will likely want to preserve architectural control for unsold inventory, linking architectural control to the board can

¹³ A recapture provision seeks to re-vest control of the association in the developer after it has transitioned to resident control. Once the association has transitioned to resident control, only in the rarest of cases is it practical to shift control back to the developer.

¹⁴ For example, in the Mueller Airport Redevelopment in Austin, Texas, the City of Austin required resident participation on the community association board as a condition to project approval.

¹⁵ Foundation for Community Association Research, Best Practices Report #7 Transition, available at www.cairf.org.

¹⁶ In Mueller, the trigger for resident participation is determined based on the issuance of planned certificates of occupancy. Mueller is subject to comprehensive land planning and the number of planned certificates of occupancy is determinable.

be an impediment to resident participation on the board, or the transition to resident control prior to the completion of sales. Consider vesting architectural control in the developer, but providing the developer with the power to assign this authority to the board at the appropriate time¹⁷.

The deed restrictions should address the association’s responsibilities regarding the ownership and maintenance of common area. In a large community, it is often not possible to specifically identify all the common area an association will be expected to maintain when the development is complete. As a consequence, the deed restrictions should include a general description of the common area. Not all common area is created equal. In most cases, no additional language is required to address the standard pocket park, swimming pool, or community clubhouse. However, special provisions are advisable for private streets or other facilities usually maintained by municipal authorities. If the community will include non-standard common area, it may be sensible to include special provisions in the deed restrictions identifying these areas and any special requirements associated with their maintenance.¹⁸

The deed restrictions should not cap assessments using a base year with maximum yearly increases. Assessment caps are used ostensibly to exert fiscal control over the association or alleviate marketing issues regarding assessment levels. Good intentions often result in financial ruin. There is nothing worse for a developer than approaching transition with a fixed assessment that cannot support the actual financial obligations of the association. A prerequisite to a smooth transition is a financially healthy association.

B. Bylaws

¹⁷ A modification committee, wherein alterations to existing improvements are reviewed and approved, can be used to reduce the administrative burdens of architectural control on the developer in the mature community. The authority to approve modifications would be assigned to a committee of the board with the developer retaining the right to review and approve new construction.

¹⁸ Private streets are a particular area of concern. Many municipalities, for example the City of Flower Mound and Round Rock, Texas, require that special provisions be included in the community restrictions. The City of Round Rock requires that a special maintenance fund be established by the association and reviewed annually by city representatives. Even if the municipality does not require special provisions, language should be added due to the unique liability and maintenance issues associated with private streets.

The bylaws include the corporate procedures associated with the operation and administration of the association. Whether or not the deed restrictions provide for resident participation on the board prior to the termination of developer control, the bylaws should allow for an increase in the number of board members. In most circumstances, while controlled by the developer, the board will consist of the statutory minimum of three (3) members.¹⁹ However, a three (3) member board may not be practical for the resident controlled association. Including the ability to expand the board in conjunction with transition (or prior to transition if the developer desires resident participation) will remove the need to amend the bylaws in conjunction with transition.

Consider permitting a majority of the board to amend the bylaws rather than requiring the approval of a majority of members of the association. Often, residents will request that the bylaws be amended in conjunction with transition to resident control. The frequency of board meetings, number of officers, time periods for meeting notices, or other provisions that suited operation of the association while under developer control may not be desirable for the resident controlled association.

Include a provision in the bylaws permitting ex-officio members of the board.²⁰ The provision for ex-officio members can be beneficial in large developments with an active committee structure. Not only will this provision assist in facilitating communication between the board and committee members in a resident-controlled community, it also provides another means to permit resident participation in board meetings during developer control.

IV. THE DEVELOPER CONTROL PERIOD- OWNER COMMUNICATION AND PARTICIPATION

A. Owner Education

A resident membership without a basic understanding of the importance, structure and responsibilities of their association leads to a poor transition. During the developer control period, there will be several opportunities to educate residents.

Professional management is often engaged to operate and administer the association during the developer control period. In addition to providing assistance with financial management of the

¹⁹ TEX. BUS. ORG. CODE §22.204(a) (West 2008)

²⁰ ID. at §22.210.

association, enforcement of the deed restrictions, and the architectural review process, the professional manager can play an important role in educating the residents about their association. One way to educate residents is to include a provision in the association management contract which requires the manager to prepare and distribute an “owner orientation package” to each new resident. The orientation package usually includes copies of the recorded deed restrictions, architectural rules, frequently asked questions, common area rules, and association procedures associated with assessment collection and architectural review. The orientation package may be the first time that the new resident has received copies of the association documents. The developer should participate in preparation of the package and approve the contents prior to resident distribution.

Annual meetings during the developer control period provide another opportunity to educate the resident membership on the functions of the association. Developer control of the association and the duration of control should be explained to the membership prior to the annual meeting. Including a brief description of developer control in the annual meeting notice can help avoid misunderstandings at the annual meeting. If the annual meeting agenda includes an item for the election of directors (or any other matter requiring a vote of the membership), a resident without an understanding of the developer control period may mistakenly conclude that the residents’ votes will determine the election of directors. It is easy to understand the resident’s consternation when they discover that the developer, and the developer alone, decides these issues until termination of the developer control period.²¹

B. Resident Committees

Resident participation in association matters during the developer control period can ease the transition process. For the community with a long developer control period, a committee is one way to permit resident participation short of actual representation on the board. Active committees provide a release valve for the natural desire on the part of resident members to control their community. More importantly, active committees breed well-

²¹ One way to avoid director elections during the developer control period for the non-condominium association is to implement the same appointment and removal process for directors used for the condominium association, i.e., the board members are appointed by the developer rather than elected.

informed resident-participants and help to build a sense of community.

Some committees can be created in the early stages of development and require little oversight or involvement by the developer. The primary purpose of early-creation committees is to establish a sense of community and to provide services not easily provided by the developer or professional association management. Examples of early-creation committees include a neighborhood watch or safety committee, a social committee, and a welcoming committee.

As the community matures and transition nears, mid or late creation committees should be considered. The main purpose of the mid or late creation committee is to educate resident participants, establish and identify resident leaders, and allow residents to make certain some decisions affecting operation and management of the association. Examples of mid or late creation committees include a finance committee, advisory committee, architectural modification committee, and resident transition committee.

V. TRANSITION TO RESIDENT CONTROL

As the community matures, at some point the developer will be able to estimate the approximate date of transition.²² In many cases, transition will actually occur prior to the trigger date or event specified in the governance documents as a result of resident pressure or control fatigue. Whatever the cause, if possible, the developer should allow at least 4 to 6 months from the time the decision to transition is made until the actual date of transition. A 4 to 6 month period provides an opportunity for the developer to correct problems that may result in claims against the developer post-transition, ensure that certain rights and obligations external to the governance documents have been transferred or assigned to the association, and to prepare residents for the transfer. For communities with active resident leadership, expect that separate counsel will be retained to assist the resident leadership in the transition process.²³

²² If the developer control period terminates on a date specified in the governance documents, the date of transition can be precisely determined. Where the date of transition is based on the number of votes allocated to the developer relative to the votes held by the resident members, and the votes allocated to the developer are based on the number of lots owned by the developer, the date of transition is an approximation based on marketing projections.

²³ It is good practice for the association to have counsel separate from the developer during the developer control period. However, this is good practice not often applied.

A. Preparing for Transition

The developer may know of issues that need to be addressed or corrected prior to transition. Assessments may need to be increased to place the association on firm financial footing,²⁴ or the governance documents may need to be amended to conform to changed conditions. While the specific challenges will differ for each community, there are certain tasks that can be performed pre-transition to assist in understanding and resolving these issues. Many of these tasks require a significant amount of time to complete. A developer is advised to complete these tasks or understand the time it will take to complete before establishing an official transition date.

1. Review the Governance Documents—Again.

Prior to transition, the developer should arrange for a thorough review of the community governance documents. In some cases, specific restrictions may need to be corrected, approvals documented, or policies clarified. The purpose of this review is not to remove developer prerogatives reserved in the documents that may no longer be needed post-transition²⁵. Instead, this is the developer’s last opportunity to correct errors and anticipate areas that need attention prior to transition.

2. Common Areas Transfers.

Rights in and to the common area to be maintained by the association should be conveyed to the association prior to transition.²⁶ Each recorded plat should be reviewed to determine the location of all common area lots and easement areas to be maintained

by the association. Title to these areas should be confirmed and exceptions to title carefully reviewed. Consideration should be given to reserving easements over and across common areas for the benefit of the developer and its assignees.²⁷ Title should be conveyed to the association free and clear of all liens. The conveyance documents may also include protective covenants or other obligations associated with maintenance or operation of the common area established in conjunction with development and permitting.²⁸ The developer should review landscape license agreements²⁹ and permits³⁰ to confirm whether the association is the appropriate party for on-going maintenance and the procedures associated with transfer.

3. Financial Review.

The financial records of the association should be reviewed by the developer in consultation with the association’s manager. Budgets and financial statements should exist for each year of the association’s existence. Copies of audits should be located and reviewed. The adequacy of reserves should be discussed with the manager and deficiencies noted and understood in advance. For the condominium association, working capital collected during the developer control period should be documented and present in the association’s account upon transition.³¹ The present level of assessments

²⁴ Proper association fiscal management would uncover these issues well before transition. The developer and professional association manager should frequently monitor expenses, assessments, and projected developer contributions to the association throughout the control period. Assessments should be raised gradually overtime if necessary. A large assessment increase at or near transition can increase the likelihood of post-transition claims.

²⁵ Occasionally, an active resident membership will request modifications to the governance documents that will be effective post-transition to remove rights reserved by the developer. Carefully review these requests. In most cases, these rights should not be terminated until well after transition. Reserving these rights may provide the developer with an opportunity to correct or address a problem that would otherwise be resolved through an external claims process.

²⁶ Common area is usually defined as property to which the association owns or otherwise holds a possessory right.

²⁷ Easements may be necessary for utility purposes and to preserve the developer’s right to correct construction problems. Sometimes these rights are retained in the deed restrictions, but it is good practice to also retain easement rights in the conveyance instrument. In the case of a community within the jurisdiction of a municipal utility district, if the common area includes utility infrastructure to be maintained by the district, easements will need to be conveyed to the district as a precondition to the developer’s receipt of reimbursement proceeds from bond sales.

²⁸ For example, the community wet pond may require specific maintenance requirements imposed by the permitting authority.

²⁹ Landscape license agreements are agreements entered into with a municipality to permit installation of privately maintained landscape and irrigation facilities within property dedicated to the municipality (i.e., public streets and sidewalks). Usually, the original parties to these agreements are the developer and the municipality.

³⁰ Dock facilities may be permitted with a regulatory authority. The permit may be in the name of the developer.

³¹ TEX PROP. CODE §82.112(a) (West 2008). Section 82.112(a) provides that the reserves of the association and contributions to working capital paid by unit purchasers may not be used to reduce operational expenses of the association

should be evaluated based on the expected obligations of the association post-transition. The manager should be prepared to present a fiscal report to the residents at the transition meeting.

4. Corporate Record Review.

The corporate records of the association should be reviewed. It is common to find gaps in officer appointments,³² minutes, and annual consents during the developer control period. If supported by verifiable facts and records, an attempt should be made to reconstruct the corporate records. If the records cannot be reconstructed, the deficiencies should be understood. Check the corporate status of the association with the Texas Secretary of State to ensure that is in good standing at the time of transition.³³

5. Insurance Review.

Review the status and limits of all insurance policies maintained by the association. Review policy limits after consideration of common area to be maintained by the association and the obligations associated therewith. Insurance policy review should be conducted by the association's agent and any endorsements or modifications recommended by the agent should be implemented prior to transition. A brief summary of each policy and the agent contact information should be included in the corporate record book. Obtain a list of all prior claims made under the association policies. To the extent the association is involved in pending lawsuits, obtain a summary of each action from the association's litigation counsel and include the summary in the corporate record book.

B. Transition Meeting

Once the transition preparation is complete and the date of transition has been determined, it is time to notify resident members. To enhance the prospects of an orderly and efficient meeting, the developer should consider sending the resident membership a description

until the termination of developer control of the association. In most circumstances, this provision will require that the working capital collected from unit owners be available to the association upon transition.

³² In most cases, officers are appointed by the board annually.

³³ A franchise tax report must be filed annually with the Texas Comptroller of Public Accounts even if no tax is due. Failure to file this report is frequently the cause of forfeiture of the association's corporate charter. Reinstatement of the charter is a relatively simple process, but it will take time to complete.

of the transition meeting and the purpose served by the meeting before the official notice required by the association's bylaws. This informational notice can provide an opportunity to solicit nominations from residents for election to the board³⁴ and can provide the developer and manager with advance warning of unanticipated issues that will need to be addressed at, or prior to, the transition meeting. If possible, schedule the transition meeting 3 to 6 months after the latest annual member meeting of the association. The likelihood of a smooth transition meeting increases where the purpose of the meeting is limited to the actual transition.

The official meeting notice should include a form proxy and an agenda limited to the election of resident board members.³⁵

The transition meeting is usually conducted by the association manager. For the transition meeting, it is advisable to prepare a script for use by the person conducting the meeting. A meeting script ensures that the meeting is conducted in an efficient and professional manner.

Prior to the meeting, a duplicate copy of the corporate record should be prepared for the developer's files. The original corporate record book, the contents of which have been reviewed and approved in advance by the developer, will be tendered to the association manager or resident board representative at the meeting after the resident election. Resignations of developer-appointed board members should be included in the corporate record book.

A representative of the developer should attend the transition meeting and should consider making brief remarks to the membership shortly after the meeting is called to order. The developer should also consider arranging for the developer's counsel to attend the annual meeting. In most cases, developer's counsel will have no formal role at the meeting, but will be available to advise the developer during or after the meeting if unexpected issues are raised by the membership.

³⁴ Most bylaws permit members to nominate board members from the floor during the meeting. However, soliciting nominations in advance, having a slate of candidates on the ballot, and giving the candidates an opportunity to prepare in advance of the meeting, is the better approach.

³⁵ It may be helpful to remind resident members in the official meeting notice that the meeting is limited to matters included on the agenda and that questions regarding non-association matters are not appropriate during the meeting.

VI. CONCLUSION

The process of transitioning a property owners association from developer to owner control begins upon formation of the association, continues during the period of developer control and culminates at the transition meeting. Throughout each step in the process, the developer is well-advised to consider the effect of its actions (both perceived and actual) on the community's residents. To ensure a smooth transition, the developer should seek to balance resident participation with appropriate developer control, carefully assess the association's situation well in advance of transition, and address any problem areas prior to transition. The actual transition should be a cooperative effort between the developer and the residents to ensure that the residents have all materials necessary to assume control upon conclusion of the transition meeting. By keeping in mind these general considerations, and the specific suggestions set out in this article, developers and their attorneys can avoid many of the common transition traps for the unwary, and may head off the potential problems and expenses that accompany a poorly conceived or conducted transition.

SAMPLE TRANSITION DOCUMENT CHECKLIST

Restrictions

- Deed restrictions and amendments
- Architectural design guidelines, procedures, approvals and variances
- Subdivision plats, permits and development approvals
- Management certificate

Organizational Documents

- Articles of Incorporation/Certificate of Formation and amendments
- Bylaws and amendments
- Organizational consent
- Member meeting minutes

Operational Documents

- Association rules, regulations, and procedures
- Board resolutions
- Board meeting minutes
- Member meeting notices
- Manager and vendor contracts
- Employment contracts
- Member newsletters and notices
- Member roster

Financial Documents

- Transition year budget
- Transition year financial statements
- Prior year budgets
- Prior year financial statements
- Financial audits
- Federal tax returns
- Franchise tax reports
- Current assessment collection report

Insurance Documents

- Association maintained policies (property, G/L, fidelity, and directors and officers)
- Insurance agent contact information
- Summary of prior-year claims
- Summary of current claims
- Summary of prior and pending litigation and settlement agreements

Common Area Documents

- List of real property owned and easements held
- Property deeds
- Easement instruments

- Schedule of personal property
- Property maintenance contracts and warranties
- Title policies/abstract certificates
- Reserve reports/studies
- Plans for common area improvements
- Common area improvement contractors and subcontractors
- Permits associated with use of common area improvements

Transition Documents

- Updated corporate record book
- Developer board resignations
- Transition meeting script
- Transition information member letter
- Transition meeting notice