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Funding Options for Major Association Maintenance Obligations

As common interest development housing stock ages, associations face decisions which will directly affect the market values in their communities, and the pocket books of their owners. Because reserve funding levels and deferred maintenance responsibilities have never been properly reflected in market values, current owners will increasingly become the deep pockets for funding major repair and renovation projects. Also, since many associations choose to keep their regular assessments low to avoid the negative market impact of high monthly charges, most will have inadequate reserves to fund the entire cost of a big project. A combination of increased assessments, special assessments, or a loan, may be necessary to supplement reserves so that the planned project may proceed.

After all statutes of limitations have run against builders and contractors, and all building material warranties have lapsed, there is no one to turn to but the owners themselves to fund necessary repairs. The Davis-Stirling Common Interest Development Act is crafted to provide an association board which needs to raise money with the power to raise assessments, while protecting owners by limiting the extent of increases that may be made without approval. In the long term, a board is better off with advance planning of future increases so that it will have the ability to fund projects without calling a special meeting or obtaining owner approval by written ballot. Even if owner approval is not required, a board should still mount an active public relations campaign to

provide owners with detailed information about the project. If the owners can be convinced that the project has been carefully planned with their best interests in mind, voluntary cooperation and prompt payments should be forthcoming.

A board will have to consider the political climate in the community, the finances of its members, and the nature of the project, to determine the preferred method for raising the funds. If quick completion of a project is critical, the Board may have no choice but to go to the owners. An association's current fiscal year budget will dictate the limits for assessment increases that may be levied without asking for owner approvals. Civil Code Section 1365, the pro forma operating budget includes revenue and expenses on an accrual basis. The budget may include assessments sufficient to perform its obligations under its governing documents and the Davis-Stirling Act. The amount of expenses used to compute allowable increases includes amounts assessed to fund the reserves, in addition to operating expenses.

Civil Code Sections 1366 and 1366.1 govern the ability of an association to levy and increase regular and special assessments to pay for major renovation and repairs or debt service for a loan. The need for owner approval at a special meeting or by a mail ballot depends on the amount by which the Board needs to increase assessments. Regular or special assessment increases may be made by a board as follows:

1. Increase of Regular Assessments over Prior Year of 20 Percent or Less. This increase may be levied by the Board without owner approval only if the Board has previously complied with all the pro forma budget and financial disclosures required by Civil Code Section 1365. For example, the current year's budget could be increased to \$600,000, if the prior budget was \$500,000. If the Board has not complied with Section 1365, owner approval is required for any increase. If the Board has complied with Section 1365, no owner approval is required.

2. Increase of Regular Assessments over Prior Year of More than 20 Percent. If the prior budget was \$500,000, the new budget may not exceed \$600,000 without obtaining owner approval.

3. Special Assessment of Five Percent of Current Fiscal Year Budget. If the current budget is \$600,000, a special assessment of up to \$30,000 may be passed in the same fiscal year without obtaining owner approval.

4. Special Assessment of More than Five Percent of Current Fiscal Year Budget. If the current budget is \$600,000, a special assessment of more than \$30,000 requires owner approval.

Owner approval required for any of the above assessments or increases must be obtained by calling a special meeting or, if permitted by the Association's bylaws, by written ballot under Corporations Code 7513. Regardless of the quorum or voting requirements in the Association's governing documents, the quorum for the meeting is more than 50 percent of the owners, and the required approval is by a majority of votes. At a minimum, affirmative approval of the increase by 26 percent of the owners will be necessary to go forward.

If an association has different requirements for increases of regular and/or special assessments in its governing documents, it should be made aware that the Davis-Stirling Act provisions supersede any of its governing document provisions that are more restrictive. The notice of increase provisions of the Act also supersedes all notice of increase provisions found in an association's governing documents. Notice of any increase in regular or special assessments must be provided to the owners by first-class mail, not less than 30 or more than 60 days prior to the due date of the increased assessment. Even if the declaration provides that the notice only has to be delivered to owners, it must now be sent by first-class mail.

Loans may also be considered to fund part of the project. Financial institutions are now aware of the market potential of common interest development lending. An association can be the ideal borrower since it has nowhere to go, and will likely not declare bankruptcy. Association loans are treated as commercial loans and future assessment payments may be pledged as collateral. The Association's operating accounts will likely have to be moved to the bank making the loan. Carrying costs aside, loans are advantageous since they allow an association to spread the cost of a major project over more of its useful life, rather than burdening only current owners. However, even an aggressive bank will typically require that a portion of the project be funded through reserves or assessments. Owner approval may be required under the governing documents for the loan itself and for the increase in assessments necessary to service the debt.

Loans will be out of the question for some associations that are in poor financial condition and have failed to fund their reserves. As more complexes become dilapidated, and the need for affordable housing increases, some municipalities are considering making low and no interest long term loans to associations, providing that affordable housing goals are met through the

cooperative effort. This type of financing is clearly a long shot, but something that politically connected owners should consider. These municipal loans have typically been made available only to single family homeowners.

A special category of emergency situation assessments was also created by the legislature to give a board the power to make certain assessment increases without the necessity of owner consent. Because voluntary payment of assessments is so important, a board should not be creative in relying on Civil Code Section 1366 (b)(1)-(4) to levy emergency special assessments. Allowable purposes are:

1. An extraordinary expense required by court order.
2. An extraordinary expense necessary to repair or maintain a part of the common interest development for which it is responsible where a threat to personal safety on the property is discovered.
3. An extraordinary expense necessary to make repairs that are the responsibility of the Board "that could not have been reasonably foreseen" when the last pro forma budget was prepared and distributed. [Caution: the Board must pass a resolution containing detailed findings regarding the necessity of the expense and why it was not, and could not have been, reasonably foreseen in the budget process, and distribute the resolution to the owners.]

Limits on an association's power to assess in Civil Code 1366.1 prohibit an association from imposing or collecting assessments or fees that exceed the amount necessary to defray the costs for which it is levied. A recent case where an owner tried to use this statute to avoid a special assessment, backed the decision of the Board. In *Foothills Townhome Association v. Christiansen* (1998) 65 Cal.App.4th 688, 76 Cal.Rptr.2d 516, the

court upheld an association assessment to replenish the reserve fund after it used reserves to repair storm damage. The owner argued that because the reserve fund could have been replenished over a period of time, the assessment exceeded the amount necessary to defray the costs for which it was levied. The court found that the assessment was within the amount necessary to defray the costs for which it was levied – the cost of replenishing the reserve fund and that:

"As a matter of law, an assessment does not violate Civil Code section 1366.1 merely because the costs *could* have been recouped incrementally. Nothing in the language of the statute suggests that is so." 65Cal.App.4th at 694.

This decision provides guidance to a board as it determines not only how much the project cost per unit will be, but also how long an owner will be given to pay. Multi-year assessments will allow a board to use its five percent special assessment right on an annual basis, or to increase regular assessments by up to 20 percent in one year and special assessments by up to 5 percent in the same year and future fiscal years to meet its funding goals.