

SOUTH COAST HOMEOWNERS ASSOCIATION

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Volume 18, Sample Edition

2005

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BILLS SIGNED INTO LAW – EFFECTIVE JANUARY 1, 2005

The following bills were signed and will become effective as of January 1, 2005. Details will be available at our January law update meeting and future newsletters.

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

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

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

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

- 2) Reserve calculations using straight-line method or “an alternate, but generally accepted, method of calculation” must be used to determine how much is needed in reserves (depreciation-to-date). However the code does not require a specific method (straight-line or cash flow) to calculate the reserve funding plan going forward.
- 3) Interest rate on investments limited to 2% above the discount rate published by the Federal Reserve Bank of San Francisco.

Extends the period of time to distribute the operating budget from the 45-60 day window prior to the beginning of the year currently in effect to 30-90 days prior. For December 31 fiscal year-end associations, this period is from October 3rd to December 1st.

Proscribes a specific form to be used called an “Assessment And Reserve Funding Disclosure Summary” to be provided to the members.

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

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

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

Disclose the current reserve balance, and based upon either the straight-line or alternative method of funding, the “required” amount in the reserve fund.

ARE YOUR ASSOCIATION RESERVE FUNDS WORKING HARD ENOUGH FOR YOU?

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

Money Market Accounts: Most bank and money fund accounts are paying around 0.5% to 0.75% interest. However, in performing accounting reviews for the 2003-04 year, I noted that several stock brokerage money market funds were paying much less than bank savings accounts. For example, the Charles Schwab money fund was paying 0.05% at December 31, 2003. Even worse, another mutual fund money market account was paying 0.01% interest at the same date. A \$70,000 investment in that fund earned 40 cents interest in December 2003. Some brokerage accounts also impose annual fees for keeping the account open, further eroding your interest earnings. For example, Merrill Lynch charges \$300 per year, Wachovia - \$175 and Morgan Stanley - \$125. If you are holding a number of CDs or

Treasuries in these accounts, these fees may be worth it. However, if you just have a money market account, the extra fees and hassle of dealing with the brokerage may not justify having a brokerage money market account, especially when their rates are no different and perhaps lower than our local banks. Brokerage money market funds are not insured by the FDIC.

Certificates of Deposit: There has been some upward movement in CD rates recently. A recent newspaper ad showed a one-year certificate at 4.5%. Compared to a 1.5% money market, your association could earn an additional \$3,000 on a \$100,000 investment. Higher rates are available for longer-term investments. Several banks have come out with a certificate with some liquidity that could be attractive for some associations. This CD requires a base investment that can't be withdrawn prior to maturity like other CDs (premature withdrawal subject to penalty). Amounts over the base amount can be added or withdrawn during the CD period without penalty and the additional amounts deposited will earn the CD rate.

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

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

For associations with substantial reserves, you can "ladder" your investments. Assume you have \$100,000 in a money market account earning 1.5%. It pays \$1,500 per year. After reviewing your reserve study, you could consider leaving \$25,000 in the money market account and then purchasing 3 CDs of \$25,000 each maturing in 4, 8 and 12 months. When the 4-month CD matures, make it a one-year CD since the original 8-month CD will only have 4 months remaining to maturity. Within 8 months, all of the association's CDs will be 12-month CDs, maturing 4 months apart. Assuming the 4.5% rate cited earlier, 75% of your funds would be earning this rate in eight months. Interest income would be \$3,750 per year, an increase of \$2,250 from leaving it all in the money market account with no additional risk. Funds should be available to meet the association's anticipated reserve fund expenditures.

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

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

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

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

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

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

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

The ruling continues. “The record indicates that the developer paid the ordinary costs of maintenance until the Association was turned over to the homeowners after the last unit was sold in May 1974....the Developer and its employees totally controlled the Association until

May 1974...all directors of the Association were either the owners or employees of the Developer. As a result of its prior experience, the Developer had learned that it was unwise to turn an association to “inexperienced homebuyers” and “expect them to run a business”. Accordingly, the Developer recommended a professional manager who was employed on the night that the homeowners first were elected to the board of the Association. Six months later, the homeowners’ board independently selected and employed a new manager. The new manager had to sue to obtain the Association’s financial records from the former manager.

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

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

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

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

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

THE FINDING

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

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

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

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

BOARD BASICS

WHAT IS THE “DAVIS-STIRLING” ACT

You have seen many references in this newsletter and other HOA resources about the “Davis-Stirling Act. What exactly is the “Davis-Stirling” Act? Why do association boards need to know about it?

Background: As common interest development housing started to be developed in the late 1960s and 1970s, laws were enacted by the California Legislature to define associations and regulate their operation. As these pioneer associations aged, it became apparent that these organizations were unique, a blend of business and government. In the early 1980s, special state legislative committees, chaired by Gray Davis and Larry Stirling, were convened to bring some order to the chaos surrounding association law. Different laws pertaining to associations were scattered around the California Civil Code and other codes. The committee brought the existing law into one place, Title VI of the California Civil Code (CC sections 1350-1376), and created new laws with the purpose of improving association operations. In 1985, the Davis-Stirling Common Interest Development Act was passed. Since then, the Act has been amended or changed nearly 50 times. Every year, there are numerous proposals to change the Act and some of them pass each year.

What it contains: The Act starts with definitions of association concepts. Here you will find guidance as to what is exclusive use common area and a separate interest, for example (CC 1351). In recent years, a section was added to help resolve association disputes (CC 1354). Some guidance is provided for unit modification and handicap access (CC 1360). Another important section includes membership discipline and fines (CC 1363) and open meeting laws (CC 1363.05). Repair responsibilities pertaining to termite and other wood destroying pests are outlined in CC 1364. Financial responsibilities such as budget preparation, reserve study requirements and required disclosures are found in CC 1365 and 1365.5. Board and association liability protections are found in CC 1365.7 and 1365.9. Limitations on special assessments and regular assessment increases are found in CC 1366. The ability to lien a member's unit for past due assessments was extensively changed last year. Those laws are found in CC 1367. Construction defect resolution procedures are found in CC 1375.

The Act takes up 65 pages in the *Condominium Bluebook* that we distribute to each association annually. Yet the Bluebook is over 300 pages long. Other laws in the Corporation Code, Health and Safety Code and elsewhere in the Civil Code also affect association operations. However, the laws in the Davis-Stirling Act are exclusive to common interest developments. They do not apply to any other type of organization or corporation. Unless otherwise provided in the law, the Act applies to all associations no matter how large or small. Many provisions of the Davis-Stirling Act are incorporated verbatim into governing documents such as your CC&Rs and bylaws. Governing documents recorded prior to the passage of the original Davis-Stirling Act do not contain the Act's provisions. In many cases, California law will supercede these governing documents when there is a conflict, rendering these documents obsolete.

No governmental agency tells boards about the Davis-Stirling Act. The California Department of Real Estate is involved when units are sold for the first time but drops out of the picture when the last unit is sold in a new development. Qualified professional management should be knowledgeable about the existence of the Act and its contents and how it applies to your association. Many associations, especially small associations, cannot afford professional management so it is up to you as board members to be aware of the Davis-Stirling Act and its provisions. Association professionals such as your attorney or CPA should also be knowledgeable about the Act. Disseminating information such as the Davis-Stirling Act provisions and changes was a prime reason why South Coast HOA was formed

nearly 15 years ago. By having more information at your disposal, we believe that you will make a more informed decision and in the long run, make better decisions.

HOMEOWNERS ASSOCIATION Records Retention Schedule - Financial/Tax Issues

By: Gayle Cagianut, CPA

Retain Permanently:

- Governing Documents
 - CC&Rs
 - Bylaws
 - Articles of Incorporation
 - Rules & Regulations
- Minutes - Board & Annual
- Federal & State Tax Returns
- State Tax Exempt Status Letter
- Year End CPA Reports
- Annual General Ledgers
- Budgets
- Insurance Claims
- Reserve Studies
- Fixed Asset Purchases

Retain for Seven Years:

- Monthly Financial Statements
- Bank Statements
- Monthly General Ledgers
- Accounts Receivable Listings
- Assessment Ledgers
- Check Registers
- Employee Records

Retain for Four Years:

- Paid Invoices
- Bank Reconciliations
- Payroll Tax Returns
- Deposit Slips
- Canceled Checks
- Collection Action Items

Retain for Life plus 4 Years:

- Insurance Policies

SOUTH COAST MEMBER SURVEY RESULTS – PART I

In September 2003, all South Coast association members received a 2-page survey to ask for our members' input regarding current association financial and management information and in some cases, to be able to compare data from our previous surveys.

Sample Size: We received 95 responses, approximately 70% of our associations took the time to respond. This compares to the 74 responses that we received three years ago. 20 responses came from North Santa Barbara and San Luis Obispo Counties. 74 came from South Santa Barbara County while a single response came from outside this area.

Type/Age of Associations: 55% of the responses were from condominium associations, the same percentage as in 2000. However, 61% of the South County responses were from condominiums while only 35% of the North County responses were from condos. Overall, the median association (half older and half newer) was built in 1979 – 24 years ago. Again,

geographic differences occur. The median North County association was built in 1984 while in the South County – 1975, 9 years difference.

Note: In many cases, I have used medians instead of averages in making comparisons. A median is defined as where half of the values are larger than the median and half are smaller. In some cases, averages can distort the data. For example, if you had a sample of 5, 10, 15, 20 and 100, the average would be 25 which is larger than 4 of the 5 numbers in the sample. 15 is the median where 2 items are smaller and 2 are larger.

Median Size of Associations: The median size association responding was 38 units, exactly the same as our 2000 survey. For condos, the North County median was 30 units while the South County median was only 20 units. For planned developments, the medians were nearly identical – 48 for the North County and 46 for the South County

Fair Market Value of Units: For the first time, we asked how much your homes are worth on today’s market. For the North County, the median was \$265,000, \$237,500 for condos and \$330,000 for planned developments. I don’t think that anyone will be surprised that the South County median was more than double - \$555,000. South County condos were at \$525,000 while planned development units were at \$625,000.

Reserve Funds: The following chart shows the reserve funding of our sample:

	<u>North</u>	<u>South</u>	<u>Total</u>
Median Reserve Funds on Deposit	\$ 54,496	\$ 57,000	\$ 56,000
Condominiums	NA	46,589	43,178
Planned Developments	58,991	78,000	65,500
Funds per Unit – Total	1,147	1,500	1,474
Funds per Unit – Condo (2003)	NA	2,329	2,056
Funds per Unit – Condo (2000)	NA	2,250	2,250
% Change from 2000		3.5%	-8.6%
	<u>North</u>	<u>South</u>	<u>Total</u>
Funds per Unit – PUD (2003)	\$ 1,229	\$ 1,696	\$ 1,379
Funds per Unit – PUD (2000)	833	1,065	833
% Change from 2000	47.5%	59.2%	65.5%

There are generally overall increases in the reserve funds held by associations. In the case of our planned developments, the median increased 65.5% to \$1,379 per unit while the total reserves decreased slightly for condos to \$2,056 per unit.

Assessments: We asked you what your assessments were this year and last year in order to track changes.

	<u>North</u>	<u>South</u>	<u>Total</u>
Total All Assessments – Median	\$ 146	\$250	\$ 225
Last Year’s Assessments – All	140	230	215
% Change from last year	4.3%	8.7%	4.7%
 <u>Condominiums Only:</u>			
Median Assessment – Current Year	\$ 150	\$254	\$240
Last Year’s Assessment	145	235	228
% Change from last year	3.4%	8.1%	5.3%
 <u>Planned Developments:</u>			
Median Assessment – Current Year	\$ 88	\$230	\$195
Last Year’s Assessment	81	220	180
% Change from last year	8.6%	4.5%	8.3%

All of these percentages are significantly higher than the 2% CPI factors published by the government.

Primary Reason Why Assessment Changed:

	<u>Number of Associations</u>	<u>North</u>	<u>South</u>
Utilities	10	3	7
Insurance	34	5	29
Reserve Funding	16	1	15
Common Area Maintenance	19	1	18
Management/Admin	5	1	4

As a general rule, planned developments have less maintenance and insurance obligations than condominiums and these figures bear this out.

HOW TO JOIN SOUTH COAST HOA

We hope you have found this kind of information useful for the operation and management of your homeowners association. Elsewhere on our website is a membership application noting all the benefits of membership. The newsletter is published 6-8 times per year and an e-mailed copy as well as a hard copy is included with your membership. Also on the website is a list of professional members who advertise in the newsletter.

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