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CONDOMINIUM DEVELOPERS AND FIDUCIARY DUTY

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REAL ESTATE ALERT

Balancing the needs and desires of residential owners, commercial constituents, and Developers within a mixed-use development project presents unique challenges. Among those challenges is determining how best to establish a managing association and its controlling documents. In a residential-only development, a typical homeowners association will generally suffice, however, when a development includes office, retail, and parking space, a more complex arrangement may be necessary. Developers and commercial stakeholders need to understand how to retain control of the common elements and development uses while permitting the individual residential owners to enjoy their homes.

Developers and Controlling Unit Owners May Owe a Fiduciary Duty to Other Unit Owners

Developers and controlling unit owners of condominium master associations may owe a fiduciary duty to non-controlling unit owners.¹ “Fiduciary duties are those imposed in order to prevent one in whom special trust or confidence is placed from representing his or her own interests over those of his or her charges.”² As discussed below, a Developer or controlling unit owner is not someone in whom other owners have placed such a special trust simply by virtue of being a majority owner in a “majority wins” situation.

Master associations generally serve as an umbrella association to separate retail, office, and/or residential associations. Due to the relative newness of mixed-use developments, there is little case law discussing master associations and related conflicts. Several cases have found that Developers owe a fiduciary duty to unit owners, hence, Developers should consider this issue when analyzing options regarding the best ownership structure for the development.³ Many courts have found that a Developer owes a fiduciary duty to unit owners and the condominium association during the period of declarant control (i.e. before the Developer has turned over management to the association). After termination of the declarant control period, however, a Developer or controlling unit owner who possesses control through majority ownership of units and number of votes allocated to it, may now owe a fiduciary duty to other unit owners based on this superior voting power and control.

Voting Structures

Developers and controlling unit owners may legally achieve their desired level of control by establishing a class voting structure within the association. Texas property law permits class voting on specified issues “if necessary to protect valid interests of the class.”⁴ Votes must be allocated by a formula that is fair to all owners, the “allocations may not discriminate in favor of units owned by a declarant.”⁵ No Texas courts have addressed the issue, but a South Carolina court of Appeals case, *Goddard v. Fairways Development General Partnership*, dealt one such voting scenario.⁶ In *Goddard*, the Declaration created two classes of voting rights in the Association (i) Class “A” which included all owners, except the

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¹ *See, e.g.,* Concerned Dunes West Residents, Inc. v. Georgia-Pacific Corp., 562 S.E.2d 633 (S.C. 2002); *Goddard v. Fairways Dev. Gen. P’ship*, 426 S.E.2d 828 (S.C. Ct. App. 1993); *Unrau v. Kidron Bethel Retirement Serv.*, 27 P.3d 1 (Kan. 2001).

² *Unrau.*, 27 P.3d at 14.

³ *See* cases cited *supra* note 1.

⁴ TEX. PROP. CODE ANN. § 82.057(c)(1) (2006).

⁵ § 82.057(a).

⁶ *Goddard v. Fairways Dev. Gen. P’ship*, 426 S.E.2d 828 (S.C. Ct. App. 1993).

Declarant (the Developer), and (ii) Class “B” which applied only to the Developer/Declarant.⁷ Class “A” members received one vote for each “Lot” owned.⁸ Class “B,” the Developer, retained 50 votes for each Lot owned, and a total of 1500 votes for existing parcels that would later be subdivided by the Developer into lots.⁹ This system of voting was to continue until the Class “A” shares equaled the Class “B” shares.¹⁰

After six condominiums were completed and conveyed to owners, the Developer turned over control to the Association, which included, as in most cases, the maintenance of the common areas.¹¹ Because there were only six owners who were required to pay for this maintenance, present assessments were inadequate to maintain the common areas.¹² Due to its superior voting power, the Developer completely controlled the amount of the assessments.¹³ The disgruntled owners sought relief and proposed that the Developer pay assessments in proportion to its voting power, instead of paying assessments only on the one lot it owned.¹⁴ The Developer refused.¹⁵ In response, the owners sued the Developer that the Developer owed them a fiduciary duty because of its superior voting strength and that the Developer had an obligation to assess the villa owners at a level necessary to maintain sufficient reserves to fund the common areas.¹⁶ In addition, they argued that based on this fiduciary duty, the Developer had an obligation to expend its own funds for maintenance until such time as sufficient reserves were generated to maintain the areas through assessments.¹⁷

The court ambiguously held that “assuming a fiduciary relationship exists . . . because of superior voting power,” the court could not say that under the circumstances of the case that the Developer violated such a duty by not voting for higher assessments.¹⁸ The court analogized the situation to the principle in corporate law known as the “business judgment rule.”¹⁹ The business judgment rule protects the decisions of the directors of the homeowners association rule absent a showing of bad faith, dishonesty, or incompetence.²⁰ Hence, where the Developer’s vote was worth 50 times the vote of each individual owner, the court found the voting structure was valid and remanded to case to the trial court to determine the Developer’s ultimate liability.²¹

Limitations on Retaining Control

Establishing class voting may be an effective means of retaining control of an association, but voting structures are subject to limitations. A 2001 Kansas Supreme court case, *Unrau v. Kidron Bethel Retirement Serv., Inc.*²², addressed a fact situation similar to *Goddard*. Via the Declaration, the Developer retained control of the association through a class voting structure.²³ Like *Goddard*, the owners sued the Developer based on breach of fiduciary duties when the Developer used its superior voting power to its advantage.²⁴ The individual owners held all Class “A” shares and retained one vote, the Class “B” shares, provided the Developer with one vote for each condominium unit it owned and

⁷ *Id.* at 830 n.1.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Goddard*, 426 S.E.2d at 410–411.

¹² *Id.* at 411.

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Goddard*, 426 S.E.2d at 413.

¹⁷ *Id.*

¹⁸ *Id.* at 414.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.* at 415.

²² *Unrau v. Kidron Bethel Retirement Serv., Inc.*, 27 P.3d 1 (Kan. 2001).

²³ *Id.* at 7.

²⁴ *Id.*

another three votes for each Class A share outstanding.²⁵ Although the Uniform Condominium Act recognizes class voting, the trial court pointed out that the “units may not constitute a class simply because they are owned by the declarant,” but instead, “[p]ermissible unit distinctions must pertain to the characteristics of the unit rather than characteristics of the owner.”²⁶ For instance, it is permissible for residential units to constitute one class of voting and office/retail units another class, but not for developer-owned units to be Class A and individual-owned units to be Class B.

In *Unrau*, the Developer, by virtue of its superior voting power, consistently exercised control regarding the association’s affairs.²⁷ The court recognized that some jurisdictions allow Developers to control condominium associations.²⁸ However, the court distinguished these cases by stating that none of the jurisdictions have allowed the Developer to control the association indefinitely.²⁹ The trial court went on to state that even if the Developer was allowed “to control the association for a reasonable period of time during the initial development and marketing [], that time had come and gone.”³⁰ Ten years had elapsed and the vast majority of the condominiums had been sold.³¹ Although the Developer still owned many of the condominiums through repurchase, the court held that such ownership did not justify Developer control for an indefinite time.³² The trial court acknowledged that, ultimately, the Developer would control the association because eventually, the Developer would own a majority of the condominium units via its buy-back agreements with the present condominium owners.³³ The court then ordered that the voting class system be changed to give the Developer one vote for every condominium unit it owned.³⁴ The court did not address whether the Developer, through ownership of a majority of units, and hence control of the association, would owe a fiduciary duty to other individual condominium unit owners.³⁵

Voting Units Within a Master Association

A 2004 Washington court of Appeals case, *Bellevue Pac. Ctr. Condo. Owners Ass’n v. Bellevue Pac. Tower Condo Ass’n*,³⁶ addressed voting schemes within the master association context. The Developer divided the mixed-use development into three units: residential (individual-owned), parking (Developer-owned), and office (Developer-owned).³⁷ All three units were under the umbrella of a master association.³⁸ Each unit was allowed one vote, but because the Developer owned two of the three units it always had a majority.³⁹ The court did not specifically address the issue of fiduciary duty, but it did suggest that as long as each unit has equal voting rights and bears the same share of common expenses, there is no discriminatory voting in a “majority wins” situation, even if one party is always the winner.⁴⁰

Based on the cases discussed herein, it appears that courts are more concerned with the manner in which an association voting scheme is established than whether the voting results are discriminatory. If a class voting system provides a vehicle for a developer to retain control indefinitely, then a court may

²⁵ *Id.*

²⁶ *Id.* at 5.

²⁷ *Unrau*, 27 P.3d at 7.

²⁸ *Id.*

²⁹ *Id.* at 7.

³⁰ *Id.* at 8.

³¹ *Id.*

³² *Unrau*, 27 P.3d at 8.

³³ *Id.*

³⁴ *Id.*

³⁵ *See Unrau*, 27 P.3d 1.

³⁶ *Bellevue Pac. Ctr. Condo. Owners Ass’n v. Bellevue Pac. Tower Condo. Ass’n*, 100 P.3d 832 (Wash. Ct. App. 2004).

³⁷ *Id.* at 2.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.* at 9.

go so far as to find a breach of fiduciary duty. If each ownership unit is given the same number of votes, however, and a Developer happens to own the majority of units, a court is less likely to find a breach of fiduciary duty, despite the fact that the Developer may never relinquish control of the vote.

The Business Judgment Rule is Likely to Apply

In most jurisdictions,⁴¹ where a developer or controlling unit owner is found to owe a fiduciary duty to the other unit owners, the prevailing standard is to borrow from corporate law principles to apply the “business judgment rule.” In *Goddard*, the court assumed a fiduciary relationship existed between the Developer and the unit owners.⁴² The court also found that the Developer had superior voting power, but “refrained from exercising [its] superior voting strength . . . in deference to the wishes of the [unit owners] . . .”⁴³ Where the Developer had superior voting rights, but refrained from exercising those rights in a manner that would have been unfair to the homeowners, the Developer’s conduct was not a violation of its fiduciary duty.⁴⁴

Not all jurisdictions apply the business judgment rule to condominium association decisions. Generally, New York courts apply the business judgment rule to scrutinize the decisions of association boards of directors which shields directors from “indiscriminate attack” but also “permits review of improper decisions” such as those that have no “legitimate relationship to the welfare of the cooperative, deliberately singles out individuals for harmful treatment, [are] taken without notice or consideration of the relevant facts, or is beyond the scope of the board’s authority.”⁴⁵ In *Croton River Club*, the Developer was the party subject to discriminatory treatment.⁴⁶ The homeowners association allocated 53% of the costs to maintain a marina to one member of the association, which happened to have been the Developer.⁴⁷ The lower court found the allocation was unfair and the association’s decision should not be accorded business judgment rule protection.⁴⁸ The *Croton River* court found that there may have been discriminatory intent behind the board’s actions and because the Developer had no power to vote on the allocation, there was increased risk of overreaching by the board.⁴⁹ After rejecting the business judgment rule standard, the court applied a reasonableness standard and found the allocation was unreasonable.⁵⁰ In *Bellevue Tower* where the result was discriminatory, but the voting scheme was fair on its face the voting scheme survived.⁵¹ In contrast, the *Croton River Club* court found both discriminatory intent and a discriminatory result and granted relief (in this case to the Developer).⁵²

Bottom Line

Fiduciary duty cases in this context seem to deal primarily with allocation of expenses between the Developer and the individual owners. No cases were found to address non-financial aspects of managing a property such as altering exterior features or implementing use restrictions. Case law in this area is scant at best and practically nonexistent in Texas. The Texas Property Code does, however, stipulate that, unless provided otherwise in the declarations, a unit owner “may not change the appearance of the common elements or the exterior appearance of a unit . . . without prior written permission of the association.”⁵³ Hence, Texas law recognizes the importance of maintaining the

⁴¹ South Carolina, Florida, inter alia. California has adopted a version of the business judgment rule as applied to non-corporate entities. No court has articulated the standard would be applies Texas.

⁴² *Goddard*, 426 S.E.2d at 414.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *In re Croton River Club, Inc.*, 162 B.R. 648, 652 (1993).

⁴⁶ *Id.* at 652.

⁴⁷ *Id.*

⁴⁸ *Id.* at 653.

⁴⁹ *Id.*

⁵⁰ *In re Croton River Club, Inc.*, 162 B.R. at 655.

⁵¹ See notes 36–40 and accompanying text.

⁵² See notes 45–50 and accompanying text.

⁵³ TEX. PROP. CODE ANN. § 82.061(a)(2) (2006).

integrity of the external aspects of a development. Furthermore, if the voting structure is established in a manner that is fair on its face (such as one unit one vote in *Bellevue*) then even if the majority always wins, it is likely to be valid. Courts will not automatically find that a Developer owes a fiduciary duty to individual unit owners. The individual owners must have had a reason to put special trust in the Developer. This area of law will continue to develop, but at present, a proper voting structure and strict declarations will likely provide assurance to all parties involved.

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