

## *SOUTH COAST HOMEOWNERS ASSOCIATION*

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Michael J. Gartzke, CPA, Editor

### IN THIS ISSUE

Upcoming Meetings

New Law Affects Association Records Disclosure/Accounting Procedures

The Uncertain Future of Common Interest Developments

Newsletter Sponsors

### UPCOMING SOUTH COAST MEETINGS

**“HOA 101”** – A one day seminar for board members on the fundamentals of homeowner association operations in California – What to do and what not to do! Subjects covered will be legal, financial, administrative, and insurance issues, and more. Attendees will receive a 100+ page course manual, developed by the Executive Council of Homeowners (ECHO) of Northern California. At press time, about half of the 50 spaces have been reserved so don't wait!

Your check for \$60, payable to South Coast HOA includes the course book, a state HOA statute booklet, breakfast, lunch and networking with some of the finest professionals serving associations. See the enclosed flyer for registration form and additional information.

**Saturday, April 22, 2006**

**Elephant Bar Restaurant**

**521 Firestone Road (On Hollister, one block west of Fairview)**

**Goleta**

**Registration/Breakfast 8-8:45**

#### **Scheduled to Present:**

**David A, Loewenthal**, Loewenthal, Hillshafer & Rosen – **Legal Basics** – 8:45-10:15

**Jan Hickenbottom, PCAM**, First Bank & Trust – **Administration Basics** – 10:30-noon

**Tim Cline**, Timothy Cline Insurance Agency, **Insurance Basics** – 12:45-2:15

**Michael J. Gartzke, CPA** – **Financial Basics** – 2:30-4:00

## Upcoming Meetings Continued

**An evening with Skip Daum, Administrator/Advocate for Community Association Institute's California Legislative Action Committee (CAI-CLAC).** For many years, Mr. Daum has been the voice of Community Associations to the California Legislature. Based in Sacramento, Mr. Daum lobbies on behalf of associations to support appropriate legislation and to work with legislative staff to revise and/or oppose legislation that is not in the best interests of community associations, its boards and their members. At our last meeting, one of our attendees asked if there was a lobbyist to promote associations in Sacramento. Yes, there is and come find out what a daunting task he has. Learn about the legislative process, what other groups lobby the legislature on association issues, pending 2006 legislation, why the legislature has such a poor opinion about association board of directors and much, much more. Learn how you can participate in the process and get involved.

**Tuesday, May 23, 2006  
Holiday Inn, Goleta  
5650 Calle Real  
7PM**

**Annual Summer Legal Forum with Beth Grimm.** Beth has provided our summer program for us since 1999. While the topics for this year's event have yet to be determined, we do have the dates set so that you can mark your calendars.

**Monday - July 24 – 7 PM – Holiday Inn, Goleta  
Tuesday – July 25 – 7 PM – Quail Meadows West HOA, Santa Maria (New)**

## Upcoming Events from Other HOA Organizations

**CAI Channel Islands Chapter – “Loans, Litigation and Reserves – What Comes First”.** Topics include appropriate reserve strategies and funding plans, what banks look for when lending to an HOA, pending legislation requiring reserve funding, overview of legal requirements to fund and spend reserve monies. Presentations made by a banker, reserve study preparer and attorney

**Luncheon Meeting – Tuesday, April 18** at the Cypress Ridge Banquet Facilities, 1050 Cypress Ridge Parkway, Arroyo Grande. Cost \$30 before April 10, \$40 after that date. Call Krisi Davis at CAI for more information – 805-658-1438.

**Community Association Day at the Capitol** – An annual event set up by CAI-CLAC (see above) to meet all those who deal with Sacramento and pending legislation on a daily basis.

**Monday, April 24 in Sacramento.** If you are interested in attending, click on this link - [http://www.magnetmail.net/images/clients/CAI\\_GPA/attach/2006CADAYBrochure.pdf](http://www.magnetmail.net/images/clients/CAI_GPA/attach/2006CADAYBrochure.pdf) or go to [www.clac.org](http://www.clac.org) for a brochure. Some classes will be held on the weekend before (4/22-4/23)

**Executive Council of Homeowners Annual Seminar – June 3 – Santa Clara.** Upwards of 1,000 people attend this seminar each year featuring 16 educational seminars and a trade

show with over 100 vendors providing services and information to board members. Join your editor at this year's event! Additional information is available from your editor or go to [www.echo-ca.org](http://www.echo-ca.org).

## **ASSEMBLY BILL 1098 – ACCOUNTING PROVISIONS** **Michael J. Gartzke, CPA**

Much of Assembly Bill 1098 – New Civil Code Section 1365.2 - deals with making association records available to owners. However, a little-noticed section of the Code will require associations to make substantial changes in how they maintain their accounting systems and prepare financial reports. The law is effective July 1, 2006 so there is a chance that the law could change. Discussion on this topic is occurring in Sacramento now. The new law pertaining to accounting systems and reports follows:

According to the Legislative Analyst, this bill requires the association to make association records, as defined, for the current fiscal year and the previous 2 fiscal years available for inspection and copying by a member of the association, or the member's designated representative subject to payment of certain costs by the member, as specified. The bill would require the association to make the records available within 10 business days of receipt of the request for current association records or 30 calendar days of receipt of the request for association records prepared during the previous 2 fiscal years. The bill would specifically authorize a member to bring an action to enforce his or her right to inspect and copy association records in small claims court if the amount demanded does not exceed the jurisdiction of that court. The bill would also authorize the court to assess a civil penalty of up to \$500 for the denial of each separate written request. The bill would make other related changes.

New text of Section 1365.2 follows – with accounting system/reports changes shown in bold

### Section 1365.2 is added to the Civil Code, to read:

1365.2. (a) For the purposes of this section, the following definitions shall apply:

(1) **“Association records”** means all of the following:

(A) Any financial document required to be provided to a member in Section 1365. (Editor's Note – this means operating budget, reserve study, reserve funding disclosures, year-end financial statements, lien rights and procedures, insurance disclosure summary)

(B) Any financial document or statement required to be provided in Section 1368. (Editor's Note – this means (CC&Rs, bylaws, rules and regulations, construction defects disclosures, pending assessment changes, unpaid assessments)

**(C) Interim unaudited financial statements, periodic or as compiled, containing any of the following:**

**(i) Balance sheet.**

**(ii) Income and expense statement.**

**(iii) Budget comparison.**

**(iv) General ledger. A “general ledger” is a report that shows all transactions that occurred in an association account over a specified period of time.**

The records described in this paragraph shall be prepared in accordance with **generally accepted accounting principles. (Emphasis Added)**

**Editor’s Comments:** I attempt to track HOA legislation on a regular basis to report to you what is happening currently in Sacramento. The Legislature has an email subscription service where you can identify which bills you are interested in and you are then notified by email when any action is taken such as a vote or amendment, committee hearings, etc. It is not instantaneous notification, sometimes several days pass between the action and the notice.

AB 1098 was introduced in early 2005. Some hearings were held in the spring and not much happened in the summer. On September 2, the day before the Labor Day weekend, substantial amendments were made to the bill. On September 6 (the day after Labor Day), the Senate voted to approve the bill and on September 8, the Assembly approved and sent it to the Governor. The votes were unanimous. The Legislature adjourned for the year on September 9.

Why is this timeline important? Because in the September 2 amendment, the language identifying financial statements by name and the statement that these statements be “prepared in accordance with generally accepted accounting principles” was placed into the bill. No discussions, no hearings, nada. No opportunity was made available to tell the Legislature what “generally accepted accounting principles” mean. It appears that this language was inserted into the bill by a nonaccountant who probably heard somewhere that “generally accepted accounting principles” are the only way to prepare financial reports.

I was made aware of this provision in mid-September by Beth Grimm, a frequent South Coast HOA contributor. She asked for my opinion. I simply stated that less than 1% of the associations will be in full compliance with this statute and that I wasn’t going to encourage any more compliance and who is their right mind wrote such nonsensical legislation?

So what are “generally accepted accounting principles” (GAAP)? For homeowner associations, GAAP includes the full accrual method of financial reporting. It also includes the use of fund accounting concepts (operating and reserve funds) and the disclosure of major replacement and repair information. Other industries have GAAP that are specific to their industry, too. Accountants also recognize “other comprehensive bases of accounting (OCBOA)”. OCBOA reporting includes cash basis, income tax basis or modified cash-accrual basis.

Many small associations will report on a cash basis. Assessments are posted when collected and expenses are posted when paid. Some associations will report on a modified cash-accrual basis. They will report their income when it’s due (accrual basis) but report expenses when paid (cash). Software such as Quickbooks or Yardi is set up to track members’ receivable or prepaid balances readily and this type of reporting is quite common for associations.

Full accrual (GAAP) reporting under California Civil Code section 1365.2 would require associations to set up general ledgers and financial statements that show:

- 1) Assessments Receivable and Prepaid
- 2) Prepaid insurance and other expenses if not paid monthly
- 3) Accrue payables at month-end for services incurred in one month but paid in the next.
- 4) Accrue income taxes on taxable income
- 5) Accrue payroll, payroll taxes and vacation/sick pay if unpaid at month-end

The law makes no distinction as to the size of the association that is required to do this. According to the law, all associations must.

According to the press release from Assembly member Dave Jones, "These common interest developments operate in many ways like mini-governments and now they must open their financial records to inspection, just like governments". The lobbyist for the California Association of Retired Americans (CARA), Marjorie Murray stated "I've heard from hundreds of homeowners who were denied access to basic information about how their homeowner association dues were used".

The issue in AB 1098 is all about accountability. The primary focus of the bill is to identify association records and enable access by members. It will take time from the association's volunteers and professionals to comply with requests. And the professionals must be compensated.

However, establishing financial records using GAAP provides no additional benefit for most associations than recognized OCBOA methods of accounting. I made several futile attempts to get Assembly member Jones' office staff and the CARA lobbyist to contact me about why this section was inserted into the law. There is no accountability with the Legislature and the lobbyists. It would appear that this section could have been inserted by a young intern who may have taken a beginning accounting class at Sacramento City College or by someone who was totally clueless about what "generally accepted accounting principles" meant. But, it sure sounds impressive!

So if you think that legislation is developed carefully by experts skilled in their craft, guess again.

The remaining text of Civil Code 1365.2 follows:

- (D) Executed contracts not otherwise privileged under law.
- (E) Written board approval of vendor or contractor proposals or invoices.
- (F) State and federal tax returns.
- (G) Reserve account balances and records of payments made from reserve accounts.
- (H) Agendas and minutes of meetings of the members, the board of directors and any committees appointed by the board of directors; excluding, however, agendas, minutes, and other information from executive sessions of the board of directors as described in Section 1363.05.
- (I) (i) Membership lists, including name, property address, and mailing address, if the conditions set forth in clause (ii) are met and except as otherwise provided in clause (iii)  
(ii) The member requesting the list shall state the purpose for which the list is requested which purpose shall be reasonably related to the requester's interest as a member. If the

association reasonably believes that the information in the list will be used for another purpose, it may deny the member access to the list. If the request is denied, in any subsequent action brought by the member under subdivision (f), the association shall have the burden to prove that the member would have allowed use of the information for purposes unrelated to his or her interest as a member.

(iii) A member of the association may opt out of the sharing of his or her name, property address, and mailing address by notifying the association in writing that he or she prefers to be contacted via the alternative process described in subdivision (c) of Section 8330 of the Corporations Code. This opt—out shall remain in effect until changed by the member.

(J) Check registers.

(2) **“Enhanced association records”** means invoices, receipts and canceled checks for payments made by the association, purchase orders approved by the association, credit card statements for credit cards issued in the name of the association, statements for services rendered, and reimbursement requests submitted to the association, provided that the person submitting the reimbursement request shall be solely responsible for removing all personal identification information from the request.

(b) (1) The association shall make available association records and enhanced association records for the time periods and within the timeframes provided in subdivisions (i) and (j) for inspection and copying by a member of the association, or the member’s designated representative. The association may bill the requesting member for the direct and actual cost of copying requested documents. The association shall inform the member of the amount of the copying costs before copying the requested documents.

(2) A member of the association may designate another person to inspect and copy the specified association records on the member’s behalf. The member shall make this designation in writing.

(c) (1) The association shall make the specified association records available for inspection and copying in the association’s business office within the common interest development.

(2) If the association does not have a business office within the development, the association shall make the specified association records available for inspection and copying at a place that the requesting member and the association agree upon.

(3) If the association and the requesting member cannot agree upon a place for inspection and copying pursuant to paragraph (2), or if the requesting member submits a written request directly to the association for copies of specifically identified records, the association may satisfy the requirement to make the association records available for inspection and copying by mailing copies of the specifically identified records to the member by first—class mail within the timeframes set forth in subdivision (j).

(4) The association may bill the requesting member for the direct and actual cost of copying and mailing requested documents. The association shall inform the member of the amount of the copying and mailing costs, and the member shall agree to pay those costs, before copying and sending the requested documents.

(5) In addition to the direct and actual costs of copying and mailing, the association may bill the requesting member an amount not in excess of ten dollars (\$10) per hour, and not to exceed two hundred dollars (\$200) total per written request, for the time actually and reasonably involved in redacting the enhanced association records as provided in paragraph

(2) of subdivision (a) The association shall inform the member of the estimated costs, and the member shall agree to pay those costs, before retrieving the requested documents.

(d) (1) Except as provided in paragraph (2), the association may withhold or redact information from the association records for any of the following reasons:

(A) The release of the information is reasonably likely to lead to identity theft. For the purposes of this section, “identity theft” means the unauthorized use of another person’s personal identifying information to obtain credit, goods, services, money, or property. Examples of information that may be withheld or redacted pursuant to this paragraph include bank account numbers of members or vendors, social security or tax identification numbers, and check, stock, and credit card numbers.

(B) The release of the information is reasonably likely to lead to fraud in connection with the association.

(C) The information is privileged under law. Examples include documents subject to attorney—client privilege or relating to litigation in which the association is or may become involved, and confidential settlement agreements.

(D) The release of the information is reasonably likely to compromise the privacy of an individual member of the association.

(B) The information contains any of the following:

(i) Records of a—la—carte goods or services provided to individual members of the association for which the association received monetary consideration other than assessments.

(ii) Records of disciplinary actions, collection activities, or payment plans of homeowners other than the homeowner requesting the records.

(iii) Any person’s personal identification information, including, without limitation, social security number, tax identification number, driver’s license number, credit card account numbers, bank account number, and bank routing number.

(iv) Agendas, minutes, and other information from executive sessions of the board of directors as described in Section 1363.05, except for executed contracts not otherwise privileged. Privileged contracts shall not include contracts for maintenance, management, or legal services.

(v) Personnel records other than the payroll records required to be provided under paragraph (2)

(vi) Interior architectural plans, including security features, for individual homes.

(2) Except as provided by the attorney—client privilege, the association may not withhold or redact information concerning the compensation paid to employees, vendors, or contractors. Compensation information for individual employees shall be set forth by job classification or title, not by the employee’s name, social security number, or other personal information.

(3) No association, officer, director, employee, agent or volunteer of an association shall be liable for damages to a member of the association as the result of identity theft or other breach of privacy because of the failure to withhold or redact that member’s information under this subdivision unless the failure to withhold or redact the information was intentional, willful, or negligent.

(4) If requested by the requesting homeowner, an association that denies or redacts records shall provide a written explanation specifying the legal basis for withholding or redacting the requested records.

(e) (1) The association records, and any information from them, may not be sold, used for a commercial purpose, or used for any other purpose not reasonably related to a member's interest as a member. An association may bring an action against any person who violates this section for injunctive relief and for actual damages to the association caused by the violation.

(2) This section may not be construed to limit the right of an association to damages for misuse of information obtained from the association records pursuant to this section or to limit the right of an association to injunctive relief to stop the misuse of this information.

(3) An association shall be entitled to recover reasonable costs and expenses, including reasonable attorney's fees, in a successful action to enforce its rights under this section.

(f) A member of an association may bring an action to enforce the member's right to inspect and copy the association records. If a court finds that the association unreasonably withheld access to the association records, the court shall award the member reasonable costs and expenses, including reasonable attorney's fees, and may assess a civil penalty of up to five hundred dollars (\$500) for the denial of each separate written request. A cause of action under this section may be brought in small claims court if the amount of the demand does not exceed the jurisdiction of that court. A prevailing association may recover any costs if the court finds the action to be frivolous, unreasonable, or without foundation.

(g) The provisions of this section apply to any community service organization or similar entity, as defined in paragraph (3) of subdivision (c) of Section 1368, that is related to the association, and this section shall operate to give a member of the community service organization or similar entity a right to inspect and copy the records of that organization or entity equivalent to that granted to association members by this section.

(h) Requesting parties shall have the option of receiving specifically identified records by electronic transmission or machine-readable storage media as long as those records can be transmitted in a redacted format that does not allow the records to be altered. The cost of duplication shall be limited to the direct cost of producing the copy of a record in that electronic format.

(i) The time periods for which specified records shall be provided is as follows:

(1) Association records shall be made available for the current fiscal year and for each of the previous two fiscal years.

(2) Minutes of member and board meetings shall be permanently made available. If a committee has decisionmaking authority, minutes of the meetings of that committee shall be made available commencing January 1, 2007, and shall thereafter be permanently made available.

(j) The timeframes in which access to specified records shall be provided to a requesting member is as follows:

(1) Association records prepared during the current fiscal year, within 10 business days following the association's receipt of the request.

(2) Association records prepared during the previous two fiscal years, within 30 calendar days following the association's receipt of the request.



- (3) Any record or statement available pursuant to Section 1365 or 1368, within the timeframe specified therein.
- (4) Minutes of member and board meetings, within the timeframe specified in subdivision (d) of Section 1363.05.
- (5) Minutes of meetings of committees with decisionmaking authority for meetings commencing on or after January 1, 2007, within 15 calendar days following approval.
- (6) Membership list, within the timeframe specified in Section 8330 of the Corporations Code.
- (1) There shall be no liability pursuant to this section for an association that fails to retain records for the periods specified in subdivision (i) that were created prior to January 1, 2006.
- (m) As applied to an association and its members, the provisions of this section are intended to supersede the provisions of Sections 8330 and 8333 of the Corporations Code to the extent those sections are inconsistent.
- (n) The provisions of this section shall not apply to any common interest development in which separate interests are being offered for sale by a subdivider under the authority of a public report issued by the Department of Real Estate so long as the subdivider or all subdividers offering those separate interests for sale, or any employees of those subdividers or any other person who receives direct or indirect compensation from any of those subdividers, comprise a majority of the members of the board of directors of the association. Notwithstanding the foregoing this section shall apply to that common interest development no later than 10 years after the close of escrow for the first sale of a separate interest to a member the first phase of the development.
- (o) The section shall become operative on July 1, 2006.

## **The Uncertain Future of Community Associations Thoughts on Financial Reform**

**Author: Tyler P. Berding, Esq.  
Berding & Weil, LLP**

Editor' Note: Starting in 1999, Mr. Berding wrote a series of articles that appeared in the Executive Council of Homeowners (ECHO) Journal reflecting upon the future of common interest developments. Recently, Mr. Berding re-edited the articles into a small book. With his generous permission, we will serialize the book in successive issues of the newsletter to provoke further thought and discussion on the topic. Mr. Berding received an M.A. and Ph.D. in Government from the Claremont Graduate School and his J.D. from the University of California at Davis. He can be reached at [tberding@berding-weil.com](mailto:tberding@berding-weil.com).

### **PREFACE**

This book ties together the broad experiences of a law firm whose attorneys have, for thirty years, worked with thousands of members, directors and managers of community associations and hundreds of professionals serving the association industry. Tyler Berding, a founding and senior partner of Berding & Weil, LLP, based in Alamo, California, has had a

unique vantage point in observing new, aging and “evolving” community associations confront and respond to the issues associated with construction defects, membership apathy, leadership vacuums, inadequate funding, misunderstandings, ignorance and naiveté that contribute to the basic thesis of this book: that without clarity, wisdom and “tough love” community associations, as viable shared community living arrangements are doomed to failure. The thesis is supported by the thousands of hours Berding and others in the firm have spent working with communities dealing with the day to day consequences of a deteriorating infrastructure, whether it be litigating defects, negotiating loans for repairs, dealing with disclosure lawsuits and breach of fiduciary duty claims, amending governing documents or garnering member support for large special assessments and capital repairs. These experiences, and this book, are intended to serve as a “wake up” call to those who choose to live or invest in associations and all whose professions involving serving associations and their members.

Steven Weil

## **CHAPTER ONE**

### **The Theory of Obsolescence The Flaws in the Community Association Funding Model**

Everyone knows that certain consumer products become “obsolete”. The phrase “planned obsolescence” applies to a manufacturer’s scheme to insure profitability by building into a consumer product the seeds of its demise, and thereby create future demand for its replacement. Obsolescence also happens to improvements to real estate, and specifically to community associations, although it is rarely planned and replacement, under current law, may be impossible. Neighborhoods can become “obsolete” when the condition of the property no longer supports the use for which it was originally intended. Residential neighborhoods that gradually industrialize become ill suited as a location for homes. Similarly, ranch land that is developed into suburban enclaves usually can no longer support viable agricultural operations. Traditional downtown shopping districts can become obsolete and deteriorate when a modern mall is built on the outskirts of the city. Foreign competition may render some industrial property valueless when the cost of environmental cleanup is factored in. Property that has become obsolete may languish in value until such time as a city or private developer redevelops it into a more appropriate use. Virtually all developed real property improvements reach obsolescence if given enough time.

This obsolescence pattern is equally applicable to community associations. The idea that a project will last forever in its original form is no truer for community associations than it is for any other kind of real property improvement. In most cases, physical obsolescence follows a loss of economic value due to the changing conditions of the neighborhood. In the case of a community association, it is usually a combination of physical and political factors that lead to deterioration and loss of value. And it may be a single political factor: the inability to reach group consensus on such important issues as funding for major repairs that hastens a community association’s demise.

Fifteen years ago, we wrote an article entitled “No Plan for the Future?” It was essentially a warning about the hidden costs of maintaining community associations. We stated that reserve accounts might be seriously under funded, especially for the unexpected costs of replacing some of the major building systems. That article broke new ground. It suggested that the budgets for reserves that had been approved by the California Department of Real

Estate were inadequate. Our firm's experience with failed building systems made us realize that the construction employed in most community association projects was so inferior that many components that were assumed to last the life of the building, would not. Our conclusion: inspect the project very carefully and assume nothing.

In the years following the article's appearance, the concern over component longevity and funding for repairs has not lessened. In fact, as we have learned more, our concern has grown. It is now clear that many community associations will not live up to the expectations of their owners or the governing documents that assume a project's "perpetual" life. However, while a project's failing physical systems are certainly cause for concern; they are only a symptom of larger issues affecting the future of community associations.

### **Common Needs vs. Individual Rights**

There is no modern analogy to a community association. It is more than a quasi-governmental agency. It is more than an investment. It is more than a social organization. A community association is a unique blend of law, business and sociology. It is a multi-dimensional mix of principles of real estate law (restrictions on the use of private property), corporate law (the community association), business and economics (project management and funding), sociology (communal living), and psychology (individual interests and expectations) all marinating in an active political environment. The closest historical analogy might be a small village where the rules and politics were largely internal matters and the main concern was protection against the forces of nature. The survival of the village depended upon the resourcefulness of the relatively few inhabitants. The impact of failure was the loss, not only of economic interests and basic shelter, but of the social system as well.

America's brief experiment with "communes" in the Sixties provides a comparison only so far as it demonstrates the inevitable predominance of individual will. Regardless of the high-minded ideals upon which a group living situation is founded, self-interest will eventually decide the fate of the community. For communal living to succeed, the welfare of the group must prevail over the rights of the individual. That concept is completely at odds with the instincts of most of us. In America, self-determination usually prevails, and that basic truth illuminates the fundamental flaw in the community association concept:

In community association living, the success of the group is wholly dependent upon the voluntary contribution of capital by each owner, and the inability to reach consensus on the need for such contributions will lead to eventual failure through economic collapse.

### **Opting Out Not an Option**

If a small business fails, the owner can declare bankruptcy, shut the door and walk away. A governmental agency can simply draw upon a broad base of taxpayers to provide funding. An investor only loses his or her capital. A community association in trouble cannot simply close the doors and walk away. The "village" has to pay the utilities, remove the garbage, and maintain the buildings if the owners are to have shelter. This cannot be effectively done without a consensus of the owners, because without owner approval, the association cannot raise sufficient funds to operate. More importantly, without consensus, the social system that binds the community begins to break down. Once the social and political breakdown begins, the "community" ceases to operate as one.

In other types of communities, social and political breakdown does not necessarily doom the community. Individuals can prevail over a failed social or political system by turning inward and using their personal resources to enhance and protect their property and provide shelter for their families.

This ability to exercise independent judgment on matters relating to the care and maintenance of property, however, is essentially denied to owners of property in attached housing communities. An individual owner, in most cases, cannot act independently to preserve his separate interest. Both the physical configuration and the legal restrictions of many community associations make independent action virtually impossible. An owner of a condominium cannot repair “her” roof if the community association fails to do it. An owner of a condominium cannot act alone to reconstruct his portion of the project in case of a natural disaster. The overriding concept of a community association is that all such actions shall be taken by the community. And it takes consensus for this community to act.

### **The Loss of Consensus**

As long as the community can raise sufficient funds to adequately maintain and repair the property, the restrictions on individual action are unimportant. Adequate funding, however, requires the continued willingness of the community members to assess themselves to pay for required maintenance and repair. This continued willingness depends upon the reasonableness and affordability of the maintenance assessments. Once the assessments are perceived to be unreasonable or unaffordable by a majority of owners, consensus is lost.

When projects are new, they require little maintenance, and most of the assessment dollar is devoted to operations and reserves for future repairs. Assessments then do not represent an inordinate percentage of the owner’s cost of housing. Owner agreement with board decisions is founded upon the perceived affordability of the development. Consensus can be lost once the assessments begin to increase to a higher percentage of the owner’s overall housing expense. Lack of consensus leads to political instability. In a community association, that often can translate into uncomfortable confrontation. In many community associations political instability is avoided almost literally “at all costs. The governing board will steadfastly avoid confrontation through the expedient of keeping assessments low. This unwillingness to raise assessments then deprives the community of the revenue stream it needs to deal with known maintenance and repair requirements. A failure to properly maintain and repair the property brings loss of value, difficulty in selling or refinancing, higher non-owner occupancy percentages, and accelerated deterioration of not only the physical plant but also of the quality of life enjoyed by the residents.

This dynamic is a vicious cycle. The threat of political instability or lack of economic sophistication brings about resistance to raising revenues, which results in inadequate maintenance or repair, which then brings about a loss of quality of life which then results in political instability, ad infinitum. This cycle can continue for many years and the conditions it fosters can be gradual, or not, depending on many factors, including: the quality of the original construction; the business acumen of the board and the association’s manager; and, perhaps most importantly, the willingness of the ownership to adequately fund the project. A large number of positives in that equation will usually mean an extended period of reasonable stability. More negatives, however, will usually mean an accelerated move toward instability and obsolescence.

The individual owner is trapped in this cycle. She cannot “opt out” of the system. Her only choice is to vote for increased assessments, or not, or to sell. If she sells, her successor will be given the same choices. If the community fails, the owner’s interest will be lost. There is no present means by which an owner can readily salvage her separate interest equity in a failed community association.

### **Exceptions to the Rule**

There are means by which a project’s obsolescence can be postponed, but it is most probable that there are no means by which obsolescence can be permanently avoided in most community associations. Illustrated below are the four stages of an association’s evolution toward eventual obsolescence. These stages can be lengthened or shortened, depending upon the general quality of the project, the wealth of the owners, its geographic location, the past fiscal practices of the board of directors, and the general competency of its board and management. A high-end, well-located project such as a high-rise condominium on San Francisco’s Nob Hill, may never become truly obsolete because its intrinsic value is so high and because its owners have both the ability and the willingness to pay whatever the cost of reconstruction may be. On the other hand, a low-end condominium project, perhaps one converted from an old apartment complex fifteen or more years ago, will almost certainly become obsolete.

Postponement of obsolescence can be achieved if a sophisticated board or property manager strives to educate the membership and convince it to accept the burden and the benefits of sound fiscal management. That usually includes creating a reserve for future repairs that acknowledges the probable failure of some major building systems that are not traditionally considered appropriate for a reserve budget. Examples include siding systems, and most other external structures constructed of wood, like entry stairs and balconies, as well as plumbing components. Having adequate reserves means having the funds to repair or replace major building components many years into the project’s life when failure will most likely occur. A very good professional manager can anticipate future needs and has the persuasive powers to encourage owners of even modest means to save for the future.

However, these exceptional circumstances run against the tide. Most projects are not located in the upscale sections of a city. Most projects are built in locations which are easily duplicated elsewhere, and therefore possess no particular intrinsic value. Many projects exist through a succession of boards whose degree of sophistication in business and finance is highly variable. Most projects do not obtain the benefits of sophisticated management during the majority of their existence. The owners of most projects cannot be counted upon to agree to contribute whatever is necessary to stay even with the bare rate of inflation of the cost of repairs. This is especially true with the many buildings, which were not built of the highest quality materials or with the patience and skill provided by custom builders. Most community associations were built under the time pressures of mass-market production, using generally unskilled labor that was not adequately supervised.

Some of these inadequacies are caught early enough in the project’s life to be the subject of a claim against the developer so that recompense is obtained and repairs instituted. However, there will be, in almost all instances, other examples of deterioration that will not be found until much later in the project’s life, no matter how good or how competent are the early inspections. Inspectors cannot be expected to tear the buildings to the ground to ferret out all examples of defects, nor do they enjoy the ability to see into the future to determine what the weather in the ensuing ten or twenty years will do to the buildings. Therefore, other than in

exceptional cases, it is inevitable that many community associations will evolve through the stages in the following chapter. The only real question is how long that evolution will take.

## **CHAPTER TWO**

### **The Four Stages in the Life of a Community Association Do Increasing Levels of Financial Instability Seal an Association's Fate?**

**The First Stage.** A brand new project enters the first stage. The duration of that stage depends upon many of the factors outlined above. Generally, during the first stage, the regular assessments will appear to cover all projected maintenance and repair costs without the necessity to resort to special assessments or outside sources, and with only modest annual increases. Non-owner occupancy is at the lowest percentage it will ever be, usually ten percent or less. Board members and professional managers are easy to find, the political climate is benign and the members are generally supportive of the board. The project looks and feels new and exciting. The membership's attitude reflects these qualities. Resales are brisk and values stay high with modest appreciation reflecting general market trends.

**The Second Stage.** In a project's second stage of evolution, regular assessments will be insufficient to satisfy mounting maintenance and repair costs. If the true costs of repair have been identified and projected by a competent board using professional management, the members will contribute to capital by means of a special assessment on at least one occasion during this stage. If required maintenance and repair has not been identified, the project will appear to be within its budget. There may have been a discovery of defective construction conditions, which will demand a remedy. Non-owner occupancy has increased beyond 25%. The board of directors will begin to face political issues which emanate, in part, from the increasing percentage of non-owner occupants. There will be a growing number of complaints from residents about the general condition of the project or about the necessity for specific repairs. Recruitment of board member candidates may be necessary. If true repair costs are identified and brought to the members, there will be general resistance to the request for a special assessment, but the members will ultimately support the board's request if the cost of repairs at this stage of the project's evolution remains affordable. This will be true if deferral has not postponed needed repairs for too long. Sales of units are comparable to the market generally. Government-backed mortgages and re-financing is still obtainable.

**The Third Stage** In the third stage of evolution, those associations (and there are thousands) which have failed to store enough nuts away for the winter will have to appeal to the membership for emergency funding and/or apply to a bank for a loan. Bank financing of large reconstruction projects is becoming quite commonplace, but most financial managers will argue that borrowed capital is not an adequate substitute for capital that is contributed by the owners. This is especially true if the repayment of the borrowed capital prevents the association from adequately reserving for the next round of reconstruction. Borrowed capital for reconstruction should only be considered as a temporary means of achieving solvency for the association. The assessments for repayment of the loan should be in addition to contributions to reserves adequate to fund future repairs.

In this stage, non-owner occupancy has increased 'beyond 35%. Government-backed mortgages become difficult to obtain. Management costs increase due to the additional workload presented by the many complaints from residents about the physical condition of the buildings. Political strife within the association increases as the demands upon the residents for funding, coupled with a decreasing quality of life, increase. Board members

resign rather than be subjected to the increasing volume of the owners' demands. Recommendations for current repair now include several building components that were not anticipated with the requisite reserve accounts. The price of such repairs is beyond the association's financial ability. The economic and political climate of the association begins to be reflected in the sales price and turnover of units. The project begins to show the effects of deferred maintenance. Painting is delayed, landscaping deteriorates, and resident complaints about maintenance and repair issues further increase putting added stress on the board and management.

**The Fourth Stage.** Given that many, many associations have failed to anticipate the full extent of eventual reconstruction costs, they will, sooner or later, exhaust both contributed and borrowed capital sources. This includes such one-time influxes of capital as that provided by insurance recoveries or litigation settlements. Once all outside sources of capital are exhausted, the ravages of obsolescence will be hard to forestall. By this Fourth Stage in the project's evolution, the owners have long since refused to provide meaningful contributions of additional funds, lending institutions have refused further advances; and the projection for immediate or future repairs is well beyond any projected accumulations in the reserve accounts. Non-payment of assessments begins to climb to the point where the association's ability to pay for essential services, including utilities, insurance and management, is fading fast. Essential repairs are being deferred to such an extent that the basic habitability or safety of the buildings is being called into question.

Non-owner occupancy has risen beyond 50% and refinancing or mortgage lending by most traditional lenders is precluded. Behavioral problems increase, vandalism to the property becomes more than just occasional, and political problems within the association make recruitment of board members and management very difficult if not impossible. The ship is rudderless and sinking.

#### **Next issue – Beyond the Fourth Stage**

**Email** – We offer email distribution, one email per association/professional member, of our newsletter, meeting reminders and other pertinent information. If your association is not on the email list, you may send me an email to [gartzke@silcom.com](mailto:gartzke@silcom.com). The email contact can then forward to other members of your board. Over 110 members are receiving the newsletter via email – no additional charge.

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South Coast Homeowners Association – March 2006

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