SOUTH COAST HOMEOWNERS ASSOCIATION

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IN THIS ISSUE

UPCOMING SOUTH COAST MEETING

ASSOCIATION FINANCES

Arm yourself with the latest information on association finances. What expenses are increasing and why? Is anything going down in cost? What is California's inflation rate? How does this tie to our monthly assessment? How do you read a financial statement? Why is this important? Why do reserve funds need to be segregated from operating funds? These topics and more will be examined by **Michael J. Gartzke, CPA,** a founding member of South Coast HOA.

How do you use a reserve study? What do you do with a reserve study after you receive it from the preparer? What new materials and technologies are available to repair or replace your common area components? How do these new materials affect future costs? What changes will AB 2718 make to reserve study preparation. How will the new disclosure form be implemented? **Chris Andrews of Stone Mountain Corporation** will discuss these issues.

A question and answer session will follow.

DATE – Wednesday, October 6, 2004
TIME – 7 PM
PLACE – Holiday Inn, 5650 Calle Real, Goleta

RAVEN'S COVE TOWNHOMES, INC. VS. KNUPPE DEVELOPMENT CO. (1981) 114 Cal.App.3d 783

Editor's Note: What follows is a summary of a California court case from 1981. This case precedes the enactment of the Davis-Stirling Act by three years and sheds light on the thinking a generation ago about the responsibility and fiduciary duty of an association's board of directors with respect to its finances. I have cited the case frequently in South Coast programs dealing with reserve funding.

BACKGROUND: As noted in the court's ruling, this association is fairly typical –

"The association is a nonprofit corporation whose members are the owners of 65 townhomes in the Raven's Cove development in Alameda, California. In November 1972, defendants James and Barbara Knuppe, the sole owners of the Knuppe Development Company, Inc. conveyed the common areas and facilities in fee simple to the Association. The Developer had been in the residential home building business for over 18 years and had built about 3,000 units, including several townhome developments, before Raven's Cove. The Association was incorporated on November 1, 1972. In August 1973, the Developer recorded its grant deed to the common areas to the Association. By October 1973, construction had been substantially completed and sales commenced. Until May of 1974, when it was turned over to the homeowners, the Association was under the control of the Knuppes, who could not recall any functions that they performed, other than the signing of the Association's bylaws as officers.

"The association holds title to the common areas, including nearly two acres of lawns and shrubbery and landscaped areas. The association also is responsible for maintenance and repairs of the roofs and siding of the individual units, the common areas, and has the responsibility of assessing and collecting dues from the homeowners to establish: 1) an operating fund to pay current costs of upkeep, payment of water bills, and the cost of landscape personnel; 2) **a replacement reserve fund for major costs, such as painting exterior surfaces of the individual units, replacement of roofs and major private street repairs.** (*emphasis added*). Replacement reserves have to be accumulated because the Association: 1) cannot assess its members a sufficient amount in a short period of time to pay for the work and materials required for major repairs and improvements; 2) cannot borrow funds for this purpose as the result of the nature of its assets. **No reserve or operating funds were ever established or turned over to the Association."** (*emphasis added*).

The opinion then describes the various defects in the landscaping, soil and drainage problems, and irrigation systems. The builder did not paint the siding and used ungalvanized nails in the trim resulting in premature deterioration. The lawsuit was brought to correct the construction defects previously noted and to cure the **breach of fiduciary duties by the initial Association directors for failing to establish an adequate reserve fund.**

The ruling continues. "The record indicates that the developer paid the ordinary costs of maintenance until the Association was turned over to the homeowners after the last unit was sold in May 1974….the Developer and its employees totally controlled the Association until May 1974…all directors of the Association were either the owners or employees of the

Developer. As a result of its prior experience, the Developer had learned that it was unwise to turn an association to “inexperienced homebuyers” and “expect them to run a business”. Accordingly, the Developer recommended a professional manager who was employed on the night that the homeowners first were elected to the board of the Association. Six months later, the homeowners’ board independently selected and employed a new manager. The new manager had to sue to obtain the Association’s financial records from the former manager.

“As indicated above, in 1974, no reserve or operating funds had been created; thus, none were turned over to the Association. As a result, the homeowners had to vote a dues increase for operating costs only. Thus, no funds were available to be set aside for reserves, although in one instance $35 had been set aside in escrow for this purpose. Generally, maintenance reserves are set aside for the purpose of roof replacement, painting and long-term maintenance, and the reserve fund is ordinarily commenced with the conveyance of the common area. At Raven's Cove, the conveyance of the common area occurred in 1973 simultaneously with the sale of the first unit.

“The Developer here knew that the bay front exposure of Raven's Cove created particular maintenance problems as to the paint and exterior trim which were the result of severe wind and salt spray exposure of the site. A replacement reserve is a portion of the overall operating budget; in preparing it, the components of the operating budget are used to consider "all those things that will wear out, fall apart, need to be replaced or repaired substantially.

“Each purchaser at Raven's Cove received copies of the Association's articles and the 1972 estimated operating budget, which set forth a contingency fund comprised of $28-$30 per unit per month. The Association's expert testified that $10 per unit would have been a more reasonable initial replacement reserve budget; by the time of trial, the assessment should have been $15 a month per unit.

“The record indicates that pursuant to the declaration of covenants, conditions and restrictions signed by the Developer and each homeowner at the time of purchase, monthly assessments were to start with the conveyance of the common areas to the Association. Necessarily, at the time of purchase, Raven's Cove homeowners bought as yet uncompleted landscaped units.

“The parties have not cited, and our research has not disclosed, any specific authority in this state. Nevertheless, **it is well settled that directors of nonprofit corporations are fiduciaries.** The statutory provisions here applicable are former Corporations Code section 9002, which provided that the provisions of the general corporations law were applicable to nonprofit corporations. The pertinent provision was former general Corporations Code section 820, which **required directors and officers to "exercise their powers in good faith, and with a view to the interests of the corporation."**

THE FINDING

"We conclude that since the Association's original directors (comprised of the owners of the Developer and the Developer's employees) admittedly failed to exercise their supervisory and managerial responsibilities to assess each unit for an adequate reserve fund and acted with a conflict of interest, they abdicated their obligation as initial directors of the Association to establish such a fund for the purposes of maintenance and repair. Thus, the individual initial directors are liable to the Association for breach of basic fiduciary duties of acting in good faith and exercising basic duties of good management." (emphasis added)

COMMENTARY: So while the Davis-Stirling Act does not specifically mandate the funding of reserves or a certain amount of reserves (yet), this California Appellate case from 23 years ago held the developer's board liable for failure to fund reserves because the developer knew that major repair and replacement expenses would occur in the future and that funds should be set aside on a current basis to meet these expenses. Should owner-elected boards be held to the same level of fiduciary duty or a lesser level? I don't see how different boards could be held to different standards. Especially with all that has been published over the past 20 years on the subject.

We know that associations that have substantial common area will incur major expenses at irregular intervals. In South Santa Barbara County, half of the associations are 29 years old (source: South Coast HOA 2003 Member Survey). Boards that have knowledge of these expenses from their prior history, DRE budgets, subsequent reserve studies, consultation with industry professionals, etc. should make the effort to fund reserves in to meet the Civil Code requirement of Section 1366 – "the association shall levy regular and special assessments sufficient to perform its obligations under the governing documents…".

Many boards are under political pressure from their members to limit assessment increases or keep assessments the same. Some members do not believe that they have any responsibility for funding future major and repairs on a current basis. (I fielded a call from one frustrated board President on this very topic two weeks ago) Some boards will consider reducing reserve funding or using reserves to meet unavoidable increases in operating costs. Some associations will simply transfer into their reserve account whatever money is left over each month, if any. Boards need to use the documentation such as this case to stand up to this pressure and perform their fiduciary duties responsibly.

ARE YOUR ASSOCIATION RESERVE FUNDS WORKING HARD ENOUGH FOR YOU?

As you all know, over the past 2 ½ years, interest rates on savings and certificate of deposits have fallen to historic lows. As a result, I have noted an apathy in some associations in pursuing higher returns on invested monies. In some cases, the association board was not aware of how low the rates of return had fallen on some of their cash accounts. With CD rates starting to improve, perhaps now is a good time to review the association investments and see if you can increase your returns with minimal effort and no additional risk.

Money Market Accounts: Most bank and money fund accounts are paying around 0.5% to 0.75% interest. However, in performing accounting reviews for the 2003-04 year, I noted that several stock brokerage money market funds were paying much less than bank savings accounts. For example, the Charles Schwab money fund was paying 0.05% at December 31, 2003. Even worse, another mutual fund money market account was paying 0.01% interest at the same date. A $70,000 investment in that fund earned 40 cents interest in December 2003. Some brokerage accounts also impose annual fees for keeping the account open, further eroding your interest earnings. For example, Merrill Lynch charges $300 per year, Wachovia - $175 and Morgan Stanley - $125. If you are holding a number of CDs or Treasuries in these accounts, these fees may be worth it. However, if you just have a money market account, the extra fees and hassle of dealing with the brokerage may not justify having a brokerage money market account, especially when their rates are no different and perhaps lower than our local banks. Brokerage money market funds are not insured by the FDIC.

Certificates of Deposit: There has been some upward movement in CD rates recently. A recent newspaper ad showed a one-year certificate at 2.81%. Compared to a 0.5% money market, your association could earn an additional $2,310 on a $100,000 investment. Higher rates are available for longer-term investments. Several banks have come out with a certificate with some liquidity that could be attractive for some associations. This CD requires a base investment that can't be withdrawn prior to maturity like other CDs (premature withdrawal subject to penalty). Amounts over the base amount can be added or withdrawn during the CD period without penalty and the additional amounts deposited will earn the CD rate.

Remember, for all bank accounts and CDs, FDIC insurance is only available for up to $100,000 per association per bank. (Not per account). Some banks have subsidiaries or sister banks where funds can be placed to maintain the FDIC insurance.

Treasury Bills and Notes: These can be purchased from some banks and brokerages with maturities ranging from 3 months to 30-years. They can also be purchased directly from the Federal Government through the Treasury Direct program. For most associations, interest on Treasury bills and notes are state tax-free. If a CD and a Treasury Note are paying the same rate, you will keep more of the interest from the Treasury note since the tax burden is generally lower. Redeeming a Treasury note or bill prior to maturity will subject your association to market rate risk. If interest rates rise, the value of your note falls to yield the higher market interest rate to the buyer.

For associations with substantial reserves, you can "ladder" your investments. Assume you have $100,000 in a money market account earning 0.5%. It pays $500 per year. After reviewing your reserve study, you could consider leaving $25,000 in the money market account and then purchasing 3 CDs of $25,000 each maturing in 4, 8 and 12 months. When the 4-month CD matures, make it a one-year CD since the original 8-month CD will only have 4 months remaining to maturity. Within 8 months, all of the association's CDs will be 12-month CDs, maturing 4 months apart. Assuming the 2.81% rate cited earlier, 75% of your funds would be earning this rate in eight months. Interest income would be $2,232 per year, an increase of $1,732 from leaving it all in the money market account with no additional risk. Funds should be available to meet the association's anticipated reserve fund expenditures.

Reserve funds can only be withdrawn by two officers/directors of the association. They can never be withdrawn by the manager or the accountant. (California Civil Code Section 1365.5(b)).

ANNUAL BUDGET DISCLOSURES

If you are a calendar year association, you have started thinking about your 2005 budget and some of you may already have a working draft. Budgets are required to be distributed to members no later than 45 days prior to the start of the next fiscal year. For calendar year associations, that means distributing the budget by November 16. Over the years, California has imposed an ever-increasing number of requirements for disclosure with the association's operating budget. In addition to the operating budget, the following disclosures are also required to be distributed to the members:

____ 1) A summary of the association's reserves based upon its most recent study that includes estimated current replacement costs, estimated remaining life and estimated useful life of each reserve component; the amount of cash reserves necessary to repair the reserve components; the amount of cash actually set aside to make these repairs; the reserve funded percentage (cash divided by reserves necessary)

____ 2) Whether the board anticipates that a special assessment will be required in the future to meet its reserve component repair obligations

____ 3) A statement describing the procedures used for the calculation and establishment of reserves

____ 4) Statement describing the association's policies and practices in enforcing lien rights or other remedies for default of payment of assessments

____ 5) Civil Code specific notice regarding delinquent assessments and foreclosure

____ 6) Notice of Assessment Increase

____ 7) Notice regarding the distribution of board minutes and how to obtain them

____ 8) Alternative Dispute Resolution (ADR) procedures and requirements

____ 9) Insurance coverage information (name of insurance company, type and policy limits of the insurance, deductibles)

____ 10) Civil Code insurance disclosure acknowledging that all property and risks are not covered

____ 11) Schedule of monetary penalties (recommended, not required)

A GLIMPSE INTO THE FUTURE?

CALIFORNIA LAW REVISION COMMISSION PROPOSES THE CREATION OF A STATE COMMON INTEREST DEVELOPMENT OVERSIGHT AGENCY

As part of the continuing review of the Davis-Stirling Act by the California Law Revision Commission (CLRC), the CLRC has issued a recommendation to establish a statewide agency to regulate HOA operations.

Research was done by the Commission's staff to review agencies in other states such as Nevada, Florida and Hawaii. For example in Nevada, one complaint is received annually for every 100 dwelling units. With an estimated 3 million dwelling units in California, that would translate into 30,000 complaints per year directed to the proposed agency.

The proposed agency would become a part of the California Department of Consumer Affairs which has many regulatory agencies under its umbrella. It would not be part of the Department of Real Estate or the Department of Justice. The proposal then analyzes whether a board of directors or an executive officer would be in charge of the agency. Given that the State is looking to eliminate a lot of boards right now, the CLRC recommends an executive officer to run the agency.

The agency would look to mediate as many disputes as practical without resorting to litigation and would provide educational opportunities via a web site, publications and training seminars. If the agency finds a violation of law and cannot remedy the violation through mediation, it would have the ability to impose a fine of not more than $1,000 per violation.

So how would the agency be funded? In the proposed model, no general fund monies would be used. A fee would be paid every two years by every homeowner association in the state - $10 per unit. Based on the estimated 3 million units, the agency would collect $15,000,000 per year to fund its work. For a 3-unit association, the fee would be $30 every two years. For a 300-unit association, the fee would be $3,000 every two years and would be collected by the Secretary of State. (Given the problems the SOS office has had in handling the CID information forms and the timely deposit of the filing fees, this could be a problem) Something to budget for!

The commission has circulated this recommendation for public comment and will be looking for a legislator to sponsor the recommendation to the 2005 Legislature for hearings, possible amendments and approval.

If the bill was passed during 2005 and signed into law, it would appear that the earliest the new agency could be up and running would be January 1, 2007.

CALL FOR ARTICLES: Thanks to all who have contributed articles to our newsletter recently. I appreciate the viewpoints of many in getting useful information to all our members.

There isn't a week that goes by that someone calls to comment on how useful the newsletter is. Thanks for your support.

PENDING CALIFORNIA LEGISLATION

By: Michael J. Gartzke, CPA
South Coast HOA Newsletter Editor

The California Legislature has adjourned for the year. Of the six bills presented in the last newsletter, four passed the Legislature and have been sent to Governor Schwarznegger for signature. Two bills were not passed. The Governor has until September 30 to sign any legislation that was passed. Copies of all proposed bills, committee reports and votes are available on the state's web site www.leginfo.ca.gov. Unless deemed to be an emergency statute, new laws are effective January 1, 2005.

AB 1836 – Dispute Resolution – This law would revise the dispute resolution statutes in the Davis-Stirling Act to clarify that any governing document or legal dispute (not just CC&Rs violations) would be subject to these procedures. The bill encourages associations to use local dispute resolution programs. The bill also specifies what a "fair, reasonable and expeditious" dispute resolution procedure is. – **To the Governor**

SB 1581 – Elections – Elections pertaining to assessments, selection of association board members and amendments to the governing documents would be required to be held by secret ballot. Any instruction given in a proxy that directs the manner in which the proxy holder is to cast the vote shall be set forth in a separate page of the proxy that can be detached and given to the proxy holder to retain. The proxy holder shall cast the member's vote by secret ballot. A person may not count votes in an election in which he/she is a candidate. Ballots are to be stored for at least one year after the election in a secure place. **– Did not pass**

AB 2376 – Architectural Review – This bill would add to the rulemaking provisions enacted last year "any procedures for reviewing and approving or disapproving a proposed physical change to a member's separate interest or to the common area." That means that these provisions must be placed in your governing documents or rules. The procedure shall provide for prompt deadlines and state the maximum time for response to an application or a request for reconsideration from the board of directors. The board's decision shall be made in writing. If disapproved, the decision shall disclose the reasons why. – **To the Governor**

AB 2718 – Reserve Studies/ Association Disclosures – The bill would make a number of changes to how reserve studies are prepared including:

1) Disclose how the association will fund reserves (regular assessments, special assessments, borrowing, deferral of repairs, etc.)

2) Reserve calculations using straight-line method

3) Interest rate on investments limited to 2% above the discount rate published by the Federal Reserve Bank of San Francisco.

Extends the period of time to distribute the operating budget from the 45-60 day window prior to the beginning of the year currently in effect to 30-90 days prior.

Proscribes a specific form to be used called an assessment and reserve funding disclosure summary to be provided to the members.

Disclose whether the currently projected reserve account balances will be sufficient at the end of each of the next 30 years to meet the association's obligation to repair or replace major components.

If the balances are insufficient, a disclosure is required as to when additional assessments would be required and how much would be required per unit per month.

Disclose what major components that the association is responsible for that are not being provided for in the current reserve funding.

Disclose the current reserve funded amount and based upon the "simplified" or alternative method of funding, the "required" amount in the reserve fund.

These provisions would apply starting July 1, 2005.**- To the Governor**

SB 1682 – Nonjudicial Foreclosure – Did Not Pass

AB 2598 – Signs, Records Inspection, Foreclosure Restrictions - The bill would extend the new laws pertaining to the display of signs and banner in a member's separate interest to exclusive use common area.

The new records inspection law would be modified to allow court costs and attorney fees to be awarded to a member if it is deemed by the court that access to accounting records was unreasonably withheld. Would expand the definition of records to include all contracts to which the association is or has been a party along with invoices, receipts, check registers, cancelled checks, purchase orders, accounting books and records, internal accounting statements, bank statements and common area maintenance records.

The bill would permit the return of increased assessments to the members if the association did not comply with the disclosure and notice requirements in distributing budgets. A prior version of this bill would have limited assessment increases to the California Consumers Price Index. That provision is no longer in the current version of the bill.

For liens filed after January 1, 2005, foreclosure is not a collection option until the unpaid balance of the assessment (not counting late fees and penalties) exceeds $2,500 no matter what size the association. Members have the right to request ADR in assessment and/or foreclosure disputes. Foreclosure may be done via court (judicial) or without court (nonjudicial). For balances under $2,500, small claims court remains the only collection option. – **To the Governor**

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October 2 – CAI – Channel Islands Chapter Annual Expo and Conference – 8 AM – 2 PM
Residence Inn (Marriott) River Ridge in Oxnard

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