The moral hazard of mandatory membership in private clubs

Leon Hoke
The University of Tampa

Brian T. Kench
The University of Tampa

Charles Skipton
The University of Tampa

ABSTRACT

There is a trend sweeping the private club industry in Florida, mandating that all homeowner association members pay initiation fees and dues to the private country club in their housing development. So-called "mandatory membership fees" are an attempt to eliminate, or at least reduce, a free-rider problem concerning the financial health of ailing private country clubs. This paper argues that the implementation of mandatory memberships creates a moral hazard problem. Because of mandatory memberships, homeowners now have little to no protection from the board of directors and staff of the country club that might be interested in empire building or promoting salary and benefits increases while forcing homeowners in the housing development to pay the tab. Finally, the authors offer an explanation of how this mandatory membership moral hazard may actually lead to decreases in property values and rent transfers among the participants.

Keywords: agency theory, common interest community, mandatory membership, moral hazard

INTRODUCTION

There is a trend sweeping the private country club industry, mandating that all common interest association members pay initiation fees and dues to the private country club in their private community. In many cases, private country clubs have fallen on hard times and are threatening to go bankrupt, thereby negatively affecting housing values in the housing development. The argument made by the private golf clubs for mandatory membership fees is that as housing values in the development surrounding the golf course are positively impacted by the success of the golf club so should all of the home owners within the community contribute financially to the well-being of the private country club. Hence, “mandatory membership” is an attempt to eliminate, or at least reduce, an individual home owner’s *incentive* (within the housing community possessing the golf club) to let *someone else* pay for the costs of these ailing clubs.

In the jargon of economics, mandatory membership is an attempt to eliminate a free-rider problem where the public good is the golf club (with its manicured greens) and the non-excludable parties (who benefit from the positive externalities created by the club) are the proximal property owners within the housing development. In short, the argument for mandatory membership is one which endeavors to bring an efficient level of golf course / club provision to a market where the potential for under provision exists.

Though economic efficiency arguments for mandatory membership contracts suggest their use in some cases, they can have a dark side. Mandatory membership fees create a moral hazard problem where the interests of the principal (both the home owners and the private owners of the club) are no longer in line with those of their agents (both the board of directors, hereafter BOD, and staff of the club). Once mandatory membership is in place, the principals have little to no protection from a BOD and staff whose personal interests may be empire building, while the home owners pay the tab.[1] These issues, along with an explanation of how the potential for the moral hazard problem may actually lead to decreases in property values and rent transfers among the various participants, are addressed here.

The next section reviews the common interest community governance structure and its treatment by courts. Section three lays out the current state of the golf industry. Section four introduces the concept of mandatory membership to a country club and how the Court has treated such contracts. Section five argues that mandatory membership programs are a poor organizational design mechanism to solve the financial problems of country clubs. The last section concludes the paper.

[1] *Empire building* describes the actions of decision makers to maximize the size of their division’s budget, number of employees, size of facility, etc., instead of maximizing its profits (or minimizing its costs). Such behavior is often suggested to occur whenever decision makers are neither residual income claimants nor compensated in some fashion which explicitly aligns the interests of the principal and the agent. In the public choice literature, which studies government decision making, the study of such behavior is called bureaucracy theory (see Niskanen, 1996).

COMMON INTEREST COMMUNITY GOVERNANCE

More than 62 million American live in common interest communities in which owners of separate real estate parcels have some common interest that is owned and managed by a group.[2] Drewes (2001, p.322) writes that common interest communities attract investors because they (1) seem to provide traditional services such as trash collection more efficiently than a local government, (2) enable an investor to acquire private access rights to golf courses, tennis courts, and other amenities that otherwise they otherwise could not afford, (3) efficiently regulate conduct within the boundaries of the community, and (4) foster a belief by investors that such restrictive regulations and other services provided ensure that property values will remain high.

Examples of common interest communities include gated communities, condominium associations, and cooperatives. More formally, property law defines a common interest community as:

> A real estate development or neighborhood in which individually owned lots or units are burdened by a servitude that imposes an obligation that cannot be avoided by nonuse or withdrawal (a) to pay for the use of, or contribute to the maintenance or, property held or enjoyed in common by the individual owners, or (b) to pay dues or assessments to an association that provides services or facilities to the common property or to the individually owned property, or that enforces other servitudes burdening the property in the development or neighborhood.[3]

Common interest communities have restrictive covenants[4] or constitutions that are tied to land and are enforceable against the initial owner entering into the contract and the covenant is also tied to any future owner of the property. All current and future land owners in a common interest community must agree to abide by the benefits and burdens of the communities restrictive covenant.

Common interest communities are organized around community associations. Most commonly, community associations are governed by an elected BOD. In this setting, the governance mechanism requires homeowners to join the community association and then hand over the control of the community to the governing body. This organizational model places homeowners in a similar situation to that of shareholders in a large corporation; residents are freed from management worries and are able to sit back and watch their property values grow.

On the rare occasion when a “covenant” issue arises in the common interest community, a full referendum among all the members of the community is called. Otherwise, the day to day governing matters are left to the governing body to vote on the level of services delivered and internal assessments. The BOD typically hires an independent management team to manage the day to day management affairs, *e.g.*, hiring security and collecting association dues, of the common interest community.

Nelson (2002, 66) writes that the residents of a community association choose the members of the BOD through an election. The terms of members are usually staggered so that only part of the BOD is elected at any given time. Candidates generally run as individuals

[2] See http://www.caionline.org/about/facts.cfm (last visited May 9, 2012).
[3] Restatement, third, of Property, Servitudes, Section 6.2, (2000).
[4] Covenants are also called Declarations of Covenants, Conditions, and Restrictions (CC&Rs).

without any party labels. A typical term might be two or three years. Most elections are at large; all the candidates run against one another and the highest vote getters win the allotted number of seats on the BOD. In the normal arrangement, voting rights in community elections are assigned equally to each housing unit. Hence, multiple owners of single units must share a single vote, and renters usually do not have any vote at all. Once elected, the BOD will normally have its own voting rules that apply for the standard kinds of decisions it handles, and it usually operates by majority rule.

All common interest communities are private organizations. As such, a community association has the power to modify existing or add new community bylaws. Because these communities are private organizations, courts generally show deference to their internal activities and to the decision-making and rule-making functions served by community associations (Rogers 2004, 1457). However, if a disagreement over the common interest community's covenant or bylaws develops, then the courts are called upon to resolve the matter. In adjudicating these matters, courts have adopted a variety of approaches to balance the interests presented by the parties; the most common of which is contract law because the covenant is a contract tied to land (Rogers, 1458).

Matters commonly brought to the court address cases where a BOD (1) assiduously enforced covenants of which many residents were unaware (despite having signed the covenant upon their purchase and sale) and (2) promulgated restrictive new policies without the input of most residents (Drewes 2001, 322).

As for the first matter, a strict view of contract law suggests that investors should be bound by the contract they explicitly sign, no matter whether the investor fully understood the contract at the time of its signing. The most cited legal example of the view is the following:

> [Covenants, conditions, and regulations (CC&Rs)] are clothed with a very strong presumption of validity which arises from the fact that each individual unit owner purchases his unit knowing of and accepting the restrictions to be imposed... Although case law has applied the word "reasonable" to determine whether such restrictions are valid, this is not the appropriate test, and to the extent that our decisions have been interpreted otherwise, we disagree. Indeed a use restriction in a declaration ... may have a certain degree of unreasonableness to it, and yet withstand attack in the courts. If it were otherwise, a unit owner could not rely on the restrictions found in the declaration of condominium, since such restrictions would be in a potential condition of continuous flux.[5,6]

This commonly cited precedent set by Hidden Harbour supports a hands-off judicial policy by the Court.

---

[5] Hidden Harbour Estates, Inc. v. Basso, 393 So. 2d 637, 639-40, Fla. Dist. Ct. App. 1981.

[6] For additional examples of this view see: Noble v. Murphy, 612 N.E.2d 266, 270-71 (Mass. App. Ct. 1993), Nahrstedt v. Lakeside Vill. Condo. Ass'n, Inc., 878 P.2d 1275, 1286 (Cal. 1994), Carl B. Kress, Comment, Beyond Nahrstedt: Reviewing Restrictions Governing Life in a Property Owner Association, 42 UCLA L. Rev. 837, 839 (1995), and Lamden v. La Jolla Shores Clubdominium Homeowners Ass'n, 980 P.2d 940, 953-54 (Cal. 1999).

The Courts have subjected the second matter of addendums to the restrictive covenant to the test of "reasonableness". Drewes (2001, 333-4) writes that Courts test reasonableness with four broad questions:

1. was the rule adopted in a good faith effort to serve a purpose of the subdivision;
2. are the means adopted to serve the purpose reasonable;
3. is the rule consistent with the declaration and other superior documents; and
4. is the rule consistent with public policy.

The use of these four questions places much weight on the wording of the original covenant of the community association. And the fourth question becomes a serious factor only when a state has passed statutes explicitly authorizing or prohibiting certain actions by community associations, when an action violates an honored common law rule or when an action conflicts with federal law (Drewes, p. 334). Thus, as Natelson (1989) has recognized, most courts give wide latitude to the association, and if the purpose behind a rule is proper, it is seldom invalidated on the grounds of unreasonableness.

Yet, Rogers (2004, 1466) argues that from the perspective of the property owner, this analysis is too deferential. Contract law should account for the expectations of every party to a contract. The current reasonableness model does not lend enough consideration to the expectations of an association member. Do persons investing in common interest communities have a legally enforceable expectation that aspects of the community in existence when they invest will not change without their consent (Randolph 1998, 1081)? By focusing on the effect on the association, the reasonableness model does not consider whether a change is so significant as to change the "deal" for the individual association members.

THE GOLF INDUSTRY AND COUNTRY CLUBS

The U.S. golf industry includes approximately 15,751 facilities (NGF 2012) with an estimated 27 million adult players.[7] Florida ranks first in 18-hole equivalent golf courses with 1,204 and California ranks second with 909.5 (NGF 2012). Across the country, approximately 14.8% of Americans play at least one round of golf a year. Of this population of golfers (in 1994-5) 72.4% were male, 26.2% were 30-39 years old, and 62% earned between $25,000 and $75,000 dollars annually (U.S. Dept. of the Interior 1994). Further, the data shows that most golfers continue to golf through their highest earning years into retirement (15.2% of the golfing population in 1994-5).[8] Nationally, golfers spend approximately $24.3 billion (in 2002) on greens fees and related equipment (NGF 2005). Although golf expenditures declined nationally by nearly 18% during the great recession, year-on-year changes in golf expenditures have stabilized (American Express 2011). Despite the recent downturn, golf is very big business.

While the growth rates of the total number of U.S. golf courses and the growth rate of real GDP in the U.S. (for the period 1929 to 1996) are highly correlated (with a correlation

---

[7] See <www.ngf.org>.

[8] This empirical observation of behavior regarding the persistence of golf as a leisure activity through the different measured life periods within the data is discussed in the 1982-83 Nationwide Recreation Survey, the earlier title for the NSRE – National Survey on Recreation and the Environment – which is cited above.

coefficient of 0.989) the division of market share between the different types of venues (forms of organizational structure) has changed markedly in the last 50 years (Melvin and McCormick 2001). Since 1970, private county clubs have been losing market share to public golf courses. According to the National Golf Association, private golf courses represented 47% of all U.S. golf courses in 1970, by 1985 that number had declined to 40%, and by 2003 the number was only 26.5% (NGF 2012). A separate, comprehensive study of the golf industry by Melvin and McCormick (2001), which included data from nearly 98% of U.S. golf courses, found the same general pattern in course ownership – with the growth in the market share for public golf courses growing steadily since the mid-1950s. At the very end of their study sample period (1994-96), Melvin and McCormick find the public course market share at 46%, with the private and semi-private facilities possessing 27% and 20% respectively (leaving 6% held by resort courses for which ownership distinction was not identified).[9]

The challenges faced by the private country club reflect difficult conditions faced by the golf business as a whole – strong consistent growth in the number of U.S. golf courses while, at the same time, a slowing in the growth rate of golf participation. At the same time, National Golf Foundation statistics indicate a slowing in the growth of golf participation, especially since 1990.[10] Golf participation grew by 52% between 1980 and 1990, an increase from 15.1 to 23 million golfers; ten years later, between 1990 and 2000, golf participation grew by only 10%, an increase from 23 to just 25.2 million. Further, during the same period, the number of rounds played per course decreased from 40,955 in 1985 to 33,385 in 2003.[11] The downward trend in golfers per course is because of faster growth in courses than in players and, at the same time, a reduction in the number of rounds played per golfer.

MANDATORY MEMBERSHIP TO A COUNTRY CLUB

Mandatory membership to a country club requires that every resident of a common interest community pay an *assessment* to financially support the associated country club. This charge is similar to the way a typical community association maintains all of its common areas and common elements through mandatory maintenance fees and assessments (Patasnick 2004, 3).

There are variations in the process of imposing mandatory memberships on the members of a community association. Generally, though, the common interest community is approached by the country club BOD to change the community association's bylaws so that all community members are required to be members of the country club at some level.

The transition to a mandatory membership is a first generation matter. The goal is to design a transition program to ease the current generation of general community members into becoming country club members. For example, some common interest communities have a golf membership category and a non-golf membership category. In the later category no golf amenities are allowed to be used. In other cases, existing homeowners are "grandfathered into" the mandatory membership program. In such cases, an existing community resident who chooses

[9] Regarding specific private ownership organizational structure, Melvin and McCormick (2001) also found 39.3% of the courses in their 1994-96 sample (98% of all U.S. courses) were independently owned, 26.2% equity owned, and only 17.1% corporately owned.

[10] See www.ngf.org, the National Golf Foundation website, for additional statistics.

[11] Statistics from www.ngf.org.

not become a county club member would not have to move out of the common interest community. However, when these grandfathered members choose to sell their home, the new property owner, *i.e.*, the second generation homeowner, must pay a club initiation fee and, thereafter, mandatory country club dues. In many programs, the second generation community member is required to take on the same or higher level of mandatory membership held by the seller of the property (Patasnick 2004, 8).

Consider the following example of a community association that converted to mandatory membership in an associated country club. In 1999, Desert Crest Mobile Home Park, managed by OSCA Development Company, formally amended article 19 of Desert Crest's covenant to require mandatory membership to the adjacent Desert Crest Country Club. The original and amended sections of article 19 states:

> Members of the Desert Crest Community Association shall pay to Desert Crest Hot Springs, as compensation for the privileges herein granted and for the services furnished or secured by Desert Crest Hot Springs, such amount as may be assessed ratably against said member by Declarant each month, provided, however, that the aggregate amount as assessed per member shall not at any time exceed One Hundred Eighty Dollars ($180.00) per year, provided that this maximum may be increased by Desert Crest Hot Springs in the same proportion as the cost of living index of the United States Department of Labor increases above such index on the date of recording these restrictions.
>
> Said fees, however, shall not include the privilege of playing golf on the golf course owned by Desert Crest Hot Springs. Golf playing privileges are hereby extended to the members of the Desert Crest Community Association on a non-exclusive basis by the payment of such fees as may from time to time be set by Desert Crest Hot Springs. . . .

A majority of the community association approved the following amendment to article 19 of Desert Crest's restrictive covenant:

> Each owner by acceptance of the deed to the Owner's Residential Lot, is deemed to covenant and agree to pay to OSCA Development Company or its successor in interest the maintenance assessments duly levied by OSCA Development Company pursuant to these [covenants]. The maintenance assessments and any late charges, reasonable costs of collection and interest, as assessed by OSCA Development Company in accordance with this paragraph shall also be a personal debt of the owner of the residential lot at the time that the maintenance assessment and other charges are levied. The assessment and late charges, costs of collection, and interest shall be in accordance with the Collection Policy of OSCA Development Company, which shall be separately provided to each owner of a residential lot. **The owner may not waive, opt out of, or otherwise escape liability for these assessments by nonuse of the Community Area or any of its facilities or improvements, or nonuse or abandonment of the owner's residential lot.**" (Boldface in original.)

The mandatory membership to the country club shown above is a tool to spread the financial obligations of the club over all the residents of the Desert Crest Mobile Home Park and does not offer access to play golf on the golf course.

As you might imagine, some common interest community members do not approve of a mandatory membership to a county club. For instance, in Desert Crest Mobile Home Park example the management company filed suit against some of the community members over the mandatory membership matter. In OSCA Development Company v. Blehm *et al*. (2003) the parties disagreed over the 1999 majority vote (300 for, 213 against) amending article 19 of the Desert Crest Community Association's restrictive covenant, which required membership in the county club and the payment of maintenance fees.[12] Many of the 213 homeowners in the minority refused to pay the mandatory fee and this caused OSCA Development Company to bring a breach of covenant lawsuit against these community members.

The court applied the test of reasonableness discussed earlier. It ruled that a person who buys a property subject to a restrictive covenant is bound not only by the existing provisions, but also every lawful amendment enacted in compliance with that provision. In this case, community association's restrictive covenant states that amendments must be adopted based on the majority vote rule. Because the association did adopt the amendment based on the majority vote rule, the California Court of Appeal concluded that the association adopted the amendment in accordance with the governing documents. The courts have articulated that they will not intervene to reverse the actions of private parties.

From a contract law perspective, there appears to be no legal recourse to mandatory membership programs. And so, the practice of moving to mandatory memberships for country clubs is increasing in frequency. In most of these cases, proponents of the mandatory memberships claimed that the country clubs were forced into this solution because their community residents were aging and could not be as active in the club as they once were. The proponents of mandatory membership claim the country club is a helpless victim of uncontrollable negative demographic trends (Salisbury 1999, A1) and that mandatory membership serves are a viable solution to the financial problems of these private golf clubs.

ASSOCIATIONS, CLUBS, MANDATORY MEMBERSHIPS, AND THE PRINCIPAL-AGENT PROBLEM

Within any organization, transaction costs of various sorts can generate economic inefficiencies. One potential source of economic inefficiency that may arise with the mandatory membership systems described above is related to the classic principal-agent problem. The principal-agent relationship may be described as any situation in which one party, the *principal* (the resource owner or residual claimant), contracts with another party, the *agent*, to engage in any activity in support of the principal's goals. "Agency problems" result from conflicts of interests between agents who are under contract with one or more principal(s) (Jensen and Meckling 1992; also see Harris and Raviv 1978). Typical agency problems involve the cost and challenge of aligning the interests of the agent with those of the principal; agency problems are very complex as it is not possible to write a complete contract for every action that the agent might take which can impact the overall welfare of the principal (Brennan 1995). For example, a

[12] OSCA Development Company v. Blehm, E032843, Court of Appeal of California, Fourth Appellate District, division two, October 14, 2003, Cal. App. Unpublished.

manager might shirk, consume perquisites, and choose investment and operating policies that reduce profits but increase the manager's expected well-being (Brickley *et al*. 2002). Agency problems typically occur when it is difficult and / or expensive for the principal to monitor the behavior of the agent to ensure that it is aligned with the interests of the principal. In such a situation, information is said to be "asymmetric," creating what economists call "moral hazard."

Two broad strategies that the principal may pursue in order to realign the interests of agent with that of their own would be to offer them performance based incentives (performance pay) or to find a way to monitor them more closely. For example, in the trucking industry some managers use trip recorders and electronic records of speed, idle time, and other data to monitor their drivers. Studies demonstrate that when employees operate trucks that were electronically monitored there were significant differences in those efforts in the interest of the principal (Png 2002). Each type of agency problem does have a potential solution, but solutions always come at a cost. Agency costs, therefore, are the sum of the costs of designing, implementing, and maintaining appropriate incentive and control systems and the residual loss resulting from the difficultly of solving these problems completely (Jensen and Meckling 1976).

In some instances, though, the agency cost of realigning the incentives of the principal and the agent become prohibitive. In such a case, it is Pareto optimal to take the agent's task and relocate it outside the boundaries of the organization – that is, outsource the activity. In these instances, contracting at arm's length is the structural setting needed for optimal behavior. For example, outsourcing janitorial services in many organizations lowers agency costs and increases the quality of the service provided.

Many activities of common interest communities and private country clubs are characterized by agency relationships. For example, board members are both principles and agents. As elected representatives, board members are agents of the members at large and have a responsibility to protect the interests of the members. Board members are also principles, overseeing the general manager who is an agent of the BOD. Moreover, the general manager is a principle and his staff members are his agents.

In the country club setting, agency problems are observed at several levels. In particular and most obviously, the BOD is typically made of amateurs in the country club business, charged with the responsibility of evaluating the performance of a professional general manager. The problem is magnified since the board members' primary source of information is delivered in the form of the manager's report that is commonly presented at the monthly board meeting. Typically, the BOD relies on the general manager to self-report outcomes that could negatively affect the BOD's evaluation of the manager and, ultimately, renewal of the manager's contract. Under these circumstances, there is a strong incentive for the manager to at best spin, or at worst deliberately misrepresent, the information the BOD uses to make decisions.

Given that some members of the BOD have inadequate management experience in the business, it would be difficult for them to know what questions to ask, what information to seek or where to find the information. Board members may be reluctant to even ask questions for fear of offending and alienating the general manager, who has influence over the board member in many subtle ways, such as tee time reservations and table selections on holidays.

Similarly, the general manager is also faced with the problem of asymmetric information. The club is likely to be open from before sun up until late at night. The wait staff may lock up at three in the morning and the golf maintenance staff will arrive before dawn. The operation is spread out over many acres. The manager cannot be everywhere all the time and often employees are unobserved and can easily shirk and engage in opportunistic behavior. For example, the cart boy who is supposed to be wiping down the carts may find it easier to just spray the towels to make it look like he did his job. Or the beverage cart person may round up from $2.75 to $3.00 and charge $12 for four drinks to the unsuspecting guest or new member.

Club members are unlikely to be aware of any of these problems, and therefore are unlikely to bring any pressure to bear on the BOD to promote the effective and efficient use of the club's resources for the benefit of the members. In fact, most members will judge the performance of the BOD in terms of how individual decisions affect them personally. Under these circumstances, board members are likely to filter out information that might lead to criticism of board decisions.

In short, the private country club represents a case of moral hazard brought on by layers of asymmetric information and the lack well-defined contracts to deal with problems. Although general managers typically have employment contracts, the standard contract is not designed to handle the myriad of agency problems mentioned, either by implementing performance pay clauses or by creating mechanisms to monitor the general manager. Because of the general lack of knowledge of the mechanisms that exist to solve agency problems, very few of these techniques are observed in the employment contracts of country club managers.

Clearly, the responsibility lies at the feet of the BOD to recognize the likelihood of an agency problem and also to be sure mechanisms are implemented to solve these types of problems. However, for the typical country club BOD, there is little incentive for them to solve agency problems or in many cases the BOD simply does not recognize that an agency problem exists; they don't know they don't know.

These sorts of governance problems with nonprofit boards have been well documented in the literature. For example, Chait and Taylor (1989, 44) write: "boards do not govern. They get bogged down in operating details, matters that are best left to staff, while ignoring the very issues that determine the enterprise's success or failure." This is precisely the criticism that is often levied at boards of country clubs. For example, the publisher of the country club trade journal *BoardRoom* writes,

> "How often have you encountered the private club that's really the personal fiefdom of board members, 'the clique of the chummy old boys network', or where board members flaunt their own personal agenda seeking personal glorification…all to the detriment of the private club and its members. Problem is, the private, personal objectives are often masked until a board member is vaulted into power and club members are powerless to do anything about it" (Fornaro, 12).

A problem in this nonprofit environment is that high powered market incentives are lost.[13] As a result, the BOD tends to be reactive by acting after an economic crisis has developed rather than being proactive and designing optimal organizational design mechanisms beforehand.

[13] With 'for-profit' organizations, profit shares encourage the creation of efficiency – regardless of how such profit shares are distributed among the decision makers within the organization. A 'residual share' serves to encourage decision makers to consider, carefully, their behavior within the firm as those decisions that create profits for the organization also create personal benefits to themselves as a residual claimant. Profits are generated either by minimizing the resource cost for a particular task or maximizing the value enjoyed by the consumer for a given resource

Economic theory would predict that agency problems will be limited by the constraint of market forces. Ultimately, in a well-functioning market, members will leave, the financial condition of the club will deteriorate and the final manifestation of the agency problem will be bankruptcy. Country club resources will be transferred to another owner with more specific knowledge and the ability to construct an architecture that promotes more effective and efficient use of the resource.

Viewed from a competitive market perspective, the decline in private club market share represents a predictable result of market forces weeding out their weaker competitors. The privately-owned-and-operated daily fee courses are proving to be too much of a strategic challenge for many private country clubs. Restaurant chains with high volume and high efficiency are creating club-like environments without corresponding initiation fees, dues or monthly minimums. Members and potential members are finding better value available elsewhere and are *voting with their feet*.[14]

The process leading to the competitive market outcome, however, has a transition period during which remaining members of the club and the BOD overseeing that club inevitably feel significant pressure to change the ownership structure for the organization. Consider the following example of a country club industry in Florida. Several community members of the Seven Springs Villas, a subdivision of New Port Richey, Florida, each bought a $7,500 equity membership in the Seven Springs Golf and Country Club upon moving into the community. Over time, they said, the club deteriorated, the BOD was guilty of mismanagement, the fees went up, the condition of the course became shabby, and they decided to quit (Raeke 2003, 1). This process, whether it be as a result of existing members participating and spending less at their clubs, members stepping down their membership category to lower dues paying levels, or members resigning from their clubs, is placing a greater share of financial pressure on the diminishing number of members who remain at their clubs (Patasnik 2004, 1).

Mandatory membership programs have been offered to common interest community BOD by accountants and attorneys as a *legal mechanism* that will "solve" the private country clubs' *economic problem*. Legal mechanisms can hide, but they cannot solve economic problems. Although the mandatory membership program is promoted as a "healthy solution" that will insulate the country club from a wide range of external threats which are collectively shaking financial foundations of many private country clubs, without substantive changes in organizational governance mechanisms at the country club level the financial problems will only be shifted around and not solved.

Consider again the Desert Crest case detailed earlier. In that case, the Court ruling for mandatory membership to a country club relied in part on an argument that housing values are increased because of the country club amenity. The community association at Seven Springs Villas in New Port Richey, FL (detailed just above) made the same argument. Because community members without memberships to the country club receive a positive benefit in the

---

commitment – or both. Hence, decision makers within for-profit firms are incentivized to employ resource efficiently by "high powered market incentives."

[14] This is a passing reference to the classic public choice paper by Tiebout (1956) in which efficient public goods provision can be achieved by the mobility of voters in political jurisdictions who do not value the mix of local public goods provided. Dissatisfied constituencies can "vote with their feet" by moving into / out of political jurisdictions where the mix of public goods provision is less than appropriate / more appropriate.

form of high home valuations, community covenants provide the legalese for the common interest community to assess fees and require the "free riders" to pay their fair share. The courts validate this view because the legal process utilized is proper.

Although not spoken by proponents of mandatory membership programs, an open question is whether a common interest community with a country club maintains its property values better than a common interest community without such an amenity.

Owusu-Edusei and Espey (2003) estimated the impact of proximity to public and private golf greens on housing values using a hedonic pricing model and found that adjacency to lush and manicured golf greens was statistically associated with a 27% market premium; further, they found that homes 300 to 1,100 feet from the greens possessed a 15% market premium.[15] Others have also found that the effects stemming from proximity to golf courses drops off very quickly. Do and Grudnitski (1995) found that property values adjacent to greens possessed a 7.6% positive effect which petered out after only 100 feet (for additional estimates of the estimated positive impact of golf green adjacency see Hirsh 1994, and Firth 1990).[16]

Even though the impact on market prices for private homes may be statistically associated with proximity to golf courses / greens, a similar affect may be present with other sorts of green spaces. Owusu-Edusei and Espey (2003) also found in their hedonic analysis that houses within 300 feet of small neighborhood parks possessed market price premium of 17%, with homes within 300 to 500 feet possessing a premium of 8% (for other studies relating to the statistically measured impact of proximity to other sorts of green spaces see Weicher and Zerbst 1973 and Mahan, Polasky, and Adams 2000).[17]

At the end of the day, the mandatory membership program is a mandatory tax on all homeowners in a common interest community that will, for a short-term, hide the ineffectiveness and inefficient country club management. If the real problem is related to unsolved agency problems, then the mandatory membership program is an attack on a symptom and not the underlying problem. Mandatory memberships mask and short-circuit the market signal that agency problems are diminishing value in the country club. As a result, economic theory predicts that homes in common interest communities with mandatory memberships programs and unsolved agency problems will, over the longer run, generate relatively lower home values per square foot relatives. Unfortunately and perhaps more importantly, the stakes are raised with

[15] A study of the impact of Florida golf courses on proximal housing market values by Haydu and Hodges (2002) found that in 12 of the 18 counties studies (in 1999) there was a statistically significant positive impact on market value (for all ownership types – private, semi-private, public, corporately owned, and / or resort). Of the remaining 6, 3 had measured negative impacts 3 had no association at all.

[16] The Haydu and Hodges (2002) study also found that the positive impact of proximity to golf courses in the state of Florida was very localized – petering out after only a few miles.

[17] An interesting result stemming from the Owusu-Edusei and Espey (2003) study is that they found that proximity to medium sized, basic parks was associated with a significant negative impact on home market values of 50% within 600 feet and 34% for those 600 to 1,200 feet away. This begs the question of whether or not the limited use nature of a small park limits the negative externality that crowds of users, their children, dogs, and parking would introduce. With this argument in mind, the structurally limited use nature of golf course greens limits the potential for such a negative impact on housing values – assuming, of course, the use of the greens was limited by private ownership (as opposed to a public greens).

mandatory membership because now a country club's BOD is responsible for making decisions that directly affect not only the country club, which they're charged with managing, but also the value of all the homes in the common interest community.

CONCLUSION

Mandatory membership, it is argued, can be used to limit the economic inefficiencies that stem from the public good characteristics of golf courses. Golf courses (and their manicured green spaces) generate positive 'spillover' benefits that accrue to parties who own the homes in the communities surrounding the golf course property. Because the golf club cannot mandate that all those who receive these spillover benefits compensate the club for the resources employed, some potential efforts by the club that would generate more benefits than costs are not pursued and economic inefficiency results. Though the empirical evidence (in the literature) indicates a positive externality is measurable for homes near a golf course, the monetary benefit enjoyed by these property owners is estimated to diminish quickly with distance (as rapidly as 100 feet); similar positive externalities (again, diminishing rapidly with distance) have also been measured and estimated for other sorts of green space (such as community parks).

No one knows how mandatory memberships will work over time. If a club's BOD wisely manages the new economic resources flowing in because of mandatory membership, then there is an obvious potential that housing values could increase, as the proponents of mandatory memberships predict. On the other hand, the moral hazard outlined in this article has the potential to gobble up and destroy value in a high-stakes negative sum game.

Unfortunately, clubs which are most likely to seek a political / legal solution to the club's financial problems are the ones mostly likely to be plagued with agency problems. The market is signaling that the club has not adapted well to changes in the external economic environment. Proponents of mandatory membership argue that the club is the helpless victim of an aging community. Opponents argue that the BOD should have recognized the demographic destiny of the club and adapted long before. Now the club is in crisis and expects the community to pay for the BOD's mistakes.

Regardless of who is right in the short term, mandatory memberships have the potential to cover up the BOD's inability to either create strategies attracting new members or contain costs sufficiently. It seems unlikely that board members will become more attentive to the needs of the market now that the club's financial security is assured regardless of what strategies are implemented.

Clearly mandatory memberships do nothing to diminish the moral hazard which exists in the private club industry. In addition, the potential damage is increased. Before the worst outcome was bankruptcy for the club and the indirect effect of bankruptcy on housing values in the community. The club would be bought by someone willing to risk his own resources and / or convince the bank that he has a plan to make the club work as a stand-alone entity. With mandatory membership, the moral hazards internal to the club have the potential to directly affect the homeowner by altering the level of a homeowner's equity in their home.

In the worst case scenario, disgruntled homeowners call for a revote and reverse the decision to require mandatory membership. Members flee and the club is forced into bankruptcy. The club is sold at a fire sale price and banks will be unable to recover the full value of their loans. The bank has the right to go after the individual homeowner and put a lien on individual homes to collect the rest of the debt. The lien and the mortgage on the house may exceed the value of the property and the homeowner would have an incentive to walk away from the home.

Ultimately then it is critical for homeowners to examine the club's problems in terms of the cause. Before agreeing to bail the club out, members of the community should hold the BOD accountable and insist the board engage in all the processes which benchmark the club against best practices in the industry. The BOD should be willing to create a written strategic plan with a mission, vision and goals as well as an incentive system which aligns the interests of all the agents. Community members should vote against mandatory membership unless the BOD is willing to engage in this process.

It may be that the country club is simply not a viable economic entity given current environmental conditions and the debt level of the country club. If that is the case then the best solution is bankruptcy. Debtors may lose part of their loan and equity members may lose the money they have invested, but the club will be bought at a price consistent with its current market value. Perhaps some golf courses would be of greater value as community parks. The problem is economic and markets do have the ability to solve such problems.

REFERENCES

America Express (2011). 2011 Spend Sights Special Report, U.S. Business & Consumer Golf Spending.

Brenan, M.J. (1995). 'Corporate Finance Over the Past 25 Years', *Financial Management* 24, 9-22.

Brickley, J., Smith, C., Jr., and Zimmerman, J. (2002). *Managerial Economics and Organizational Architecture*, McGraw-Hill Irwin.

Chait, Richard, and Barbara Taylor (1989). Charting the Territory of Nonprofit Boards," *Harvard Business Review,* January-February, 44-54.

Do, A.Q., and Grudnitski, G. (1995). "Golf Courses and Residential House Prices: An Empirical Examination", *Journal of Real Estate Finance and Economics*, 10: 261-270.

Drewes, David C., (2001). "Putting the 'Community' Back in Common Interest Communities: A Proposal for Participation-Enhancing Procedural Review," *Columbia Law Journal*, 101(March): 314-350.

Firth, W.R. (1990). "Can Golf and Housing Get Along?" *Urban Land* (February 1990): 99-105.

Fornaro, John, (2002). "Publisher's Perspective," *The Boardroom,* 52: 12-14, 52.

Harris, M. and A. Raviv (1978). "Some results on incentive contacts with applications to education and employment, health insurance, and law enforcement." *American Economic Review* 68: 20-30.

Haydu, J. and Hodges, A. (2002). "Economic Dimensions of the Florida Golf Course Industry," EDIS document FE 344, Department of Food and Resource Economics, Florida Cooperative Extension Service, Institute of Food and Agricultural Services, University of Florida (Gainesville, FL).

Hirsh, Laurence A. (1994). " Private-Equity Golf/Country Club Communities: Issues and Answers," *The Appraisal Journal* (April 1994): 188.

Hyatt, Wayne S. (1998). "Common Interest Communities: Evolution and Reinvention," *J. Marshall Law Review* 31(Winter): 303-395.

Jensen, M., and Meckling, W. (1976). Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure. *Journal of Financial Economics* **3**: 305-360.

Jensen, M., and Meckling, W. (1992). Specific and General Knowledge, and Organizational Structure. in Lars Werin and Hans Wijkander, eds., *Contract Economics*. Oxford: Basil Blackwell, pages 251-74.

Mahan, B., Polasky, S., and Adams, R. (2000). "Valuing Urban Wetlands: A Property Price Approach", *Land Economics* 76(1): 100-113.

Melvin, P. and McCormick, R. (2001). "On the Demand and Supply of Golf," working paper available online at <http://sixmile.clemson.edu/researchtopics.htm>.

National Golf Foundation—NGF (2012). *Golf Facilities in the U.S.* 2012 edition. Available online at http://www.ngf.org/.

National Golf Foundation—NGF (2005). *1st Quarter 2005 Golf Industry Report.* Available online at http://www.ngf.org/.

Natelson, Robert G. (1989). *Law of Property Owners Associations*, Little Brown & Company.

Nelson, Robert (2001). "The Rise of Private Neighborhood Associations: A Constitutional Revolution in Local Government," University of Maryland, paper prepared for a conference on "The Property Tax, Land Use and Land-Use Regulation," sponsored by the Lincoln Institute of Land Policy, January 13-15, 2002,Scottsdale, Arizona.

Niskanen, William A. (1996). *Bureaucracy and Public Economics*, New York: Edward Alger.

Patasnick, Robert (2004). "Mandatory Membership IS an amenity!" *The Private Club Advisor*, (May 15).

The Boardroom Briefs: Official Publication for the Association of Private Clubs & Directors (2005). *Directors and Executives.* Retrieved September 25, 2005, from http://www.boardroommagazine.com/executive.html.

Png, I. (2002). *Managerial Economics,* second edition, Blackwell Publishing.

Raeke, Richard (2003). "Dispute over club dues heads to court," *St. Petersburg Times*, November 9. Retrieved September 25, 2005, from http://www.stpetetimes.com/2003/11/09/news_pf/Pasco/Dispute_over_club_due.shtml.

Randolph, Patrick A., (1998). "Common Interest Development Communities: Part II: Changing the rules: Should Courts Limit the Power of Common Interest Communities to Alter Unit Owner's Privileges in the Face of Vested Expectations", *Santa Clara Law Review,* 38: 1081-1133.

Rogers, Mark A., (2004). "Comment: Community Association Law: Administrative Law as a Solution by Analogy", *Emory Law Journal*, 53(Summer): 1457-1490.

Salisbury, S. (1999). Shank shot; Homeowners argue that mandating membership isn't fair; Country club community's plan for mandatory membership has home owners concerned about selling with new restrictions, *Broward Daily Business Review,* (February 25): A1.

Tiebout, C. (1956). "A Pure Theory of Local Expenditures" *The Journal of Political Economy,* Vol. 64, No. 5 (Oct.), 416-424.

U.S. Department of the Interior, (1986). "1982-1983 Nationwide Recreation Survey," National Park Service (Washington, D.C.).

U.S. Department of the Interior, (1996). "National Survey on Recreation and the Environment, 1994-1995," National Park Service (Washington, D.C.).

Weicher, J. and Zerbst, R. (1973). "The Externalities of Neighborhood Parks: An Empirical Investigation", *Land Economics,* 49: 99-105.