

CHANGE IS HARD, BUT HOLDING OVER IS HARDER: TURNING OVER CONTROL OF A COMMUNITY ASSOCIATION (WITH FORMS)



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In theory, turning over control of a community association from the developer to the homeowners should be relatively easy. The governing documents advise when transition occurs, the date arrives, and then the developer delivers a bunch of documents to the homeowners and exits, stage left. But that’s not the way it necessarily goes, nor is it the best way to handle the transition of control in every situation.

Ideally, the election of the community association’s board of directors by the homeowners is the end of a process that began with the sale of the first lot in the development, or to be even more intentional, from the moment the governing documents for the community association were drafted. There are two things you should keep in mind for dealing with transition: preparation and process. These form the foundation of a strong and well-defined exit strategy for the developer.

Focusing on preparation and process can assist one through the transition, and it can help limit serious liability concerns. So why are preparation and process important? Because turning over a community association is almost always the last thing on a developer’s mind, until it’s time for the election! A

developer is often more focused on permits, supply, labor, construction budgets, construction loans, sales, and more, as immediate needs of the business during that time period.

It is possible, too, that in some situations, the homeowners may also resist taking over control for a number of reasons, such as: (i) concerns about the condition of the common areas; (ii) concerns over perceived defects in the community (e.g., lots, drainage, condition of roads, or condition of amenities); and (iii) concerns that arise because of a lack of understanding about how the association works. By preparing for turnover and following a set process, a developer can minimize these problems in transition, and the homeowners can come out of the transition period feeling like they have a well-developed community.

Preparation

As the old saying goes, an ounce of prevention is worth a pound of cure, and in this case an ounce of prevention is worth many pounds of cure. First, understand that transition starts with the first closing of a home in a development. It is at this point that there are suddenly people with rights and

duties that are not purely interested in the development of the community for business reasons.

This is why from the start, documentation is very important. The community association is just as much a corporation as any other, which means the laws that apply to other nonprofits apply here, too. For example, a corporate book, along with other important records, must be maintained during the development of the community. This includes documentation of: (i) annual meetings; (ii) resolutions, formal appointments and removal of directors and officers, warranty information, and ownership of any part of common areas; (iii) copies of service contracts; (iv) leases; and (v) financial and tax records.

It is also wise to convey ownership of the common areas, such as open spaces, parks, amenity areas, natural buffers, private roads, and the like, to the community association early on, especially once they have been improved with any intended amenities. A developer might assume that holding on to common areas gives some benefit to them, but that largely is not the case. Rather, conveying common areas cuts off multiple liabilities from the developer related to the property, such as the obligation to pay property taxes. In some jurisdictions, the taxing authority can tax the property as developable, despite its designation on a plat as a common area or amenity, and, therefore, the secondary benefit may be that the tax rate on the property goes down once it is conveyed to the community association.

Another benefit of conveying common areas to the community association early on is providing a bright line for when the common areas are deemed complete. This should specifically be treated as the act that affirms the transfer of the maintenance responsibility of the common areas to the community association. Maintenance of these areas is often a point of contention during the transition of control of a community association. Conveying the common areas as they are completed provides the bright line for the end of the development and improvement of common areas and marks the beginning of regular maintenance, which is the community association's responsibility.

Early conveyance of the common areas further assists a community association with establishing a more accurate picture of the maintenance costs going forward. When this is done earlier in the development (especially in developments governed by a state or federal statute, such as the Interstate Land Sales Full Disclosure Act, which require that the amenities must be completed before selling the lots), this shift helps to establish a realistic budget for the association. Unfortunately, however, when these proactive decisions are not made early on in development, the effects can cascade. It is common that the continued ownership of the common areas by the developer results in the developer using its own labor to maintain the amenities, pay for property taxes, and take other steps they perceive as "helping" the association to keep costs down. But ultimately this help often obscures the real costs of the facilities. When the rush to shift responsibility over to the homeowners right after the sale of the last lots occurs, there is often either a noticeable difference in the level of maintenance, often most evident in landscaping, or an increase in assessments to be paid by owners. This generally causes frustration and anger for the owners. This is because the owners likely cannot understand the costs of the maintenance due to how the "help" has obscured the true costs, and consequently, they may resist the developer's attempts to convey the common areas to the community association.

In addition to the above, it is very important, from the start, to open and keep separate bank accounts for the community association. Association money, such as assessments and fines, should never come in with the developer or builders' funds, even if the association is subsidized by the developer or builders. This allows for a clean and independent set of financial books to show the homeowners exactly what the expenses and liabilities for the association really are. Again, this is an area where developers often feel that they have been helping an association, as they simply fund things out of their own pocket and may not set up separate accounts until later in the development. This can cause significant problems when trying to shift control of the community association to the homeowners. Under this

situation it is simply difficult for the homeowners to be clearly and reliably advised of the liabilities at play for the association and how it affects their own personal assessment obligations. From a homeowner's perspective, it may not look like the developer was helping the association, but instead was hiding information necessary for the association to properly function. This can turn into accusations of commingling funds, conversion, and possibly embezzlement.

During the development period, and the period of developer control of the association, the developer should keep the community in good shape, physically as well as financially and operationally. The developer, or a management company it engages on behalf of the association, should periodically inspect the common areas to anticipate maintenance and keep things in good repair. In addition, the developer should make any necessary repairs or maintenance before transition to the homeowners. Depending on the nature of the repairs and/or maintenance work, it may be something the developer should cover or it may be something that the association, with association funds, should cover. While in control of the association and appointing the board of directors, the decisions to use association funds for maintenance should be well documented to avoid questions during and/or after transition.

Another financial issue that cannot be emphasized enough, a developer should make sure the community association is solvent at turnover and that it has adequate reserves. When determining adequate reserves, they should take into account the extent of amenities, improvements, and common areas that the community association is responsible for. In other words, the reserve could take into anticipated costs of making major, capital repairs to those items in the future. Associations, via their developer-controlled board of directors can obtain reserve studies that lay out a guide for the amounts that should be in these reserves. If this item is not addressed, the developer is at risk that the homeowners will press claims that the community association was significantly underfunded. Claims brought by homeowners for underfunding reserves can be for quite large

sums of money, depending upon how extensive, and expensive, the common area improvements are.

It is important to realize that there should be no need for an increase in assessments at turnover. If the community association has been managed in a way that intentionally understands that it is intended to be a separate and independent entity, the budget should be fairly accurate at the point of turnover. Managing these expenses includes making sure that all common area, services, contracts, and permits are in the association's name from the start. This would include light poles, irrigation, and even the professional management of the association, if applicable.

Copies of all as-built plans for common area improvements, as well as copies of final plats for the development, should also be put aside and delivered to the homeowner-elected board of directors at turnover, as records of the community association.

These documents can help a newly homeowner-elected board of directors for a community association because another item often overlooked by developers is the need to create a process for dealing with architectural review, including documentation of review and keeping records of all approvals and disapprovals for the association. This problem can arise when a developer-approved improvement has been installed early in development and the homeowner-controlled board of directors does not want to permit similar structures, such as fences. Often, though, the developer might not understand the value of documenting approvals and simply give owners a simple yes or no over the phone or as they stand on a job site. A failure to document approvals in written form can become problematic once the homeowners control the community association and take up architectural review responsibilities.

When managing a community association, make sure to create and maintain an accurate roster of homeowners, especially for sending turnover notices and to give to the new board of directors, once it is elected. Communication in the time leading up to the transition, or in a difficult economic

time that impacts the development negatively, will be incredibly helpful. Often, problems arise from the failure to communicate things that may be of interest to the homeowners. The disconnect is relatively normal and often due to the developer's need to focus on emergent issues. However, keeping an open channel of communication with the homeowners can make the difference between a stressful and adversarial transition of control and one that is smooth and peaceful.

Another item often overlooked prior to turnover is making sure the community association is properly registered and in good standing with the jurisdiction's secretary of state. If the community association is administratively dissolved, it can be burdensome to reinstate it depending upon the situation. Of greater concern to a developer, this oversight may allow parties to bring claims directly against the developer that might have otherwise been absorbed by the association. Keep in mind that from its incorporation, a community association is a nonprofit corporation, a distinct legal entity. For that reason, not only must the registration be kept up to date, the community association is required to hold an annual meeting each year. Often, developers may see the meetings as a burden or not realize that they are required, but failing to hold a meeting can create problems and is really missing an opportunity to leverage the community association's existence for the benefit of the community and the developer. These meetings are an opportunity to share information about the community with homeowners and to engage them in the workings of the community association in a positive way.

Remember, that when dealing with a community association, acting as a director or officer means that the person owes fiduciary duties to the community association. A developer appointee must be sure to act in the community association's interest when acting as an officer or director of the community association. Preparing for transition helps with this because it provides evidence that a developer-appointed director or officer was acting in the community association's interest when wearing the director and/or officer hat. This is one area where

liability can arise for the developer when there are no (or poorly) maintained records or when separate accounts are not opened. With no evidence to the contrary, homeowners can more easily frame developer actions as self-serving rather than in the community association's best interest.

Finally, and this is where the preparation of the governing documents is really key, the developer should identify and know which rights will last beyond the turnover of the control of the board to the homeowners. All rights under the governing documents should be considered and allowed to be treated intentionally and independently, as part of an exit strategy. This allows for a developer to give up or retain rights as necessary to account for how the development is wrapping up.

Process

As previously noted, the process begins from the moment a home is purchased, with homeowner orientation and education about the association, how it is operated, and when transition will occur. Each sale is a step closer to the developer's (hopefully successful and peaceful) exit from the community. As time goes by, the transition should be promoted through encouraging homeowners to participate in the governance of the community, by serving on architectural modifications review, finance, or maintenance committees. Even setting up a welcome committee, encouraging existing homeowners to contact new homeowners in the development, is a great way to get homeowners involved and knowledgeable about the community.

These types of activities can help homeowners gain knowledge about the day-to-day affairs of the association. Each community is different, so the problems they face will be different. They also provide a way to give owners a positive role and a way to channel energy that might otherwise become focused on finding problems and creating problems where there might not have been any.

At some point prior to transition, it may be helpful to have the homeowners elect an ad hoc committee, often also called an advisory board. Generally,

this happens as much by default as it does at the initiation of the developer. The resulting ad hoc committee and its effect within the community association is often very clearly influenced by which party decides to form it. For a developer, it is usually better to instigate and foster this type of committee than to allow one to grow out of homeowner concerns within the community. Keep in mind, too, that homeowners are generally becoming savvier about community association functions and better equipped to identify and understand problems within association operations.

Depending on the plans for transition, the ad hoc committee can be given a wide variety of helpful duties, specifically including giving substantive recommendations to the developer-controlled board or monitoring the board's activities. Preferably, the ad hoc committee acts at the request of the board to investigate or evaluate aspects of the day-to-day operations of the association. On the other hand, when an ad hoc committee is formed by unhappy homeowners, the committee may become an active voice against the developer (and possibly the builders), which may result in legal bills, expensive repairs, delays in final buildout, and, potentially, injury to the developer and builders' reputations.

This approach of intentionally forming an ad hoc advisory committee can foster involvement from a wide spectrum of homeowners, instead of only the unhappy ones. An ad hoc committee can promote organized and open communications between the developer and the homeowners. In fact, it is best to try to make the committee reflect a diversity of views and backgrounds from the community. This approach is beneficial for developers as it allows homeowner involvement without a loss of control over the association's actions. However, it can additionally alienate homeowners and sour communications with them if the committee's recommendations are simply ignored by the developer.

Sometimes an ad hoc advisory committee can create problems among the homeowners themselves if only certain factions within the community are participating on the committee. With only particular

voices represented, some homeowners may feel alienated or bullied by the other homeowners that are taking the lead. For example, the "tennis people" in the community may take the lead at transition and argue for expensive repairs to the courts, including upgrades, and then the "pool people" become unhappy as money and resources are spent to placate the tennis faction. The groups that are left out may feel like they are being ignored and then start coming up with demands of their own. Eventually, the developer may get stuck in between the multiple factions within the community.

Depending on the size of the community, its make-up, and the provisions of its governing documents, the developer might also choose to provide for the election of homeowners to the board of directors prior to turnover. Often this is a choice made at the time the governance documents are drafted. Alternatively, and depending on the provisions of existing documents, the developer might give up a right to appoint a single director so that the homeowners can elect their own candidate to the board. Over time, the developer might give up more seats on the board until it became a minority and then, no longer held any seats. Generally, the latter option is done at specified points in sales of lots and works best in larger communities. A community of around 100 homes, for example, would probably sell too quickly to make this type of transitional board very useful.

Either way, prior to the election at which owners will be able to elect the entire board of directors of the community association, the developer should send out a letter or other notice letting the owners know that the transition is approaching. The letter should outline what needs to be done for the election, set expectations for what happens both at the election, and offering an organizational meeting between the new, homeowner-controlled board and the developer's representatives. This letter would be informational and would precede any formal, legal notice of an annual or special election where an election is held. It may solicit nominations for the board of directors from the homeowners. Following that letter, and any period for nominations,

the election meeting notice should be distributed, along with proxies. The intent of this letter is to clearly set expectations for the events that follow, to prevent anxiety among the homeowners that can translate into adversarial positions among the relevant parties.

The election would then be held, followed quickly by an organizational meeting between the newly elected board members and the developer. At this meeting, the developer should be sure to turn over all of the association's records, which include, but might not be limited to, its financial information, plats for the community, contracts in the association's name, and other related documentation. The new board should also review any "quirks" that the community may have and go over regarding the state of the amenities, if applicable.

Another component of such an organizational meeting can be a walk-through of the community by the new board of directors and the developer's representatives, to discuss any open repair or improvement items to be completed. Often, discussions focus on the overall financial health of the community association and any concerns over loans from the developer to the community association that might have been made during the course of the development. Such debts existing on the community association's books can cause disputes at this time, so producing documentation of loans and referencing any legal authorization that the underlying governing documents give for entering into such loans can be key.

At this point, no recurring services should still be in the developer's name. There should also be an adequately funded reserve account ready for administration by the new board, especially if there are significant capital items such as roads or buildings that need to be maintained by the community association going forward. Access to the bank accounts should be signed over to the board. Documentation removing the developer's directors, officers, and registered agent and replacing them with homeowners' representatives should be completed, if necessary. The amenities, if any, should be in good

working condition. Note, however, that that does not mean the amenities should be "like new." Amenities only need to be operational and well maintained.

Conclusion

Use preparation and process to help to make transition of developer control to the homeowners as smooth as possible—or at the very least, to help minimize liability exposure for the developer. The attitude with which the transition is approached is also very important. It is vital for both developers and homeowners to listen to each other and not to be defensive. Being defensive has a tendency to shut down communication, preventing actual concerns from being addressed.

Be communicative. Be available. Be open. Doing so creates trust between the parties. Simply providing information about the community association's annual finances and giving basic information about amenities can assure homeowners that the developer is making decisions affecting the community in an above-board manner. Be patient and listen to determine what the problems are and be willing to work with the various parties involved in the community to create solutions.

After the preparation, process, and attitude factors are taken into consideration, it all boils down to a very important truth: the homeowners and the developer have similar interests at the transition of the control of the community association. The homeowners have an interest in being able to knowledgeably and effectively run the community to preserve and enhance the value of their homes and make the community a place where they enjoy living. The developer has an interest in no longer having to run the association, but having the community run as well as or better than it was intended will enhance its value, and thus, the reputation of the developer. 🍀

FORM

ANNUAL ASSOCIATION RESPONSIBILITY CHECKLIST

1. Prepare annual budget and compute assessments
 - ☐ Deliver copy of budget and notice of annual assessments to all members.
 - ☐ Check deadlines for delivery of budget in declaration.
2. Prepare annual financial statements
 - ☐ An annual report including the association's balance sheet, income statement, and financial position shall be prepared by an independent public accountant.
 - ☐ Make report available in corporate records before end of association's fiscal year.
3. Meeting of members
 - ☐ Hold first meeting within one year of date of incorporating the association.
 - ☐ Subsequent annual meeting to be held as provided in association by-laws.
4. Board meetings (or written resolutions)
 - ☐ Declarant appoints and replaces directors unilaterally by resolution, if declaration and by-laws grant such rights to declarant. If weighted vote is the method giving declarant control of board, election must be held.
 - ☐ Organizational meeting for each board of directors (appointing officers, adopting budget and approving renewal of service contract, if any) should be held after the annual meeting of members. By-laws should provide for when meeting must be set.
 - ☐ Hold regular board meetings, preferably at least one each quarter or as provided by by-laws.
5. Association records
 - ☐ Maintain permanent, current records of the minutes of all board, committee and member meetings and all waivers of notice of such meetings.
 - ☐ Maintain current and accurate accounting records.
 - ☐ Make list of association members available for inspection at each membership meeting.
6. Annual corporate registration
 - ☐ File annually with the Secretary of State and pay registration fee.
7. Tax return
 - ☐ Make sure association has a Federal tax identification number.
 - ☐ Association files form 1120 or form 1120H with the Internal Revenue Service.
8. Architectural review
 - ☐ Comply with the requirement in declaration for composition of architectural review committee.
 - ☐ Comply uniformly with process, if any, outlined in declaration or set by architectural review committee for all items architectural review committee is given jurisdiction over.
 - ☐ Maintain records of all applications for approval, approvals, and disapprovals, including any related correspondence.

TURNOVER REMINDERS

1. Early activities

- ☐ Put all common property utility services (electric, water, gas, telephone, etc.) in the name of association.
- ☐ Update association record books and accounts.
- ☐ Review all association records to ensure they are up to date.

2. Preparation for turnover

- ☐ Prior to the transition to owner control, an advisory committee of owners representing a cross section of the interests in the community may be appointed to begin review of association records and understand the day to day management of the association.
- ☐ At about three to four months before the turnover date, a notice should be sent to the homeowners by the management agent, if any, advising them of the approaching turnover and what to expect
- ☐ The homeowners meet to elect the new board of directors, often at a special meeting. It is purely a homeowner function, facilitated by the managing agent. This is often referred to as the "turnover meeting."
- ☐ Obtain the names, addresses, and telephone numbers of the board members and the minutes from the election as soon as possible after the meeting.
- ☐ After the election meeting adjourns, the new board should establish officers- a President, Secretary, and Treasurer. Generally, this would occur at a follow board organizational meeting.

3. After the turnover meeting

- ☐ Organizational board meeting should be scheduled as soon as possible with the newly elected homeowner board of directors. This meeting is not open to the general association membership. Attendees should include a former member of the developer-controlled board and management agent, if applicable. The post turnover board meeting is for the sole purpose of discussing association issues. It does not address construction or warranty issues related to individual homes.
- ☐ Review the association's corporate book & records.
- ☐ Review the association's accounts. (Current financial statements, account histories, tax returns, and control of the association's accounts.)
- ☐ Discuss doing a physical review of the community.
- ☐ Review the association's operations.
- ☐ Change the association's registered agent with the secretary of state.
- ☐ In particular, review the association's insurance policies and make sure that the board has the contact information for the insurance agent and any vendors.