

**SWEDELSON & GOTTLIB LEGAL UPDATE
2004 ANNUAL DISCLOSURE CHECKLIST**

**BUDGET DEADLINE –
NOVEMBER 17, 2004**

That's right, it's budget time again. Community managers and Board members are hard at work preparing their associations' budgets and other required disclosure documents.

As we do each year, Swedelson & Gottlieb is providing you with our 2004 Annual Disclosure Checklist. The California Civil Code requires that community associations provide members with an ever-growing profusion of information and disclosures each year, many of which must be distributed "not less than 45 days nor more than 60 days" (the 15 day window) prior to the beginning of the association's new fiscal year. In 2005, for some "disclosures", the timeline will change from a 45 - 60-day time frame (resulting in a 15-day window) to a 30 - 90-day time frame (resulting in a 60-day window). For those community associations operating under a calendar fiscal year, the budget and other disclosures are required no later than November 17, 2004.

For those associations whose fiscal year commences on a date other than January 1, 2005, the information in this newsletter should be utilized at the applicable time by calculating the appropriate calendar deadlines prior to the commencement of the fiscal year. If an association's fiscal year commences any time in 2005, the new notice periods will be controlling. Please access our Blog at www.hoalawblog.com for an update on applicable statutes.

The California Civil Code mandates the distribution of a "pro forma operating budget" which includes, among other things, information regarding the association's expenses, income and reserves. The Civil Code also requires that associations provide members annually with other information

about the association and their membership rights. We address these requirements in our checklist which follows.

Note that there are significant changes to the Civil Code for 2005 requiring new or additional disclosures that do not take effect until 2005 and are not applicable until then. Some of the more problematic disclosure issues and requirements and the 2005 changes are addressed in this newsletter.

**ANTICIPATED SPECIAL
ASSESSMENTS**

California Civil Code Section 1365 details what is required to be stated or presented in an association's budget and financial reports. In addition to the budget and other required financial disclosures, that Code Section states that associations, through their boards of directors, are required to set forth a statement as to whether "...the association has determined or anticipates that the levy of one or more special assessments will be required to repair, replace, or restore any major component or to provide adequate reserves therefor." [Civil Code § 1365(a)(3)]. New additions to the Civil Code applicable in July 2005 will require greater disclosure obligations regarding reserves and the precise amount of increased assessments for the association's fiscal year.

What does this mean? It means that each association needs to take a good hard look at its budget and anticipated expenses for the upcoming year to determine whether any special assessments will be required.

This has been an "issue" at several associations because the board knew or should have known of the need for a

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special assessment to fund the cost of a common area repair or replacement project for which there are no monies in reserve.

We are increasingly surprised at how many associations are purposely choosing to underfund reserves and rely on special assessments for these projects, the theory being that the homeowners who will immediately benefit should pay. Commencing January 1, 2005, this procedure will not work. While technically that practice may be in compliance with the Code, as no reserves are actually required, new law for 2005 will require that the board of directors carefully reviews what projects it believes will need to be undertaken and determine whether the association has sufficient funds or will require a special assessment, and make the appropriate disclosure.

We are also finding that some associations are disguising assessment increases by calling them special assessments. Rather than increase the regular assessments, some boards are passing a special assessment of a certain amount per month (for example, \$50.00) to fund a repair program or reserves when, in reality, this money should be part of the regular assessments. This practice could be challenged by owners, especially buyers. Some associations are then failing to provide any notice of this ongoing special assessment for the following year. In order to be in compliance with Civil Code Section 1365, it is appropriate to present this information in the budget.

MOLD, DEFECTS AND LEAKS

In a similar vein, some associations are not fully disclosing all of the "issues" that the board has knowledge of when the budget is being finalized. Even if the board is not anticipating making any major repairs to deal with "issues" (although, these days, they probably should), disclosure of these "issues" should be made. Technically it could be said that these "issues" fall between the cracks in the Civil Code. These "issues" should either be included as a reserve item or the board should disclose that at some point they anticipate an assessment to repair or fix the "issue(s)". To avoid problems, the board should make full disclosure of what "issues" it is dealing with, especially if it anticipates that this will affect the budget. The "issue" needs to be disclosed somewhere in the financial disclosures that are made so that the board is not misrepresenting the association's true financial condition.

The failure to disclose the cost of a mold abatement project has become a serious problem for associations that anticipate this work and/or need legal assistance to deal with an uninsured mold claim. The cost of these "issues" is not typically budgeted. Although not every expenditure can be calculated or anticipated in advance, if the board is going to "borrow" from reserves, (meaning using reserve money for work not designated as a reserve item) then this must be disclosed, along with the board's plan for replenishing the "borrowed" reserves.

INSURANCE DEDUCTIBLES AND MOLD POLICY

Community associations should develop and distribute a deductible policy setting forth the association's policy on dealing with insurance claim deductibles. It is quite simple. The policy needs to state that if the claim originates as a result of a cause which is the homeowner's responsibility, such as a broken flex line or leaking toilet, the homeowner would be responsible for the deductible. If the cause of the damage is related to the association's maintenance and repair responsibilities, the association would be responsible for the deductible. This policy can be included with the insurance disclosures and should include the amount of the deductible.

It is probably no secret that associations are trying to avoid submitting many insurance claims. Insurance premiums have skyrocketed and those associations that have a large number of insurance claims are finding that their premiums have risen dramatically. Some associations have increased the amount of the deductible to keep the cost of insurance down and ensure that owner related claims are being handled by the owners (or their own insurance policies). Many insurance companies will allow associations to increase the water damage claim deductible to as high as \$25,000. Some associations are going to "bare wall" policies if permitted by their CC&Rs.

Insurance industry statistics show that 60% of all association claims are related to damage that is the homeowner's responsibility. Having a \$25,000 (or more) deductible will eliminate many claims (that are less than the deductible) and will help keep insurance costs down. For those claims that are the association's responsibility, the association could take the insurance premium savings, if any, and/or budget some additional monies into a

contingency fund in reserves to deal with these uninsured claims. Frankly, with so many claims resulting from mold, which are generally not covered by insurance, associations should have a contingency fund to deal with these and other uncovered claims.

If the association adopts a deductible policy that includes a significant deductible, disclose this change to your members – and disclose it again – and again. Encourage homeowners to obtain their own insurance policies to cover this gap in the association's coverage. Check with your insurance professionals and perhaps have a legal review to ensure that the association can increase the deductibles and/or go to a "bare wall" policy.

In terms of mold claims, associations need to adopt a mold policy and disclose that mold policy to the homeowners. Associations should also consider preparing a maintenance and repair policy and checklist. Often associations end up in disputes with homeowners over who is responsible for what maintenance repairs. If you are interested, contact our law firm and we will provide you with a proposal for the preparation of a maintenance checklist and mold policy. Homeowners need to be told that if they do not report water damage claims within 24 hours, the association cannot be held responsible for the resulting mold, as the association did not have an opportunity to eliminate the water damage before it became a mold problem.

Important advice: Do not debate responsibility as the first reaction to a water damage claim. Associations should immediately eliminate the water, then debate repair responsibility later.

DISCLOSURE OF ALLEGED VIOLATIONS OF GOVERNING DOCUMENTS

Although not part of its annual disclosure obligations, there is another disclosure that associations are failing to make: escrow notification of alleged violations of the governing documents. Not only can this disclosure assist the association in CC&R and Rule enforcement, but the association's failure to make this disclosure may affect an association's enforcement rights.

California Civil Code Section 1368 requires that associations provide, along with all other documents delivered on behalf of an owner to escrow, "[a] copy or a summary of any notice previously sent to the owner pursuant to

subdivision (h) of Section 1363 that sets forth any alleged violation of the governing documents that remains unresolved at the time of the request. The notice shall not be deemed a waiver of the association's right to enforce the governing documents against the owner or the prospective purchaser of the separate interest with respect to any violation. This paragraph shall not be construed to require an association to inspect an owner's separate interest."

This means that Associations are obligated to disclose to prospective owners violations on an owner's property. So, for example, if an owner has installed an unauthorized patio enclosure, and the association has made a demand that the owner remove or fix the patio enclosure so as to be in compliance with architectural guidelines, and the owner fails to comply, through escrow, notice can be given to the prospective buyer of the problem. This may likely compel the seller to correct the violation, as the prospective buyer will not want to inherit this problem.

NOTICE OF NEW RULES, CHANGES AND ARCHITECTURAL MODIFICATIONS

Although not an annual notice required to be distributed to the homeowners, a 2003 amendment to the California Civil Code requires that the adoption of or changes to certain rules and regulations must be noticed in writing to the homeowners, if the definition falls under the definition of an operating rule. The board of directors is now required to give members 30 days notice of a proposed new operating rule change. The board must include the text of the rule change, and a description of the effect of the rule change, except those rules adopted for emergency procedures. If the operating rules are then approved by the board, the board must notify the homeowners 15 days after approving the rule change. Further, the board is obligated to deliver the notice to the homeowners. These new operating rules are subject to reversal by a majority of a quorum of the members if at least 5% of the voting power of the association petitions the board for a special meeting for the purpose of reversing an operating rule. As a result of Assembly Bill 2376, commencing in 2005, there will be additional restrictions on the types of rules that boards of directors can implement without prior notice and homeowner discussions, the requirements of which can be found in new Civil Code Section 1378.

Beginning January 1, 2005, any procedures for reviewing and/or approving or disapproving a proposed physical change to a member's separate interest or the common area will now be subject to the rule adoption procedures referenced above. Further, if an association's governing documents require the owner to obtain association approval before making a physical change to the owner's separate interest or to the common area, the association must, by statutory requirements, have a standard to review and approve or disapprove the proposed change. Those requirements are set forth in Section 1378 of the California Civil Code (a new provision), which also amends Sections 1357.120(a), 1357.130 and 1367.40 of the Civil Code, and must satisfy the following minimum requirements: fair, reasonable and expeditious procedure for making a decision, must include prompt deadlines and shall identify the maximum time for response to an application or an owner's request for reconsideration by the board of directors if the first request is denied. Further, the board's actions must be made in good faith and may not be unreasonable, arbitrary or capricious; the decision must be consistent with the association's governing documents and prevailing

law, including the Fair Employment and Housing Act. If disapproved, the board is required to provide the decision in writing with an explanation of why the proposed change is disapproved and advise the homeowner of what the homeowner must do for reconsideration of that decision. Finally, if a proposed change is disapproved, the applicant is entitled to reconsideration by the board in an open meeting. Exceptions to reconsideration are found in this Code provision and are not required if the decision is made by the board or a body that has the same membership as a board that satisfies the requirements of Civil Code Section 1363.05 (the Open Meeting Act). The new law is cumbersome, is consumer-based law and is supposed to be based on fairness.

Remember, Civil Code Section 1378 is not intended to authorize a physical change that is prohibited by the association documents or governing law. Civil Code Section 1378 does provide that an association must provide its members with notice on an annual basis of any requirements for association approval of physical changes to the property.

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2004 ANNUAL DISCLOSURE CHECKLIST FOR COMMUNITY ASSOCIATIONS
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With the budget or summary, or in any general mailing during year:

Notice of Right to Minutes of Board Meetings
<input type="checkbox"/>

On an annual basis, the association must notify members of their right to receive copies of the minutes from board of directors meetings.

The notice should state:

- ✓ members’ right to receive approved minutes, an unapproved draft, or a summary of the minutes within thirty (30) days of a board meeting upon member's request and upon reimbursement of association's costs to distribute minutes; and
- ✓ how and from where those minutes may be obtained.

Civil Code § 1363.05(d)

45 to 60 days prior to beginning of fiscal year¹:

<i>Pro Forma</i> Operating Budget
<input type="checkbox"/>

The association must distribute its operating “pro forma” budget within the “15-day window” in order to retain its ability to unilaterally increase assessments. If this requirement is not met, the members must approve any increase to the regular assessments.

The budget must contain the following:

- ✓ an estimate of revenue and expenses on an accrual basis;
- ✓ a summary of the reserves printed in bold type;
- ✓ with respect to construction or design defect cases, the summary must also include a separate line item for:
 - (1) funds received from compensatory damage award or settlement, and
 - (2) expenditure or disposition of funds, including amounts for direct/indirect costs of repair of defects. (If association is required to have a CPA conduct a review of its financial statements, above information may instead be contained in such review.)
- ✓ a statement as to whether the board anticipates the levy of one or more special assessments;
- ✓ a basic description of the procedures used to calculate the reserves.

Civil Code § 1365(a)

<i>Summary of Pro Forma</i> Operating Budget
<input type="checkbox"/>

(Alternate to Above) The association may distribute a summary of the operating budget in lieu of the pro forma budget.

The summary budget must give members notice that:

- ✓ the complete budget is available for review at the association's business office or other suitable location within the development; and
- ✓ copies of the complete budget will be provided upon request at no charge to a member within five (5) days of the request.

These notices must be printed in at least 10-point bold type on the front page of the summary.

Civil Code § 1365(c)

Assessment and Reserve Funding Disclosure Summary
<input type="checkbox"/>

The association must distribute an Assessment and Reserve Funding Disclosure Summary in the form prescribed by Civil Code Section 1365.2.5. This disclosure requires more than just a description of the amount of reserves and/or the association’s budget contributions. Disclosure of, among other things, the components being reserved for, their anticipated remaining life and how much money is currently in reserves allocated to that component must be disclosed.

45 to 60 days prior to beginning of fiscal year, or in any general mailing during the year²:

Arbitration/
Mediation of CC&R
Disputes

Annually, the association must distribute a summary of Civil Code Section 1354 to its members.

Section 1354 provides, in part:

- ✓ encouragement of arbitration or mediation prior to litigating an action to enforce the governing documents, in seeking injunctive or declaratory relief, or injunctive or declaratory relief plus damages of up to \$5,000 (other than assessments);
- ✓ thirty days in which the responding party may accept or reject “alternative dispute resolution.”

Civil Code § 1354

1 to 60 days prior to beginning of fiscal year³:

Insurance
Coverages

The association must distribute to the members a summary of its property, general liability, earthquake, flood and fidelity insurance policies. The summary shall include a statement which is set forth in the Civil Code. The summary should also state:

- ✓ the name of the insurer and the type of insurance; and
- ✓ the policy limits and deductibles, if any.

To the extent the above information is contained on the policy's declaration page, that page can be distributed in lieu of the summary. The summary or declaration page must include the statement provided in Civil Code Section 1365(e)(4). This statement must be in at least 10-point boldface type.

Notice of a lapse, cancellation or non-renewal of any policy, or of any change in policy shall be provided to the members by first-class mail as soon as reasonably practicable.

Civil Code § 1365(e)

Assessment
Collection
Policy

Members must receive a description of the policies and practices which the association will apply to enforce payment of assessments. The failure to adopt and distribute this assessment collection policy may affect an association's ability to collect delinquent assessments.

This notice usually describes:

- ✓ how, when and under what conditions the association will record and foreclose upon assessment liens;
- ✓ the nature and amount of late charges, interest and collection costs.

Civil Code § 1365(d)

Notice of Assessments
Foreclosures and
Payment Plans

The association must distribute to its members during the sixty (60) day period prior to the beginning of the association's fiscal year the notice specified in Civil Code Section 1365.1, pertaining to assessments, the association's rights of foreclosure, payments of assessments and meetings and payment plans concerning a delinquent assessment.

Civil Code Section 1365.1

Within 120 days after close of fiscal year:

Review of
Financial
Statement

For any fiscal year in which the association's gross income exceeds \$75,000, a review of its financial statement must be prepared by a licensed California accountant and distributed to members within 120 days after the close of each fiscal year.

Civil Code § 1365(b)

<input type="checkbox"/> to Receive Annual Report

For any fiscal year in which the association's gross revenues are at least \$10,000, it must prepare an annual report within 120 days after the end of the association's fiscal year and notify members on an annual basis of their right to receive this report. The association must provide the report at its own expense to any member submitting a written request for a copy of the report.

- The annual report must contain:
- ✓ a year-end financial statement;
 - ✓ a notice stating where records of the association members' names and addresses are stored; and
 - ✓ disclosure of transactions with interested parties and of indemnification agreements.

The association must attach either the accountant's report, if an independent accountant has reviewed or audited the financial statement, or a certificate by an officer indicating that the statement was prepared without review or audit.

Corporations Code § 8321

Other Required Disclosures:

<input type="checkbox"/> Assessment Increases

Notice of an assessment increase or special assessment must be provided by first-class mail to members not less than 30 nor more than 60 days before the increase or assessment is due. Note: Even if the budget shows the increased assessments, prepare and distribute a general notice.

Civil Code § 1366(d)

<input type="checkbox"/> Schedule of Monetary Penalties

Associations which impose fines on members for violating governing documents or association rules must distribute a schedule of the monetary penalties via first-class mail or hand delivery when the schedule is adopted or revised (recommended annually).

Civil Code § 1363(g)

<input type="checkbox"/> Escrow/Sale of Unit
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Within ten (10) days of written request from an owner, an association must provide the owner (or owner's agent/escrow) with a copy of various documents and information so that the owner may satisfy certain disclosure obligations to a prospective buyer. Among the documents and information to be provided by the selling owner is a statement of unpaid fines and other monetary penalties, as well as a copy or summary of any notices of alleged violations of the governing documents that remain unresolved at the time of making the disclosure to the prospective buyer.

Civil Code § 1368(a) and (b)

<input type="checkbox"/> Disclosure of Construction Defect Issues Before Suit

Thirty (30) days before an association files a lawsuit for construction defects, it must provide notice to all owners of the defect issues, schedule a members meeting to discuss the claims, and the available options, including any settlement offer from the builder, as referenced in California Civil Code Section 1375(k)(1)(E).

Civil Code § 1368.4(a), § 1375(k)(1)(E). Effective January 1, 2005, Civil Code § 1368.4 will be renumbered to ¶1368.5

<input type="checkbox"/> Disclosure of Construction Defect Settlement

As soon as practicable upon settling a construction defect claim with the builder, the association must so inform the members and (1) disclose what will be repaired (2) estimate when the defects will be repaired and (3) disclose any defects that may not be repaired.

Civil Code § 1375.1

<input type="checkbox"/>	Reserve Fund Transfer
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When an association uses or transfers any funds from its reserve account to fund litigation, it must notify the members of the transfer and of the availability of an accounting in the next available mailing to the membership.

Civil Code § 1365.5(d)

<input type="checkbox"/>	Litigation Expenses
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Unless the association's governing documents impose more stringent standards, the association shall prepare an accounting of the litigation expenses on at least a quarterly basis. The accounting shall be made available for inspection by members at the association's office.

NOTE: Pursuant to Civil Code Section 1365.5, the definition of "reserve accounts" includes funds received and not yet expended or disposed from either a compensatory damage award or settlement to an association arising from construction or design defects. Such funds must be separately itemized.

Civil Code § 1365.5(d)

<input type="checkbox"/>	Annual Corporate Statement
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If an association is incorporated, it must file with the Secretary of State an annual statement, plus an accompanying statement identifying the association as a common interest development and giving the association's address and managing agent's name and address. These statements are due up to five months prior to the anniversary date of incorporation. Failure to file the statement may cause the Secretary of State to place an association in suspended status.

Corporations Code § 1502 and Civil Code § 1363.5

END NOTES:

- ¹ For associations with a fiscal year beginning on or after July 1, 2005, the budget must be distributed not less than 30 days nor more than 90 days prior to the beginning of the association's fiscal year.
- ² Beginning on January 1, 2005, an association operating on a fiscal year other than a calendar year shall annually provide its members a summary of the provisions of Article 2 of Chapter 7 of the Davis-Stirling Common Interest Development Act, the statement provided in Civil Code Section 1369.590 and a description of the association's internal dispute resolution process. (Civil Code Sections 1369.590 and 1363.850)
- ³ For associations with a fiscal year beginning on or after July 1, 2005, the insurance summary and assessment collection policy must be distributed not less than 30 days nor more than 90 days prior to the beginning of the association's fiscal year.