Study H-853 January 19, 2005

Second Supplement to Memorandum 2005-2

State Assistance to Common Interest Developments (Comments on Tentative Recommendation)

A letter from Beth A. Grimm, commenting on the Commission's tentative recommendation, was misaddressed and was only recently received. The letter is attached and is discussed below.

GENERAL REMARKS

Ms. Grimm is generally not in favor of the proposed law:

> I have at times thought a reporting agency or Bureau for CID oversight might be a good idea. Of course, I envisioned knowledgeable and balanced people running the show. However, the latest recommendation leads me to the conclusion that without a meaningful study and some real life taste of what the majority of the complainers have in common, the Commission is flying blind, and that spells disaster. Like every other situation, the squeaky wheel tends to get the grease and it appears that the Commission has been lead astray if it has come to the conclusion that associations are for the most part bad and therefore all who live in them should pay a hefty price to be criticized, investigated, and publicly humiliated.

COST IMPACT

Ms. Grimm is concerned that the proposed fee to fund the Bureau is too high. Citing the statutory maximum fee of $10 per unit per year, she notes that an 18,000 unit development would be required to pay $180,000 per year. See Exhibit at 2. That is a very large sum. However, that is the aggregate cost for a development the size of a small town. If the concern is affordability, it might be better to consider the cost to each household, which would start at $5 per year and could be decreased or increased by regulation (up to maximum of $10 per unit per year).

Ms. Grimm also suggests that there should be a filing fee of $75-100 to initiate a formal investigation by the Bureau. This would help to deter nuisance complaints and would provide an alternative source of income. This change

could be coupled with a decrease in the per unit fee, in order to more equitably allocate costs. **In Memorandum 2005-2 at 18-19 (available at www.clrc.ca.gov) the staff recommends such an approach.**

NEED FOR FURTHER STUDY

Ms. Grimm agrees with others who have commented on the need for better empirical data on the volume and nature of the probable workload of the Bureau before moving forward: "A state agency that collects millions and has no particular direction and little experience or education about how disputes arise and fester, or how best to solve them, is, in my view, a disaster waiting to happen." See Exhibit at 2. For additional discussion of the need for further study, see Memorandum 2005-2 at 6-10.

The staff agrees that additional data on the Bureau's likely workload would help to refine the proposal. In particular, it would help in setting an appropriate funding level.

However, the staff disagrees that the proposed Bureau would have no direction or experience with resolving disputes. The proposed law states the purpose of the Bureau and expressly sets out its duties and powers. Note also that the Bureau would be part of the Department of Consumer Affairs, which has considerable experience in setting up and operating consumer service programs of the sort proposed. CID law would be new to DCA, but the operational aspects of the Bureau's duties would not.

WEBSITE PUBLICATION OF VIOLATION INFORMATION

Ms. Grimm believes that it would be unduly harsh to publish information about violations of CID law on the Bureau's website.

> If a Board makes a mistake, should everyone in the Association have to pay by suffering the stigma attached to a public proclamation of wrongdoing? Should an Association be permanently stigmatized by something that can be easily corrected with education?

See Exhibit at 3. Ms. Grimm's basic concern about the fairness of collective punishment by Internet publication of citations is reasonable. The Commission should consider whether to remove that sanction from the proposed law.

However, the problem is overstated slightly. Only a formal citation that survives administrative and judicial review would be publicized. The Bureau

could not issue a citation for violation of law without first giving the association an opportunity to resolve the problem informally. See proposed Civ. Code § 1380.310(b). Mistakes and minor problems could be resolved at that stage of the process, without a corrective citation being issued or publicized. Only an association that refuses to cooperate when confronted with a finding of a violation would be cited.

ELIMINATE ENFORCEMENT POWERS

Ms. Grimm recommends that law enforcement be left to the court. In her view, court authority to award attorney fees to the prevailing party in some CID cases would provide an adequate mechanism for leveling the playing field between an association and an individual homeowner. See Exhibit at 3.

However, fee shifting only applies to an action to enforce an association's governing documents. See Civ. Code § 1354(c). It is not available in the type of cases that the proposed Bureau would have authority to adjudicate: violations of statutory law.

INDEMNIFICATION OF AGENTS

Under proposed Section 1380.310(g), if the Bureau finds that a person has violated CID law, and also finds by clear and convincing evidence that the violation involved malice, oppression, or fraud, that person is deemed to have acted in bad faith and cannot be indemnified by the association.

Ms. Grimm is concerned that this conflicts with most CID governing documents in the state, which provide for indemnification of directors. She also thinks it would deter voluntary service on boards.

Under existing law, a corporation may indemnify its agent (including a director) when an action is brought against that person based on their agency relationship with the corporation. However, the person may only be indemnified if the person *acted in good faith and in a manner reasonably believed to be in the association's best interest*. See Corp. Code § 7237; C. Sproul and K. Rosenberry, Advising California Common Interest Communities § 4.47 (2003).

Malice, oppression, and fraud are inconsistent with good faith. Therefore, under Section 7237 an association cannot indemnify an agent for misconduct involving malice, oppression, or fraud. Under Section 7237(g), an

indemnification provision in a corporation's governing documents is invalid if it is inconsistent with Section 7237.

For those reasons, the staff does not believe that proposed Section 1380.310(g) would conflict with any legally valid indemnification provision of an association's governing documents. A governing document provision authorizing indemnification of conduct involving malice, oppression, or fraud would conflict with Section 7237 and be unenforceable.

However, there may be another problem with the proposed indemnification rule. Section 1380.310(g) could perhaps be read as superseding Section 7237, in order to *allow* indemnification of bad faith conduct so long as the conduct does not rise to the level of malice, oppression, or fraud. That was not our intent.

Given that existing law already bars indemnification for bad faith conduct, Section 1380.310(g) is not strictly necessary. **The staff recommends that subdivision (g) be deleted and that the following language be added to the Comment:**

> An association's governing documents may provide for indemnification of a director or other agent of an association who is investigated by the Bureau for an alleged violation of law. However, the power of a corporation to indemnify an agent for conduct relating to the agency relationship is limited by Section 7237 of the Corporations Code.

This would alert readers to the relevant law, without establishing a different and potentially confusing standard.

EXHAUSTION OF ADR

Ms. Grimm suggests that the proposed law should address whether exhaustion of ADR is required before the Bureau can intervene in a dispute. That issue is discussed in Memorandum 2005-2 at 30-32.

DRAFTING PROBLEM

Among other things, proposed Section 1380.220(a)(1) would require that the Bureau post the following to its website:

> (1) The text of this title, the Nonprofit Mutual Benefit Corporation Law, and any other statute or regulation that the bureau determines would be relevant to the operation of a common interest development or the rights and duties of a community association or homeowner.

Ms. Grimm reads this as an attempt to assign the name "Nonprofit Mutual Benefit Corporation Law" to "this title." See Exhibit at 3. That was not our intent. The section was meant to state a list of three items, the second of which is the Nonprofit Mutual Benefit Corporation Law — "this title" refers to the Davis-Stirling Act, of which Section 1380.220 would be part.

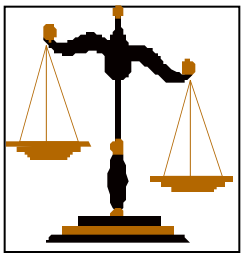
The potential for confusion on this point could be avoided by numbering the items, as follows:

> (1) The text of (i) this title, (ii) the Nonprofit Mutual Benefit Corporation Law, and (iii) any other statute or regulation that the bureau determines would be relevant to the operation of a common interest development or the rights and duties of a community association or homeowner.

The staff sees no problem with making this change.

Respectfully submitted,

Brian Hebert
Assistant Executive Secretary



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December 28, 2004

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Re: Law Revision Studies and Publications - Subject of State Oversight of CIDs – My Response to The Tentative Recommendation of CLRC Dated September 2004

Dear Mr. Hebert:

I last wrote to the Committee in April of this year but have been involved in providing input to the Committee through the advocate for Community Associations Institute-California Legislative Action Committee (CLAC), Skip Daum. I have read the recommendation noted above and this is my feedback. It is based on many things, including my extensive participation in this industry including teaching, authoring helpful books and speaking publicly about CID living and the law, involvement in legislation, and my representation of (besides professionally managed associations) many owners and many self managed boards. There is truly a supermajority of people who know very little about operations and day to day issues encountered in common interest developments. I am not just talking about those owners and self-managed boards, but judges, legislators and news media.

There is a terrible lack of educational opportunities for board members about operations in Associations, and on the opposite end of the spectrum there is an abundance of extremely complicated laws. Most of the classes taught by professionals and industry groups is geared toward managers. Because of this, and the fact that common interest living puts people literally "on top" of each other, a huge percentage of the disagreements are fueled by emotions.

A state agency that collects millions and has no particular direction and little experience or education about how disputes arise and fester, or how best to solve them, is, in my view, a disaster waiting to happen. These are my reactions to the recommendations:

1. **Proposal of $10 per dwelling per year as the cost. I literally had to catch my breath. That's a $3,000 per year additional cost for a 300 unit condominium, a $180,000 additional expense for an 18,000 unit development. Incredible. I have to wonder if any of the proponents of a fee of this magnitude have had experience putting together association budgets in the past few years. Expenses for management, insurance and utilities have all increased because of new laws, market rates conditions, and certification requirements. But I guess it is all relative – with a proposal like this, original suggestions of $1.00 per door sound pretty palatable. My questions are: (1) *if* an agency went forward and charged this fee and *if* an agency successfully collected all the money due (which you estimate to be more than $30,000,000), what would a fledgling bureaucratic agency do with that kind of money when there has never even been a study to determine how best to effectively resolve owner-association disputes and resolve complaints; and (2) why is no consideration given to charging an application/processing fee to be charged to complainants rather than putting the biggest brunt on the Associations and innocent members of them. Does this indicate that there is a pre-supposition that every homeowner complaint is going to be valid? It sure sounds that way.**

As I have previously said to the committee, having represented Owners for a number of years (and being in the minority of knowledgeable attorneys that takes on Owner clients), at least 95% of the calls that come to me are based on the Owner's lack of understanding about responsibilities, and the drawbacks of living in a CID. And the lack of understanding and acceptance of the way of life leads to emotions running so high that a reasonable approach to solving a problem is often rejected by these Owners. By the time they call an attorney many want to "***get***" the Board. Calling on the complainants to share the cost of the Bureau is only fair, and might deter complaints lacking any foundation. The agency could institute a process to allow for waivers for those without the means to pay the fee. It should be set at $75 or $100, probably. Anticipating (your figures) hundreds of thousands of complaints/applications for review per year, that could net millions that would not even require collection efforts.

One more thing on this. You note that $30,000,000 is the approximate budget of other agencies but I am assuming you are talking at least in part of agencies that are funded by tax money which is paid over a much larger population base than just HOA members. At $10 a door, you are talking about sums that (as does most other legislation regulating associations) make affordability a question rather than an answer.

2.**<u>Reporting Violations Of The Law And Non-Compliance By Associations On A Public Website</u>. This suggestion constitutes excessive punishment and should be rethought. Who can even reasonably interpret the laws besides an attorney trained to analyze difficult legalese or a manager who attends every legal seminar there is and reads and understands the Davis Stirling Act. If a Board makes a mistake, should everyone in the Association have to pay by suffering the stigma attached to a public proclamation of wrongdoing? Should an Association be permanently stigmatized by something that can be easily corrected with education?**

I have at times thought a reporting agency or Bureau for CID oversight might be a good idea. Of course, I envisioned knowledgeable and balanced people running the show. However, the latest recommendation leads me to the conclusion that without a meaningful study and some real life taste of what the majority of the complainers have in common, the Commission is flying blind, and that spells disaster. Like every other situation, the squeaky wheel tends to get the grease and it appears that the Commission has been lead astray if it has come to the conclusion that associations are for the most part bad and therefore all who live in them should pay a hefty price to be criticized, investigated, and publicly humiliated.

How much could it cost to set up a website, receive and process complaints, and get some real hard facts about what to expect before collecting $30,000,000 from innocent parties. Why not work on legislation that requires the Courts to send parties to a lawsuit to mediation and possibly even counseling (like family law cases in many jurisdictions) before they can proceed to trial. What if that website offered incentives to learn, more, both for Boards and for Owners.

After reading the September recommendations, I now believe it is best to leave the devisive and difficult issues to the Courts, and to stick to education and possibly ombudsman services for the Bureau. Law already allows for the prevailing party to recover attorney fees. Head off the disputes that are festering between reasonable, but emotional people.

And two more things about the proposed law:

1. **Title and Website**: Section 1308.220 suggests a name for this body of law and for use on the website of "the Nonprofit Mutual Benefit Corporation Law". That will create confusion since that is the exact name of a body of law already existing in California law (Corporations Code Sections 7150 et seq.) including corporations that are and are not homeowner associations.
2. **Exhaustion of Remedies**. CLRC worked hard the last few years and the result is new laws that require internal ADR procedures in HOAs, yet I did not see anything in this recommendation requiring owners to avail themselves of those procedures before coming to this agency.

3. **Indemnification**: The proposed Section 1380.310(g) precludes indemnification protection for Board members that are perceived by the Commission to have acted with malice. There are two potential problems with this – (1) it creates an immediate (and unresolved by the language) conflict with almost all documents in the state because most all provide some sort of indemnification provision in them for board members; and (2) if indemnification protection can be taken away, it will deter many good board members from serving. These kinds of disputes get emotional, personal and sometimes ugly. That is not to say that Board Members who purposely misuse their powers to hurt others should go unpunished – but something that seriously threatens to serve as a deterrent to board service at the outset could be quite dangerous to the entire concept of voluntary board membership.

Please feel free to contact me or pose specific questions if there is any more I can do to assist the committee.

Respectfully,
Beth A. Grimm
BAG/mg