

TRANSITION OF CONTROL OF OWNER ASSOCIATIONS

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TRANSITION OF CONTROL OF OWNER ASSOCIATIONS

1. Declarant Control of an HOA is allowed under CCIOA. The Colorado Common Interest Ownership Act ("CCIOA") allows a declarant of a common interest community subject to that Act to control the Board of Directors, until milestones for various percentages of closings on the total number of properties that can be included in the community occur.
2. CCIOA/Outside Limits on Declarant Control in Most New Communities. The declarant control period in communities subject to CCIOA terminates 60 days after the earliest to occur of the following events:
 - a. 75% of the properties (or 'units' under CCIOA) that may be created have been conveyed to owners
 - b. Two years after the last conveyance of a unit by the declarant in the ordinary course of business (i.e., closings come to a stop for a two-year period), or
 - c. Two years after any declarant right to add new properties was last exercised.
3. CCIOA/Outside Limits on Declarant Control in Large Planned Communities. In new large planned communities (those started after July 1, 1992; with at least 200 acres; zoning for at least 500 properties and zoning for at least 20,000 square feet of commercial use space), the declarant may maintain control until the earlier of 60 days after any one of the following events:
 - a. Sale of 75% of the maximum number of properties that may be created under zoning or development approvals,
 - b. The lapse of six years after a conveyance by the declarant in the ordinary course of business, or
 - c. 20 years after recordation of the declaration.

Within 60 days after one of these events, a meeting of the members must be held (to elect a board, the majority of which are owners), records must be delivered, and an audit must be provided to the association.

4. Transition and CCIOA. Before CCIOA, "transition" from declarant control to owner control was a haphazard, informal and an ongoing process. CCIOA has sought to change this. To the extent CCIOA applies, CCIOA requires the declarant (developer) to turn over control of the association gradually, as Properties are sold, time expires or sales or annexations lapse for a 2-year period. At all times the executive board elects the officers.
5. CCIOA and the Election of Initial Owner/Board Members. Under CCIOA, 2-3 member meetings are anticipated during the declarant control period. More meetings may be advisable and fewer may be possible, but fewer meetings are not recommended.

Preparations and planning for these member meetings should begin by the developer and the initial manager of the HOA before the first closing. Then, transition meetings should be implemented through the declarant and management of the association.

6. CCIOA Transition Meetings

- a. Member Meeting 60 Days after Conveyance of 25% of the Properties That May Be Created. A member meeting is to occur not later than 60 days after the conveyance of 25% of the properties that may be created. The trigger is the conveyances (closings) to owners other than the declarant. At that time, at least one member, but not less than 1/4 of the members of the executive board, must be elected by owners other than the declarant.
 - b. Member Meeting 60 Days after Conveyance of 50% of the Properties That May be Created. A member meeting is to be held not later than 60 days after the conveyance of 1/2 of the properties that may be created. Here, the trigger is the conveyances (closings) to owners other than the declarant. At this meeting, not less than 1/3 of the members of the executive board must be elected by owners other than the declarant.
 - c. Member Meeting 60 Days After the termination of Declarant Control. The third member meeting is to be held not later than the termination of the period of declarant control. At that meeting, owners are to elect an executive board of at least three members, a majority of whom must be owners other than the declarant.
 - d. Additional Meetings. Beyond these three meetings, more meetings of the members are recommended during the declarant control period, up to and even after transition. Transition occurs much more smoothly with communication between a declarant-controlled association and the owners.
7. CCIOA Requirements upon the End of Declarant Control. Within 60 days after the earliest of one of these events to occur, or after conveyance of 75% of the properties that may be created, a meeting must be held, certain records must be turned over to the Association, and an audit of the association performed.
8. CCIOA/Declarant Surrender of Control. In communities subject to CCIOA (and in communities exempt from CCIOA), the declarant may voluntarily surrender the right of appointment and removal of the executive board members before the termination of the declarant control period. CCIOA provides that the declarant may require, for the duration of the period of declarant control, that certain actions of the executive board, which the declarant has previously set forth in a recorded instrument, be approved by the declarant before they become effective. This veto right of a declarant is sometimes retained in the area of design review, architectural control, assessments, etc. CCIOA gives the declarant this power to veto certain actions of the executive board as long as the veto is executed properly.

9. CCIOA Turnover of Documents. In communities subject to CCIOA, within 60 days after the end of declarant control, CCIOA requires the declarant to turn over miscellaneous documents, records and an audit of the association.

a. Under CCIOA, the items to be turned over include the following:

- i. The original or certified copy of the recorded Declaration, as amended and/or supplemented;
- ii. The association's Articles of Incorporation, Bylaws, Minute Book, other books, records and all Rules and Regulations that may have been promulgated;
- iii. An accounting of association funds and financial statements from the date the association commenced receiving funds and ending on the date on which the declarant control period ends (the "Transition Audit");
- iv. The association's funds or the control thereof;
- v. All of the tangible personal property of the owners and the association held or controlled by the declarant;
- vi. Copies of the plans and specifications used in the construction of the improvements in the Common Elements;
- vii. All insurance policies currently in effect;
- viii. Copies of all certificates of occupancy that may have been issued for common element improvements;
- ix. All other governmental permits;
- x. All warranties of contractors, subcontractors, suppliers and manufacturers that are still in effect;
- xi. A roster of the owners and their mortgagees, together with addresses and telephone numbers;
- xii. Employment contracts and service contracts in which the association is the contracting party.

b. The declarant should furnish the association with the following to complete transition:

- i. All documents needed to support any meetings of the association held to elect members of the executive board (to include notice, proxy, certificate of mailing, control list of the members, attendance records, together with the ballots);
- ii. The resignations of the declarant's appointed members of the executive board and officers;
- iii. Certificate of Good Standing for the association from the Secretary of State dated just prior to transition;
- iv. Signature cards for all association bank accounts and appropriate banking resolutions;
- v. Prior and current budgets;
- vi. Prior year's income tax returns (Colorado and Federal);
- vii. Tax ID numbers;

- viii. Change of address cards for the billing of all services rendered to the association (trash, utilities, etc.).
10. CCIOA and Transition Audits. In communities subject to CCIOA, a transition audit must be performed by an independent CPA and the delivery of the audit must be accompanied by a letter from the CPA expressing the CPA's opinion that the association's financial statements fairly reflect the financial position of the association in conformity with general accepted accounting principles; or a disclaimer of the CPA's ability to attest to the fairness of the presentation of the financial information in conformity with general accepted accounting principles and the reasons therefor. CCIOA states that the expense of the Transition Audit shall not be paid for or charged to the association. Depending upon the length of the time the community takes to sell out, this audit could be expensive. If sales are not completed within a year or two, it is advisable to then perform annual audits while the association is controlled by the declarant.
11. Transition in Communities Exempt From CCIOA. In communities which are exempt from CCIOA, transition is dependent on the provisions of the governing documents for the community. Review the governing documents to determine the time frame and process for transition. In situations where the CCIOA transition process does not apply, the governing documents for some associations will provide for a gradual phasing in of owners on the board of directors. Even where such a process is not mandated by statute or the governing documents of the project, a procedure similar to that set forth in CCIOA is advisable in almost every community association. Transition and involvement of owners gives owners access to information concerning the manner in which the association is being operated. This, hopefully, will avoid misinformation being circulated among the owners.
12. Owner Participation During Declarant Control/Under CCIOA or in Communities Exempt From CCIOA. Having one or more owners on the board of directors prior to the time that the owners obtain control of the board is only one manner of involving owners in the governance of the project. At all times, participation of owners should be provided for and encouraged by the declarant as another step in training and educating the owners to take over the operational responsibilities of the association.
13. Ad Hoc Committees as an Aid Toward Transition. During the period of declarant control of an association, we recommend the use of owner committees to assist the executive board in making decisions and to assist in a smooth transition. Owners can be placed on various committees of the association. These committees can have responsibility for architectural control, maintenance of the common property and preparation of budgets, monitoring of the financial status of the association, etc. This can assist in creating a better environment for the relationship between the declarant and the owners. Often Communities are developed with owners feeling the declarant, developer or builder acts only in their own interests. A declarant, developer or builder may even give the impression to owners that they cannot wait to get out of the association and to transfer all association responsibility to the owner-elected board. This can create hard feelings, ill will and potential lawsuits. We have found that by involving owners in the community

early on, a feeling of confidence and team work may evolve. This would give owners the opportunity to learn about their community before turnover to their control, so there will be some experience in the community at that time. Committees also help assure future success of the community. Declarants sometimes desire to maintain control of the association for as long a period as they can, particularly if they plan or expect any changes in the final stages of the development or the final sales of properties. Yet, if everything is going well, declarants often consider releasing control earlier. In any event, having owner involvement through an ad hoc committee of owners or other means can be a tremendous benefit to the declarant, the owners and the association.

14. Misinformation -- A Cause of Transition Problems. The declarant can limit the potential for problems with the association once the owners have obtained control of the board of directors if the declarant communicates effectively with the owners prior to that time. One thing the declarant can communicate to owners about is the manner in which the association is being operated for their benefit. One of the biggest causes of problems for the declarant is misinformation which leads to unfounded rumors concerning the governance of the association being circulated among the owners. Misinformation may lead to distrust of the declarant and a belief by the owners that the declarant is attempting to hide something from them or to control the association solely for the declarant's benefit and not for the owners' benefit.
15. Looking Forward vs. Backward. If the owners have been involved in the governance of the association from the beginning of the project, they are less likely in many instances to delve deeply into the past operations of the association once they have obtained control of the board of directors. Without involvement of the owners early in transition, owners often look into past acts of the association to determine whether the declarant did something illegal or improper during the time the declarant controlled the board of directors.
16. Transition a Process Rather Not an Event. Transition is viewed by some as one event (the meeting of the members at which control of the board is transferred from the declarant to the owners). Others view transition as a process beginning with the first closing, continue through the election of owners to the board and continuing on with regard to the operation of the association. In our view, transition should be a process which occurs over a period of time during which the owners gradually become more involved in the governance of the community. Transition involves many components, including:
 - a. The transfer of control of the board of directors to the owners,
 - b. The transfer of control of the financial operation of the community association,
 - c. Acceptance of responsibility for the maintenance of any common properties still maintained by the declarant, and
 - d. The turnover of documents.

17. Association Actions That May Be Considered after Transition.

- a. Retention/Selection of Managing Agent. One of the first things a new owner-controlled board of directors may do is to decide on the managing agent for the association, if the association is to be professionally managed. Hopefully, the new board of directors should consider the current managing agent and the relationship of that managing agent to the declarant in determining whether the management agent should be retained or a new managing agent hired.
- b. Retention/Selection of Attorney and/or Accountant.
 - i. The new owner-controlled board of directors may make a decision regarding an attorney and an accountant to represent the association in the future.
 - ii. In some instances, the declarant's attorney may also have been engaged as the association's attorney during the declarant control period. That counsel may be appropriate to retain, if they are viewed as qualified and available for matters unrelated to disputes with the declarant. For any disputes the association may have with the declarant, new independent counsel will be needed.
 - iii. In many instances, the declarant, during the time the declarant controlled the board of directors, will not have retained legal counsel or an accountant for the association. In those instances, the board of directors will move promptly to hire counsel and a new accountant for the association.
- c. Review of Financial Information.
 - i. The owner-controlled board may consider having the accountant for the association review the transition audit provided by the declarant and all financial information of the association for the time during which the declarant controlled the board of directors.
 - ii. The accountant may then be instructed to determine whether the declarant has paid all assessments and other amounts required to have been paid by the declarant during the period of declarant control of the association.
 - iii. The accountant may also be instructed to determine whether the amounts budgeted during the period of declarant control were adequate to pay all of the common expenses of the association or whether the declarant kept the assessments artificially low to encourage sales.
 - iv. Finally, the accountant may be asked to advise the board of directors of any accounting irregularities found during the accountant's review of the

financial records and to advise the Board as to whether the financial records are complete.

- d. Review of Prior Enforcement Actions. The board of directors may review all enforcement actions taken by the declarant-controlled board of directors or any violations which the declarant-controlled board of directors failed to enforce to determine whether any enforcement actions need to be filed by the association and to evaluate whether particular types of violations may have been waived through non-enforcement of the restrictions by the declarant-controlled board of directors.
- e. Legal Document Review. The owner-controlled board may consider requesting the association attorney to review the governing documents of the association to determine whether there are any unusual provisions in the governing documents or any provisions which should be amended in order to avoid future problems.
- f. Association Records. The board of directors may check to determine if all records of the association have been obtained from the declarant.
- g. Review of Insurance. The owner-controlled board may review all of the insurance policies of the association (through an insurance agent and other experts) to determine whether the insurance policies in effect conform to the governing documents of the project and to otherwise make sure that the association has adequate insurance coverage. Particular attention is often paid to directors and officers (D&O) insurance.
- h. Reserve Study. The board of directors may consider engaging an expert to prepare a reserve study to determine whether the declarant-controlled board of directors budgeted for and funded adequate reserves for the repair and replacement of the common elements of the project or if the association desires to change reserve funding. (See more on this below).
- i. Physical Inspection.
 - i. The association may engage an expert or an engineer to review the plans and specifications for the project and make a physical inspection of the project to determine whether the plans and specifications were followed in the construction of the project and whether any construction defects exist through poor workmanship or defective materials.
 - ii. The board of directors may consider obtaining a written report from the engineer and could then determine, in consultation with the association's legal counsel, whether any claims should be made against the declarant for any construction defects which are found to exist in the project.
 - iii. See more on this topic below.

- j. Conveyance of Common Areas. If the project is a planned community, the board of directors may confirm that all common areas have been conveyed to the association by the declarant in accordance with the governing documents of the project and any applicable state law. The board of directors might also consider obtaining title insurance for the common areas conveyed to the association.

18. Construction Defects and Transition Issues.

- a. Transfer common property before control of the Board passes to the Unit Owners. It is a mistake for both the developer and the owners to postpone the transfer and/or acceptance of the common property to the association until after seventy-five percent of the properties have been sold and the owners assume control of the governing board, especially where there is significant time lapse due either to the size of the project or the slow rate of sales. We prefer to see the developer-controlled board of directors under these circumstances permit the minority unit owner members to select an independent engineer, at the expense of the association, to inspect the completed portions of the common property and to negotiate the extent of the remedial work with the developer, subject to an express written agreement that there is no waiver of any legal rights by either the association or the developer pending turnover of control of the board of directors to the owners. Although this approach may not be feasible in every circumstance, it encourages the separation of construction defects from maintenance problems and helps to isolate the responsibility for each type of problem. It also eases problems of proof for both sides should formal proceedings ultimately be instituted and encourages cooperative rather than adversarial solutions with respect to the physical problems which may exist. Most importantly, the developer can look to its subcontractors to remedy defects while they are still on the job and monies have been retained under their contracts.
- b. Physical Inspections and Engineering Reports.
 - i. The association should consider engaging an expert or an engineer to review the plans and specifications for the project and make a physical inspection of the project to determine whether the plans and specifications were followed in the construction of the project, whether any construction defects exist through poor workmanship or defective materials and whether the project was constructed in compliance with the Fair Housing Act's accessibility requirements.
 - ii. The board of directors should consider obtaining a written report from the engineer and should then determine, in conjunction with the association's legal counsel, whether any claims should be made against the declarant for any construction defects which are found to exist in the project.
 - iii. Engineering reports are not intended to be primarily for litigation purposes. The primary purpose of an engineering report commissioned

by an association is to obtain professional assurance for the board that the physical condition of the property is satisfactory and to identify deficiencies which need to be addressed. Its main object is to discharge the board's fiduciary duty to ascertain the physical condition of the property before it is accepted for maintenance and not to serve as a spring board for settlement negotiations or litigation against the developer. Therefore, given this perspective, a clean report by a qualified engineer is the best result for both sides.

- iv. Canned engineering reports may do more harm than good in transition negotiations. Canned engineering reports, as well as those which are overly judgmental, tend to raise questions about their technical credibility. A report which is more individually tailored and factual is normally better because the other side will address it more seriously. Also, the separation of maintenance problems from construction problems is important. To homogenize them in the same report can foster the notion that most of the problems are maintenance related, which is not always the case. Also, the engineering report should not contain either absurd or peripheral items for they only detract from the importance of the significant issues and impact negatively upon the credibility of the entire report. Also, this type of report tends to result in both parties getting hung up in the detail. Try to cull out these items before submitting a report to the other side and focus on the important items. The others usually disappear anyway, if and when the primary issues are resolved.
- v. Do not be too quick to give a formal engineering report to the other side. Engineering reports can be trouble for either side if they are not judiciously prepared and reviewed by counsel before being finalized. Nothing can destroy the credibility of a report more completely than obvious mistakes engendered by carelessness, boiler plate language, stretching of the facts, or inadequate homework. In addition, a report which is too candid or says too much can prejudice one's client in the fact of any litigation. Consideration should be given to having the engineers for each side prepare summary reports which cover the major defects, although notes can be made and maintained by the engineer. The summary report can be used as a basis for initial discussions to see if basic agreement can be reached on the major issues between the clients and their technical consultants. Otherwise, too many details may stand in the way of reaching agreement on the important issues.

c. Use of Experts for any Proposed Transition Agreement.

- i. Experience in transitions and in court is an absolute must when choosing a law firm and experts for the transition. In choosing a professional consultant in connection with a transition negotiation, try to obtain assurance from your attorney that the consultant's report and his individual testimony will stand up in court. An experienced adversary will

know or quickly learn about the weaknesses of each and exploit them during the settlement negotiations, as well as the time of trial, just as he will in the case of a law firm which does not have experience in construction defect or community association transition and litigation. Be on guard against penny wise and pound foolish in this area for it is clearly more expensive to have to hire a second professional if the first turns out to be inadequate, not to mention the prejudice that may have occurred to your case as a result of the wrong initial choice.

- ii. Information communications between professional consultants can be effective and economical. Consider having the engineers and the accountants for both sides talk to each other early in the transition process. If they are professional in their approach, it should enhance communications, eliminate spurious claims and minimize professional fees for both sides. Attorneys by nature tend to be adversarial and therefore communications through attorneys do not necessarily promote constructive dialogue. It is a good idea, however, to have a written understanding between the attorneys as to the ground rules and the fact that none of the discussions between the other professionals can be utilized in any subsequent litigation.
- d. Punch lists from unit owners impede successful transition negotiations. The compilation of a unit owner punch list, especially with respect to individual properties, is a deterrent to a successful transition negotiation because it unduly raises the expectation level of the individual unit owner. Therefore, it is more difficult politically for the board of directors to reach a fair and reasonable settlement with the developer. Furthermore, an association is not empowered to settle unit claims and the unit owners should not be led to believe otherwise when it is clear that any knowledgeable developer will reject unit claims as a matter of course. As for an alternative to a punch list, a questionnaire prepared by the engineer related to specific physical aspects of the common elements may be useful tools in helping the engineer identify the construction problems which may exist, but care should be exercised to make certain that its purpose is not misunderstood.
- e. Do not indiscriminately sue developers personally. Combative instincts of attorneys tend to encourage the inclusion of the principals and/or the officers and directors of the developer as a defendant in community association litigation even when their potential liability appears to be highly speculative or nonexistent. Suing them personally should not be a reflex action because if there is either the hope or potential for true settlement dialogue, nothing can cause a developer to stonewall an association more quickly than to make him an individual defendant. Accordingly, the potential for settlement may be diminished significantly, if not extinguished altogether, and instead, the association may be faced with the aggravation and expense of years of litigation.

19. Questions on Transition for the Board to Consider:

- a. Have you reviewed the legal sufficiency of the governing documents?
 - b. Have you reviewed the insurance policy to determine whether there is sufficient coverage and whether coverage is consistent with requirements of governing documents and statutes?
 - c. Have you reviewed the budget line items to determine whether adjustments are necessary (amounts as well as line items)?
 - d. Have you obtained/reviewed a reserve study to determine whether it meets the needs of the community?
 - e. Have you inspected the common areas before “accepting” them from the declarant (if appropriate)?
 - f. Have you engaged an expert to review the plans and specifications for the project and make a physical inspection of the project to determine whether the plans and specifications were followed in the construction of the subject, and whether any construction defects exist through poor workmanship or defective materials?
 - g. Do you have deeds for all common areas conveying ownership to the association?
 - h. Have you reviewed all enforcement actions taken by the Declarant or any violations which the Declarant failed to enforce to determine whether any enforcement actions need to be filed by the association.
 - i. Have board members been provided with copies of all contracts, governing documents, contact information, budget, reserve, etc.?
 - j. Have board members received an “orientation” to the operation of the community and their fiduciary responsibilities?
 - k. Do you understand the relationships/interplay between the association and the districts and sub/master associations, if any?
 - l. Do you have contact information for any master or sub associations and/or special districts?
 - m. Do you have copies of marketing materials used by the developer and/or builder in seller homes within the community?
20. Communication is the Key to Successful Transition. The key to a successful transition from declarant to owner control of a community association is communication between the declarant and the owners. Communication with the owners should begin with the



sale of the first closing. The goal of the communication with the owners should be to educate the owners about the role and operation of the association and to establish trust between the declarant and the owners.