Six Legislative Interventions that will make a Difference

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Prologue: This is my 42nd year of involvement in the California Common Interest Development (CID) world. My first encounter with the legislative process was in the early 80's with the first embryonic involvement of the California Association of Realtors in this real estate segment which resulted in the requirement for Major Repair and Replacement (Reserve) studies and independent CPA reviews Since then the California Legislature has been active in the CID world which now manifests itself in what is known as the Davis-Stirling Act (the Act) or the California Civil Code Sections 4000 to 6150.

I have been active in the industry as an independent CPA performing audits and reviews, as an accounting, management, and HR service provider as well as an activist owner, director and president of a large-scale community. My bottom line observation of the current state of California CID law is that it is ineffective at the margins and that reasonable checks and balances between the owners and abusive or well-intended inept volunteer association directors are weak. CID law and the lawyers that represent them put the owners at great disadvantage in any dispute resolution process or transparency issue. The Associations have the funds. Their lawyers know how to play the edges and, because authoritative case law is mainly absent in key areas, they make up legislative intent to favor their client.

At a recent California Association of Community Managers leadership conference, it was announced that the public perception of California CIDs is that they are: Restrictive, Punitive, Self-Serving, and Adversarial. They lack the reputation pillars of trust, integrity, character and respect.

The notion of an Ombudsman or public defenders for CID owners is worthy of consideration and it may be time to resurrect that discussion (See AB770, Mullin, 2006). However, it has had mixed success in other states and may be politically unacceptable in California right now). What follows, and submitted for your consideration, are a few proposed legislative initiatives that will help restore owner/association balance of power, reduce the cost and simplify certain ministerial activities, and clarify and expose the typical vastly underfunded Major Repair and Replacement obligations.

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The Proposals.

1. Small Claims Court.

   The Issue: The Small Claims Court (SCC) limit for corporations has been, essentially, stuck at $2,500 decades. Meanwhile, the limit for individuals has been increased to $10,000. CID's are a group of individuals maintaining their communities using a corporate form. The SCC is a low-cost prompt effective method for collecting unpaid assessments and settling CCR disputes. Unpaid assessments put a burden on other owners to cure those deficiencies.

   The Proposal: Increase limits for CIDs to that of individuals. There is existing precedent in the SCC act for such a carve out.

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2. Member Meeting. (Corporations Code §7510(e) Division 2, Part 3. Nonprofit Mutual Benefit Corporations)

   The Issue: The Member Meeting is a little used ostensible owner check and balance tool on abusive or inept Board actions. Its language and intent seems clear:

   > *§7510 (e) Special meetings of members for any lawful purpose may be called by the board, the chairman of the board, the president, or such other persons, if any, as are specified in the bylaws. In addition, special meetings of members for any lawful purpose may be called by 5 percent or more of the members.*

   This language is similarly reflected in most California CID bylaws.

   A common legal definition of "lawful purpose" is*:*

   > *A purpose is lawful unless it is (a) forbidden by law, or (b) is of such a nature that, if permitted, it would defeat the provisions of any law, or (c) is fraudulent, or (d) involves or implies injury to the person or property of another, or (e) the Court regards it as immoral or opposed to public policy.*

   CID lawyers interpret "lawful purpose" very narrowly which, absent any relevant interpretive case law, renders the provision essentially useless. Leaving owners with only the costly, contentious and dreaded "board recall" event as a check and balance method.

   The Proposal: Clarify the legislative intent of "…lawful purpose…". It seems to me the intent is to provide the members with a common sense low cost quick check and balance remedy for Board ill-advised or poorly handled decisions. The Davis-Stirling act should clarify that at a properly held member meeting, a membership quorum can step in the Board's shoes on any matter (lawful purpose). If a Board knows this member meeting remedy is out there, it may give them more pause to think things thru and to engage the community in the conversation on big deal issues. Most board and owner disputes arise from a "failure to communicate." There must be a middle ground between simply forced to accept CID board actions or curing board dysfunction at the next election or by a board recall. See Article 5 of the Act for how this issue is handled for "Rules."

   Are there risks of abuse by a small (5%) of owners calling such meetings? Yes. Does that risk trump the benefits? I think not. Moreover, such abuses can be cured by other sanctions.

3. Records Access.

   The Issue: Access to "…books and records…" is another contentious issue. To CID attorneys it means "only if I must." Civil Code §5200 arose because owners were being denied access to records as provided by Corporations Code §8333:

   > "*The accounting books and records and minutes of proceedings of the members and the board and committees of the board shall be open to inspection upon the written demand on the corporation of any member at any reasonable time, for a purpose reasonably related to such person's interests as a member*." (Added by Stats. 1978, Ch. 567.)

Civil Code §5200 enumerated many such items to provide guidance to lay board members. But, it was never intended to be an exhaustive list. Just guidance. It is not entitled "books and records." It is entitled "*Association Records and Enhanced Records*" which in my mind is a simple subset of the larger "…books and records…" concept. Most CID attorneys have taken the position that if it is not listed in §5200, it is not books and records. The Securities and Exchange Commission and several states such as Delaware and Arizona have taken more expansive views.

The Proposal: Amend §5200 by adding (c) something like:

> *For this Section's purposes "…accounting books and records…" as referred to by Corporations Code §8333 means "Association records", "Enhanced association records" and any other tangible embodiment of information made or kept by the association including Electronically Stored Information (ESI) not otherwise protected by attorney client privilege or specifically excluded by this Article 5.*

Yes. This standard could be abused by edgy owners. Our inventive CID lawyers can certainly craft some language or invoke other legal tools to curb such activities.

4. Executive Session.

The Issue: Probably the most abused provisions of the Act. Two provisions are used to avoid open discussions of CID issues – "…to consider litigation" and the "…formation of contracts…"

CID lawyers have concluded that litigation is anything that may someday under some condition might result in a law suit. If an owner expresses a concern about any issue, well, that could be potential litigation event and needs to be discussed in ES. Obviously, any attorney client privileged conversation is still an ES event. However, even the attorney client privilege is abused. But that is a conversation for another day.

In my mind "…matters related to the formation of contracts..." was intended to apply to negotiations of a selected vendor's contract terms and conditions, not to the general processes of deciding upon an action, developing RFPs, considering RFP responses, selecting vendors, considering vendor contract performance, executing contracts, etc. I am hard pressed to understand the business case for conducting these processes outside of the owners' view and awareness in the CID setting.

The Proposal: Add two definitions to Article 2**.**

§4156 Litigation. An action brought in court to enforce a particular right.

§4147 Formation of Contracts. The act of negotiating a proposed contract's terms and conditions.

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5. Committee Meetings.

The Issue: According to Davis-Stirling.com **"**There is no law requiring that committees hold open meetings or post agendas. The Open Meeting Act applies only to meetings of the board. Most committees are advisory in nature and deliver their recommendations to the board of directors in open meetings where members can hear the committee's recommendations."

This reality allows CIDs to dialogue and discuss operational matters outside the owners view and awareness and acts as a method used by Boards and their advisors to defeat the intent of the Open Meeting Act. Even the California legislature has robust open committee events where interested parties may observe and comment on proposed committee actions or recommendations.

Some CID corporate bylaws provide for open committee meetings. However, this remedy is uneven and challenging to adopt.

The Proposal: Define a Committee (new §4094) as any executive, mandatory, standing or ad hoc committee appointed by or at the direction of the board of directors. Define an "Open Meeting" (new §4168) as any Board (§4090) or Committee Meeting.

6. Accounting.

The Issues: Most CID stakeholders would agree that CID's books and records should accurately and fairly reflect its transactions and disposition of assets and that it's resulting financial reports should reflect the entity's economic reality and not be misleading.

In the United States, the Financial Accounting Standards Board (FASB) establishes U.S. Generally Accepted Accounting Principles (GAAP). It should be noted that GAAP is primarily designed to inform investors about an entity's economic reality. However, in addition to GAAP, there is another world of "management accounting." Management accounting techniques are used to bring Key Performance Indicators (KPIs) and other insightful information to the table to add context to GAAP standards.

Since FASB exists to establish U.S. GAAP, it is inappropriate and misleading for the California legislature to create accounting standards as it did with "Modified Accrual." (Civil Code §5200(a)). There is no U.S. GAAP "modified accrual" standard for commercial entities. The term should be removed from the Act because there is no such standard. Therefore, there is no accountability.

While the California legislature should not be in the accounting standards setting business, it is entirely appropriate for it to bring clarity as to which accounting standard shall apply to specific situations or to mandate additional notes and disclosure in annual GAAP compliant financial statements.

Given this context, what are the issues?

First, the accounting methods language is housed in Article 5. Records Inspection. §5200 (a)(3). It should be moved to Chapter 7. Finances, Article 1. Accounting with a new §5505 Accounting Methods. This reform is a mere technical adjustment.

Second, and probably the most significant financial reporting reform, is to bring clarity to CID stakeholders about the current state of their Major Repair and Replacement (Reserves) obligation and related funding deficit to the annual financial statements. Reasonable, but incomplete, information regarding this Critical Success Factor (CSF) is mandated and disclosed in the annual budget report. However, the annual Generally Accepted Accounting Principles (GAAP) compliant Reviewed, Audited or Compiled financial statements probably omit this information or provide minimal disclosures in the supplemental information which is misleading and fails to reflect economic reality in the core financial statements – Balance Sheet, Income Statement & Cash Flow Statement.

Move the accounting methods from CC 5200 (a)(3) to its appropriate Chapter 7 Article 1. Accounting. Add Section 5505 Accounting Methods and Policies. (Subject to legal language fine tuning)

(a) The Association's accounting books and records shall be maintained on an accrual accounting method in accordance with the U.S. Financial Accounting Standards Board (FASB) Accounting Standards Code (ASC). However, nothing in this Section shall prevent an Association from maintaining and providing to its members and other stakeholders additional or supplemental information regarding cash activities or other Key Financial Performance Indicators. Moreover, the Association shall be given a reasonable time to comply with this standard upon any allegation by a member that the Association has filed to comply or that the Association's books and records are misleading or fail to reflect economic reality.

(b) For accounting purposes, the Association's obligation to repair, replace, restore, or maintain its major common area components at an ascertainable standard as typically defined in its governing documents shall be considered – probable and reasonably estimable. Therefore, as required by ASC 450-20-25 shall be recognized by an annual charge to income and by an annual estimate of the accrued obligation (liability). Expenditures to repair, replace, restore or maintain major common area components shall reduce the accrued liability. The annual study required by Section §5550, FASB's Interpretation No. 14, Reasonable Estimation of the Amount of a Loss (or expense), (*September 1976),* and guidance from Subject Matter Experts shall provide the basis for estimating the annual expense and the accrued liability at end of each accounting year. The Association's estimated annual expense and accrued obligation at the end of the Association's accounting year shall be considered reasonable using these guidelines unless the result is misleading or fails to reflect economic reality.

Note: Over the last 30 years FASB has required annual expense and related liability recognition in the following areas: pension plans; post retirement health care; land fill clean ups; environmental remediation; the impairment or disposal of long-lived assets, Etc. FASB defines liabilities as "…probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events." (FASB Accounting Concepts #6, Paragraph 35. Footnote 21 *Probable* is used with its usual general meaning…to that which can reasonably be expected or believed…but is neither certain nor proved.) California CID attorneys consider that the typical CCRs are "restrictive covenants" that create "equitable servitudes" that establish the probable present obligation. The past event triggering the recognition is the passage of time or the wearing out factor of the major components analogous to an annual depreciation charge to the income statement.