SOUTH COAST HOMEOWNERS ASSOCIATION

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2nd ANNUAL SPRING BREAKFAST!

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STRIKING THE PERFECT BALANCE FAIRNESS AND CONSISTENCY IN RULE ENFORCEMENT, ARCHITECTURAL CONTROLS, FINANCES AND DELINQUENT ASSESSMENTS

With **Jan Hickenbottom, PCAM**, owner of Condo Consulting Services in Irvine, CA and critically acclaimed columnist in the *Los Angeles Times* from 1989-2001. She recently published a collection of her columns Questions and Answers About Community Associations that we distributed to all 2003 members. Additional copies will be able at the special price of $20 at this event.

SATURDAY, MAY 15, 2004

Moby Dicks Restaurant
Stearns Wharf, Santa Barbara
Registration – 8:30-9:00 AM
Breakfast 9:00 - Program to follow
Cost - $10 per person by May 12
Mail registration and payment to our address above
$20 at the door

2004 CONDOMINIUM BLUEBOOKS

The Condominium Bluebooks arrived the first week on January and all members who have renewed their memberships for 2004 received a copy. Additional copies of the Bluebook are available for $16 per copy, postpaid.

ASSOCIATIONS NOW RESPONSIBLE FOR CONTRACTORS' VIOLATIONS OF LABOR LAW

By: Karen A. Mehl, Attorney at Law

Editor's Note: Karen is a long-time contributor to South Coast HOA through her participation in our law update meetings and newsletter articles. She is the Secretary for the California Legislative Action Committee (CLAC) which is part of the national homeowners association, Community Associations Institute. This issue was discussed by Karen in our Santa Maria law update program this past February.

SB 179 was passed last year by the California Legislature and signed by Governor Davis. The purpose of this new law is to provide additional protections for workers whose employers do not comply with the labor laws. This new law allows the workers to sue a person or entity (e.g. your association) who contracts with an employer (e.g. your contractor) to provide services in certain industries. In order to bring the lawsuit, the worker must show that the person (your association) hiring the contractor knows, or should have known, that the amount of money he paying for the contract was not sufficient for the contractor to comply with all state and federal labor laws.

Community associations frequently use three of the industries covered by this law. Those industries are: construction, security guard services, and janitorial services.

There is a way for associations entering into such contracts to protect themselves. If the contract for these services contains all of the information below, and if the information is kept up to date, then the law assumes that the contract price was sufficient to cover the cost of compliance with all of the labor laws, and the worker or workers bringing the lawsuit must prove that the association knew or should have known that the contract price was not sufficient to cover the cost of compliance with the labor laws. The contract must:

1. Be in writing and in a single document;

2. Contain the name, address and telephone number of all parties to the contract;

3. Contain a description of the labor or services to be provided and a statement of when the services are to be commenced and completed;

4. Contain the state tax employer identification number of the contractor;

5. Contain the workers' compensation insurance policy number and the name, address and telephone number of the insurance carrier for the contractor;

6. Contain the vehicle identification number and the vehicle liability insurance information for any vehicles to the used in performing the contract;

7. Contain the address of any property to be used to house workers under the contract;

8. Contain the total number of workers to be employed under the contract and the total amount of wages to be paid, and the dates upon which those wages are to be paid;

9. Contain the amount of the commission or other payment to be paid to the contractor for services under the contract; and

10. Contain the total number of persons who will be used under the contract as independent contractors, along with the license numbers of those contractors for any required licenses

Any changes made to the contract must meet all of the requirements of the original contract. Estimates may be used for the number of workers and independent contractors, but the parties must keep updated records as that information becomes available. The association must keep a copy of the contract for 4 years after termination of the contract.

There are penalties for violating this law. An employee of a contractor, who has not complied with all of the labor laws, may sue the association for his actual damages or $250 dollars per employee per violation, whichever is greater. If there is more than one violation, then the penalty rises to $1,000 per employee for each subsequent violation. An employee who wins may be awarded his attorney fees and costs of suit. The employee may not bring a lawsuit under this law unless the employee can show that he was injured as a result of a violation of a labor law or regulation in connection with the performance of the association's contract.

Associations should re-negotiate all of their contracts for construction, security and janitorial services to include the information requested by SB 179. All new contracts for these types of services should contain this information. If a contractor is unable or unwilling to provide this information, then the association should refuse to contract with him. Furthermore, the association should contact contractor's insurance carriers to make sure that all policies are in force and should make sure that their contracts provide that failure to maintain the insurance listed in the contract is considered a violation of the contract terms and a permitted reason for the association to cancel the contract. For additional information regarding the types of provisions that contracts should contain, the association should contact its attorney.

PLEASE FEEL FREE TO MAKE COPIES FOR YOUR BOARD MEMBERS
SHARE THIS NEWSLETTER WITH YOUR ENTIRE BOARD OF DIRECTORS

RESERVE STUDIES -
Should Associations Be Required To Be 100% Funded?

By Chris Andrews Stone Mountain Corporation

Association Board members often tell their reserve study specialist that they would like to be 100% funded and they want to know how can they achieve that goal.

Recently, the Legislature of the State of California is considering *requiring* homeowners associations to be 100% funded.

Definition

Percent-Funded = (Cash in reserve account) / (Depreciation of reserve items to-date).

"Depreciation" is simply a measure, in dollars, of how much of an asset (roof, pool, paving, etc.) has been "used up" since it was new.

As an example, suppose your association is a simple planned unit development that has only one reserve component such as paving of road surfaces. And suppose for this example that your roads need to be re-paved every 10 years at a cost of $100,000. If your roads were last repaved 5 years ago, you should theoretically have one half of $100,000 (ignoring inflation for now), or $50,000 in reserve at this point in time.

If your association currently has $50,000 in reserve funds, it would indeed be 100% funded for the depreciation that has occurred to date. If your association has $25,000 in reserve, then it would only be 50% funded.

Although being 100% funded is indeed a noble goal, not to mention fiscally responsible, there are important subtleties that should be understood before making campaign speeches to your association membership about how "we must be 100% funded."

Indeed, there are cases where "underfunded associations" may be able to ramp up to being 100% funded over a period of years.

If your association has not diligently saved enough reserve funds to offset depreciation of the association's capital assets (roofing, paving, pools, etc.), your reserve study will show the association's "percent funded estimate" as being quite low. A low percent-funded rating is typically below 50%.

The difference between the amount of reserve funds the association has now and how much it should theoretically have in order to be 100% funded is called the *"unfunded depreciation liability."* Most reserve studies indicate the amount of your unfunded depreciation liability.

If your current Board wishes to raise the percent-funded rating to 100%, your membership will have to resuscitate their reserves with a transfusion of cash at some point in time (Translation: Special assessment or higher regular assessment).

The question is how much and how fast? Should the association special assess for the shortfall in reserves immediately? If your Board plans to do so, then that brings up an ethical question as well: Is the current class of homeowners being unfairly penalized for the shortfall in reserves?

In an ideal world, you would like to be able to collect back payments from all the past owners who have lived in the association during the years when the association was not saving reserve funds at the same rate as their capital assets (roofing, paving, etc.) were depreciating.

Unfortunately, some of those owner/members who benefited from the use of the roads, streets, pool, etc., have moved elsewhere and didn't have to pay for the depreciation of those items, leaving the members who are still living in the association to foot the bill.

And what about the new owners who have just moved into the association?

Is it fair for new home buyers to have to pay for the "wear-and-tear" on the roads, roofs, tennis courts, etc. that occurred before they moved in? Not at all! With that in mind, some smart prospective condominium buyers have successfully negotiated with sellers to credit the buyer for the seller's share of unfunded depreciation liability as shown in the reserve study!

Indeed, crediting new home buyers for each seller's share of the unfunded reserves should become a standard part of the escrow process. Thus no one would be able to "escape" from paying their fair share of depreciation that occurred during their tenure.

Because it isn't an ideal world, the current escrow process routinely allows sellers to move out of associations having paid only a fraction of what they should have for the aging of the common area assets.

Recognizing that it is not always feasible to collect for a reserve shortfall from all past owners, should the current class of owners have to pay for <u>all</u> of the association's unfunded depreciation liability in the form of one or more special assessments? One might justifiably argue that the current class of owners should not be penalized for the entirety of past funding shortfalls.

A more equitable solution to this dilemma is to spread out the funding of the reserve shortfall over several years. But for how many years? One way to determine over how many years you can spread the cost is to perform a 30-year cash flow analysis and determine which year in the next 30 years does the reserve balance go the lowest.

Then, using cash flow optimization techniques, determine the correct level of annual reserve funding such that your reserve account balance does not go below zero (or some minimum dollar amount you specify) in that "most difficult year" in the 30-year cash flow projection.

By using the optimized cash flow funding method, your association essentially distributes the burden of paying for the current reserve shortfall over several years, and perhaps over several different groups of owners. Unless the "most difficult funding year" in your 30-year cash flow analysis happens to be the current year, this method does not unfairly penalize the current class of owners in the current year. For many associations, this is the most palatable way to fund a reserve shortfall.

With the optimized cash flow method of funding, it is indeed true that the association may not be 100% funded immediately, or perhaps for several years. But the cash flow analysis proves that at the prescribed rates of funding to reserves, the association should be able to fund future reserve expenses as shown in the projection.

Note that some states have requirements that associations be at certain percent funded levels, but not necessarily at 100% funded. For example, in the state of Hawaii, H.R.S. Section 514A-83.6(b) requires associations to be either 50% funded for replacement reserves, or they must fund 100% of the estimated replacement reserves using a cash flow plan.

In summary, having an inordinate emphasis on being 100% funded as soon as possible can result in an inequitable burden on current owners. This can be ameliorated by more gradual funding over time as determined by optimized cash flow analysis.

SOME ADDITIONAL POINTS TO PONDER – RESERVE FUNDING

By: Michael J. Gartzke, CPA

I'm sure that everyone has noticed how real estate prices have increased in Santa Barbara County. This phenomenon is not exclusive to our county but to all of California, especially the coastal areas. According to recent information published by the Santa Barbara Association of Realtors and recently reported in the Santa Barbara News-Press, the median priced condo in the South County sold for $545,000. That is probably a 1,000 square foot, 30 year-old townhome in Goleta. In today's marketplace, would a $5,000 per unit unfunded depreciation liability have an impact on sales? I'd venture to say no. The $5,000 underfunding represents less than 1% of the unit's fair market value in today's market. Scarce supply and low interest rates are much more important factors than reserve funding in this market.

Last year, the Executive Council of Homeowners (ECHO) published an article by attorney Tyler Berding and my colleague David Levy which analyzed 687 reserve studies to determine trends in reserve funding. Some of the findings included:

- The average reserve percent funded dropped from 80% if the association was less than 5 years old to 40% if it was over 20 years old

- Associations with less than 25 units averaged nearly $ 6,000 in unfunded reserves per unit while associations of more than 100 units had unfunded reserves of less than $2,000 per unit.

- Based upon their analysis of unfunded reserves, they computed an unfunded liability of $5.1 billion in California (less than the state budget deficit!). According to their study, the average association has 106 units. If the average association unit in the entire state sold for $140,000, the average unfunded liability would represent 1% of the fair market value of the property.

Do I think associations should quit funding reserves because they are inconsequential to the fair market value of the property? Absolutely not! Case law is clear on association's responsibilities to maintain adequate reserves. The disclosure requirements in Davis-Stirling lead you to conclude that adequate reserve funding is prudent. Legal costs required to attempt to defend a position of not funding reserves would be consequential. By taking the position that you are funding reserves to maintain these ever increasing values, members should be more willing to make the investment now to cover future major expenditures.

An additional challenge to sound reserve funding and association governance is the emergence of a speculative market for purchasing residential real estate. I have recently seen several instances of association units being purchased for investment and held for only a few months before they are re-sold. A quote in a recent *Santa Barbara News-Press* article attributed to a real estate office walk-in customer stated "I don't need to buy anything, but I feel like I should". This is how people were buying stocks and mutual funds several years ago. Additionally, many properties are being purchased with low-interest rate adjustable mortgages. These mortgage payments will increase when interest rates rise causing financial hardship to the owner. Should real estate values decline as a result, foreclosures may increase and association assessments may become uncollectible if the unit has more debt on it than the fair market value of the property.

FACING THE CHALLENGES OF MOLD

By: David A. Loewenthal, Esq., Loewenthal, Hillshafer & Rosen, LLP

The media has jumped on the topic of mold. Newspapers and magazines publish article after article about "toxic mold" and TV News Shows have featured the topic of mold. Articles addressing "toxic mold" have become commonplace in many publications and appear to have lulled many who are not immediately affected by a mold related issue into a false sense of complacency. However, mold and mold related issues are exploding across the United States and this is no time for homeowners associations to sit back and ignore the implications.

Mold has infiltrated the nation's courthouses, both literally and figuratively, and has crept its way into the California state legislature. In one state, toxic mold verdicts in upwards of $30 million have the largest insurers in the land reeling from unfathomable, and likely inevitable, repercussions as toxic mold becomes better understood and as its harmful effects become further defined.

Certain strains of mold, such as *Stachybotrys*, are developing evil, media friendly names like 'black mold', or 'killer mold' and are being linked to causing horrific tragedies such as infant lung hemorrhaging and mass deaths in elderly communities. Mold can destroy the building it

plagues, and recent articles are even blaming toxic molds for deaths and illness of the beloved household pet.

With press like that and a future which appears to be more grim than other despised household pollutants like asbestos, lead paint, and Radon, homeowners associations have a definite interest in being prepared to deal with mold-related issues and to prevent mold related issues from developing into mold related disasters.

IMPACT OF MOLD ON HOMEOWNERS ASSOCIATIONS

Some of the information available to homeowners associations regarding mold is quick to point out that developers, general contractors, and others involved in the design and construction of the buildings in the association may be found liable for mold damage after a successful construction defect suit. Available information is also quick to point out the potential liability of the association's insurer for damages or for the mishandling of a mold related claim.

However, much of the available information ignores the result of the newfound popularity of mold litigation which has caused new mold related injuries and causes of action and in turn, new classes of popular defendants.

Homeowners associations are among those who have been silently drawn into the mix and have become prime candidates to be named as defendants in toxic mold lawsuits. Associations are considered to have potential liability because they have the ability to aggravate mold problems through the abatement procedures, or lack thereof. In addition, the homeowners association is responsible for maintaining the common areas of the association as delineated in both the Civil Code and associations' recorded governing documents (CC&R's). Mold growth which results from water penetration through the roofs, exterior walls or any other component maintained by the association is likely the responsibility of the association.

From the above diatribe on the horrors of any involvement with toxic mold, it should be readily apparent that becoming a defendant in a toxic mold lawsuit should be avoided and the best course of action for any association is to prevent a mold disaster before it occurs.

PREVENTING A MOLD DISASTER

Avoiding a mold disaster is an obtainable goal if the association follows some general guidelines. Awareness of the evils of mold and its potential to cripple an association if handled improperly is probably the most important step.

Evading mold problems starts with prevention. Mold is everywhere. Mold exists in the outdoor environment and as well as indoors. Mold should not generally create any problems if the mold spores outdoors and indoors are similar in both types and quantities. Non toxic mold in small quantities is inevitable in all indoor atmospheres, however, precautionary measures can be taken to prevent mold from infiltrating an association.

One of the most important preventive measures associations can take is to locate and repair all sources of water intrusion, including any defective roofing, common area plumbing leaks, exterior wall leaks, and other sources of water intrusion from common area components.

INSURABILITY OF A MOLD LOSS

If the association either stumbles at the preventative stage or, through no fault of the association, a water loss occurs which leads to a potential mold problem, the association will have to decide how to deal with the insurability of the claim. In the past, when there were no specifically identified mold exclusions within insurance policies, and mold was seen as a consequential damage arising from a covered water loss, associations proceeded forward in making these claims directly to their master policy of insurance. At that time, if the association's insurance performed properly, it would protect the interests of its insureds, and generally cover the damage to the unit as well as the costs associated with remediation of the unit for mold contamination. However, as more mold claims arose and the cost associated with a water loss went well beyond removing and replacing drywall, and included the potential cost of a hygienist, more expensive mold remediation costs, etc. insurance companies began to claim that mold was excluded from the policy, even if it was not specifically so listed. As an example, some carriers argued that mold was a "pollutant" and therefore excluded under a pollution exclusion. Others stated that coverage of mold was never contemplated as part of the policy and therefore should be excluded. These initial arguments had varying degrees of success, though without a specific exclusion identifying mold it is our opinion that such coverage defenses by the insurance carrier are inappropriate.

Over the last two (2) years, experienced carriers have become much more precise and exact with respect to their insuring and excluding the language, and most carriers are now inserting specific mold exclusions within the policy. Such exclusions generally will state that although a water loss may be covered, there is no insurance for the mold that may arise therefrom. Thus, in a typical water loss case, the insurance company may pay the cost associated with drywall removal and replacement, but not the cost associated with mold abatement, mold testing, remediation, clearance, etc. It is often the "mold remediation" aspect and the testing associated thereto, which constitutes a substantial portion of any such loss. This may ultimately be borne by the insured, i.e., the homeowners association.

The issue of mold exclusions, whether or not they are explicitly identified within the policy as an exclusion or being interpreted as such under other policy provisions by an insurance carrier create significant challenges for homeowners associations in financially dealing with water intrusion/mold claims. This issue, along with the skyrocketing cost of insurance over the last few years, which industry insiders have attributed to sources including, but not limited to, the September 11, 2001 World Trade Center attacks, various natural disasters including the Northridge earthquake and various hurricanes, substantial losses over the last several years with respect to insurance company investment portfolios, and a dramatic increase in mold claims, has been passed on to the consumer, i.e., homeowners and homeowner associations. It has not been unheard of in the last eighteen (18) months for associations to have either their insurance non-renewed or to have increases of up to 400%. In order to battle this issue, some associations have created strict policies regarding the obligation of homeowners to report water losses in a timely manner, and failure to do so can create a demand from the association back to the homeowner for reimbursement of costs associated with the loss. In addition, other homeowner associations have substantially raised their water

loss deductibles so as to attempt to preclude small claims from being filed in an *ad hoc* manner against the insurance company so as to maintain a better loss history. Unfortunately, no matter how you look at it, once there is a water loss, the association is looking at a potential substantial cost whether it be from the cost of remediation, an increased deductible which must be satisfied by the homeowners association, or skyrocketing insurance premiums.

Regardless of the scope and degree of the problem, all allergic and toxic mold should be removed and the source of the water must be repaired. A Certified Industrial Hygienist can be hired to test both the affected surfaces as well as the air in the areas affected by the mold. The hygienist will recommend a course of action for the remediation of the mold. At that time, the association would be wise to hire a mold remediation company that has both the knowledge and equipment to properly remediate the mold. The hygienist should return after the remediation company has completed the work and do sample tests again in order to clear the area and certify that the mold species and counts in the area are acceptable. The costs for mold testing by a hygienist as well as the remediation of the mold are high, however ignoring a mold problem can be much more costly.

PAYING FOR REMEDIATION

How does an association pay for the mold testing, remediation process and repairs related to a mold problem? Usually there is no line item in an association's budget for mold. Most associations are not funding reserves for mold. What happens to associations that are faced with an expensive mold remediation project that is not related to a construction defect claim and is not going to be covered by an insurance policy? An association could borrow from the reserves to pay for the repairs, however as per the Civil Code, the loan is to be paid back within a year. An association can raise assessments to cover the costs or possibly pass an emergency special assessment if the factual situation allows. An association can do any or all of the above if necessary to pay for the repairs. Though the costs may be high and no one likes to have to pay higher assessments, association boards of directors are charged with the responsibility to maintain the common areas in the community and must do so in order to carry out their fiduciary responsibility. Most important, a board of directors must address the mold issues that may exist in the community and take proper steps to resolve the matter. It will not help to ignore the problem if it exists, the mold menace will not just go away.

Following these guidelines should keep any association mold free, or at least provide the association with the tools to handle and prevent a mold related disaster. To recap; prevention and awareness are top priority; water intrusion is unacceptable and must be immediately remedied. If mold related damage is discovered, immediately contact the association's insurer. If mold is present in the association, eliminate it thoroughly and immediately. Use experts when dealing with the remediation of mold. No association wants to become a defendant in a mold related property or physical injury case.

The above information is intended for general information only. For specific legal advice, contact your legal counsel.

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CONDOMINIUM BLUEBOOKS

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ASSOCIATION MEETING CALENDAR

June 11 – 12 ECHO – Executive Council of Homeowners – Annual Seminar – Santa Clara Convention Center, Santa Clara

October 2 – CAI – Channel Islands Chapter Annual Expo and Conference – Oxnard/Ventura

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