

Memorandum 2009-14

Small Associations (Introduction of Study)

Since 2000, the Commission has been studying various aspects of the law governing Common Interest Developments (“CIDs”). A CID is a real property development in which ownership of a “separate interest” is coupled with an interest in “common area” property. See generally Civ. Code § 1351 (defining “common area,” “common interest development,” “separate interest,” and other related terms).

A CID is managed by an “association,” which can be incorporated or unincorporated. See Civ. Code § 1363. The duties and powers of the association, and various procedures governing its operations, are specified in relevant provisions of the Corporations Code and in the Davis Stirling Common Interest Development Act (“Davis-Stirling Act”). See Civ. Code §§ 1350-1378. The operations of the association, including maintenance and repair of the common area, are funded from assessments paid by the owners of separate interests. See Civ. Code § 1366(a).

CIDs vary widely in size, from a handful of separate interests to over ten thousand separate interests. For the most part, existing law does not differentiate between CIDs of different sizes. That one-size-fits-all approach is problematic. Statutory requirements that make sense in a development the size of a small city may be unnecessary or unworkable in a development comprised of only a few homes.

The purpose of this study is to consider whether the statutory law governing CIDs should be adjusted to impose simpler and less burdensome governance requirements for small associations. That may be appropriate where more complex requirements would be cost prohibitive or would not make sense when applied in a small community.

“SMALL” ASSOCIATIONS

The premise of this study is that small associations are different in kind from larger associations and should therefore be given special statutory treatment. In exploring this premise, it will be necessary for the Commission to decide what is meant by a “small” association.

The staff sees two obvious ways in which the size of an association might be measured: by the total annual revenue of the association or by the number of separate interest “units” in the association. There are precedents for either approach.

Revenue as Measure of Association Size

Civil Code Section 1365(c) distinguishes between large and small associations by reference to the income of the association. It requires that an association’s annual financial statement be reviewed by a licensed accountant *if the association’s gross income for the year exceeded \$75,000*.

The advantage of using revenue as a basis for judging the size of an association is that revenue directly relates to the financial resources available to the association. That bears on the association’s ability to absorb the cost of statutory requirements. An association with a large annual revenue may find it relatively easy to set aside funds to pay statutory procedural costs that would impose a significant burden on an association with a smaller annual revenue.

One disadvantage of using revenue to judge the size of an association is that it does not take into account differences in assessment rates between associations. Assessments vary widely. Members of one association might pay \$50 per month in assessments, while members of another pay \$500 per month. Based on those possibilities, an association with \$75,000 in annual revenue might have 125 units or 13 units. In the staff’s view, the operational practicalities of a 125 unit community are very different from those of a 13 unit community.

Another disadvantage of a revenue-based definition is that any dollar amount used to define a “small” association would need to be periodically adjusted for inflation, or it would lead to significantly different results over time. For example, the \$75,000 amount specified in Section 1365 was added in 1985 and has not been adjusted since. See 1985 Cal. Stat. ch. 874, § 14. Adjusted for inflation, that amount would be approximately \$150,000 in 2008. U.S. Bureau of Labor Statistics Inflation Calculator <<http://data.bls.gov/cgi-bin/cpicalc.pl>>. Thus,

Section 1365 now applies to associations that are effectively half the size of what was originally intended.

A revenue-based definition would also be more unpredictable than a definition based on the number of units. Changes in the assessment or collection rate for a year could cause an association's total annual revenue to wobble above or below the statutory threshold for a "small" association. An association near the margin might be "large" one year, and "small" the next. That sort of variability in the legal status of the association could cause problems.

Number of Units as Measure of Association Size

An alternative would be to define the size of an association by reference to the number of units in the association. For example, the Corporations Code provides special election rules for larger nonprofit mutual benefit corporations, as measured by the number of members in the corporation. See Corp. Code §§ 7521-7524 (special rules for corporation with 500 or more members; 5,000 or more members).

The main advantage of this approach is that it relates directly to the operational scale of the community. For example, in a community of 15 units, member meetings could be held in a living room, notices could be personally delivered, and many procedures could be handled on a face-to-face basis, without the need for bureaucratic governance structures. By contrast, in a community of 1,000 units, an auditorium would be required for member meetings, and bureaucratic procedures would be a practical necessity.

Also, the number of units in a CID should be fairly constant over time. Therefore, a rule based on the number of units would provide stability and predictability to small associations, in terms of determining applicable law.

The disadvantage of using the number of units as a measure of association size is that it does not take into account differences in available revenue. Some associations with only a few units will be luxury developments, with very large assessments and legally sophisticated owners. Those communities might well be able to afford and manage more complex governance procedures, despite the small number of units.

Statistical Data

In considering the appropriate measure of a "small" association, it is helpful to understand the existing demographic breakdown of California CIDs by size.

The table below shows the distribution of California CIDs based on the number of units in the association:

Number of Units	Percentage of the Whole	Cumulative Percentage
2-5	10%	10%
6-10	19%	29%
11-15	9%	38%
16-20	8%	46%
21-25	5%	51%
26-50	15%	66%
51-100	14%	80%
101-325	16%	96%
326+	4%	100%

Levy & Erlanger, *2008 California Community Association Statistics 1* (2008).

As the data shows, most associations are relatively small. More than a third have 15 units or fewer. More than half have 25 units or fewer. Two-thirds have 50 units or fewer.

These numbers underscore the importance of this study. Depending on what size is chosen in defining “small association,” simplified procedures for small associations could benefit one-third to two-thirds of all CIDs in California (approximately 15,000 to 30,000 small self-governed communities). *Id.* A reform that saves each small association \$100 per year in operating costs would result in a total savings statewide of \$1.5 million to \$3 million per year.

The following table shows the distribution of California CIDs by total annual revenue:

Annual Revenue (in thousands)	Percentage of the Whole	Cumulative Percentage
0-25	24%	24%
25-50	18%	42%
50-75	11%	53%
75-100	7%	60%
100-200	16%	76%
200-300	7%	83%
300-400	4%	87%
400-500	3%	90%
500+	10%	100%

Id. That data also shows that most associations cluster at the smaller end of the range, though it is harder to intuit what level of revenue would be a good cut-off for “small” associations.

Staff Recommendation

The staff favors using the number of separate interests to define “small association.” It would provide a clear and predictable standard, that would not change over time (with fluctuations in revenue or as a result of inflation).

The disadvantage of this approach is that it would not differentiate between a small association with scant resources (which would probably be the most typical case) and a small association with ample resources. However, that should not be a problem if any special procedures created for small associations are made *optional*. That way, if a small association has the resources and sophistication to benefit from more formal procedures, it could elect to use the more formal procedures.

The staff is not sure what number of units to use in defining a “small association.” **As a starting point, the staff would recommend the following rule:**

Civ. Code § 1351. ...
(m) “Small association” means an association with 25 or fewer separate interests.

...

It seems clear that an association of that size would have an operational scale that would be suited to less formalized procedures. Also, most associations of that size would not have the resources for professional management or the ability to spread costs widely. **The staff invites public comment and suggestions on this issue.**

INCREMENTAL APPROACH

In conducting this study, the Commission decided to proceed incrementally, studying just one aspect of association governance at a time. CLRC Memorandum 2008-40, p. 32; Minutes (Oct. 2008), pp. 2-3.

This will allow the Commission to “test the water” to see whether the overall concept is feasible, both practically and politically, before committing extensive resources to the project. This is prudent because many aspects of CID law are politically polarized and therefore difficult to reform.

The study will begin by examining the possibility of simplifying member election procedures in small associations.

MEMBER ELECTIONS

Existing Law

Although there are important election-related provisions in the Corporations Code, the main source of statutory law governing CID elections is Civil Code Section 1363.03. That section sets out a detailed procedure that must be followed when holding specified types of member elections in a CID (i.e., an election to approve an assessment, choose or remove a director, amend the governing documents, or grant exclusive use of common area property). See Civ. Code § 1363.03(b). The procedure is as follows:

- (1) *Association selects election inspectors.* The association must select one or three independent election inspectors to oversee the election. The election inspectors determine who is eligible to vote, determine the authenticity of proxies, receive ballots, authenticate ballots, count ballots, and report the results of the election. Election inspectors also hear and decide challenges or questions relating to voting rights. Civ. Code § 1363.03(c).
- (2) *Association prepares and distributes ballots.* At least 30 days before the election date, the association must prepare and distribute ballots to all members who are entitled to vote. A ballot must not be marked in any way that would identify the member who casts it. Along with the ballot, the association must provide two envelopes, an inside envelope and an outside envelope. Civ. Code § 1363.03(e).
- (3) *Member casts ballot.* The member marks the ballot to indicate a vote and then seals it within the inside envelope. The inside envelope bears no marks that would identify the member. The inside envelope is then sealed into the outside envelope. The member signs the outside envelope and writes the member's name and address in the upper left hand corner. The outside envelope is then addressed to the election inspector. The member may either hand deliver the ballot or mail it. *Id.* (However, the association has the option of requiring that *all* ballots be mailed. Civ. Code § 1363.03(k).)
- (4) *Election inspectors tabulate votes.* The election inspectors count and tabulate the votes at an open board meeting or member meeting, which any member can attend to observe the process. Civ. Code § 1363.03(f)-(g).

That process is expressly modeled after the absentee ballot process used by county election registrars. Civ. Code §1363.03(e) ("The association shall use as a model those procedures used by California counties for ensuring confidentiality of voter absentee ballots....").

For the most part, that process should work reasonably well in a large association. The procedural cost imposed by the use of an outside inspector and the production of complicated ballot materials could be spread across all of the members and would therefore not impose too great a burden. The institutional guarantees of neutrality, secrecy, and accuracy provided by the process would help to establish the legitimacy of an election that is conducted on a large scale.

Problems with Existing Procedure

The use of the double-envelope system to preserve the secrecy of the ballot could cause a number of problems.

First, the staff has heard a number of complaints about the fact that ballot envelopes must be *signed* before being delivered. Many homeowners are concerned that placing a signed envelope in the mail creates a risk of identity theft.

The double-envelope system could also cause authentication problems when used in elections involving differential voting power and the use of proxies:

Multiple Votes

In many associations, a member can cast one vote for each separate interest that the member owns. In others, the voting power of the member is based on the square footage of the member's separate interest or some other measure of value.

Suppose a developer retains ownership of 100 unsold units in a large CID and is therefore entitled to cast 100 ballots in the election. How would that be done under the double-envelope system?

The developer could not simply mark a ballot to indicate that it represents 100 votes. Unless there is some way to match the identity of the developer with the ballot, there is no way to confirm that the ballot correctly reflects the developer's voting power. Existing law expressly prohibits marking a ballot to indicate who cast the ballot. Civ. Code § 1363.03(e).

Unless the association is willing to compromise the developer's secrecy, it would seem that the only lawful way to cast the 100 votes would be to execute 100 separate ballots and deliver them in 200 envelopes. The awkwardness of that requirement invites corner-cutting, which could undermine the validity of the votes cast or of the election as a whole.

Proxies

In some associations, a proxy may be given to allow one member to cast the vote of another member, on the proxy-giver's behalf. The use of proxies is often critical in achieving a quorum for an election.

A proxy may grant general discretion to the proxy-holder as to how to vote the ballot, or it may include specific direction on how the proxy-holder is to vote the ballot.

In evaluating a proxy, an election inspector would need to authenticate the identity and voting power of the person who gave the proxy, determine whether the proxy is general or directed, and then confirm that the ballot cast by the proxy-holder actually conforms to the authority granted by the proxy.

The staff sees no way to lawfully accomplish those tasks under the existing double-envelope procedure. If the proxy form is *outside* of the sealed ballot envelope, the election inspector could authenticate the proxy, but could not determine whether the ballot conforms with the authority given by the proxy. If the proxy is contained *inside* the sealed ballot envelope, the election inspector could check whether the ballot conforms to the proxy, but could not authenticate the proxy itself without violating the rules on ballot secrecy.

It seems inevitable that the use of proxies will result in technical violations of the statutory procedure, which could result in spoiled ballots or provide the basis for a judicial challenge of the election's validity.

Problems Applying Existing Procedure to Small Association

In addition to the general problems described above, the statutory procedure seems to be a poor fit for small associations. The staff sees two general problems:

First, the formality of the procedure seems unnecessary when conducting an election on a small scale. The clear goal of the statutory procedure is to ensure the secrecy of the ballot and the transparency and integrity of the tabulation process. In a small association, those goals could be achieved using a much simpler in-person voting procedure (as discussed below).

Second, the cost of the statutory procedure could be unduly burdensome for a small association. Suppose that the minimum fee charged by an election inspector is \$500. In an association with 500 units, the pro rata cost of \$1 per unit would be easily absorbed. But in an association with 5 units, the burden of a \$100 per unit cost would outweigh the benefit of having an independent inspector

count five ballots. (If that cost were eliminated for small associations, the savings statewide would probably be over \$10 million annually.)

It seems inevitable that some small associations will be ignorant of the law or will ignore it on the grounds that it seems unrealistically costly and cumbersome. Elections in those associations would be subject to legal challenge. All of the actions of a board elected in violation of the procedure could be challenged as invalid.

GENERAL PROPOSAL

The staff believes that the law should provide a simplified procedure for small associations that meets all of the following goals:

- (1) *Secrecy.* The procedure should not compromise the existing guarantee of secrecy of the ballot.
- (2) *Procedural transparency.* The procedure should allow members to directly observe the process, as a check against error or fraud.
- (3) *Reduced cost and complexity.* The procedure should be simpler and less expensive than the procedure provided under existing law.
- (4) *Optional.* Some associations may prefer to use the more complex procedure provided in existing law.
- (5) *Validation of common-sense practices.* Many owners in small associations may be unaware of the Davis-Stirling Act. The new procedure should be designed to conform to common-sense practices, so that an association that follows such practices will be in compliance with the law by default. That would validate many informally conducted elections that might otherwise be subject to challenge.
- (6) *Preserve existing rules on campaigning and judicial review.* Existing law provides rules for use of association funds for campaign purposes (Civ. Code § 1363.04) and judicial review of a member election (Civ. Code § 1363.09). Those provisions do not impose any procedural burden on an association and should probably continue to be applicable to a small association.

The staff invites comment from interested persons on whether those goals are appropriate and whether any other goals should be added to the list.

IN-PERSON VOTING

In its work on simplification and reorganization of CID statutory law, the Commission considered adding an optional simplified procedure for elections

conducted entirely in-person (i.e., with no mailed ballots). That procedure was largely consistent with the goals described above.

The staff believes that the general concept of in-person voting provides a good starting point for discussion of a possible approach to elections in small associations. In general, in-person voting should be workable in a small association.

Possible Language

The in-person voting concept could be adapted to the small association context with language along the following lines:

Civ. Code § 1363.08. In-person voting in small association

1363.08. (a) Notwithstanding Section 1363.03, a member election in a small association is valid, if the small association substantially complies with the following requirements:

(1) Notice of the election shall be provided to each member at least 30 days before the meeting at which the election is held. The notice shall state the time and place at which the meeting will be held. If the election is to approve an action that requires the approval of the members, the notice shall describe the proposed action. If the election is to select or remove a board member or other elected officer, the notice shall state which positions will be affected.

(2) The election shall be held at a meeting of the members at which a quorum is present, either in person or through written proxies.

(3) A candidate for elected office may be nominated prior to the election or at the meeting at which the election is held.

(4) Votes shall be cast by secret written ballot.

(5) After all of the members present have had an opportunity to vote, the ballots shall be counted openly, at the meeting at which they were cast.

(6) If members representing a majority of the voting power present at the meeting agree, a second vote may be immediately conducted to resolve a tie.

(b) A small association is not required to conduct a member election under this section.

The staff believes that this language provides a good starting point for discussion. **Public comments on the merits of this approach are invited.**

Other Benefits

In addition to providing a simpler and less expensive procedure for member elections in small associations, the proposed language would also offer the following benefits:

- It would incidentally validate existing practices in many small associations.
- It would not require a signature on the outside of an envelope, thereby avoiding the identify theft issue raised by some commenters.
- It would avoid the problems involved when a member is entitled to cast more than one vote. The member's voting power could be authenticated in person, and the member could then cast the appropriate number of ballots.
- It would avoid the problems involving the validation of proxies. A proxy could be openly evaluated at the meeting, and the proxy-holder could be given a ballot to vote on behalf of the proxy-giver. If the proxy dictates how the ballot is to be cast, the ballot could be marked in accordance with the instructions and then placed into the ballot box.
- It would allow for an instant run-off, avoiding the need to schedule a new meeting to resolve a tie.

CONCLUSION

The staff believes that a simplified election procedure for small associations would do a lot of good, without compromising any of the values that existing law is intended to preserve.

The language proposed above seems like a workable model, but is only offered as a starting point for discussion. **Interested persons are encouraged to comment on the merits of the proposed language or suggest alternative approaches.** The Commission will consider those comments at future meetings, with the goal of preparing a tentative recommendation to circulate for public review and comment.

Respectfully submitted,

Brian Hebert
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