

SOUTH COAST HOMEOWNERS ASSOCIATION

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UPCOMING SOUTH COAST MEETINGS

2007 LAW AND LEGISLATIVE UPDATES

James H. Smith – Grokenberger & Smith

David A. Loewenthal – Loewenthal, Hillshafer and Rosen

It's time again for our popular legislative update meetings. This year saw the passage of amended election rules, records disclosure and accounting method legislation (first passed in 2005) along with new reserve fund disclosures. The state HOA agency legislation was vetoed. In addition, we will have a discussion of the earthquake insurance issues and the issue of "loans, litigation and reserves" from the article appearing in this issue. Time permitting, our speakers will take your general legal questions as well.

Note Meeting Locations

Wednesday – January 17 – 7 PM

Encina Royale Clubhouse – 250 Moreton Bay Lane, Goleta (At Encina Lane)

Monday – February 5 – 7 PM

Quail Meadows West HOA Clubhouse – 866 Whippoorwill, Santa Maria

2007 SOUTH COAST DUES PAYABLE NOW

Your 2007 membership bills were mailed the week of October 3. No price changes for 2007! Your dues and other optional charges remain the same from 2006. Note that if you pay your dues before November 30, you receive a \$20 discount (1/3 off). Collecting all the dues in a short period of time is more efficient for the other South Coast volunteers and myself. Thank you for your prompt attention when your renewal notice is delivered.

THE UNCERTAIN FUTURE OF COMMUNITY ASSOCIATIONS BOOK

Those who attended our November 2nd meeting received a copy of Tyler Berding's book. We have approximately 20 copies available for sale. They are \$10/each postpaid. Send your check payable to South Coast HOA at P. O. Box 1052, Goleta, CA 93116.

WHY ARE EARTHQUAKE INSURANCE RATES CONTINUING TO INCREASE?

**By: Timothy Cline, CIRMS, President
Timothy Cline Insurance Agency, Santa Monica**

Editor's Note: The following article is actually an email response sent by Mr. Cline to me in late September. Over the past 3-4 months, I had heard from a number of you regarding the cancellation of earthquake policies by carriers or the enormous increases in premiums. Managers have received instructions from their boards to go out and get 3-4 bids. Since 9/11, insurance premiums have escalated substantially and have continued to do so. A poor stock market and low interest rates were some factors cited as reasons for increasing premiums during the past five years along with catastrophic losses from terrorism and natural disasters. Now interest rates are up and the Dow is at an historic high. Some associations have reduced the coverage limits for earthquake damage compared to the limits carried for fire. Some other associations are considering dropping the coverage but that brings up issues relating to members' expectations and whether the board would be liable for dropping the coverage in the event of earthquake damage (read: consult with your attorney before making that kind of decision). Tim is the President of Timothy Cline Insurance Agency in Santa Monica. He holds the Community Insurance and Risk Management Specialist (CIRMS) designation from the Community Association Institute. Tim's contact information appears at the end of the newsletter.

The earthquake markets are a complete state of hysteria – and, believe it or not, Santa Barbara County, while bad, hasn't been impacted as badly as some other areas in California. We still have some carriers that are writing in Santa Barbara County. By comparison there are virtually no earthquake carriers writing new business in Zones A or B. My firm had nine (9) accounts that lost their earthquake coverage last month. Two couldn't afford the renewals (large, large increases – 300% or more). The remaining seven HOA's lost their renewal carrier (no longer writing earthquake coverage in California) and there wasn't any carrier

offering them replacement coverage.

State of California
Earthquake Zones

<u>Zone</u>	<u>Counties</u>
A	San Francisco area-all areas surrounding the bay, as far south as San Jose and Santa Cruz
B	Los Angeles and Orange
C	Kern, San Luis Obispo, Santa Barbara, Ventura
D	San Diego
E	Alpine, Imperial, Inyo, Mono, Riverside, San Bernardino
F	Fresno, Kings, Madera, Mariposa, Merced, Tulare
G	Amador, Butte, Calaveras, El Dorado, Glenn, Nevada, Yuba, Placer, Sacramento, San Joaquin, Stanislaus, Sutter, Tuolumne, Yolo
H	Lassen, Modoc, Plumas, Shasta, Sierra, Siskiyou, Tehama, Trinity

Why now?

All commercial earthquake policyholders in California are feeling these impacts because of the horrific events in the Southeast last fall. The Insurance Information Institute reports there was a total of \$61.2 Billion in catastrophe losses paid last year and five major hurricanes (Katrina, Wilma, Rita, Ophelia and Dennis) caused some 94% of the damage.

There are three reasons these 2005 Losses in the Southeast are impacting us commercial earthquake rates today:

- 1) **Reinsurance:** Almost half of the \$61.2 Billion was paid by the Reinsurance industry. Simply said, reinsurance is the insurance that insurance companies purchase to “spread the risk.” These Reinsurers (about half are domestic, half are Bermuda or London based) have much less capital to write catastrophe coverage (earthquake, wind and flood coverage). As a result, it’s the old game of “supply and demand.” There is a lot of demand for catastrophe reinsurance much less coverage available, driving the rates skyward. When the cost of reinsurance goes higher, the “front line” carriers pass those costs onto consumers.

- 2) **Catastrophe Modeling Software was found to be “Overly Optimistic”** - Analysts that write the software that provides a “prediction” of catastrophic events discovered some problems in their modeling software. Their modeling software didn’t fully predict the amount of damage and especially underestimated something called “demand surge.” Demand surge is the artificially higher costs of labor and materials that follow an event the magnitude of these larger catastrophes such as Katrina, Wilma and Heidi. As a result, the modeling software has been adjusted upward to account for the larger losses and higher costs. The same carrier who runs this modeling software on a condominium association here in Southern California will now find the “probable maximum loss” to be much greater than on the identical building last year. As a result, carriers are not willing to take on the same exposure as in previous years.

- 3) **Pressure from Rating Companies** -- A. M. Best, Standard and Poor, Weiss Reports and other rating agencies have adjusted their Reserve requirements “upwards” for carriers who write catastrophe coverage. For example, for every \$10 of coverage you write, you must have at least \$1 in Reserves to pay claims. If the rating folks increase that requirement from \$1 to \$2, then the carrier can only write \$5 of coverage for that original \$1 in Reserves. You can see how this would have an impact on carriers. If a carrier wants to maintain their “A” rating, it might well mean that they can’t insure as much property for catastrophe losses as they could in past years.

This news isn’t particularly recent – as we first began to feel the impacts around May 15, 2006. We have sent two warning letters to our policyholders since that time as we saw carrier after carrier either leave the marketplace altogether – or dramatically change their appetite for earthquake business.

Rate increases of 200% to 300% are not uncommon in Zones A & B. And, as I’ve mentioned, we’ve had a number of smaller accounts here in the LA Basin where we’ve not been able to find any coverage at all.

What I find especially ironic about the timing of this whole thing:

1. The California Earthquake Authority (CEA) -- the state-run program which insures single family homes, tenants in apartment buildings and individual unit owners in condominium associations – announced a state-wide rate change effective August 1, 2006, which reduces the rates by an average of 22%. So it’s a bit difficult for a board member to understand how his individual rates have gone down (at least in most areas), how his/her individual rates have decreased, but the Master earthquake rates have gone up. I think this has more to do with the fact that the rate change for the CEA was approved in early August 2005 (before Katrina),
2. Thus far, the 2006 Hurricane Season has been remarkably free of large events. As a result (and assuming this trend continues) by this time next year, we should start to see Reinsurance rates come back down – which means that the Commercial earthquake insurance rates will come back down as well.

REVISITING THE UNCERTAIN FUTURE OF COMMUNITY ASSOCIATIONS

**By James H. Smith, Esq.
Grokenberger & Smith, Attorneys at Law**

Editor’s Note: Over the past several newsletters, we have published a series of articles by Tyler Berding (our November 2 speaker) regarding the future of community associations and some proposed solutions to ongoing problems. By publishing these articles, we have increased awareness among our members and advanced the discussion of the importance of proper maintenance and funding of our associations. There are other viewpoints to be considered. Jim Smith, one of South Coast’s founding members, has developed some additional issues for your consideration.

After reviewing the article published in the September, 2006 South Coast Homeowners Association's newsletter, "The Uncertain Future of Common Interest Developments – Part IV", I wish to commend the author, Tyler Berding, for underscoring what are, without question, three concerns Homeowner Associations are faced with. However, I respectfully disagree with his proposed solutions for those problems. The three concerns may be fairly described as follows:

1. The statutory caps on assessments (*California Civil Code* Section 1366(b)) have resulted "in severe underfunding of reserves";
2. With the average reserve account only 44% funded, "Associations lack sufficient capitalization to meet long-term repair and other obligations"; and
3. Poor construction quality and lack of a funded warranty to cure such deficiencies.

For each of the three concerns, Mr. Berding suggests that the solution is more legislation, government intervention and bureaucracy. Mr. Berding concludes his article by stating:

State legislatures should review the condition of Community Association housing in each state, and enact necessary safeguards and oversight to protect homeowner interests, as well as an orderly process for unwinding those interests when protection is too late.

Whenever I hear someone advocating for the government to solve our problems, I am reminded of these words:

"Government is not a solution to our problem, government is the problem."
(*Ronald Reagan – First Inaugural Address, January 20, 1981*)

For the three concerns described by Mr. Berding, I submit we do not need more legislation. The solutions for each of the three concerns are found in the law which currently exists. Simply stated, the concerns do not arise out of a problem with the law or lack thereof, the problem is the failure to comply with the legislation that currently exists.

Mr. Berding first states that the statutory caps on assessments "results in severe underfunding of reserves". **NOT TRUE.** If the law currently on the books was followed, even with the statutory caps which Mr. Berding claims have created the underfunding, there would be no underfunding. Pursuant to *California Corporations Code* Section 7231(a), a Director is required to act in good faith and in the manner such Director believes to be in the best interests of the Corporation.

Since 1985, when *California Civil Code* Section 1366(a) was enacted, and subject to the limitations on increasing assessments, Directors have been obligated to levy regular and special assessments sufficient to allow the Association to perform its obligations under the governing documents and the Davis Sterling Act.

Since 1985, *California Civil Code* Section 1366(b) has stated that Directors may not impose a regular assessment that is more than 20% greater than the regular assessment for the

Association's preceding fiscal year or impose a special assessment which in aggregate exceeds 5% of the budgeted gross expenses of the Association for the fiscal year in which the special assessment is levied. Stated another way, and to reemphasize, since 1985 the current law (CC §1366(b)) has allowed Directors to increase assessments, from one year to the next, by 20% without a vote or approval of the Owners.

Based upon the foregoing let us assume that in 1985 an Association's monthly assessments per unit were \$100 per month. The Directors of that Association could have increased that Association's assessments, from 1986 through 2006, from \$100 per unit, per month to over \$4,000 per unit, per month, without ever requesting Owner approval. That does not even take into account the money that could have also been raised, without Owner approval, through special assessments.

If, over the past twenty years, Directors simply raised assessments within the limitations allowed by current law, I sincerely doubt that any Association would today be pleading poverty. Moreover, if an Association did face unforeseen circumstances requiring an infusion of cash, that too is resolved by legislation currently on the books. *California Civil Code* Section 1366(b) also provides that the Directors may levy a special assessment, disregarding the 5% limitation, for extraordinary expenses which include unforeseen repair and maintenance expenses and/or where repair is necessary to mitigate against a threat to personal safety.

If the foregoing is accurate, and I submit to you that it is, then why do so many Associations find their reserves underfunded? The answer is found in Mr. Berding's very own article:

Funding decisions are as often based on politics as on pragmatism. If a Board can delegate responsibility for unpopular funding decisions to the owners, that is exactly what it will do four out of five times – deferring to the political will of the owners to avoid raising assessments.

Mr. Berding's statement begs the question; If underfunding is a consequence of a Board's lack of will power to take the unpopular but responsible action, then how is passing legislation removing the assessment caps set forth in *California Civil Code* Section 1366 going to solve the problem? The answer, of course, is that passing new legislation removing the caps will not solve the problem because, as demonstrated above, the caps are not the problem. The problem lies with a succession of Directors who proudly, from year to year, announce to the Owners that "No increase in the monthly assessments is necessary." Somehow such Directors have managed to accomplish what no economist or property owner in the history of mankind has figured out; immunity from inflation and the gradual deterioration of structures.

I will now address Mr. Berding's second concern. Mr. Berding states that "the average reserve account has only 44% of the funds it should have". Mr. Berding concludes that this underfunding has resulted in Associations lacking "sufficient capital to meet long-term repair and other obligations". Once again, I certainly do not disagree with that statement. What I take exception to is Mr. Berding's proposed solution where he again recommends solving the problem via more legislation. Mr. Berding proposes enacting legislation pursuant to which payment on assessments would be deferred upon conditions approved by the Board. In fact, Mr. Berding sets forth a "Model Assessment Deferral Statute". By enacting such legislation,

Mr. Berding suggests Owners would then not be as reluctant to vote against assessments exceeding the caps set forth in *California Civil Code* Section 1366.

There are two fundamental flaws with Mr. Berding's proposed legislation. First and foremost, if Mr. Berding's recommendation to eliminate assessment caps is successful, then there would not be any need for his proposed "Model Assessment Deferral Statute". This is due to the fact that no incentive would be needed to get Owners' approval to exceed the caps because the caps would no longer exist.

The second flaw with the "Model Assessment Deferral Statute" is that it defeats the very purpose for which Mr. Berding advocates its enactment. If Associations lack sufficient capital to meet long-term repair and other obligations, how does levying an assessment, and then deferring payment of that assessment, assist the Association in meeting its capital needs? This is particularly true when, as suggested by Mr. Berding, repayment could be postponed to an unknown date, perhaps years away, when the Owner receiving the deferral sells their unit.

Once again, we do not need to enact more legislation to solve this problem. Legislation already exists. While I do not recommend the use of payment plans, *California Civil Code* Section 1367.1(c)(3) sets forth a procedure pursuant to which an Owner may submit a request to meet with the Board to discuss a payment plan for repayment of assessments levied in accordance with *California Civil Code* Section 1366. The Association is obligated to meet with the Owner within forty-five days of an Owner's request and provide to the Owner any standards for payment plans that the Association has adopted.

Finally, we reached the third concern discussed by Mr. Berding in his article: "Poor quality control and the lack of a funded warranty program". It is Mr. Berding's contention that Common Interest Developments suffer from poor construction quality and the lack of a funded warranty. In discussing this issue, one should take great care not to characterize Common Interest Developments as poorly constructed. The majority of developments are not plagued with defects and protracted litigation.

Once again, Mr. Berding views the Government as the solution to the problem. Mr. Berding proposes "a new state department" devoted to regulating developers who build condominiums as well as regulating an Association's funding decision. One, of course, must ask how this Department would be funded and who would pay the costs. However, with respect to regulating developers and builders of condominiums, we already have three such departments in place. They are known as the State Contractors' License Board, regulating contractors; the Department of Building and Safety, reviewing and approving plans, as well as conducting field inspections during the course of construction; and the Department of Real Estate which regulates an Association's initial governing documents as well as their initial proposed budgets and reserve studies. If these three agencies are not effective, I submit that a fourth governmental agency will not fare any better. Rather than create yet another government agency with its paid staff, medical benefits, pension plans, facilities and equipment, I suggest the focus should be placed upon those departments we already have and pay for.

With respect to Mr. Berding's proposal that a new state department be created regulating an Association's funding decisions, I question how a state agency is going to be in a better position to make funding decisions for the 30,000+ Associations that exist throughout the

State than each Association's on-site Board of Directors. One must also question why the state would be any more successful regulating an Association's funding than the State has been in regulating their own funding decisions.

There already exists legislation that is specifically designed to guide Directors with respect to an Association's fiscal matters. There is *California Civil Code* Section 1365 requiring the annual preparation and distribution of a pro forma budget; Section 1365.2.5 requiring the annual preparation and disbursement of an Assessment and Reserve Funding Disclosure; Section 1365.5(a) requiring a quarterly review of the Association's financial records; Section 1366(a) requiring that Directors levy assessments sufficient to perform the obligations of the Association under the governing documents; and Section 1365.5(e) requiring a Reserve Study be conducted every three years. If the foregoing sections are complied with, and Directors act responsibly with respect to the information generated, I see absolutely no reason to have yet another Government agency looking over the shoulders of Directors for purposes of telling them how to make funding decisions for their Association.

Mr. Berding next proposes, as a solution to poor construction quality and lack of a funded warranty, that there be created "Major Medical Warranty" coverage that would cover the costs of correcting construction defects. He suggests this would be funded by a "viable insurance carrier" or "state funded". It is Mr. Berding's vision that an Association would cover the first 25 percent of repair costs leaving the insurance carrier (i.e. private insurance company or state funded insurance company) responsible for the remaining 75 percent. Mr. Berding suggests that the cost of the insurance premiums would be "split between the builder and the owners".

Anyone familiar with the difficulties of obtaining insurance for an Association could well imagine that there would not be a rush to provide insurance coverage as proposed by Mr. Berding. If coverage was offered, the premiums would pale in comparison only to the National Debt. Further, let's examine who would actually be paying for the correction of the defects caused by the builder of the development. Under Mr. Berding's plan, the first 25 percent of the cost to repair is paid by the Association (presumably from assessments collected from the owners). The balance of the repair costs (the remaining 75 percent) is paid by the insurance carrier from premiums collected. However, according to Mr. Berding 50 percent of the premiums are collected from the "owners" and 50 percent from the "developer". It is not unreasonable to conclude that the developer would merely pass the cost of the insurance onto the owners by increasing the sale price of the Units. Therefore, under Mr. Berding's "self funding Major Medical Warranty" program, it will be the owners who end up paying for the construction defects.

Additionally, Mr. Berding suggests that the "Self-Funding Warranty" will "reduce substantially the number of claims which must be litigated." That too is subject to debate. I submit that Mr. Berding's proposed Self-Funding Warranty will merely shift who the Association will have to litigate against when a defect is discovered. Rather than litigate against the builder to recover funds necessary to repair, Associations will find themselves litigating against the entity holding the "purse strings" to the Warranty Fund.

Finally, Mr. Berding suggests yet another concept to achieve financial stability in the form of a "Community Maintenance Trust". Under this concept, multiple Associations would pool their funds and form a "Maintenance Insurance Pool to deal with ongoing repair needs of the

member Associations.” In effect, the Associations would be self insuring. Of course the flaw with this concept is that well-maintained and constructed developments, of which there are many, would be paying to remedy problem-plagued complexes. Undoubtedly, the well-run and constructed complexes, with adequate reserves, would want nothing to do with such a program. Conversely, problem-plagued complexes would rush to join such a program resulting in a “Community Maintenance Trust” of bankrupt Associations.

Further, the existence of a Community Maintenance Trust would be a potential nightmare to administer. How, and under what circumstances, would an Association be entitled to draw from the Trust Fund? Who would make that decision? What would happen if the demands on the Trust Fund exceeded the available funds?

In an effort to provide protection to the purchasers of new housing, including purchases of Common Interest Developments, in 2002 there was enacted comprehensive standards which residential housing must comply with. There is also set forth a procedure for resolving disputes with the builder for violating the stated standards. These provisions are found *California Civil Code* Sections 895 through 945.5. Additionally, provisions were enacted which are specifically designed to resolve disputes between Associations, Builders and Developers of Common Interest Developments. These provisions are found in *California Civil Code* Sections 1375 through 1375.1.

In discussing the foregoing issues, I do not in any way mean to criticize my colleague, Tyler Berding. His article raises very real and concerning issues faced by Homeowner Associations which must be discussed and dealt with. However, I do not necessarily agree with his proposed solutions.

Statistics clearly establish that Community Interest Developments managed by Homeowner Associations will continue to be a major player in the housing market. Based upon my experience, most Homeowner Associations are properly and competently managed by hard working, intelligent, and devoted Directors and Property Managers. There are, of course, some Associations that are in need of a mid-course correction. With proper guidance, I have seen even the most problem-plagued Associations make remarkable turnarounds. I do not believe the future of Community Associations is “uncertain”. Indeed, Community Associations are playing a vital and increasingly important role in the housing market. By simply working within the framework of existing law, and with proper guidance and management, the future of Community Associations is indeed very bright.

LOANS, LITIGATION AND RESERVE What Comes First?

**By: David A. Loewenthal, Esq.
Loewenthal, Hilishafer & Rosen, LLP**

Common interest developments (CIDs), whether they are planned unit developments, condominiums, or cooperatives have become the favorite mechanism of residential construction over the last several decades. The trend toward building common interest developments began to rapidly escalate in the late 1960s and has continued to flourish and

grow ever since that time. At present, most new residential construction in California is in fact a common interest development, governed through a homeowners association. There have been ongoing debates over the pros and cons of living within a homeowners association with topics ranging from maintaining the integrity of the buildings and improving property values on the pro side to overly controlling boards of directors, financial mismanagement, homogenization of community character, etc. on the other side. Regardless of our personal feelings and opinions pertaining to residing within community associations, one thing is clear, the financial interests of all members residing within the community association are tied together.

It is this last issue, the financial connection that homeowners share when they own within a community association that is the topic of this article and is an issue that is becoming increasingly more important for members of community associations, especially as developments continue to age.

One of the primary duties of a board of directors of a homeowners association is to preserve the values of the properties contained therein. The method and manner to fund the association is through regular assessments which are designed to cover both the monies necessary for operating expenditures such as insurance, utilities, management, accounting, etc. and for reserves which is to cover the cost of replacement of component parts once their useful life has been met.

Civil Code § 1366 specifically discusses assessments and states as follows:

(a) Except as provided in this section, the association shall levy regular and special assessments sufficient to perform its obligations under the governing documents and this title. However, annual increases and regular assessments for any fiscal year as authorized by subdivision (b) shall not be imposed unless the board has complied with subdivision (a) of § 1365 with respect to that fiscal year, or has obtained the approval of owners, constituting a quorum, casting a majority of the votes at a meeting or election of the association conducted in accordance with . of the Corporations Code.

(b) Notwithstanding more restrictive limitations placed on the Board by the governing documents, the board of directors may **not** impose a regular assessment that is more than 20% greater than the regular assessment from the association's preceding fiscal year or impose special assessments which in the aggregate exceed 5% of the budgeted gross expenses of the association for that fiscal year without the approval of owners, constituting a quorum, casting a majority of the votes at a meeting or election of the association conducted in accordance with. . . of the Corporations Code.

It is through the use of assessments that the Association obtains the appropriate funding to ensure the proper operating, maintenance and restoration of those aspects of the community in which the board is so vested.

Again, reserve funds are only to be spent for the purposes of repairing, restoring, maintaining, replacing major component parts or pursuing litigation involving the repair, restoration, replacement or maintenance of major component parts of the common interest development which the homeowners association is required to maintain. **See Civil Code § 1365.5(c)(1).**

The determination of the amount of the regular assessment necessary for operating and reserves is determined on an annual basis. Specifically, the association must prepare and

distribute a proforma operating budget pursuant to **Civil Code § 1365**. The following must be included:

1. The estimated revenue and expense on an accrual basis;
2. The summary of the association's reserve based upon the most recent review or study pursuant to § 1365.5, based only on assets held in cash or cash equivalents
 - a. The current estimated replacement cost, estimated remaining life, and estimated useful life of each major component part.

Based upon the amount of money that is needed for operating and reserve, the pro forma budget is to be prepared, approved by the board and distributed to the members. Unfortunately, it is also this misstep that can become the downfall of an association.

Specifically, when an association's board of directors improperly budgets, either on purpose or by oversight for reserves, year after year, an increasing shortfall develops. This shortfall may ultimately lead to a disaster for the association in the form of substantial deferred maintenance, which may cause irreparable harm to its members. The one thing we know about component parts of the buildings that comprise a common interest development, is that they do not improve with age. (Editor's Note – CIDs are not fine red wines!) All components will ultimately wear out and require replacement. Component parts that are put into a building when new that are thought to have a 30, 40 or 50 year life span will ultimately wear out, especially if the expected life span of a building is approximately 75 years. For example, a condominium project constructed in 1966 with galvanized pipes may have originally had a life expectancy of approximately 30 to 35 years, We are now 40 years past original construction and unless properly reserved for, the pipes may be at a point of failure and the costs to remove them and replace them will be dramatic. The costs are not only those that are necessary to replace the component parts, but also the significant expenses necessary to reach the component parts, i.e., opening up drywall, cabinetry, etc.

Homeowners associations who do not take the responsibility for properly assessing its members and thus obtaining money to reserve for component parts at the beginning of the life of an association will condemn future owners to the reality of potentially large special assessments to fund the reserve accounts.

As previously stated, if there are substantial shortfalls in the association's reserve accounts, one manner to try and collect money to pay for the replacement of component parts is through a special assessment. However, **Civil Code § 1366(b)** places specific limitations on the amount of a special assessment that a board can place upon a member, without consent of the membership. Specifically, § 1366(b) states as follows:

“Notwithstanding more restrictive limitations placed on the board by the governing documents, the board of directors may not impose a regular assessment that is more than 20% greater than the regular assessments of the association's preceding year or impose special assessments which in the aggregate exceeds 5% of the budgeted gross expense of the association for that fiscal year without the approval of owners, constituting a quorum, casting a majority of the votes at a meeting or election of the association. . . .“

When there have been year after year failures to properly reserve, an increase in the regular assessment of 20% andlor a 5% special assessment will most often fall woefully short of the amount of money necessary to perform significant repairs, restoration or replacement of component parts. As such, the board will ultimately need to go to the membership in the hopes of having a special assessment passed in a sum sufficient to perform the appropriate

repairs and/or replacements. However, again, this requires a majority vote of a quorum of the membership. Since homeowners often vote with their checkbook, the passage of large special assessments is often difficult to obtain. In addition, when there is an attempt to pass large special assessments to pay for these items, arguments are generally raised by members which include, but are not limited to, the following:

1. Why should we have to pay for this now, we didn't cause the problem? Though it may be true that certain current members or new members to the association may not have reaped the benefits of several years of deferred maintenance caused by artificially low assessments, condominium projects are largely comprised of common area component parts, wherein each homeowner is responsible to fund the proper maintenance and repair of the buildings, even if it is not specifically directly affecting their own individual unit. Payments will ultimately be necessary in order to preserve the integrity of the buildings which directly ties to the valuation of the property. Lenders will often look at the percentage of an Association reserve in deciding whether or not to provide loans for purchases and/or refinancing existing loans.

2. How did the board of directors allow this to happen and can we sue them? Typically homeowners will seek to pass blame onto the decisionmakers of the association, i.e., the board of directors. This is an interesting issue since the current board who is trying to take appropriate action to replenish reserves so that major components parts can in fact be repaired or restored may not be the cause for the long-term shortfalls. Members would need to look to see whether or not the current board has also been in power for many years and did in fact contribute to the shortages, or if they are simply the board that is now attempting to right the ship. Although an association's membership could seek to sue the current board or prior boards of directors for negligence and/or breach of fiduciary duties, it is extremely difficult to establish. Issues that would need to be viewed by members who are considering bringing suit against the board or prior boards would include, but not necessarily be limited to, determining whether or not prior boards were advised by professionals that they were in fact under-reserving for major component parts; did prior reserve budgets indicate that the percentages being reserved were too low and they disregarded the advice to increase the budget to raise the reserve contributions; did the prior boards actually attempt to increase the assessments to the maximum amount allowed by § 1366, i.e., 20% for regular assessment and 5% for special assessments in hopes of increasing their monetary stability over a course of time as opposed to seeking a large special assessment from the membership, did the prior board actually attempt to go to the membership to raise monies via large special assessment but were unsuccessful; did a major component part fail well in advance of its anticipated life span so that it had not yet fully been reserved; when did breaches of fiduciary duty and/or negligence occur since it may raise issues of statute of limitations.

It should also be noted that when there is substantial deferred maintenance, there is a substantial likelihood that homeowners will in fact bring claims against the association in both the form of insurance claims and lawsuits. Causes of actions may include, but not necessarily be limited to, breach of the covenants, conditions and restrictions, declaratory relief, negligence, injunctive relief in attempting to compel the association to perform certain repairs. Owners may also seek damages to both personal property and often times personal injury, especially in water intrusion cases where mold may arise. Regardless of the validity of such a claim, the mere existence of the claim and/or lawsuits costs the association money in the form of legal fees, increase in insurance premiums and expenditures of significant time. Thus, the threat of insurance claims and/or lawsuits will likely lead to either dramatic increases in

insurance premiums or loss of insurance coverage which is ultimately to the detriment of **all** the members. One way or the other, the association pays for this deferred maintenance whether it is in the form of increased assessments to properly reserve, or in the form of paying for litigation costs, insurance, etc.

The board of directors' defense in such an action will largely be based upon the business judgment rule. Specifically the board and each of its directors must conduct themselves in good faith and act in the best interest of the association as a whole. Pursuant to this rule, a board is **not** liable for a poor decision, unless there is a showing of bad faith, fraud or negligence. Boards may rely on the advice of professionals in their defense.

3. Why not simply proceed against the association's directors and officers insurance? Members may simply state that they should sue the boards of directors, as identified above, in an attempt to get to the Directors and Officers insurance policy which may be several million dollars. Although this may at the outset look like an easy fix to solve the association's problems, it is in reality, quite the opposite. First, the Directors and Officers insurance carrier will hire counsel to defend the board of directors. That defense will be vigorous especially if the amount at stake is significant. Insurance companies do not wish to part with their assets, and as such, members attempting to go after a board through the Directors and Officers insurance should be prepared for a significant battle and will need to establish negligence, fraud, and/or bad faith in the manner that the board has conducted itself.

4. Can we simply patch up the problem and put it off to the future? This is probably what got the association to the place it is currently in, i.e., patching and deferral versus properly reserving for repair and/or replacement of major component parts so that the money is available when necessary. Patching and deferral will only last so long and over time will create a snowball effect which will cause greater and more significant damage to the association. As an example, once pipes begin to leak, it will lead to such items as water damage to the units, possible mold growth, additional damage to drywall, flooring, cabinetry and potentially personal injury lawsuits. This is true with many types of component parts affecting the condominium development including, but not limited to, the water pipes, drain lines, roofs, flashing details, etc.

5. Can the board simply pass an emergency assessment? This is a tricky area of the law since emergency assessments are specifically limited by the Civil Code. **Civil Code § 1366(b)** provides for three (3) distinct situations where a board of directors may unilaterally pass an emergency assessment without the consent of the membership, which are as follows:

- a. An extraordinary expense required by an order of a court;
- b. An extraordinary expense necessary to repair and maintain the common interest development or any part of it for which the association is responsible where a threat to personal safety on the property is discovered;
- c. An extraordinary expense necessary to repair or maintain the common interest development or any part of it for which the association is responsible but could **not** have been reasonably foreseen by the board in preparing and distributing the proforma operating budget under § 1365. However, prior to the imposition or collection of an assessment under this subdivision, the board shall pass a resolution containing written findings as to the necessity of the extraordinary expense involved and why the expense is not or could not have been reasonably foreseen in the budgeting process, and the resolution shall be distributed to the members with a notice of assessment.

It is generally the second and third sections pertaining to emergency assessments that boards try to use in obtaining money from the membership to deal with the major component parts. The second category, that there is a threat to personal safety, is sometimes used when the board becomes aware of a failure or imminent failure of a major component part that if it is not immediately repaired or replaced could actually injure an individual. As an example, a substantially sagging roof, which, if another rainfall occurs, would put an additional load on the roof and thus could create a catastrophic failure, would likely be a legitimate use of this emergency assessment provision in the repair and/or replacement of that specific roof. However, this would not provide the association with an opportunity to necessarily replace all of the roofs within a development. Again, it would generally be specific to those area(s) where there is a threat to personal safety. The board would need a professional, such as a structural engineer, roofing expert, industrial hygienist or other to advise the board in writing of the threat to personal safety if the component part is not dealt with immediately. This would provide the board with a reasonable basis for an emergency assessment under this section.

The third section of the emergency assessment caveat is that the association's board could not have reasonably foreseen the expense at the time of the distribution of the pro forma operating budget. As an example, this could occur when a tree falls and strikes a portion of the property and an emergency repair would be necessary and could not have been foreseen at the time of the creation of the operating budget. This could also occur if a major component part has a major failure actually causing damage to a unit versus creating a potential threat of danger to the personal safety as identified under section 2. As an example, a water line that ruptures and is causing water infiltration into the unit which could quickly turn into a mold situation, would appear to legitimately fall under section 3. Again, it would not necessarily authorize an association to start using an emergency assessment for the universal removal and replacement of that specific component part everywhere throughout the project absent a sharing as required under section 3.

Again, section 3 of the emergency assessment is designed so that the board is obligated to identify the proper reserve components and costs as part of the pro forma operating budget and not avoid this obligation, via the imposition of an emergency assessment, unless, it is truly an unanticipated emergency.

If an association is still young enough, it is possible that an association may also file a claim against a developer for under reserving. The developer creates the original budgets and represents to the buyers the amount of assessments at the time of purchase which should include amounts necessary to fund for both operating and proper reserving. Failure to so budget by the developer may be actionable. Often times in construction defect lawsuits against the developer, claims of under reserving are in fact included.

Again, homeowners in common interest developments, especially condominium projects, cannot escape the costs that are necessary to properly maintain the project and its component parts. The old saying of pay me a little bit now or a lot later clearly applies to homeowners associations more so now than ever in the past.

ANNUAL ASSOCIATION DISCLOSURES TO MEMBERS

Listed below are the annual disclosures to be made to members when distributing the annual budget. Approximately 75% of area associations use the calendar year as their budget and accounting year. This means that the budget and related disclosures are due to be mailed to the membership by December 2nd, 30 days before the start of the new fiscal year. Managers and boards are busy compiling this information package right now.

- 1) Proforma Operating Budget for 2007
- 2) Reserve Study Summary Information
- 3) Notice of Right to Receive Annual Financial Report
- 4) Assessment and Reserve Fund Disclosure Summary Form (new 2005)
- 5) Notice of Change in Regular Assessment
- 6) Association Assessment Collection Policy/Members Rights
- 7) Property Alteration and Modification Procedures – Architectural Control Guidelines
- 8) Insurance Coverage Summary
- 9) Notice of Right to Receive Board Meeting Minutes
- 10) Notice of Fines and Monetary Penalties Schedule, if any
- 11) Alternative Dispute Resolution (ADR) Disclosure
- 12) Internal Dispute Resolution Process

Further details on what is required for these disclosures can be found in the Davis-Stirling Act of the California Civil Code. Budget, reserves and insurance disclosures are found in Sections 1365-1365.9. Assessment and collection disclosures are found in Sections 1366-1367. Minutes, fine schedules and internal dispute procedures are found in Section 1363. ADR disclosures are found in Section 1369. The text of these laws can be found in the *Condominium Bluebook* distributed annually or on the web at www.leginfo.ca.gov – California Law.

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