

# **THE PITFALLS OF MEMBERSHIP DOCUMENTATION**

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### **A. INTRODUCTION**

The term “club” is a general term used to describe an association of people united by some common interest or purpose.<sup>1</sup> It includes any kind of group that has members who meet for social or recreational purposes, such as country, dining, athletic and alpine clubs.

Successful clubs are able to harmoniously foster the members’ commonality of interest. Conversely, clubs tend to struggle when disharmony occurs in the membership ranks. Disharmony is often the result of a disagreement between club management and a member. Unfortunately, even when club management “wins” a dispute with a member, the proverbial war may be lost due to the disharmony created by the dispute.

Many member disputes can be avoided with membership documentation that clearly documents the rights, privileges and responsibilities of the members. An ambiguity in the documentation favors the member because of the disharmony that may result merely from the disagreement itself. This article is intended to briefly examine the key membership documents and to highlight several areas where drafting mistakes are often made.

### **B. A HISTORICAL PERSPECTIVE**

Two types of clubs exist. One is an incorporated member club comprised of individuals who contribute the funds necessary to run the activities and events for which the club is formed. This type is frequently referred to as an “equity club” or a “member owned club.” The second type is the unincorporated proprietary club where a third party owns the property used for the club’s activities and funds and conducts the club in an effort to make a profit. This type of club is sometimes referred to as a “for-profit club” or a “developer club”. In the for-profit club, the members are given the right, typically a license, to use the property of the owner in exchange for the payment of dues and fees.

The equity club is typically incorporated as a not-for-profit corporation governed by state statute. The corporation often operates as a tax exempt organization under Section 501(c)(7) of the Internal Revenue Code.<sup>2</sup> The not-for-profit corporation is distinguished from the for-profit corporation in that it cannot issue stock or dividends. Instead of shareholders, it is controlled by its members who elect a Board of Directors to govern the organization.

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<sup>1</sup> The American Heritage® Dictionary of the English Language, Fourth Edition. Houghton Mifflin Company, 2004. *Answers.com* 12 Jul. 2006. <http://www.answers.com/topic/club>

<sup>2</sup> Exempt from federal income taxations are: “Clubs organized for pleasure, recreation, and other non-profitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.” I.R.C. § 501(c)(7)

The bylaws of the not-for-profit corporation serve a dual purpose. First, they serve as the bylaws for the corporation, the governing constitution, setting forth the internal workings of the corporation and the parameters under which it is to be operated. Second, they describe the rights and powers of the members, including the rights of the members to enjoy the club's facilities.

In addition to bylaws, most equity clubs have rules and regulation that serve as the rules for the conduct of the members in the use of the club. In the equity club, a member's "contract" is embodied in the bylaws enacted through representatives elected by the members.

Historically, most clubs were equity clubs. However, in the last 20 to 30 years, an increasing number of private clubs have been developed that are owned as for-profit clubs by third party operators. The equity club membership documents and structure served as the model for the membership documentation for the for-profit clubs, and the principal documentation consisted of a membership application, membership bylaws and rules and regulations. While this seems like a logical extension of concepts, it is not always a perfect fit because the bylaws for an equity club are actually the governing document for a legal entity comprised of members with an ownership stake in the entity. Although an entity exists in the case of a for-profit club, it is an entity owned and controlled by the third party operator and not by the members themselves. A membership in the for-profit club is merely a right to use; it is not ownership. Ownership in an equity club comes with obligations to assist with funding the club's operations, including the obligation to pay assessments. As a result, ownership is not something that can be easily surrendered. The same obligations do not exist in the for-profit club.

Membership documentation for the for-profit club has been slowly evolving due, in part, to what appears to be a recognition that the for-profit club and the equity club have some inherent differences between them. This is evident in the trend away from the use of membership bylaws for the for-profit club. Such use often creates confusion among the members for a number of reasons, including the fact that the bylaws are not the same as the bylaws for the corporation that may own the club's facilities. What is being used with growing frequency today is a membership plan. Although it contains most of the provisions found in the standard set of membership bylaws, it frequently is drafted in a less legalistic fashion with a slight marketing bent to it.

The typical membership documentation in a for-profit club consists of a membership application, membership plan and rules and regulations. The membership application is an important component of the documentation because it usually is the only document actually signed by the member. As a result, it is the primary piece in the member's "membership contract" with the club owner. From the member's perspective, if the member wants to memorialize a particular promise of the club owner, that promise should be embodied in the membership application (which is actually an agreement) instead of the club's membership plan, which generally is not signed by the club owner and which usually provides that it may be amended from time to time by the owner.

## **C. POTENTIAL PITFALL AREAS**

While the nuances of membership documentation are numerous, the basics can be summed up by considering the following questions: What do I have? What can I do? How can you change what I do? What do I owe? How can I leave? How can I get some of my money back when I leave? These are the primary questions that must be addressed in the membership documents. In preparing the documents, care should be taken to avoid certain recurring pitfalls. Some of the more common pitfalls are discussed below.

### **(1) Identifying the Member**

The membership documentation should clearly state who the member is and what rights others have to enjoy the privileges of membership. The prevailing trend is to make most memberships family memberships, which means that all immediate family members may use the club's facilities. However, a primary, designated or named member should be identified, preferably in the membership application because it provides a default mechanism for the club in the case of disputes (or lack of agreement) between and among persons enjoying the privileges of membership under a single membership. Having a designated member is important (i) where members have voting rights and only one vote per membership is allowed; (ii) in the case of divorce where the husband and wife cannot agree on who is to retain the membership; and (iii) when the club owner needs to regulate the usage of certain golf or other facilities by limiting usage during certain times to one person per membership. In each instance, the identification of a primary member allows the club owner to avoid being dragged into disputes among multiple individuals with privileges under a single membership.

If a club offers corporate memberships, care must be taken (i) to identify with specificity the permitted designees under the membership; (ii) to specify whether or not the permitted designees have family privileges; and (iii) to state who is liable for dues and charges under the membership.

### **(2) Membership Privileges**

The bylaws or membership plan for a club should adequately describe each type of membership and the rights and privileges associated with that membership. Memberships are usually defined in terms of the privileges accorded to the membership, which includes the member's rights to use the various facilities of the club. I generally like to think of memberships in terms of classes and categories with the class describing the right to use a particular type of club facility and the category being some subtype of the class. For example, the classes of membership in a country club might be golf, tennis, athletic and social. The categories would describe some subset for the right to use the facilities of that class, which may reflect lesser usage rights at lesser joining fees with lesser monthly dues, such as a week day golf category that permits golf course usage privileges only on week days.

Unfortunately, membership documents often list every type of membership and generically refer to each as a membership class. This is a common occurrence in an established equity club where one may find in excess of 15 different membership classes. The danger with not clearly identifying membership classes and categories lies in how the various descriptions of the

memberships are referred to or treated in the other sections of the bylaws or membership plan. Poorly drafted descriptions of classes and categories lead to ambiguities and drafting errors in other sections of the bylaws or plan, such as those sections dealing with transfers, voting and membership caps.

### **(3) Membership Transfer and Redemption**

The ownership distinction between equity clubs and for-profit clubs is important to understand when documenting membership transfer and redemption rights. For-profit clubs frequently borrow the equity club model on transfer without the recognition of the inherent differences between the equity club and the for-profit club. In certain respects, the members in the equity club are the similar to shareholders in a for-profit corporation. Once issued, a membership does not go away, which means, that if a member wishes to resign from the club, that person's membership must be transferred to a new member who will assume both the privileges and the obligations of the membership. Thus, the bylaws of the equity club must include provisions on how memberships can be transferred. In the for-profit club, the club owner simply grants each member a license to use the club's facilities. The license exists as long as certain contractual obligations are met. Although theoretically possible, the licenses are not numbered such that the license, once issued, can be passed from person to person. When the for-profit club member wants to resign from the club, the owner can, by contract, make the member liable for certain financial obligations. However, the failure of the member to meet those obligations does not usually increase the financial burden of the other members as it would in the case of an equity club where a member failed to pay his or her share of a capital assessment.

The for-profit club membership documentation usually prohibits the transfer of memberships "except through the club". However, the concept of transferring memberships in a for-profit club is usually just a fiction, despite terminology in the membership documents to the contrary. The real issue for the member is generally one of refundability or availability, not one of transferability. The member's primary concern is not whether or not the membership can be sold to someone else who will assume the responsibility to pay the monthly dues. It is either (i) when can I get back some or all of the joining fee I paid to acquire my membership, or (ii) how can I be assured that the person buying my property can have a membership at the club.

The provisions in the membership plan and bylaws regarding "transfer" and refundability are perhaps the most difficult of all to draft. The nomenclature employed in describing these concepts is important in order to avoid creating ambiguities. For example, many clubs institute a waiting list approach for members seeking to "sell" their memberships following resignation. Until a club has reached a full capacity of members, the memberships of resigning members are typically "sold", "refunded" or "redeemed" on some sort of alternating basis with the club, such as one membership of a resigned member on a waiting list for every three memberships sold by the club for its own account.

The terminology to employ in the membership documents depends on the character of the membership. Is the membership an ownership right in an equity club? Is it merely a license to use the facilities owned by a third party? Is transfer really the issue or is it an issue of refundability? Is the membership being "redeemed"? Is it appropriate to refer to a "reissuance" of the membership?

The waiting list concept used in connection with membership transfers and redemptions can become complicated. The general premise behind the concept is to allow the equity club or the third party owner, as the case may be, to sell memberships for its own account instead of simply replacing outgoing members. This is an area where the classification and categorization of memberships is important. By way of example, assume that a club offers a full golf membership for \$25,000, a corporate golf membership for \$50,000 and a tennis membership for \$3,000, and it promises to refund 80% of the joining fee for each membership on a 3-in, 1-out basis (*i.e.*, the club will transfer or redeem 1 outgoing membership from a waiting list for every 3 memberships sold for its own account). If the club only maintains a single waiting list, it could find itself having to refund \$40,000 to a resigned corporate member following the sale of 3 tennis memberships from which it netted a total of \$9,000. Ideally, the club should maintain separate waiting lists for each class and category of membership; however, that is not always feasible where there are only a few memberships in a given class or category as a member may be on the list for years before receiving the promised joining fee refund.

The waiting list and member refund provisions may be further complicated if the equity club or for-profit operator finances memberships by allowing new members to pay for memberships over time. If that happens, the equity club or for-profit operator may be in a position of having to refund a portion of a membership joining fee without having collected sufficient cash from the previous three memberships sales to cover the refund.

#### **(4) Amendments to Bylaws and Membership Plans**

Flexibility in membership document is obviously important and the club owner should reserve the right to make changes to the bylaws or membership plan. The club is an operating business and it must be able to adjust to changing circumstances. The club owner may retain the absolute discretion to made changes in the bylaws or plan or it may provide that certain document provisions cannot be changed without a vote of the affected members. If a voting mechanism is set up, it should be carefully crafted to ensure that it achieves the desired goal.

#### **(5) Turnovers**

A common exit strategy for real estate developers who build golf courses to enhance their real estate sales is for the developer to turn the club over to the members after the developer's project has been sold out. Several different structures may be used, but all of them typically result in the conveyance of the club to a not-for-profit entity controlled by the members. Perhaps no area of membership documentation has greater potential for drafting mistakes than that of member turnovers. Many member law suits have been threatened or filed over the issues arising in conjunction with a member turnover.

Member turnovers are complicated, and unfortunately, many drafters try, typically with poor results, to cover the topic in a brief paragraph or two. The successful turnovers tend to be those in which the process has been thoroughly documented.