The Uncertain Future of Community Associations

Thoughts on Financial Reform

Tyler P. Berding, Esq.

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Berding & Weil, LLP
Alamo, California
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PREFACE

This book ties together the broad experiences of a law firm whose attorneys have, for thirty years, worked with thousands of members, directors and managers of community associations and hundreds of professionals serving the association industry. Tyler Berding, a founding and senior partner of Berding & Weil, LLP, based in Northern California, has had a unique vantage point in observing new, aging and "evolving" community associations confront and respond to the issues associated with construction defects, membership apathy, leadership vacuums, inadequate funding, misunderstandings, ignornance and naivete that contribute to the basic thesis of this book: that without clarity, widsom and "tough love" community associations, as viable shared community living arrangements are doomed to failure. The thesis is supported by the thousands of hours Berding and others in the firm have spent working with communities dealing with the day to day consequences of a deterioriating infrastucture, whether it be litigating defects, negotiating loans for repairs, dealing with disclosure lawsuits and breach of fiduciary duty claims, amending governing documents or garnering member support for large special assessments and capital repairs.These experiences, and this book, are intended to serve as a "wake up" call to those who choose to live or invest in associations and all whose professions involving serving associations and their members.

Steven Weil

CHAPTER ONE

The Theory of Obsolescence

The Flaws in the Community Association Funding Model

Everyone knows that certain consumer products become "obsolete." The phrase "planned obsolescence" applies to a manufacturer's scheme to insure profitability by building into a consumer product the seeds of its demise, and thereby create future demand for its replacement. Obsolescence also happens to improvements to real estate, and specifically to community associations, although it is rarely planned and replacement, under current law, may be impossible. Neighborhoods can become "obsolete" when the condition of the property no longer supports the use for which it was originally intended. Residential neighborhoods that gradually industrialize become ill-suited as a location for homes. Similarly, ranch land that is developed into suburban enclaves usually can no longer support viable agricultural operations. Traditional downtown shopping districts can become obsolete and deteriorate when a modern mall is built on the outskirts of the city. Foreign competition may render some industrial property valueless when the cost of environmental cleanup is factored in. Property that has become obsolete may languish in value until such time as a city or private developer redevelops it into a more appropriate use. Virtually all developed real property improvements reach obsolescence if given enough time.

This obsolescence pattern is equally applicable to community associations. The idea that a project will last forever in its original form is no truer for community associations than it is for any other kind of real property improvement. In most cases, physical obsolescence follows a loss of economic value due to the changing conditions of the neighborhood. In the case of a community association, it is usually a combination of physical and political factors that lead to deterioration and loss of value. And it may be a single political factor: the inability to reach group consensus on such important issues as

funding for major repairs that hastens a community association's demise.

Fifteen years ago, we wrote an article entitled "No Plan for the Future." It was essentially a warning about the hidden costs of maintaining community associations. We stated that reserve accounts might be seriously under funded, especially for the unexpected costs of replacing some of the major building systems. That article broke new ground. It suggested that the budgets for reserves that had been approved by the California Department of Real Estate were inadequate. Our firm's experience with failed building systems made us realize that the construction employed in most community association projects was so inferior that many components that were assumed to last the life of the building, would not. Our conclusion: inspect the project very carefully and assume nothing.

In the years following the article's appearance, the concern over component longevity and funding for repairs has not lessened. In fact, as we have learned more, our concern has grown. It is now clear that many community associations will not live up to the expectations of their owners or the governing documents that assume a project's "perpetual" life. However, while a project's failing physical systems are certainly cause for concern; they are only a symptom of larger issues affecting the future of community associations.

COMMON NEEDS VS. INDIVIDUAL RIGHTS

There is no modern analogy to a community association. It is more than a quasi-governmental agency. It is more than an investment. It is more than a social organization. A community association is a unique blend of law, business and sociology. It is a multi-dimensional mix of principles of real estate law (restrictions on the use of private property), corporate law (the community association), business and economics (project management and funding), sociology (communal living), and psychology (individual interests and expectations) all marinating in an active political environment. The closest historical analogy might be a small village where the rules and politics were largely internal matters and the main concern was protection against the forces of nature. The survival of the village depended upon the resourcefulness of the relatively few inhabitants. The impact of failure was the loss, not only of economic interests and basic shelter, but of the social system as well.

America's brief experiment with "communes" in the Sixties provides a comparison only so far as it demonstrates the inevitable predominance of individual will. Regardless of the high-minded ideals upon which a group living situation is founded, self-interest will eventually decide the fate of the community. For communal living to succeed, the welfare of the group must prevail over the rights of the individual. That concept is completely at odds with the instincts of most of us. In America, self-determination usually prevails, and that basic truth illuminates the fundamental flaw in the community association concept:

In community association living, the success of the group is wholly dependent upon the voluntary contribution of capital by each owner, and the inability to reach consensus on the need for such contributions will lead to eventual failure through economic collapse.

OPTING OUT NOT AN OPTION

If a small business fails, the owner can declare bankruptcy, shut the door and walk away. A governmental agency can simply draw upon a broad base of taxpayers to provide funding. An investor only loses his or her capital. A community association in trouble cannot simply close the doors and walk away. The "village" has to pay the utilities, remove the garbage, and maintain the buildings if the own-

ers are to have shelter. This cannot be effectively done without a consensus of the owners, because without owner approval, the association cannot raise sufficient funds to operate. More importantly, without consensus, the social system that binds the community begins to break down. Once the social and political breakdown begins, the "community" ceases to operate as one.

In other types of communities, social and political breakdown does not necessarily doom the community. Individuals can prevail over a failed social or political system by turning inward and using their personal resources to enhance and protect their property and provide shelter for their families.

This ability to exercise independent judgment on matters relating to the care and maintenance of property, however, is essentially denied to owners of property in attached housing communities. An individual owner, in most cases, cannot act independently to preserve his separate interest. Both the physical configuration and the legal restrictions of many community associations make independent action virtually impossible. An owner of a condominium cannot repair "her" roof if the community association fails to do it. An owner of a condominium cannot act alone to reconstruct his portion of the project in case of a natural disaster. The overriding concept of a community association is that all such actions shall be taken by the community. And it takes consensus for this community to act.

THE LOSS OF CONSENSUS

As long as the community can raise sufficient funds to adequately maintain and repair the property, the restrictions on individual action are unimportant. Adequate funding, however, requires the continued willingness of the community members to assess themselves to pay for required maintenance and repair. This continued willingness depends upon the reasonableness and affordability of the maintenance assessments. Once the assessments are perceived to be unreasonable or unaffordable by a majority of owners, consensus is lost.

When projects are new, they require little maintenance, and most of the assessment dollar is devoted to operations and reserves for future repairs. Assessments then do not represent an inordinate percentage of the owner's cost of housing. Owner agreement with board decisions is founded upon the perceived affordability of the development. Consensus can be lost once the assessments begin to increase to a higher percentage of the owner's overall housing expense. Lack of consensus leads to political instability. In a community association, that often can translate into uncomfortable confrontation. In many community associations political instability is avoided almost literally "at all costs." The governing board will steadfastly avoid confrontation through the expedient of keeping assessments low. This unwillingness to raise assessments then deprives the community of the revenue stream it needs to deal with known maintenance and repair requirements. A failure to properly maintain and repair the property brings loss of value, difficulty in selling or refinancing, higher non-owner occupancy percentages, and accelerated deterioration of not only the physical plant but also of the quality of life enjoyed by the residents.

This dynamic is a vicious cycle. The threat of political instability or lack of economic sophistication brings about resistance to raising revenues, which results in inadequate maintenance or repair, which then brings about a loss of quality of life which then results in political instability, ad infinitum. This cycle can continue for many years and the conditions it fosters can be gradual, or not, depending on many factors, including: the quality of the original construction; the business acumen of the board and the association's manager; and, perhaps most importantly, the willingness of the owner-

ship to adequately fund the project. A large number of positives in that equation will usually mean an extended period of reasonable stability. More negatives, however, will usually mean an accelerated move toward instability and obsolescence.

The individual owner is trapped in this cycle. She cannot "opt out" of the system. Her only choice is to vote for increased assessments, or not, or to sell. If she sells, her successor will be given the same choices. If the community fails, the owner's interest will be lost. There is no present means by which an owner can readily salvage her separate interest equity in a failed community association.

EXCEPTIONS TO THE RULE

There are means by which a project's obsolescence can be postponed, but it is most probable that there are no means by which obsolescence can be permanently avoided in most community associations. Illustrated below are the four stages of an association's evolution toward eventual obsolescence. These stages can be lengthened or shortened, depending upon the general quality of the project, the wealth of the owners, its geographic location, the past fiscal practices of the board of directors, and the general competency of its board and management. A high-end, well-located project such as a high-rise condominium on San Francisco's Nob Hill, may never become truly obsolete because its intrinsic value is so high and because it's owners have both the ability and the willingness to pay whatever the cost of reconstruction may be. On the other hand, a low-end condominium project, perhaps one converted from an old apartment complex fifteen or more years ago, will almost certainly become obsolete.[1]

Postponement of obsolescence can be achieved if a sophisticated board or property manager strives to educate the membership and convince it to accept the burden and the benefits of sound fiscal management. That usually includes creating a reserve for future repairs that acknowledges the probable failure of some major building systems that are not traditionally considered appropriate for a reserve budget. Examples include siding systems, and most other external structures constructed of wood, like entry stairs and balconies, as well as plumbing components. Having adequate reserves means having the funds to repair or replace major building components many years into the project's life when failure will most likely occur. A very good professional manager can anticipate future needs and has the persuasive powers to encourage owners of even modest means to save for the future.

However, these exceptional circumstances run against the tide. Most projects are not located in the upscale sections of a city. Most projects are built in locations which are easily duplicated elsewhere, and therefore possess no particular intrinsic value. Many projects exist through a succession of boards whose degree of sophistication in business and finance is highly variable. Most projects do not obtain the benefits of sophisticated management during the majority of their existence. The owners of most projects cannot be counted upon to agree to contribute whatever is necessary to stay even with the bare rate of inflation of the cost of repairs. This is especially true with the many buildings which were not built of the highest quality materials or with the patience and skill provided by custom builders. Most community associations were built under the time pressures of mass market production, using generally unskilled labor that was not adequately supervised.

Some of these inadequacies are caught early enough in the project's life to be the subject of a claim against the developer so that recompense is obtained and repairs instituted. However, there will be, in almost all instances, other examples of deterioration that will not be found until much later in the project's life, no

matter how good or how competent are the early inspections. Inspectors cannot be expected to tear the buildings to the ground to ferret out all examples of defects, nor do they enjoy the ability to see into the future to determine what the weather in the ensuing ten or twenty years will do to the buildings. Therefore, other than in exceptional cases, it is inevitable that many community associations will evolve through the stages in the following chapter. The only real question is how long that evolution will take.

1 There are also community associations in locations where the land is worth more without the existing improvements, but, because the equity ownership is fragmented, that value cannot be realized.

CHAPTER TWO

The Four Stages in the Life of a Community Association

Do Increasing Levels of Financial Instability Seal an Associations Fate?

The First Stage. A brand new project enters the first stage. The duration of that stage depends upon many of the factors outlined above. Generally, during the first stage, the regular assessments will appear to cover all projected maintenance and repair costs without the necessity to resort to special assessments or outside sources, and with only modest annual increases. Non-owner occupancy is at the lowest percentage it will ever be, usually ten percent or less. Board members and professional managers are easy to find, the political climate is benign and the members are generally supportive of the board. The project looks and feels new and exciting. The membership's attitude reflects these qualities. Resales are brisk and values stay high with modest appreciation reflecting general market trends.

The Second Stage. In a project's second stage of evolution, regular assessments will be insufficient to satisfy mounting

maintenance and repair costs. If the true costs of repair have been identified and projected by a competent board using professional management, the members will contribute to capital by means of a special assessment on at least one occasion during this stage. If required maintenance and repair has not been identified, the project will appear to be within its budget. There may have been a discovery of defective construction conditions which will demand a remedy. Non-owner occupancy has increased beyond 25%. The board of directors will begin to face political issues which emanate, in part, from the increasing percentage of non-owner occupants. There will be a growing number of complaints from residents about the general condition of the project or about the necessity for specific repairs. Recruitment of board member candidates may be necessary. If true repair costs are identified and brought to the members, there will be general resistance to the request for a special assessment, but the members will ultimately support the board's request if the cost of repairs at this stage of the project's evolution remains affordable. This will be true if deferral has not postponed needed repairs for too long. Sales of units are comparable to the market generally. Government-backed mortgages and re-financing is still obtainable.

The Third Stage. In the third stage of evolution, those associations (and there are thousands) which have failed to store enough nuts away for the winter will have to appeal to the membership for emergency funding and/or apply to a bank for a loan. Bank financing of large reconstruction projects is becoming quite commonplace, but most financial managers will argue that borrowed capital is not an adequate substitute for capital that is contributed by the owners. This is especially true if the repayment of the borrowed capital prevents the association from adequately reserving for the next round of reconstruction. Borrowed capital for reconstruction should only be considered as a temporary means of achieving solvency for the association. The assessments for repayment of the loan should be in addition to contributions to reserves adequate to fund future repairs.

In this stage, non-owner occupancy has increased beyond 35%. Government-backed mortgages become difficult to obtain. Management costs increase due to the additional workload presented by the many complaints from residents about the physical condition of the buildings. Political strife within the association increases as the demands upon the residents for funding, coupled with a decreasing quality of life, increase. Board members resign rather than be subjected to the increasing volume of the owner's demands. Recommendations for current repair now include several building components that were not anticipated with the requisite reserve accounts. The price of such repairs is beyond the association's financial ability. The economic and political climate of the association begins to be reflected in the sales price and turnover of units. The project begins to show the effects of deferred maintenance. Painting is delayed, landscaping deteriorates, and resident complaints about maintenance and repair issues further increase, putting added stress on the board and management.

The Fourth Stage. Given that many, many associations have failed to anticipate the full extent of eventual reconstruction costs, they will, sooner or later, exhaust both contributed and borrowed capital sources. This includes such one-time influxes of capital as that provided by insurance recoveries or litigation settlements. Once all outside sources of capital are exhausted, the ravages of obsolescence will be hard to forestall. By this Fourth Stage in the project's evolution, the owners have long since refused to provide meaningful contributions of additional funds; lending institutions have refused further advances; and the projection for

immediate or future repairs is well beyond any projected accumulations in the reserve accounts. Non-payment of assessments begins to climb to the point where the association's ability to pay for essential services, including utilities, insurance and management, is fading fast. Essential repairs are being deferred to such an extent that the basic habitability or safety of the buildings is being called into question.

Non-owner occupancy has risen beyond fifty percent and refinancing or mortgage lending by most traditional lenders is precluded. Behavioral problems increase, vandalism to the property becomes more than just occasional, and political problems within the association make recruitment of board members and management very difficult if not impossible. The ship is rudderless and sinking.

CHAPTER THREE

Beyond the Fourth Stage

What Lessons Does Failure Teach?

Beyond the Fourth Stage, a project's fate is hard to predict. Certainly, if the deterioration of the physical condition seriously effects habitability, health, and/or safety, local jurisdictions will be forced to intervene and will demand that those conditions be repaired. Given that the lack of ability to reach consensus on funding is the reason that these conditions have been allowed to develop, it is unlikely that the owners, now mostly absentee, will see any point in throwing "good money after bad." Their cash flow and equity may be non-existent or negative, and the condition of the project makes a sale impossible. They continue to hold their interest in the property only because they receive rental income. The local jurisdiction may condemn some or all of the buildings, accelerating the onset of obsolescence. Absentee owners, deprived of rental income, will simply walk from the project and abandon the property. Resident owners without alternative housing will stay as long as the local jurisdiction will permit occupancy. Criminal activity will make it difficult for anyone to continue to occupy the premises. Redevelopment or other government-backed programs might be called upon in rare cases to rehabilitate the property. However, in most cases, the project will be valueless, uninhabitable and unsaleable. Continued ownership will become a clear liability to the remaining investors and wholesale abandonment will ensue. In most cases, legal title to the separate interests will default to various lenders.

An example of such a project was observed in San Bernardino, California several years ago. It consisted of fourplex condominium buildings, approximately thirty-five years old, now gone beyond a Stage Four. Units were boarded up or burnt out. Whole buildings had been bulldozed and only empty lots remained. There were a few inhabitants, possibly squatters. The surrounding neighborhood was in only slightly better condition, but fully occupied, lessening the chance of a municipal re-development project. The varied condition of the units suggested that they remained under separate titles. The complexity of titles, including the interests of lenders, most likely precluded any uniform scheme to convert the property to a better use.

LESSONS

The modern community association had its birth about forty-five years ago. The average project is probably now about twenty to thirty years old. The four stages of evolution can occur over a life span of up to perhaps forty years, but more likely, signs of obsolescence will begin to appear much earlier. These statistics suggest that the beginning of a serious problem of obsolescence is just now upon us, with its greatest impact to be felt over the next ten to fifteen years.

What lessons are there to be learned? Other than the obvious, the need for prudent financial and business management of each community association, this situation also argues that quick financial fixes may be illusory. It also suggests that owner equity may often be a lot less than believed, especially if there has been insufficient attention paid by the board or management to periodic inspection, including intrusive testing where appropriate.

The most important lesson may be, however, that the concept of communal responsibility for complex residential real estate is fundamentally flawed. In most states assessments are essentially voluntary beyond certain basic minimums. Homeowners tend to view increases or special assessments through a veil of self-interest. A first-time buyer may not intend long-term ownership and hence be unwilling to contribute to reserves which may

not be used for repairs until well after his expected departure. Owners on fixed incomes have obvious limitations on their ability to pay for repairs. Since they have no ability to negotiate for more affordable repairs, they may simply veto the funding request altogether. Other owners will view the repair funding request with varying degrees of enthusiasm, or lack thereof, depending entirely upon their individual circumstances and the extent of their understanding of the problem.

OWNERSHIP CYCLE

Reservations about further investment in the property are exacerbated by the ownership cycle. The average length of ownership of an interest in a community association is seven to eight years. Since reserve budgets for long-term repair of such items as roofs and siding frequently project actual repair of those items fifteen to twenty-five years in the future, the average owner can see little advantage to investing in reserves since they won't likely be around to seem them spent. Further, since the lack of adequate reserves is a difficult problem to appreciate, it is difficult to disclose. A prospective buyer, unless he or she is very well-informed, will not be able to analyze the financial condition of the reserve account. Therefore, the condition of the long-term reserve may not play any role in a purchase decision since it is not perceived as an asset. If that is the case, owners will not be motivated to improve that "asset." From their point of view, they are better off investing in personal items, such as new carpets or drapes.

In short, one of the factors that makes single family detached homes such an attractive and perennially solid investment, the right of individual judgment and action on maintenance and repair issues, is conspicuously absent in attached dwelling situations. In the detached situation, the individual owner assesses cost and risk and can act in a manner appropriate to his or her self-interest. With attached housing, the owner has no such right, and is often distrustful of the decisions made by others. Government action of any sort is inherently suspect, but even in a post-Proposition 13 (California's 1978 measure capping property taxes) era, governments still have the right to impose most of the taxation necessary to carry out their legislative enactments. Community associations, with responsibilities not unlike other governments, have no such right, and must often seek owner approval for necessary projects. "Voluntary" taxation is largely unworkable. It is not surprising therefore that community associations are chronically under funded.

This challenge to the viability of the voluntary assessment concept will no doubt draw the fire (and the ire) of many in the community association industry. Those who object to our assertions are encouraged to take a closer look at the evolving physical and financial condition of community associations and project those conditions ten or fifteen more years. We have interviewed many industry professionals on this subject over the past five years. Not one has expressed doubt about the inevitable obsolescence of many community association projects. Those who manage and service these projects, as well as the boards who govern them, know that raising the necessary funds to deal with both expected and unexpected repair costs is their single greatest challenge. Since individual members will usually vote their self-interest, a collision with community interests is often the outcome. When that collision results in under funding, the project will likely deteriorate over time.

While our discussion of this problem might suggest it, we do not support the notion of legislating mandatory assessments or mandatory funding of reserves, or taking any voting rights away from homeowners. For one thing, that would materially change the nature of what the owners bought. For another, "mandatory"

funding of reserves requires that there be developed an objective criteria for setting the amount of the reserves. Most state legislatures has not yet shown an interest in writing laws that can detect and preserve the unique nature of each community association, and therefore can not be counted upon to propose a formula which would have universal application. Finally, enforcement of such a provision would be extremely difficult. Our purpose here is to simply point out, that given the present system, the obsolescence of many community associations is likely.

Changing to a mandatory assessment structure is not the answer. Many older projects have accumulated such a large unfunded liability for future repairs that a legislative edict of "thou shalt" fully fund reserves would have no practical effect and compliance would be unenforceable. Too many years of under funding reserves leaves a gap that residents cannot afford to close. Imposing the large special assessments that would be necessary to close that gap would merely force many residents into abandoning their interests.[2] In other words, "full funding" edicts probably won't work.

The challenge is not in finding ways to impose mandatory funding or to eliminate individual rights, but rather to achieve better long-term financial management and also to formulate an appropriate exit strategy that will protect the individual's investment when the inevitable occurs. At present, no appropriate strategy for preserving individual interests in the face of a failed community exists. It should be a legislative priority to find one.

2 That is not to say, however, that we should not consider changes that would strengthen funding requirements for future community associations.

CHAPTER FOUR

From Theory to Practice

Real Life Examples of Obsolete Community Associations

The forgoing chapters posit the theory that the design for funding the long-term repairs and maintenance of community associations is fundamentally flawed. That flaw, the reliance upon voluntary owner contributions of capital to fund long-term maintenance and repair, has led to a widespread inability by directors of community associations to raise sufficient capital. This, in turn, has been responsible for the poor maintenance and repair of thousands of condominiums and attached planned development projects throughout California and across the nation. The actual evidence of this problem is not just theoretical.

FRANKLIN VILLAS AND FRUITRIDGE VISTA

At a recent seminar for city planners and planning commission members sponsored by

the League of California Cities, the author was afforded an opportunity to speak on the impact of community associations on cities and counties. I offered the thoughts contained in the chapters above. These comments were well received, but especially so because my discussion was preceded by another, more compelling presentation that spoke of two real and tragic examples of Stage Four obsolescence in Sacramento, California. Stephen Young, with the Sacramento City and County Redevelopment Agency, described in detail the situation with Fruitridge Vista and Franklin Villas.

Fruitridge Vista consists of forty-four, fourplex buildings, totaling 176 units. It was built in the early 1970's and appears to be similar to many projects of this type built then by the McKuen Company all over California. It is managed by a single community association. The other development, Franklin Villas, consists of 700 fourplex units, and 243 townhouse-style units, for a total of 943. This project was built in the 1960's. There are five separate owner's associations. These two projects had clearly reached the end of their useful lives and the oldest was just forty years old.

Young stated, "Both developments suffered from the same causes of decline: dysfunctional homeowner's associations that would not spend the money necessary to do basic maintenance," or employ proper management. Bad tenants who were evicted could simply move into a nearby unit and continue "their criminal or anti-social activities." Further responsibility for the deterioration was laid on the poor design of the original construction. These accounts made our comments about widespread under-funding especially poignant and relevant. From the questions that came from this group of planners, it was clear that the idea

that community association projects might one day end up back in their laps had not occurred to them.

The legal title to such projects is held by hundreds of individuals and entities, many of whom are in default or can not be located. This leads to the disturbing inability of the owners to salvage equity from such property which nobody can sell. These were Stage Four projects with no way out except for the local public agencies to exercise their powers of Eminent Domain and a massive investment of public funds.

KING-GARVEY COOPERATIVE

Another real-life story of a "Stage Four" project surfaced in the March 23, 2002 edition of the *San Francisco Chronicle*. An article entitled, "Co-op Residents Up Against the Wall" writer Hene Lelchuk described the sad state of the Martin Luther King-Marcus Garvey Cooperative Apartments.[3]

A "cooperative" is another form of community association, with residents owning shares of the project which entitle them to the use of an apartment unit. The opportunity to accumulate equity through home ownership was a major part of the promise made to those who acquired these units. It opened in the 1970's as a non-profit HUD-sponsored housing project. In 1982, the project was converted and sold to the tenants. The story is significant for several reasons: first, it is yet another compelling illustration of the failure of a community association to adequately fund itself; and, second, it shows how quickly this can occur (about twenty years). Finally, and most important, it illustrates the extraordinary level of naiveté of some government policies. Excerpts from the article best illustrate these points.

"Thirty years after the pioneering complex was built (and twenty years after it was sold to individual owners,) the 400-plus residents are watching it crumble into a mess of peeling paint, unpaid bills and bureaucratic bickering between their elected board of directors and the U.S. Department of Housing and Urban Development. Ultimately they could be looking at the loss of all the equity they've built up."

"HUD ordered the development's resident board of directors this month to repair the federally financed buildings and pay off debts, or at least come up with a plan, by early April."

"It's not hard to spot the deterioration. (One resident) can see water stains on her ceiling and stucco cracking off in her bedroom closet, where the roof leaked in the 1990's. 'You can see the mold growing' (she) said. Her neighbor's apartment was flooded when a bathroom fixture broke last summer. And sometimes when (the) resident steps into the shower the water scalds her."

"A lot of the work I've requested, they tell me it's my responsibility."

"As bad news piled up, residents representing more than one hundred households at

King-Garvey signed petitions last week to recall their board. That's well over the majority needed to oust the directors."

"This month, HUD inspectors summed up what was wrong: A laundry list of defects-damaged security gates, broken windows, fire extinguishers that didn't work, leaks, roach infestations and more—were never dealt with, despite years of warnings from HUD and city building inspectors."

"The complex let its property insurance lapse and ended up paying exorbitant premiums (to get it re-instated.)"

"There's a history of liens filed on the property. The complex also owes numerous fines for failure to fix fire and health hazards found by city building inspectors. "We have resident complaints going back to 1997 that haven't been addressed. There's no excuse for letting this stuff drag on,' said city housing inspector James Sanbonmatsu... he found black mold in carpeting, fire hazards, stoves that didn't work, leaks, peeling paint and more."

"We never really had enough money to operate'. King-Garvey needs (government funds) and another $500,000 for building repairs."

This last statement says it all. Inadequate funding from the beginning of the project results in a substantial unfunded liability for repairs and many other things. There is no discussion in the article of alternatives to a government bailout. That's likely because there are no other options. The residents have obviously reached the point where they will not or cannot support the project with additional contributed capital. No doubt commercial lenders have long ago refused to invest in the development. Because of its history as a HUD project prior to conversion to a co-op, there is the continuing expectation that HUD should take care of

things. "We feel that HUD owes us this opportunity to start over," says one resident.

Whether HUD sees it the same way remains to be seen, but in truth, a government bailout appears to be the only option left for the three projects that we have discussed. In fact, Franklin Villas has already been the object of a major investment by the Sacramento Redevelopment Agency. Community associations which reach Stage Four have run out of all conventional means of funding repairs and many operational expenses. The King-Garvey project is, however, a prime example of a developer (in this case, the Federal Government) sadly raising the expectations of prospective buyers about the benefits of owning the units by not disclosing to them the true cost of long-term ownership. By the time these owners found out the truth, it was way too late to do anything but pray.

3 Lelchuk, Hene; "Co-Op Residents Up Against the Wall," *San Francisco Chronicle*, March 23, 2002.

CHAPTER FIVE

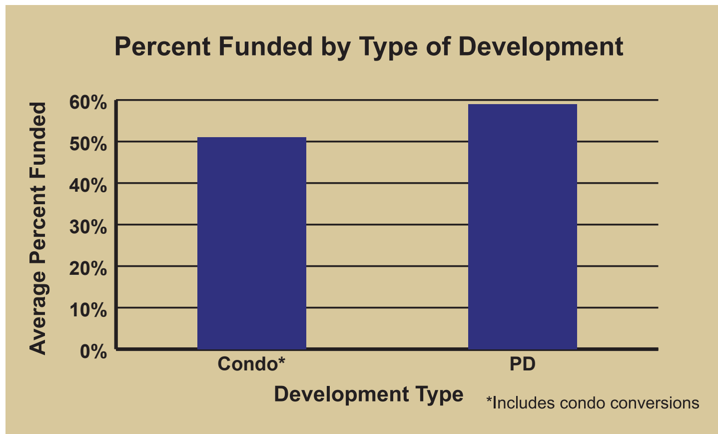
A Survey of Reserve Accounts

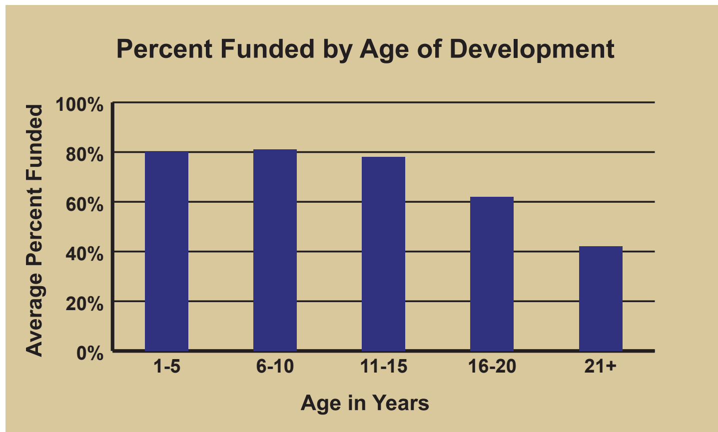
A Statistical Sample Shows Chronic Under-Funding

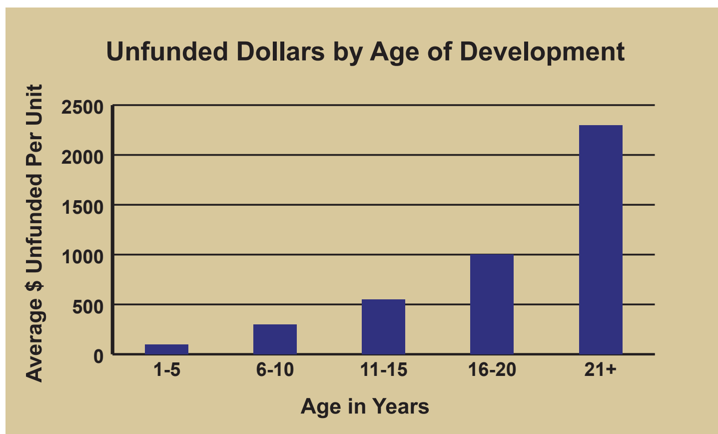
The opinions stated here are based on evidence obtained in the course of our practice over many years, and upon conversations with numerous industry professionals. While few doubt that the problem is real, it had not often been statistically verified. To remedy that, we commissioned a survey of 687 community associations to collect statistical evidence of the state of association reserve funding. What they found was not pretty.

Overall, for the 687 associations surveyed, the average percent funded was only fifty-four percent. This means that these associations have approximately half of the capital that they should currently have to fund their reserves adequately. Consider also the survey of 1,447 California community associations completed in 1995, eight years prior to the one above, by the Oakland accounting firm, Levy & Company CPAs. That survey found that the average percent funded was at sixty percent. Not only do associations have much less than they need, the trend is toward an even greater funding gap. This observation was corroborated as well by a southern California reserve study company, Association Reserves, Inc., which has observed, based on more than 7,000 reserve studies prepared by that firm over twenty years, that the average percent funded has remained in the mid-fifty percent range.

The average size of this reserve "gap" is approximately $1,400 per unit. If this sum were to prove accurate for all of the estimated 34,400 California community associations, computed at an average of 106 units per association, this would represent a combined deficit of approxi-







mately $5.1 billion. This survey may or may not be statistically representative of all of the associations in California, or in other states, but when this information is coupled with other evidence, one can easily conclude that many community associations are in serious financial trouble. The data also indicates—to no one's surprise—that the older an association is, the greater the under funding of reserves is likely to be.

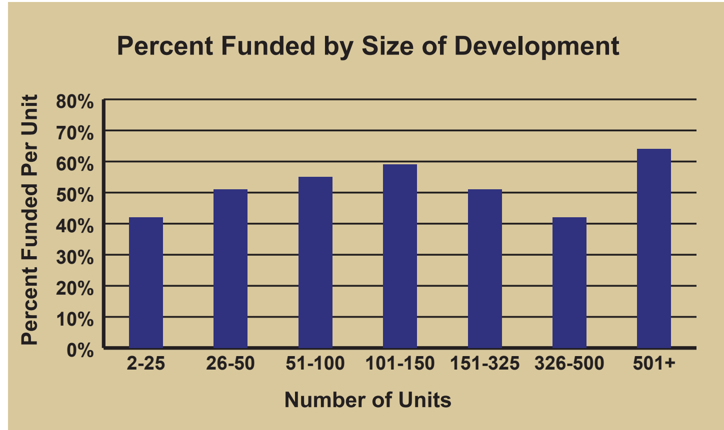
RESERVE STUDY COMPANIES

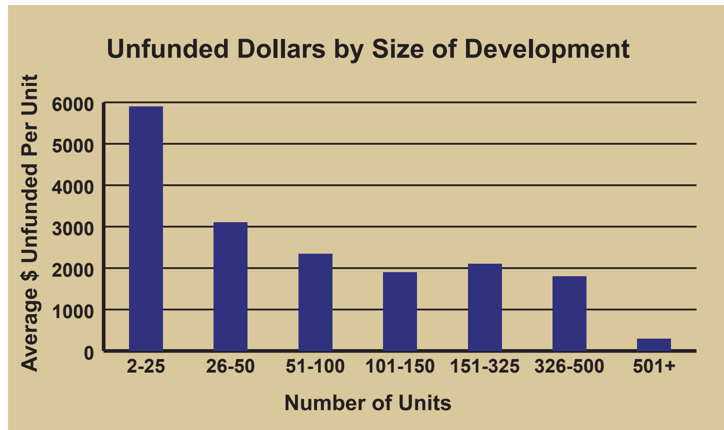
Percent funded results were also computed for thirteen reserve study companies based on ten or more studies. These results also indicate a greater degree of under funding of reserves when reserve requirements are computed solely by boards of directors or their management agents without the assistance of a professional reserve study company. This tentative conclusion is based, however, on only forty-six associations or approximately seven percent of the population surveyed.

In most respects, this survey speaks for itself. Smaller, older condominium associations tend to be worse off than larger, newer planned developments. That does not mean, however, that the newer, larger associations do not face capitalization problems. It simply means that their obligations probably have not matured to the point where the funding shortfall is critical. What the survey also indicated is that the trend is the same for all types of community associations. It also indicates that the funding crisis is just a matter of time.

What to do? As we have stated before, each director of a community association must insist on a realistic appraisal of the condition of the project and the cost of future maintenance. Any temptation to underplay these elements to keep assessments low must be resisted if the association is to have any chance at financial stability. The long-term financial security that would result from an aggressive program to increase

funding will be worth whatever adverse short-term political consequences might occur. Those boards of directors that have the courage to put such a program in place will strike a blow for sound fiscal management. For those who do not, the financial consequences seem increasingly obvious.





CHAPTER SIX

The Impact on Affordable Housing

Instability Hits the Most Vulnerable Communities Hard

That community associations are in jeopardy is a reasonably safe conclusion. But what about the specific impact this problem will have on the availability of "affordable" housing? Saving the existing housing stock may be a bigger challenge than stimulating new construction. There are more than 30,000 common interest developments in California alone. They provide affordable housing for as many as five million Californians. The loss of any substantial portion of that housing stock would greatly affect our ability to house many low and moderate income residents. The following two examples illustrate the financial impact on individual owners of low to moderate income housing when unexpected or undiscovered problems arise.

Experience with certain building components has shown that an owners' association may not discover some building failures until the damage is so obvious it can no longer be ignored. Dry rot is one of the best examples because it often attacks hidden portions of a building.

A 285-unit condominium project in Daly City, California was about nine years old when the structural supports for a portion of one building collapsed, taking parts of two units with it. The homeowner's association called in a contractor to repair the damage. As the contractor peeled away the exterior stucco of the building, he discovered that the rot extended inward to include the framing members. The cost of that one repair exceeded $60,000, and prior to failure, the damage was completely invisible from the outside of the building. Inspection of the remainder of the project revealed extensive rot in other buildings. The cost of repair for the entire project was estimated to exceed $8 million! The problem was water which leaked into the inner wall from the roof. It did not enter the units, but remained in the walls because the walls had been improperly sealed. A complete repair required that all of

the stucco on the entire project be removed and the wood framing beneath it repaired.

If the funding for the foregoing repairs had to be raised by assessing the owners, it would have been over $28,000 per unit. It is difficult to conceive of a less affordable home. More frightening: $8 million probably exceeds the aggregate total of all of the owners' equity in the project! The owners bought the homes, but clearly, without outside funding assistance, they can never afford to own them.

Another condominium project employed a contractor to perform repairs five years earlier. The repairs were poorly performed, and failed to correct widespread leakage and the consequent dry rot. The community association sued the repairing contractor, but could not sue the original builder because the statute of limitations had expired. The suit against the repairing contractor was settled and the association received several million dollars. A good result—if it had covered all of the required repairs.

Unfortunately, the repairing contractor had only worked on one phase of the project, and the claim therefore could not be asserted against the contractor for the remainder of the units, all of which suffered from similar problems. Further, the entire project suffered from poor quality firewall and seismic safety construction, claims which were also beyond the statute of limitations. The repair estimate for the entire project: $20 million. Needed assessment per unit: over $50,000.

Surprisingly, this project suffered no slowdown in the sales of units. Due to the high demand for housing in the San Francisco Bay Area, homes in this project were selling at market values determined as if the severe damage did not exist. Sellers who sold these units at full market value arguably recovered equity from the buyers which they did not own. Even considering the superheated real estate market, a truly informed buyer would not likely pay full market value for such a home. The owner's association had relevant information on the condition of the buildings available for review by prospective buyers, but few asked for it. Either they were not interested, or they were not told it existed. It is likely that most of the owners' equity in that project was offset by the unfunded liability for repairs.

Did the seller of any one of the units described above really have anything to sell? Under these circumstances, did the new buyers receive any equity? If not, are the lenders who hold the deeds of trust or mortgages on those properties really the owners? And what do the banks own—property with a massive unfunded liability for repair that someone will eventually have to acknowledge? Could it be that buyers in this situation are actually more like renters? If they cannot accumulate equity because the property is heading for obsolescence, their "ownership" will be short-lived.[4]

The "gap" does not get smaller with time. Unless extraordinary amounts of cash are injected into the project, it is unlikely that the owner's association will ever catch up with the deterioration in these buildings. Both of these projects benefited from substantial cash infusions from settlement of litigation, such that obsolescence was postponed. But many, many projects have not been so lucky, and even those that do find a temporary solution can expect to have to deal with both the forces of nature and its long-term effect on buildings. If such issues as dry rot, mold, or structural failure are allowed to continue unchecked, basic habitability will be compromised to the point where condemnation is a distinct possibility. In those cases, the "affordable" home may be only a myth.

At some point in the future, when either the economy slows enough to re-introduce simple caution into the purchase of a home, or when prospective buyers are confronted with a disclosure of the required repairs and their cost which cannot be ignored or denied, reality will catch up and the owners may discover that they don't own that "affordable" home. When that happens, the buyers will realize that their investment is as mythical as the promise of affordability.

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4 Perhaps one solution would be to create more rental housing. Even if the quality were not improved, at least the residents would not think that they were "investing" in long-term equity growth. This would protect low and moderate income home buyers from the potential loss of their down payment. With rental housing, the investor/owners take the risk, but it is a risk they are better equipped to assume. Investors are better able to investigate the condition of rental housing buildings, and, when repairs are necessary, are more likely to have the resources necessary to affect them. A "safety net" of affordable rental housing would not only provide needed, "affordable" homes, but would also protect low and moderate income buyers from entering an investment that can only produce diminishing returns.

CHAPTER SEVEN

A National Issue

Its Not Just a California Problem

Most of what has been written here is based on experience in California. But clearly, the problem is not limited to that state. Community Associations in other states share many of the same problems that have led to chronic under funding in California.

Jim Wasserman, of the Associated Press, has written on the problem of under funding from a national perspective. The article, entitled "Homeowners Associations Undermined by Cash Shortages to Maintain Properties" was picked up by newspapers across the nation on April 11, 2004.[5] Wasserman writes: "Amid more… than 260,000 private communities nationally and 36,000 in California, at least one third have steadily put off raising necessary assessments for fear of political conflict, and now need repairs and face lifts for which they significantly lack money, say those who monitor homeowner assoc citation finances."

Wasserman quotes Robert M. Nordlund, owner of California's Association Reserves, Inc., which analyzes private communities in forty-one states, Canada and Mexico. "If you give me a list of thirty names (of community associations), ten are on the list. For those ten, the deficit is so significant they'll need one or more special assessments to make it up," Nordland said.

The problem parallels the financial crisis faced by many municipalities, "The trend, especially in older privately run neighborhoods represents a striking parallel to the financial deficits plaguing local and state governments. As the public sector has delayed maintenance, many private association boards are also watching streets, pools, balconies, siding and clubhouses slowly deteriorate while their reserve funds contain half or less of the money needed to eventually fix them. And just as city halls and statehouses fear raising taxes, voluntary, often inexperienced association boards fear the wrath of homeowners over possible higher assessments," writes Wasserman.

The economy has helped to exacerbate the problem: "Low interest rates have kept reserve funds from building in recent years. Associations can also foreclose on homeowners who don't pay their dues, so residents are often wary of raising them" according to the article.

Wasserman suggests that all of this threatens the very existence of many community associations, and the impact on real estate across the nation could be substantial given the high percentage that community associations represent of all developments. The article quotes one expert as saying: "In Florida, which with California contains forty percent of the nation's condominium communities, association boards must calculate appropriate reserve funding. But a majority vote among members can block the assessments needed to reach it… There, older residents of such neighborhoods tend to think, "Why do I care about the roof in five years?"

Wasserman continues: "But under funded reserves could threaten the forty-year-old culture of living in a privately run neighborhood, which is where eighty percent of all new homes are built nationally" "CAI (The Community Associations Institute), which advises association-governed communities, estimates that fifty million Americans—nearly one in six of the country—live inside such communities with half paying between $100 to $200 a month to maintain them…"

"In California, private communities with monthly or yearly dues now contain more than one-fourth of the state's twelve million places to live and sixty percent of its new housing. Many of the state's 477 cities encourage privately run communities inside their boundaries because they build and maintain their own streets and parks, even as their residents also pay property taxes to support city facilities." Wasserman concludes: "That means new buyers will most likely have to pay higher fees to compensate for what previous owners failed to assess themselves.[6]

All of this describes an industry that has and will continue to struggle with financial stability. Short of throwing in the towel and watching numerous projects sink beneath the waves, are reforms available which might staunch the hemorrhaging? A few thoughts on reforming community association finance follow.

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5 Wasserman, Jim. "Homeowners Associations Undermined by Cash Shortages." Associated Press, April 11, 2004.

6 Wasserman, *supra.*

CHAPTER EIGHT

Thoughts on Financial Reform

Difficult and Desperately Needed

The budgets are done. Directors of community associations have again gone through the painful process of trying to do more with less. Making decisions about financial priorities that they would really rather not have to make. More money in the landscaping budget would certainly make the place look better and improve "curb appeal" for those owners who are trying to sell. New pool furniture? How long has it been since replacing the old, worn-out stuff has been discussed as anything other than a luxury? Painting more often? Having some carpentry work done to replace worn trim? Any of these things would make a big difference, but the money just isn't there.

Insurance, accounting, utilities, and making the minimum contributions to reserves for future repairs is often about all that can be done these days in many community associations. The cost of insurance, often after at least one cancellation, has climbed dramatically. Balancing the budget is a yearly exercise, but cutting expense to balance the budget only works while there are expenses that can be cut. Sooner or later someone has to look at the revenue side of the books.

Community associations have only one real source of revenue—owner contributed capital. Unless the association has a business that it can operate, and most do not, there is no other income. Capital is usually contributed through regular assessments, levied at the beginning of each year, and collected monthly. Ideally, the amount of these assessments would be adequate for operational expenses (insurance, utilities, management, etc.) and contributions to the long-term reserve for repair and maintenance, as determined by the association's reserve study. Most budgets are far from ideal, however.

Regardless of the state of the economy, unless assessments have been increased every year to keep up with, not only cost of living increases, but also to make up for prior underfunding of reserves, the association will be falling behind necessary accumulations for future

repairs. Boards often perceive present operational expenses as more pressing, and reserves as something that can be conveniently dealt with "later." This would be true if all the board of directors had to do when funds for repairs were needed was to assess the members the necessary amounts, as is possible in some states.

But in California, as in many other states, there are statutory caps on the amount a board can raise without agreement of the members. It might sound like a wonderful exercise in democracy, but more often than not such limitations result in severe under funding of reserves. Members simply don't like to approve special assessments, boards know that, and as a consequence, avoid that funding mechanism. The result is that associations are almost completely reliant on the regular monthly assessment for necessary capital contributions.

FINANCIAL STABILITY SHOULD NOT BE OPTIONAL

Raising revenues should be the first priority of virtually every well-managed association. The California Civil Code allows a majority of the members voting at an election to reject a special assessment that would exceed five percent of the prior year's budget. The same is true for an increase in a regular monthly assessment that would be more than twenty percent higher than the year before. These statutory caps on a board's authority were imposed by the California state legislature as part of the original Davis-Stirling Act in 1985.[7] The idea, of course, was to be sure that owners had some control over the financial obligations that would be imposed upon them by their community associations.

"Extraordinary" special assessments or increases in regular assessments are often the way that a board will try to cover serious funding shortfalls. The need for repairs that are unexpected or unplanned is the most serious crisis that can befall a community association. The reason for this lack of financial prudence—owners' perception of their own self-interest as often not compatible with the community's interest—can be devastating. Nevertheless, experience has shown that it is often difficult to obtain owner approval for any additional assessments. The result of failing to approve sufficient capital contributions for necessary repairs is that either those repairs are delayed or performed poorly, increasing the chance of even greater failure in the component. Extraordinary assessments are, therefore, the only way a community association can keep the buildings habitable and marketable. So, the big question is: "What happens if the owners vote no?"

This dilemma would not exist if the board of directors had the authority and the duty to assess what is necessary. A condominium board simply decides once a year on the amount of money that the association needs to operate and perform repairs—and levies the assessment. An owner either pays or a lien is recorded against the property. No vote. No argument. Owners can throw out the members of the board if they don't like what they're doing, but that's the extent of their control. The board cannot avoid a financially prudent, but politically unpopular, decision by blaming it on owner recalcitrance. It is the board's responsibility to assess what is necessary. The idea is that sufficient capital for repairs is essential in order to maintain value and owner equity, and the board has not only the power, but also the duty, to raise whatever is necessary. This is not something for which there is much room for debate if there is any chance at all of beating the obsolescence odds.

In California, of course, we debate it all of the time. 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. Using feared owner backlash as the reason for not being financially prudent is the same as giving children candy for dinner—it's easier.

Proper financial management should not be optional, and members should not be able to interfere with sound economic decisions by the board. If we are to avoid obsolete and uninhabitable communities its time to amend the law and remove the statutory caps. We should give boards the authority and the responsibility for making the right financial decisions, and take politics out of it.

PROTECTING OWNERS' EQUITY

This suggestion that state legislatures raise or remove the statutory caps on the assessments that a board of directors can impose without member approval will be unpopular. Nevertheless, since proper repair and maintenance of a community association is essential to its survival, there is no room for political debate over funding. The board can debate conflicting opinions of construction experts, perhaps, but once it is determined what has to be done, the debate has to stop.

Some industry observers will respond that volunteer, non-professional boards of directors should not be given unlimited authority to levy assessments. Mistakes in calculating long-term funding needs, or errors in contracting for necessary repairs have long-term consequences to future generations of owners. If boards of directors are free to make decisions that have such consequences, and are also free to cover those errors with unlimited assessment authority, how can members in a community association be protected from these poor decisions?

The answer, of course, is to insist that boards follow appropriate standards that are promulgated by industry professionals and adopted by state legislatures. The Reserve Standards[8] promulgated by the Executive Council of Homeowners (ECHO) in California is one example. Other standards covering the investment of funds; construction contracting; conflicts of interest; and similar topics would provide better guidance for boards, and a measure against which to apply government oversight. The California Civil Code already provides some of the regulations that community associations must follow.[9] Those code sections, however, are not adequate in detail, nor do they provide sufficient disincentives to prevent a board from ignoring the guidelines. If volunteer, non-professional boards of directors are to manage sophisticated, multi-million dollar physical plants, they must have clear guidelines to follow and there must be recognizable consequences for failing to do so.

Why this insistence on professional standards and government oversight? Simple. An owner's equity in a community association property is like any other investment—it is a share of valuable property, a security, if you will. In many cases it will be the most valuable security that an owner will ever possess. It can be bought, held, and conveyed to others. Why shouldn't shares of ownership in a community association be treated like any other financial investment—stocks, bonds, or other securities—with uniform rules of management and government supervision?

The value of an owner's share in a community association will be directly affected by the condition of the property that secures it, so why should management standards for such property be any less stringent than those required for other investments? They shouldn't be, of course, and it is the responsibility of the industry and government to recognize that these investments are losing value with each successive decision to defer an essential repair of a building component beyond its reasonable service life. They lose value when a board decides to mortgage the interests of future generations of owners by using borrowed capital to excess instead of insisting on obtaining owner-

contributed capital. They lose value every time the financial statements disclose less than full-funding of necessary reserves. And, they lose value when a board's fixation on enforcement of minor rules violations and other similar distractions causes it to lose sight of the bigger picture—protecting owners' equity through sound fiscal management.

An individual owner of equity in a community association, like the owner of shares in a public corporation or a mutual fund, is almost powerless to influence its value and must rely on the directors of the association to make decisions that will enhance the value these shares. Any discussion of reforming community association law must recognize the similarity of interests in such projects to other types of investments and provide similar safeguards.

DEFERRAL OF SPECIAL ASSESSMENTS AS A MANAGEMENT TOOL

It is a laudatory goal to give boards, acting under proper regulation, full authority to raise necessary capital. As a short-term legislative objective, however, it is probably dead on arrival. We have a long way to go as an industry before some reforms, no matter how commendable, have any chance at political success. In the meanwhile, how can we give boards of directors some additional management tools to help them achieve financial stability for their community associations? It has been well documented here that associations lack sufficient capital to meet long term repair and other obligations. When the average reserve account has only fifty-four percent of the funds it should have, something is clearly amiss. Such shortfalls might be simply the result of miscalculations of need over many years. In other cases it might represent a board unwilling to do its duty. In still others, it could be that the board of directors has anticipated the electorate's intolerance for higher assessments and deferred funding to future owners. Regardless of the reason, the inability to raise additional needed capital is dangerous to the economic health of the project.

What many boards need is an acceptable way to encourage reluctant owners to contribute additional capital. Owner reluctance to approve special assessments or extraordinary increases in regular assessments is usually born of worries over cash flow. Owners on a fixed income, almost by necessity in some instances, have to reject obligations which exceed their monthly cash flow, or their available cash on deposit. Others simply cannot stretch their monthly paychecks sufficiently to shoulder any additional financial burden. Still others see no immediate benefit accruing to them from improving the condition of reserve funds, much of which will not be used for improvements for many years. Regardless, it all results in the same thing—owners will routinely fail to approve requests from the board of directors for additional capital.

If, on the other hand, owners could defer payment of these obligations to a later date, perhaps even until the sale of their property, they would be far less reluctant to give their community association critical fundraising authority. Reserves are used to protect owner equity by funding maintenance and repair programs. As such, deferring payment of an owner's share until that equity is realized at time of sale is logical. Such deferrals could earn a reasonable rate of interest for the association, but would have to be protected by a continuing lien on the owner's property so that the association would be assured of collecting the sums due at the end of the deferral period, not unlike the manner in which a municipality's collection of property tax is protected. Actuarial analysis could determine the rate of turnover of individual interests and thus predict the cash flow that the board of directors could expect each year from these deferred assessments. A model statute appears in the footnotes below.[10]

THE NEED FOR A PROPER WARRANTY

Obsolescence happens when there's no money for repairs and rehabilitation, and as illustrated, that situation is almost inevitable. However, a better start in an association's life can at least postpone this crisis. There's been a war raging for over a decade between those who build residential housing and those who buy these new homes. The fight is over who is to bear the liability for poor quality construction. No victor has been declared. California has attempted to resolve this dispute with recent legislation.[11] This legislation fails to address the two fundamental problems with new home construction—poor quality control and the lack of a funded warranty program. Defective construction is the reason homeowners find themselves in disputes with builders, but the lack of a funded warranty program is the reason that those disputes cannot be resolved quickly. Without resolution, these early construction problems will place a community association in an early deficit position as the cost of repairing unplanned for construction problems is added to ordinary and necessary maintenance. It is important to build affordable, attached housing to increase density and avoid further sprawl, so we have to find a way to protect community association budgets from inevitable lapses in construction quality, and give them a fighting chance at fiscal stability.

Real warranty protection afforded to new community associations is one answer, but most warranty programs fail because houses are not like automobiles—the building industry lacks standardization, and, therefore, predictability. Warranties, like any insurance, must be based on some predictable measure of exposure for whoever underwrites them. With houses, there is no track record in a specific development, and almost no way to predict the future cost of warranty claims. The cost of repairing defects can and does vary widely from project to project and even from condo to condo. Some warranty plans have been bankrupted by excessive claims, while others are stillborn due to the underwriter's fear of the unknown.

Exacerbating this uneven record is the adversarial nature of most construction defect claims. Owners see builders as trying to avoid their responsibility to make repairs, and builders see owners as unwilling to take responsibility for the care and feeding of the new project. It is sometimes a fine line between defective construction and ordinary wear and tear, and lawyers and building consultants spend a good deal of time litigating such definitions. Escalating simple complaints to litigation costs money and is inefficient compared to the benefits afforded by a fully funded warranty as the source of repair funds. A partnership between owner and builder, one that is supervised by the government, could provide the necessary warranty coverage.

Homeowners can be skillful in caring for their property if properly motivated and equipped to do so. But, if the budget lacks the funds to repair the buildings, boards are more likely to postpone repairs or choose to litigate against the builder rather than attempt to obtain additional funding from the owners. Litigation would find less favor with board members if the community association were already possessed of the funding necessary to make many of the repairs themselves. Contrary to popular belief, homeowners are not naturally litigious. Boards are pushed to litigate when the builder refuses to make repairs and the association lacks sufficient funds to do it. Those repairs that are necessitated by a contractor's negligence or a product defect could still be the subject of a legal claim, but instead of a homeowner's lawsuit, that claim could be better handled by a warranty administrator while the property is being repaired.

There are problems with buildings that are not necessarily the result of negligent construction, and, even if they are, they could be easily

resolved by the owner if adequate funding existed. Some water leak issues, for example could be repaired by professional management working through established contractors, quickly and with little drama, if the association had the funds to do it. The occasional roofing problem encountered early in a project's life could be repaired by competent roofers. Random plumbing and electrical problems could receive like treatment. Repairs undertaken by the association, acting through management and experienced contractors, would give an association control over these matters early in the project's life, thus avoiding growing or insurmountable problems later. Even if these problems were clearly the responsibility of the builder, it could be more efficient for the owner to do it—if adequate funding were available.

Funding is only part of the answer, however. A comprehensive, thoughtfully drafted set of maintenance manuals, prepared by professionals, should be supplied to each project. It is exceedingly rare for the builder to leave any kind of "user's manual" for the owner to follow. What is taken for granted when you buy a new car—an owner's manual—is almost unheard of for new housing. Equipping owners and particularly boards of directors who must manage often large and expensive physical plants, with plans, manuals, and copies of applicable warranties gives them the road map that they and their professionals need to begin an adequate maintenance program.

Finally, state government must cooperate by taking a hard look at the regulations which are currently promulgated to govern the development of new real estate projects. The budget guidelines which are followed by those who must approve new subdivisions have been repeatedly found to be inadequate, at least in California, to properly maintain the development. It's that simple—they just don't require enough cash to be set aside in reserves to do what must be done. A new state department, devoted not just to regulating developers who build condominiums, but also to regulating the association's funding decisions later on, should be considered in those states where government oversight does not now exist.

Overlaying all of this must be a "major medical" type of warranty coverage for those construction problems which exceed the normal repair capabilities and funding of the owning association. The most likely source of such protection would be commercial insurance companies, but it could also be provided by a state fund. Getting insurance companies to cover only the most serious defects might seem like a daunting task, but actually carriers spend more money defending litigation and paying for the effects of failing to fix problems early. If warranties had a high deductible, after which the carriers would begin to pick up the bill, it would be easier to attract more insurance to the state to provide warranty coverage.

For there to be real protection for attached housing buyers there would have to be:

(1) A comprehensive, fully-funded budget for routine maintenance and repair that allowed the association to tackle basic problems quickly and without waiting for a "claim" to wind its way through the judicial process. These reserve funds would come, first, from a "seed money" contribution from the builder, and later, through the assessments of the members.

(2) A program of aggressive maintenance and repair guided by a professional set of maintenance manuals that provide standards for maintaining the property.

(3) "Major Medical" warranty coverage from a viable insurance carrier or state fund which would kick in after the cost of repairs reached a fixed limit. This "deductible," i.e. the repairs paid for by the association from its budget, would be high enough to protect carriers from say, the first twenty-five percent of the cost of repairs, leaving carriers responsible for

the remaining seventy-five percent. This coverage could be in lieu of the traditional funding method, the builder's comprehensive general liability policies. The premiums for ten years of coverage would be split between the builder and the owners.

Having access to both the knowledge and the means of effecting basic repairs, would put community associations in a position of control of the condition of the project and further enable them to be more responsive to owner complaints. Budgets could provide that repairs go beyond normal wear and tear to include some types of construction defects as well. There is no reason why some construction defects could not be considered a given part of an association's repair budget so long as the funding for those repairs are built into the budget with adequate funding, a substantial part of which would be provided by the builder at time of sale, and the rest by the members through regular assessments over a longer period of time.

This "self-funding" warranty would protect both builder and owner alike and reduce substantially the number of claims which must be litigated. With the addition of a "major medical" construction warranty, backed by established carriers or the state, this plan could equip the buyers of new condominiums with the means to do much more to protect themselves from the effects of poor quality construction, and to rely less on the uncertainties of litigation. A proper funding start, early in the project's life, can do a lot to postpone eventual loss of value through obsolescence.

COMMUNITY MAINTENANCE TRUSTS

There is another concept that should be considered as a way to achieve financial stability in community associations. First, let's briefly explore the problems faced by developers of new, for sale, affordable housing, as well as those encountered by community associations in existing projects. Most true "affordable" housing available for purchase in urban areas are attached developments—mostly condominium projects. Would-be builders of new affordable housing have often been unable or unwilling to develop new projects for a number of reasons. The high cost of land and the costs of construction, of course, especially in the urban areas of the state, are always a disincentive.

But even if the necessary financing is available to purchase land and construct the project, builders are still reluctant to build attached housing because they perceive that such projects will end up in litigation between the new owners and the builder. Their insurance carriers have echoed that concern. The lack of a workable warranty to cover the project against defects in construction-the overwhelmingly dominant reason for litigation in such projects-is a further impediment, as discussed above.

These circumstances could be greatly improved if it were made possible to combine many community association projects into a single, well-funded, community to which the responsibility for maintenance and repair, including warranty repairs, could be delegated. This is not without precedent. On the government side, we create special districts to administer and maintain all kinds of real estate. Landscape and lighting districts, reclamation districts, water districts, and redevelopment districts are examples of single-purpose government entities formed to maintain or service privately-owned property. These districts are governed by directors elected by the owners of the various properties within the district. A further advantage of a Special District is its ability to raise funds through the sale of public bonds.

In the private sector we have mutual insurance companies, a community of property owners who have joined together to provide financial assurance against certain identified catastrophes. Large community associations,

which may include a dozen or more "neighborhoods," are probably some of the best known examples of combining several smaller projects under the umbrella of a "community" in order to provide more efficient and comprehensive maintenance. Such well-known California communities as Rossmor in Walnut Creek, Sun-City in Roseville, The Villages in San Jose, and Leisure World in Laguna Hills are examples of a group of smaller individual projects which share the benefits inherent in a large mutually owned entity. Of course, large community or property owner associations are usually formed from contiguous parcels, but there is no legal reason why non-contiguous properties could not be aggregated for certain specific purposes without interfering with basic ownership interests.

If the combination of, say, twenty or thirty non-contiguous community associations into a mutually owned and operated "maintenance district" could be achieved, it could bring substantial benefits to each of the member projects. Not only would negotiating power be greatly enhanced when contracting for services, there could be pooling of funds to provide greater liquidity, and form, essentially, a maintenance "insurance" pool to deal the ongoing repair needs of the member associations. A large group of associations could afford more sophisticated engineering and architectural expertise to insure that maintenance and repair projects were designed and executed properly.

There are several types of organizations that would suit this purpose. In the public sector, the obvious choice would be a special district. In the private sector, trusts or non-profit corporations could be used. Whatever it's legal nature; its purpose would be the same—to provide an organization that would accept the delegation of maintenance and repair obligations for a community of non-contiguous community associations. We've coined the term "Community Maintenance Trust (CMT)" to identify these communities.

Builders and existing community associations alike could derive substantial benefits from this arrangement. New construction would have to be inspected by the CMT before the project would be accepted for membership. The reserve requirements for future maintenance would be determined, and the builder would be required to deposit several years' reserve contributions at the beginning of its sales program. Existing projects would have to be appraised and their future maintenance and repair needs estimated before they would be allowed to join the community. They would then have to "buy in" with a sum of money determined by the maintenance and repair appraisal. But once in, future maintenance and repair expenses would be born by the CMT.

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7 *California Civil Code*, Sections 1350, et seq.

8 See the Appendix.

9 *California Civil Code*, supra.

10 Model Assessment Deferral Statute:
"The collection of any regular or special assessment levied by a community association, including any assessment for which membership approval is required, may, at the discretion of the board of directors, be deferred in whole or in part upon such terms and conditions as the board may approve. Any assessment deferred pursuant to this section may include, for the period of such deferral, a reasonable rate of interest, not to exceed the legal rate, and shall be secured by a recorded lien upon the separate interest assessed. The terms and conditions approved by the board may not include a fee to be charged as a condition of such deferral. Other than deferrals which are based upon a reasonable finding of financial hardship specific to an individual member of the association, the terms and conditions of any deferral approved pursuant hereto shall be made equally available to all members of the association. Nothing herein shall affect or supersede any law regulating the collection of delinquent assessments."

11 SB 800, enacted for new construction built after January 1, 2003, can be found at *California Civil Code Section* 895 et seq.

CONCLUSION

Sifting through the Ruins

Needed: A Viable End Strategy

It should be clear that the predicted obsolescence of many community associations is more than mere theory. Many homes in community associations are owned by low and moderate income owners who least can afford the cost of maintaining these buildings. But the income level of the owners is just one of many factors that lead to obsolescence. Problems include defects in the original construction, lack of proper guidance for maintenance and repair, and unrealistic funding plans. It is all about the adequacy of the funding and usually just a question of time. That it starts first in projects owned by the most financially vulnerable should come as no surprise. That it will also come to projects owned by more affluent owners is a little harder for some people to accept. Unfortunately, this lack of understanding is one of the main reasons it occurs. A failure to face the reality of the true funding needs of a community association will only hasten its demise.

There are a number of creative ideas that might improve this picture: assessment deferral, better warranty programs, or such things as maintenance trusts, to name a few. Certainly better quality control during initial construction would avoid or postpone some types of deterioration, and more architectural or engineering oversight of large maintenance and repair projects would make existing funds go further. But in the end it will come down to the availability of owner-contributed capital, and where that is not forthcoming, and the deterioration cannot be stopped, an end strategy will be needed. When the community association can no longer operate the project as it was intended, there are usually no provisions in the covenants or in state statutes that provide directly for its orderly dissolution. Avoiding chaos is necessary to preserve any equity that owners might have left.

THE ECONOMICS OF REDEVELOPMENT

The problem with most end strategies that might be devised to dissolve community associations is that no single person or entity owns or controls all of the equity in the project. Unified control is required to convert the project into apartments, for example, or to initiate redevelopment. The fact is, in a community association the ownership interests are, by definition, separate. "Packaging" these interests into a single parcel that could be purchased and redeveloped by public or private interests usually means getting all, or a substantial number, of the individual owners to agree to sell.

Where the value of the bare land exceeds its value as a community association, that might not be a problem. But where, as will be the usual case, the value of the project is determined simply by the aggregate market value of all of the separate interests, the existing improvements will have to have some value to a potential re-developer. If the cost to rehabilitate the existing structures is too great, and the bare land value too small, the upside profit will be inadequate for commercial developers, leaving only non-profits or public entities as potential participants in a re-development of the property.

INADEQUATE LEGAL PRECEDENT

In some states, the right of partition might provide a legal avenue to force a sale of the separate interests, but of course, such a forced sale would not likely be the forum in which the highest return of equity could be achieved. Some covenants may provide for a process of dissolution in the case of major damage or destruction, especially where insurance proceeds are inadequate to rebuild, and these might also offer a legal basis for unwinding an obsolete community association project. Finally, federal bankruptcy law could provide an avenue for a court supervised plan of partition or dissolution, but it is unlikely that any of these methods would be considered an orderly way to preserve or enhance equity.

None of these alternatives offer tried or established precedent because this problem is so new. What may ultimately be necessary is legislative action to create an orderly process for closing the books on an obsolete community association which would protect any remaining owner equity. Without that, it will be every man, woman, and lender for themselves. This could mean that equities, to the extent there are any, would be tied up in an obsolete project for years, with the property itself constituting nothing but a nuisance that the local public entity will necessarily have to abate.[12]

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.

It is axiomatic that recognizing a problem is the first step toward solving it. Here's to recognition.

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12 Franklin Villas required over $90 million in public funds to achieve redevelopment.

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APPENDIX

ECHO REPAIR AND REPLACEMENT RESERVE FUND STANDARDS FOR COMMUNITY ASSOCIATIONS

Standard Number 1

All Cash flow projections should extend at least thirty years from the date the reserve study is prepared.

Standard Number 2

The rate of interest on deposited reserve funds included in cash flow projections should be no more, before taxes, than two percent greater than the inflation rate forecast for the same period.

Standard Number 3

If the cash flow projection relies upon any of the following sources of cash, such reliance must be included as a clear and separate disclosure in the financial documents distributed annually to owners:

1. Projected increases in Regular Assessments which exceed the projected rate of inflation
2. Special Assessments
3. Capital obtained from any source other than from the owners

Standard Number 4

The percentage that cash projections are met by current deposits ("Percent Funded") should be calculated as follows:

1. Calculate the Current Cash Requirement for each reserve component using the following formula ("Straight Line" method): Current Cost of Replacement divided by the component's Useful Life and multiplied by the age of the component.
2. Add Current Cash Requirements for all reserve components to obtain Current Reserve Cash Requirement.
3. Divide the actual balance (Accrual Basis) of the Reserve Fund by the Current Cash Requirements total.

The projected "Percent Funded" for each year of the funding plan must included as a clear and separate disclosure in the financial documents distributed annually to owners.

Standard Number 5

At the time of each reserve study, the Board of Directors of each community association should consider whether a visual inspection of the accessible areas of the major components is sufficient, or whether more invasive investigation of some components may be necessary to provide for adequate reserve funds.

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