

ASSOCIATION FINANCES

AFTER YOUR RESERVE STUDY IS DONE – HOW TO DEFEND A FEE INCREASE

by Chris Andrews ; Stone Mountain Corporation

Suppose you have just received your reserve study indicating that a reserve funding increase will be necessary. Without an increase, it appears that your association will not be able to properly maintain the association's common assets over time.

Most associations are legally obligated by their CC&Rs to properly maintain their property. Furthermore, California Civil Code § 1366(a) states "... the association shall levy regular and special assessments sufficient to perform its obligations under the governing documents and this title."

Your board of directors has reviewed the reserve study and some or all of the directors agree with the funding increase. The board also realizes that the increase in reserve funding will require an increase in regular monthly fees or even a special assessment.

From past experience, you know

that a regular monthly assessment increase will stir up resistance from a few vocal association members who do not like change of any sort – especially the type of change that requires them to spend more money! And what if some of these people are *on your board of directors*? On a five-person board, if you have a majority of three board members opposed to any assessment increase and only two fiscally responsible ones, you stand little chance of passing the reserve funding increase.

Your task – assuming that you are one of the fiscally responsible board members – will be to convince the dissenting board members that a reserve funding increase is the right thing to do.

In addition, you will also need a vote of your membership – per California Civil Code §1366 – if the resulting regular assessment increase

is more than 20% above the preceding fiscal year's regular assessments or if your proposed special assessment exceeds 5% of the budgeted gross assessments for the fiscal year. This means that you will have to present your argument not only to your board of directors, but also to your membership. How can you do so effectively?

Following are several tips on how to successfully gain approval for an assessment increase:

First, you must break the news gently. Association members are most receptive to hearing that "*member assessments must be increased due to factors out of our control or due to*

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new information not available to us previously." There is really no rational argument against these reasons. For example, significant increases in worker's compensation insurance in recent years have caused dramatic increases in roofing, painting, and paving contractor's prices.

Members are least receptive to assessment increases due to incompetence by board members. Common examples might be board member negligence that caused ultimate expenses to be much higher than they should have been if the board had been diligently maintaining those items. For example, not painting trim & siding caused it to become prone to dry-rot and warping; or not sealcoating asphalt frequently enough so that potholes formed prematurely.

Before uttering the words "assessment increase," build a strong case for the assessment increase by mentioning some or all of the following where applicable:

- The costs to maintain association

property have increased significantly.

- Some new reserve expenses have become apparent since the last budget and the last reserve study were prepared, for example, slab leaks, fumigation, etc. It is easiest to tie an increase in funding to forthcoming capital replacement projects that people agree are necessary.
- The association never had a proper reserve study done before and now that one has been prepared, a comprehensive inventory of capital assets (reserve components) was made with *up-to-date* replacement costs for those items.
- There have been many planned and unplanned reserve expenses in recent years. Compile a long itemized list of these expenses and show how they have exceeded your recent reserve income and depleted available reserves for future expenses.
- The percent funded estimate provided by the reserve study

indicates that in past years, the association has not set aside sufficient funds for these items for each year they have depreciated in value.

- If the percent-funded estimate is quite low, cite the fact that mortgage lenders view poorly-funded associations as higher risk and many review the reserve study before approving a loan. For reverse mortgages, the FHA requires that associations are at least 65% funded for capital expense depreciation and they prefer 80% or higher. Senior citizens who have applied for reverse mortgages have been all set for approval but then a final review of the association's percent-funded status nixes the deal.
- If the association does not maintain its property, the real estate values of each home may be adversely impacted. Ironically, in a poorly-maintained association, the net reduction in real estate values

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often far exceeds the amount of the proposed increase in assessments.

After you have presented the foregoing funding issues, then kindly explain that a reserve funding increase or special assessment will be needed. Upon hearing the magnitude of the proposed funding increase, there will inevitably be strong objections from some members.

Following are several typical objections and how to effectively respond to them:

🔊 **"I can't afford the increase."**

RESPONSE: Remind them that the association is a business and it has an obligation to maintain its common assets for the good of the community. It is not fair for a handful of individuals claiming hardship to hold hostage the entire association and the property values belonging to all members.

Although the association is usually run by volunteer board members, it is not a socialist organization. The cold reality is that nobody has a right to live in the association if they

are no longer able to uphold their responsibility to share in the costs as described in the governing documents to which they agreed during escrow. If neighbors wish to be compassionate to a neighbor who claims hardship, they should personally arrange to do so outside of the association's budget.

Once the regular assessment increase or special assessment is passed, it is remarkable to see how resourceful people actually can be in spite of their claims of hardship. With large increases in home equity, some tap into a home equity line of credit. Others with an extra bedroom in their unit decide to rent it out to a tenant to bring in extra money.

🔊 **"As a senior citizen, I won't be here in 15 years when the roof needs replacement and in 10 years when the streets need repaving. Why should I have to pay for those costs now?"**

RESPONSE: Senior citizens are not the only ones who pose this question. Young people who consider a condo as a starter home and do not plan to live

there for more than several years ask the same question. The problem with this "short-timer" logic is that these people are benefitting from the use of the roofs, streets, pool, etc. while they are living in the association. If their roof is a 30-year roof and they live in the association for 5 years, then the value of the benefit they derive from the roof during their stay at the association is 5/30th or 1/6th of the cost of the roof replacement. It is indeed fair that they pay for their incremental use of the roof, streets, pool, etc. even though they may not be living in the association in the future when the actual replacement occurs. Additionally, remind new residents that they are currently enjoying capital improvements paid for by other members before they moved in.

Another response to "short-timers" who hope to sell their unit in the next few years is to tell them that the future market value of their residence may indeed increase significantly more than the net increases in assessments

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if the association is well-maintained via those increases.

❗ **"Why don't we just special assess for future capital expenditures like roofing, paving, etc.?"**

RESPONSE: The primary drawback to the special assessment method of funding is that your board may have trouble collecting all of the necessary money from all owners when large reserve expenses occur. Suppose some owners cannot come up with \$10,000 for a roofing special assessment when your association desperately needs a new roof? It is better to collect the money gradually every year so your association has those funds when they are needed.

Furthermore, using the roofing example above, if the association does not have sufficient reserve funds to replace their roofing immediately when needed, the eventual cost to do so may increase dramatically. While the board must tiptoe through the painful process of levying a special assessment, more roof leaks and costly interior damage may occur to residential property inside the units. And, during that time, the scourge of most associations – dry rot and mold – have a chance to become established. Does anyone want a mold lawsuit? In short, having to defer maintenance even further while levying a special assessment is poor planning.

Another drawback of the special assessment funding method is that it unfairly penalizes those homeowners who happen to be living in the association at the time of the special assessment. A reserve study calculates an annual reserve funding amount which ensures that everyone pays equally for the depreciation

that occurs while they live in the association. (Depreciation represents, in dollars, how much each asset such as roofing, streets, etc. is "used up" over a period of time).

❗ **"The fees are already too high!"**

RESPONSE: Determine what the association fees are in other associations in your area with similar amenities and share this with your membership. If your association pays for trash, hot water, cable, etc., factor these items out of your fees when comparing with other associations that do not pay for these utilities. Your members may be pleasantly surprised to find that other association assessments are considerably higher.

Then explain how the reserve study works and show them the list of reserve components that the association is obligated to maintain. Ask the dissenting members if they do not want to raise assessments to the appropriate level, *which items in the reserve study (e.g. roofing, paving, fencing) do they want the association to cease to maintain?*

Suppose the recommended reserve funding increase they object to is \$10,000 per year more than last year, ask them to find a \$10,000 per year item in the reserve component list (or a \$100,000 item occurring every 10 years) that they deem to be "non-essential" and if they really want to vote to cease to maintain it. Calmly ask them if they don't mind being documented in the minutes as having taken that position.

❗ **"I can get a higher investment yield on my money than the association can so why should I be putting more of my money**

into the association's reserve account that only earns CD rates?"

RESPONSE: Ask them if they sell their unit at some point in the next few years before a major reserve expense such as roofing, do they plan to write a check to the association's reserve fund to cover the depreciation of their roofs, streets, pool, etc. that occurred during their tenure? Or, like most people, do they secretly hope to avoid having to pay for those large expenses altogether?

The problem with the "I can get a better investment yield elsewhere" argument is that there is no guarantee that the people who pose this argument will, in fact, own their unit in the future when those saved reserve funds are needed. Ask them if they are so confident that they can get a better investment yield on those funds, would they be willing to enter into a contract with the association to repay the sum total of the reserve assessments they did not have to pay to the association with compound interest at CD rates when they sell their unit in the future.

Because there is no built-in mechanism in the escrow process to cause a seller to pay for the depreciation that has occurred on all reserve components (roofs, streets, pools) during their tenure, there will always be people who sell and manage to avoid paying for those items, while new owners are burdened with those expenses.

If the foregoing rational discussion does not overcome objections, it is time to escalate the debate:

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☞ If the objections come from board members, inform them that California case law (*Raven's Cove Townhomes vs. Knuppe Development, 1981*) has held that board members can be individually liable for failing to properly fund a maintenance reserve account.

☞ If the objections come from board members, inform them that their vote against prudent reserve funding will be documented in the minutes. Then, calmly ask them again if they still want to vote against it.

If your board is in agreement on the assessment increase, but several association members vehemently oppose it, inform them that the board members have been elected to act as fiduciaries on behalf of the association and they will do what they deem is best for the association. In other words, members essentially do not have much say in the matter in most cases.

Depending on the wording of your CC&Rs, association members may have the right to force the board to call a special meeting of the membership to discuss the issue. They may even try to force a membership-wide vote on the assessment increase, but in most CC&Rs, the board has the ultimate say in whether or not to bring an issue to the membership for vote, unless, of course, the assessment increase exceeds the amount that the board is authorized to impose. Consult with your attorney for further clarification.

If the Board agrees to a vote of the membership on the assessment increase and the increase is rejected by popular vote, then the membership, rather than the board, may be seen as responsible for not funding reserves properly. To protect yourself and your fiscally-prudent allies, keep a tally of members who voted against and those who voted for the proposed reserve funding increase and document that in your minutes.

Strive to get as many members as you can on email and use that medium

to campaign for the assessment increase. Make sure that you send equivalent copies of those emails to your members who do not have email so everyone has equal access to information. In the end, persistence coupled with logic and reason should prevail.

After some rigorous lobbying for an assessment increase on your part, some members who had opposed the increase will capitulate and you will have won more votes. Or, they will become even more irrational, at which point you must realize that you will never convince them. Conserve your energy and focus your efforts on the remaining rational individuals.

Indeed, some of the foregoing suggestions may seem like playing hardball against the opposition, but you should remind yourself that the opposition is playing hardball against the association's fiduciary duty to maintain its property.

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