

Remarks to RACCA Member Meeting 9-29-2015

My name is Robert Womble. I am a partner in the Raleigh office of K&L Gates. We are legal counsel to FSC I, LLC.

Tonight I am going to speak from the perspective of someone who has been involved with Riverwood Athletic Club since before it was even an idea, on the structure of the relationship among Riverwood on the Neuse, LLC (the Developer), Riverwood Athletic Club Community Association, and FSC I, LLC (the amenities provider and manager of the Community Association).

First a word about planned communities. Typically with a planned community the developer will place restrictive covenants on the property, build the amenities (such as a swimming pool), and form a community association to own and operate the amenities and enforce the covenants. The association will have no employees, and may engage a pool management company to manage the pool and an association management company to manage the association. The association will be funded by lot owner assessments. However, until a large majority of the lots are sold, the assessments will not produce enough income to offset the association expenses, so the developer will subsidize the association. During the subsidy period the developer will be entitled to appoint a majority of the members of the association's board of directors. The plan is that as the last lots are sold the association's revenues will equal its expenses, making the developer subsidy no longer necessary. At that time the developer's ability to control the association's board of directors will disappear, the developer will step out of the picture, and the association will be on its own.

Riverwood Athletic Club follows the above pattern, with a few critical differences dictated by the nature and scope of the amenities to be provided. The land for Riverwood Athletic Club was first purchased in 1998. In many ways the community was ahead of its time. The plan was for the community to have as a central business district what we now refer to as a "mixed use" district, although at that time that term was not widely used because it was a relatively new concept. Among the unique features planned for Riverwood Athletic Club were extensive athletic-oriented amenities, going beyond a neighborhood pool to include an athletic club and access to golf.

The extensive recreational amenities were going to cost a substantial amount to construct - I am told in excess of \$2.0 million. For the sake of convenience I will refer to this amount as \$2.0 million. Since at that time the Community Association did not have \$2.0 million in available funds, and in fact did not have any funds, these funds would have to be borrowed. Since the Community Association did not have the income stream to support the repayment of that type of debt service, use of the recreational amenities by non-Community Association members, on a fee basis, would be required. In fact, the projections showed that in the early years, before a

large proportion of the lots within Riverwood Athletic Club would have been sold, use of the recreational amenities by non- Community Association members, on a fee basis, would have to exceed the use of the recreational amenities by Community Association members, in order to make the numbers work. But this would create a tax problem if the usual pattern were followed and the recreational amenities were owned by the Community Association. Among other things, community associations are tax-exempt organizations, but if on a regular basis a community association makes available its facilities for use by non- members on a fee paying basis the community association will realize unrelated business taxable income. If a community association's unrelated business taxable income becomes too great a portion of its income, the community association will lose its tax-exempt status altogether. That likely would have been the result for the Community Association, in view of the level of outside fee-paying use required.

Also, any institutional lender would require that assets be pledged to secure the \$2.0 million debt. At that time the Community Association did not have any assets. So, as a practical matter it would not be possible for the Community Association to borrow the funds required in order to build the Riverwood Athletic Club recreational amenities.

So, to avoid this result a different structure for Riverwood Athletic Club was required. The solution to the problem was for the Riverwood Athletic Club recreational amenities to be owned by an entity other than the Community Association, and for the Community Association to pay to the owner of the recreational amenities a fee, for which the owner of the recreational amenities would make available to the Community Association members those recreational amenities. At the time a Fred Smith Company affiliated entity then named SunBelt Golf Group, LLC, and now named FSC I, LLC and which I will refer to as FSC I, LLC, owned the Hedingham Golf Club Raleigh and the Riverwood Golf Club in Clayton, which could be pledged as collateral for the \$2.0 million loan, so it made sense that FSC I, LLC would be the entity to own the recreational amenities.

So that was the arrangement contemplated by the Operating Agreement for Riverwood on the Neuse, LLC, which is the developer for Riverwood Athletic Club. I drafted that Operating Agreement back in 1998, and it provided that Riverwood on the Neuse would agree with FSC I, LLC to provide the recreational amenities for the project.

So, Riverwood on the Neuse, LLC bought the land, used its funds to install the streets, utilities and other infrastructure, and sold lots to builders. Riverwood on the Neuse, LLC as Declarant placed restrictive covenants on the property. Those restrictive covenants provided for the organization of the Riverwood Athletic Club Community Association, and the Association was organized. FSC I, LLC pledged its golf course assets as security for a \$2.0 million loan, and the loan proceeds were used by FSC I to build the recreational amenities. The restrictive covenants

provided that each lot owner in Riverwood on the Neuse would be automatically granted a "Bronze Membership" in Riverwood Athletic Club, through which the lot owners could utilize the recreational amenities, with the fees for such Bronze Membership to be levied against the lot owners as a part of the Base Assessment.

FSC I, LLC entered into an agreement with the Riverwood Athletic Club Community Association where FSC I, LLC agreed to provide to the Association, for the use of its members, the "Bronze Membership" to Riverwood Athletic Club. That agreement between Riverwood Athletic Club Community Association and FSC I, which I will call the Facilities and Services Agreement, also provides that FSC I will provide common area maintenance within Riverwood Athletic Club and manage the affairs of the Riverwood Athletic Club Community Association, which does not itself have any employees.

So, that is the arrangement that is in place. FSC I owns the recreational amenities and provides them to the Riverwood Athletic Club Community Association, for use by its members, and the Riverwood Athletic Club Community Association members are entitled to use those recreational amenities. The fee set by FSC I, LLC for the "Bronze Membership" is currently \$58 per month, and represents an approximate 35% discount from the \$89 per month paid by the non-Community Association members for a "Bronze Membership" in Riverwood Athletic Club.

While pursuant to the Services and Facilities Agreement FSC I, LLC may charge the Community Association, in addition to the "Bronze Membership" fee, an incremental fee for providing common area maintenance within Riverwood Athletic Club and managing the affairs of the Community Association, prior to April 2015 FSC I, LLC did not do so and instead the costs of such services were absorbed by FSC I, LLC in what is the equivalent of a developer subsidy. Beginning in April 2015, in addition to the "Bronze Membership" fee, FSC I charges the Community Association an incremental fee for providing common area maintenance within Riverwood Athletic Club and managing the affairs of the Community Association, and that incremental fee is funded not through the Base Assessment (which continues to be the same as the "Bronze Membership" fee amount) and instead is funded through a developer subsidy.

If you examine the Riverwood Athletic Club Community Association's income statement, each month you see \$58 coming in to the Community Association from each lot owner as the "Base Assessment." Then you see that same amount being paid out by the Community Association to FSC I, as the "Bronze Membership" fee pursuant to the Facilities and Services Agreement. You will also see amounts collected by the Community Association as "Specific Assessments" from certain lot owners who have elected upgraded athletic club membership levels, and those same amounts being paid to FSC I by the Community Association for those upgraded memberships. So those "Base Assessment" and "Specific Assessment" amounts are a "wash," in that they come in and immediately go out. You will also see smaller amounts of miscellaneous income

and miscellaneous expenses. I am told that every year since the Community Association was organized those miscellaneous expenses have exceeded the miscellaneous income, resulting in a deficit. I am told that each year that deficit has been made up with funds provided to the Community Association by Riverwood on the Neuse, the Developer.

To associate some numbers with the above methodology, let's look at the Community Association income statement examples on the handout. These examples are based upon what I am told are the actual numbers for May 2015. To simplify matters, some of the line items have been combined. The first box shows how the Community Association income statement is formulated for each month beginning in May 2015. The first box shows the Base Assessments and Specific Assessments being paid to the Community Association each month, as required by the Covenants, and those same amounts being paid by the Community Association to FSC I each month, as "Bronze Membership" fees and upgraded athletic club membership level fees pursuant to the Facilities and Services Agreement. The first box also shows some miscellaneous income received by the Community Association each month, and miscellaneous expenses paid by the Community Association each month, the resulting deficit, and the Developer funds used to defray the deficit. The second box shows the same May 2015 numbers, presented in the manner the Community Association income statement was formulated for each month prior to May 2015. Prior to May 2015, since the Base Assessments and Specific Assessments were to be paid to FSC I at or about the time they were collected from lot owners, the procedure was for FSC I to directly collect those funds from the lot owners. Thus, the Base Assessments and Specific Assessments were not reflected in the Community Association income statement. But note that the other items in the Community Association income statement, namely the miscellaneous income, the miscellaneous expenses, the deficit, and the Developer funds, were exactly the same as they are for May 2015 and thereafter. So the only difference is in the presentation. In May 2015 the Base Assessments and Specific Assessments collection procedure, the FSC I payment procedure, and the resulting income statement presentation were changed, in the hope that the new presentation would be more illustrative. But note that the only thing that has changed is the presentation, and the overall economics are the same. That is, the lot owners pay the same Base Assessments and Specific Assessments as before, and FSC I receives the same fees as before. It is just that now the Base Assessments and Specific Assessments are routed through the Community Association's bank account, whereas before they were not.

One thing you will note in looking at the Community Association budgets and income statements is that they do not include some of the line items often reflected in the budgets and income statements for other community associations, such as for capital expenditures, equipment costs, depreciation, and maintenance. This is because unlike many Community Associations that own their recreational amenities, with the associated costs reflected in the

budgets and income statements, the Community Association does not own the Riverwood Athletic Club recreational amenities, which are owned by FSC I and for which the Community Association pays to FSC I a monthly fee as specified in the Facilities and Services Agreement. So, it is only that monthly fee which is reflected in the Community Association budgets and income statements, and not the costs borne by FSC I.

As I mentioned at the beginning of my remarks, an annual community association budget deficit and the deficit make-up by the developer is the typical situation for community associations in communities still in the process of selling lots. I recall a meeting in the conference room on the second floor of the Hedingham Golf Club clubhouse, that took place probably in 1998 when the Riverwood Athletic Club project was still an idea and the Riverwood Athletic Club land had not yet been purchased. During that meeting one of the investors remarked that Riverwood Athletic Club would be a 20 year project. So, as we are now around 17 years into the project, hopefully that deficit is decreasing each year as more lots are sold. Then, hopefully, when the lots have been sold and Riverwood on the Neuse, the Developer, exits as the party controlling the Community Association, the Community Association will be operating at break-even. Otherwise, since the Developer will no longer be funding budget deficits the Community Association board must either reduce expenses or increase revenues - probably through an increase in the Base Assessment.

Recall that one reason for arranging things in the way they are arranged for Riverwood Athletic Club was to allow for persons who are not lot owners to also use the recreational amenities, on a fee basis, in order to partially defray the costs of operating the recreational amenities and in that way minimize the costs to the Community Association and to lot owners. In considering whether this goal has been achieved, please review the table on the handout and compare the \$58 per month charged Riverwood Athletic Club residents for membership in the Community Association including access to the recreational amenities, to the monthly charges of between \$50 and \$180 per month for neighboring Johnston County communities with varying levels of recreational amenities.

Thank-you for allowing me to speak.

**Riverwood Athletic Club Community Association
2015 Amended Budget**

G/L	1Q2015	2Q2015	3Q2015	4Q2015	ANNUAL
	3001.00 Base Assessment		166,170.00	166,170.00	166,170.00
3001.20 Specific Assessment-Club Upgrade		10,530.00	10,530.00	10,530.00	31,590.00
3120.00 Capital Contribution		3,000.00	3,000.00	3,000.00	9,000.00
3100.10 Administrative Charge Income	3,062.50	3,675.00	3,675.00	3,675.00	14,087.50
3100.20 Violation Income	250.00	1,046.25	1,046.25	1,046.25	3,388.75
3100.30 Late Fee/NSF Income		1,425.00	1,425.00	1,425.00	4,275.00
3100.40 Town of Clayton Utility Reimb		10,518.45	10,518.45	10,518.45	31,555.35
3190.00 Interest Income		25.00	25.00	25.00	100.00
3199.00 Declarant Contribution		54,049.83	54,049.83	54,049.83	162,149.50
TOTAL INCOME	3,337.50	250,439.53	250,439.53	250,439.53	754,656.10
5001.00 Amenities Fee		166,170.00	166,170.00	166,170.00	498,510.00
5001.20 Amenities Upgrade Fee		10,530.00	10,530.00	10,530.00	31,590.00
5001.10 Administrative Fee Expense	575.00	675.00	675.00	675.00	2,600.00
5002.00 Utility Expense	1,250.00	22,442.70	22,442.70	22,442.70	68,578.10
5006.10 Community Repairs	687.50	2,250.00	2,250.00	2,250.00	7,437.50
5010.00 Professional Fees	100.00	266.67	266.67	266.67	900.00
5011.00 Liability Insurance	287.50	845.50	845.50	845.50	2,824.00
6170.00 Social Events	437.50	1,604.17	1,604.17	1,604.17	5,250.00
5015.00 Post Office Lease		4,500.00	4,500.00	4,500.00	13,500.00
5020.00 CC discount Fees		1,500.00	1,500.00	1,500.00	4,500.00
5025.00 Bad Debt Expense		3,843.00	3,843.00	3,843.00	11,529.00
5030.00 Management Services Fee		21,487.50	21,487.50	21,487.50	64,462.50
5035.00 CAM Services Fee		14,325.00	14,325.00	14,325.00	42,975.00
TOTAL EXPENSE	3,337.50	250,439.53	250,439.53	250,439.53	754,656.10
NET CASH	-	(0.00)	(0.00)	(0.00)	-

NOTES/ASSUMPTIONS

- *955 residents x \$58 base assessment
- *resident club upgrade fees
- *assume 5 per month x \$200/unit
- *assume 5 per month x \$245/unit
- *based on 2014 income actual
- *assume collect \$25 fee for 19 returns/month
- *Town of Clayton monthly utility reimb
- *payment to Sports Club
- *payment for resident upgrades to Sports Club
- *assume \$45*5 per month
- *used 2014 expense as estimate
- *used 2014 expense as estimate
- *2015 policy premiums
- *used 2014 expense as estimate
- *estimate
- *estimate based on Jan'15 delinquent dues
- *\$7.50 x 955 residents
- *\$5.00 x 955 residents

**Riverwood Athletic Club Community Association
2015 Amended Budget-Beaver Creek Townhomes**

	<u>1Q2015</u>	<u>2Q2015</u>	<u>3Q2015</u>	<u>4Q2015</u>	<u>ANNUAL</u>
3121.00 Maintenance Unit Income		23,406.00	23,406.00	23,406.00	70,218.00
TOTAL INCOME	-	23,406.00	23,406.00	23,406.00	70,218.00
5060.00 MFN Services Fee		20,916.00	20,916.00	20,916.00	62,748.00
5006.20 MFN Reserve/Contingency		2,490.00	2,490.00	2,490.00	7,470.00
TOTAL EXPENSE	-	23,406.00	23,406.00	23,406.00	70,218.00
NET CASH	-	-	-	-	-

NOTES/ASSUMPTIONS
* 166 units x \$47/mo

* 166 units x \$42/month
* 166 units x \$5/month