RESOLUTION 11-04-2018 – AS AMENDED

DIGEST

Homeowners Associations: Management of Financial Accounts

Adds Civil Code sections 5590, 5591, 5592, and 5593, and amends section 5380 to add requirements for maintaining the financial accounts of common interest developments.

STATEMENT OF REASONS

The Problem: There is growing concern over the incidence in California of embezzlement of and fraudulent activity jeopardizing homeowner funds held in accounts. Millions of homeowner dollars have been lost, usually over a period of several years, resulting in criminal prosecution in federal and state courts, imprisonment and other penalties. For example, the remaining defendant faces trial in April 2018 in San Mateo Superior Court for $2.8 million allegedly stolen through sham construction projects and other expenditures. The co-defendant previously entered a plea and is currently in prison.

An estimated 12-14 million Californian homeowners entrust their funds collected by 52,000 California associations through assessments to make long-term capital expenditures to maintain and preserve commonly-owned areas such as shared roofs, building infrastructure, walkways, parking and recreational facilities. Homeowner associations have become the only affordable housing in California for many seniors, low-moderate income families and first-time buyers.

Homeowners lose twice when embezzlement occurs: they lose the dollars they contributed to the common funds through regular assessments; then they face special assessments that boards levy to restore the monies. In addition, they risk losing their homes, as Associations have the right to foreclose if the homeowner cannot afford the assessments.

The cause is primarily inadequate control over (1) operating, reserve and other accounts of homeowner associations, (2) persons with access to the accounts, and (3) recordkeeping practices of the accounts. Excessive familiarity with the third-party funds management company personnel has led to overriding internal association controls and inadequate due diligence of suspect transactions, both by banks and association boards. In addition, there is a lack of transparency over the records detailing deposits into/withdrawals from the accounts. Persons with access to the accounts frequently commingle monies from multiple associations in their portfolio.
The Center for California Homeowner Association Law, a non-profit, non-partisan organization based in Oakland, California, supports the legislative establishment of fiduciary accounts and a fiduciary duty on those entrusted to manage homeowner funds. The Center has received an increasing number of reports of mismanagement and outright theft of funds by HOA board members, property managers, contractors and others. It offers educational resources and support to homeowners, and recently partnered with the Practicing Law Institute in January 2018 to train attorneys in common interest development law.

The Solution: The proposed solution is threefold: 1) to classify accounts in California financial institutions as fiduciary accounts in a manner similar to escrow, estate trust and attorney-client accounts, 2) to establish a fiduciary duty expressly imposed on association board members, officers, managing agents and other persons who have access to the association funds, and 3) to

require association boards to identify and exercise appropriate oversight controls on the activities of such fiduciaries in managing the association accounts.

TEXT OF RESOLUTION

RESOLVED that the Conference of California Bar Associations recommends that legislation be sponsored to add Civil Code sections 5590, 5591, 5592, and 5593 and amend Civil Code section 5380 to read as follows:

§ 5590

(a) The Legislature intends that homeowner association moneys on deposit in California financial institutions shall be treated under California law as fiduciary accounts in the same manner as escrow accounts, irrevocable trust accounts, attorney trust accounts for clients, and other fiduciary accounts.

(b) The Legislature further intends that any person or organizational entity that establishes, has access to, withdraws or deposits money from association fiduciary accounts is a fiduciary, and shall exercise the fiduciary duties in managing the association bank accounts, funds and other assets, or in managing the financial affairs of such developments.

§ 5591

Fiduciary Accounts. All reserve accounts and operating accounts of the association shall be identified or named as fiduciary accounts. Reserve and operating accounts of one association shall be established and maintained separately from the accounts of other associations, except as provided under subdivision (d) or section 5380.

§ 5592

Fiduciary Status. Each of the following persons is a fiduciary within the meaning of Title 1, Part 3 of the Corporations Code governing nonprofit mutual benefit corporations:

(a) A director or officer of a common interest development, as defined in Section 4158 (association), whether incorporated or unincorporated,

(b) A signatory to a bank account in the name or for the benefit of the association,

(c) A person authorized to utilize funds held in such bank account,

(d) A managing agent as defined in Section 5380, and

(e) A person who otherwise gains access to or receives the funds of the association in any such bank account.

§ 5593: Adequate Controls.

The association board shall implement proper controls necessary to protect the association monetary and other asset deposits which are owned by its homeowner members who are the beneficiaries of the funds in the association accounts. Proper controls include but are not limited to the following:

(a) An adequately defined scope of authority given to any person with access to the accounts, including managing agents,

(b) Periodic review of account documentation,

(c) Periodic review of the financial institution's account documents for accurate identification of and fiduciary accounts,

(d) Delivery of the financial institution's account statements directly to the association, and copies to the account managers,

(e) Confirmation of annual audits by the financial institution,

(f) Dual signatures for high risk transactions,

(g) Adequately and reasonably extended time for notification of errors, omissions or malfeasance, and statement review for all accounts;

(h) Annual association reserve account analysis, not only of the status of required repairs for each reserve line, but also an accounting of funds held for that purpose,

(i) Managing agent bond, in an amount equal to the actual funds deposited in all accounts managed,

(j) Other monitoring of the practices of the financial institution and managing agent, and

(k) More stringent controls as the association board deems appropriate.

§ 5594: Remedies.

(a) A member of an association may bring a civil action for declaratory or equitable relief for violations of this Article by the association, including, but not limited to, injunctive relief, restitution, or a combination thereof.

(b) A member who prevails in a civil action to enforce the member's rights pursuant to this Article shall be entitled to reasonable attorney's fees and court costs, and the court may impose a civil penalty of up to five hundred dollars ($500) for each violation, except that each identical violation shall be subject to only one penalty if the violation affects each member of the association equally. A prevailing association shall not recover any costs, unless the court finds the action to be frivolous, unreasonable, or without foundation.

§ 5380

(a) A managing agent of a common interest development who accepts or receives funds belonging to the association shall deposit those funds that are not placed into an escrow account with a bank, savings association, or credit union or into an account under the control of the association, into a trust fund account maintained by the managing agent in a bank, savings association, or credit union in this state. All funds deposited by the managing agent in the trust fund account shall be kept in this state in a financial institution, as defined in Section 31041 of the Financial Code, which is insured by the federal government, and shall be maintained there until disbursed in accordance with written instructions from the association entitled to the funds.

(b) At the written request of the board, the funds the managing agent accepts or receives on behalf of the association shall be deposited into an interest-bearing account in a bank, savings association, or credit union in this state, provided all of the following requirements are met:

(1) The account is in the name of ~~the managing agent as trustee for the association or in the name of~~ the association.

(2) All of the funds in the account are covered by insurance provided by an agency of the federal government.

(3) The funds in the account are kept separate, distinct, and apart from the funds belonging to the managing agent or to any other person for whom the managing agent holds funds in trust except that the funds of various associations may be commingled as permitted pursuant to subdivision (d).

(4) The managing agent discloses to the board the nature of the account, how interest will be calculated and paid, whether service charges will be paid to the depository and by whom, and

any notice requirements or penalties for withdrawal of funds from the account.

(5) No interest earned on funds in the account shall inure directly or indirectly to the benefit of the managing agent or the managing agent's employees.

(c) The managing agent shall maintain a separate record of the receipt and disposition of all funds described in this section, including any interest earned on the funds.

(d) The managing agent shall not commingle the funds of the association with the managing agent's own money or with the money of others that the managing agent receives or accepts, unless all of the following requirements are met:

(1) The managing agent commingled the funds of various associations on or before February 26, 1990 and has obtained a written agreement with the board of each association that the managing agent will maintain a fidelity and surety bond in an amount that provides adequate protection to the associations as agreed upon by the managing agent and the board of each association.

(2) The managing agent discloses in the written agreement whether the managing agent is deriving benefits from the commingled account or the bank, credit union, or savings institution where the moneys will be on deposit.

(3) The written agreement provided pursuant to this subdivision includes, but is not limited to, the name and address of the bonding companies, the amount of the bonds, and the expiration dates of the bonds.

(4) If there are any changes in the bond coverage or the companies providing the coverage, the managing agent discloses that fact to the board of each affected association as soon as practical, but in no event more than 10 days after the change.

(5) The bonds assure the protection of the association and provide the association at least 10 days' notice prior to cancellation.

(6) Completed payments on the behalf of the association are deposited within 24 hours or the next business day and do not remain commingled for more than 10 calendar days.

(e) The prevailing party in an action to enforce this section shall be entitled to recover reasonable legal fees and court costs.

(f) As used in this section, "completed payment" means funds received that clearly identify the account to which the funds are to be credited.

(Proposed new language underlined; language to be deleted stricken)

PROPONENT: Bar Association of San Francisco

IMPACT STATEMENT
This resolution does not affect any other law, statute or rule other than those expressly identified.

CURRENT OR PRIOR RELATED LEGISLATION
None known.

AUTHOR AND/OR PERMANENT CONTACT: Melissa M. Allain, P.O. Box 2130, Castro Valley, CA 94546-0130, phone: 510.861.5906, allain.melissa@gmail.com.

RESPONSIBLE FLOOR DELEGATE: Melissa Allain

COUNTERARGUMENTS AND STATE BAR SECTION COMMENTS

SAN MATEO COUNTY BAR ASSOCIATION

Resolution 11-04-2018 purports to create a set of new "proper controls" for Association finances. However, several of the controls are already required by the Davis-Stirling Act. Also, the resolution would create a conflict with the Davis-Stirling Act with respect to the "comingling" funds between two or more associations. Additionally, the resolution's proposal to require a "managing agent bond" is already before the Legislature in AB 2912.

This Resolution would add several types of "proper controls." (Lines 28-48) However, several of the proposed controls are already required by the Davis-Stirling Act. For example:

1. Proposed section 5593(b) (line 34) would require "periodic review of account documentation." However, Civil Code section 5500 already requires specified review periods for five different types of Association financial reports.

2. Proposed section 5593(f) (line 40) would require "Dual signatures for high risk transactions." However, Civil Code section 5510 already requires dual signatures, by board members, for all "reserve account" transactions.

3. Proposed section 5593(h) (lines 43-44) would require:

Annual association reserve account analysis, not only of the status of required repairs for each reserve line, but also an accounting of funds held for that purpose.

However, Civil Code section 5300(b)(2)-(6) already requires annual reporting for reserve accounts, reserve funding plans, and plans to repair or replace "major components." (*See also* section 5305, which requires an annual CPA audit for all associations with an annual gross income that exceeds $75,000.)

Additionally, this resolution would prohibit comingling of one association's funds with another association's funds. (Lines 13-14) However, Civil Code section 5380(d) specifically allows such comingling if six specific requirements are met. As a result, this resolution would create a conflict with Civil Code section 5380(d).

Further, this Resolution proposes a new "proper control" for all Associations to provide a "managing agent bond." For example, the resolution would require a "Managing agent bond, in an amount equal to the actual funds deposited in all accounts managed." (Lines 45-46) However, AB 2912 (Irwin, 2018) proposes, in Section 6, to add section 5806 to the Civil Code, to read:

Unless the governing documents require greater coverage amounts, the *association shall maintain fidelity bond coverage* in an amount that is equal to or more than the combined amount of the reserves of the association and total assessments for three months. Coverage shall include dishonest acts by the managing agent or management company and for computer fraud and funds transfer fraud. (Italics added)

Because the issue of requiring fidelity bond coverage is already before the Legislature in AB 2912, the proposed requirement for a "managing agent bond" in Resolution 11-04-2018 is not necessary.

Finally, because several parts of Resolution 11-04-2018 would be redundant to several sections within the Davis-Stirling Act, the resolution would also conflict with the Davis –Stirling Act with respect to comingling of funds between two or more associations, and because the resolution's proposal to require a "managing agent bond" is already before the Legislature in AB 2912, Resolution 11-04-2018 should be disapproved.