

Second Supplement to Memorandum 2006-33

**Statutory Clarification and Simplification of CID Law: Discussion of Issues**

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We have received two letters commenting on Memorandum 2006-33 and its First Supplement. They are attached in the Exhibit as follows:

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|  | <i>Exhibit p.</i> |
| • Wilbur Haines (8/15/06) .....  | 1                 |
| • Nancy Salzman, California Association of<br>Community Managers (8/16/06) ..... | 2                 |

The letters raise a number of issues relating to reserve funding. Those issues are discussed below. All references in this memorandum are to the Civil Code.

DEFINITION OF "MAJOR COMPONENT"

Mr. Haines correctly points out that the reserve funding study and plan requirements all hinge on a term that is not defined: "major component." Only major components must be included in the reserve funding study and plan. The lack of a bright line rule on what is meant by "component" and when a component is "major" introduces a significant amount of ambiguity and subjectivity into the reserve funding process. It would be helpful to have clear guidance with respect to this critical term. See Exhibit p. 1.

**The staff agrees with Mr. Haines that the proposed law should include a note asking for input on how "major component" might be usefully defined.**

RESERVE STUDY

Ms. Salzman is appreciative of the work that we're doing to reorganize the reserve study provisions, but raises a number of technical issues relating to proposed Section 5555:

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Any California Law Revision Commission document referred to in this memorandum can be obtained from the Commission. Recent materials can be downloaded from the Commission's website ([www.clrc.ca.gov](http://www.clrc.ca.gov)). Other materials can be obtained by contacting the Commission's staff, through the website or otherwise.

## **“Desired Balance”**

Proposed Section 5555 uses the term “desired balance” in subdivision (b)(6), along with a statement of how the desired balance is to be calculated. It then uses the term in subdivision (c), without a specific reference to the method by which the desired balance is to be calculated.

Ms. Salzman suggests that language be added to make clear that the term has the same meaning in subdivision (c) that it has in subdivision (b). See Exhibit p. 2.

**The staff has no objection and recommends that the definitional language in subdivision (b)(6) be generalized:**

(6) The desired balance for the component. ~~This~~ For the purposes of this section, the “desired balance” is calculated by one of the two following methods: (i) by multiplying the average annual repair and replacement cost and the number of years that the component has been in service, or (ii) by a generally accepted alternative method that is described in the study.

## **Thirty Year Projection**

Ms. Salzman notes that many reserve study analysts provide their clients with a thirty year projection, rather than the five years that would be required under AB 2100 (Laird). Some analysts also provide more types of information than is called for in the bill. Ms. Salzman suggests that those practices be codified. See Exhibit p. 2.

Proposed Section 5555 should not preclude the practices described by Ms. Salzman. Section 5555(d) specifically provides that the statutory form can be supplemented or modified, so long as all of the required information is provided. That should give an analyst sufficient flexibility to make a 30 year projection of the type described. **However, it might make sense to revise Section 5555(d) to expressly state that the five year projection can be extended to a longer period.**

A longer and more detailed projection would probably be preferable in many cases, but it is not clear that it should be required for all associations. Most associations are small (52% have 25 units or fewer). See Levy, 2005 Cal. Community Ass’n Stat. 1 (2005). A small association may have less need for a detailed reserve study and fewer resources with which to prepare one. Any proposal to make the study more complex must be considered from that perspective.

The staff is also concerned that a significant change to the reserve study requirements would disturb policy choices that have just been made in connection with AB 2100.

### **“Current” Regular Assessment**

Ms. Salzman suggests that the reference to the “current” regular assessment in proposed Section 5555(c)(4) may be ambiguous. See Exhibit p. 2.

Is the “current” assessment the amount as of the date the report is prepared, or as of the end of the fiscal year for which the report is prepared. The latter was the staff’s intention, consistent with the other provisions that address the scope of the study. See proposed Section 5555(b), (c)(1).

**The staff has no objection to adding the following clarification to proposed Section 5555(c)(4):**

(4) ~~The current~~ At the end of the fiscal year for which this study is prepared, the regular assessment per unit is \$\_\_\_\_\_ per \_\_\_\_\_.

### **Loan Information**

Proposed Section 5555(c)(7) would require that information about outstanding loans be provided as part of the reserve funding study.

Ms. Salzman is concerned that the loan information could be confusing in this context. See Exhibit p. 2.

While AB 2100 requires that the loan information be included in the annual budget report, it is not required as part of the reserve funding study summary.

**The staff has no objection to moving the loan information disclosure from the reserve study summary to the annual budget report.** That would be more consistent with AB 2100. This could be implemented by deleting proposed Section 5555(c)(7) and adding a paragraph (4) to proposed Section 4800(b):

(b) The annual budget report shall include all of the following information:

(4) If the association has an outstanding loan with an original term of more than one year, the lender, amount owed, interest rate, annual payment, and retirement date of the loan.

### **“Capital Asset”**

Proposed Section 5555(f) would continue an existing provision that authorizes a board to treat a component with a remaining useful life of more

than 30 years as a “capital asset” in its reserve funding study. Ms. Salzman asks what is meant by “capital asset” in that context.

The staff continued the provision in order to avoid an unintended substantive change, but is also uncertain as to its meaning. A staff note following Section 5555 asks for comment on the issue.

Respectfully submitted,

Brian Hebert  
Assistant Executive Secretary

Exhibit

**EMAIL FROM WILBUR HAINES (8/15/06)**

Brian:

One big remaining weakness in the reserves law is its failure to define “major component,” a term of art which drives everything else in the law.

I failed to notice this problem before the die was cast on AB2100. I am hopeful that this problem can be addressed in the commission’s work.

An example: Our association has something like 20-30 MILES of coaxial TV cable buried under the streets, with an estimated replacement cost of several million dollars. For many, many years our Boards failed to carry that several-million-dollar and rapidly aging asset as a “major component” and reserve for it, saying they’d just dig up and replace failing sections of it someday, as needed, as a current-year expense. FINALLY several years ago a Board got smart and realized that NOT carrying that huge asset as a reserve item was a mistake, and they started pounding substantial money into the reserves for it. But we had to play some serious catch-up. Other CIDs may not have the good luck to discover and correct such omissions in time to avoid a financial crisis.

So, our story has a reasonably happy ending. But its moral is that a tight-fisted Board which is hypersensitive to dues levels, or a developer who seeks to artificially suppress the reserves component of dues to enhance marketability during buildout, has a free hand under existing law to quietly determine without public discussion or disclosure what is, and what isn’t, a “major component” for which they are obligated to reserve. In some cases a penny-wise, pound-foolish Board could put their successors in a very bad bind by failing to reserve for something that will fail 10-25 years later and cause a huge financial crisis for the HOA. AB 2100’s wise requirement that Boards must explicitly disclose and justify any choice NOT to replace or repair (and thus not reserve for) any “major component” is undermined by the ability to simply not regard some expensive asset as a “major component.”

Sec. 1365.2.5 says “‘Major component’ has the meaning used in Section 1365.5.”

That sounds promising, but then when you read 1365.5 you find there’s no real definition there...just a circuitous reference to “major components which the association is obligated to repair, replace, restore, or maintain....”

That existing tautological non-definition of “major component” undermines the purpose and potential effectiveness of the entire reserves disclosure and security regimen. I suggest that you solicit input from stakeholders and seek to arrive at a non-controversial definition, scalable perhaps to the percentile relationship between replacement cost and annual budget, which could be employed in the revised Act.

Thank you again for the Commission’s fine work.

Wilbur Haines

**EMAIL FROM NANCY SALZMAN, ESQ., CALIFORNIA  
ASSOCIATION OF COMMUNITY MANAGERS (8/16/06)**

Brian—

Roy Helsing, Marybeth Green (chair of the CACM legislative committee) and I plan to attend the Aug. 18 CLRC meeting. Do you know about what time the CID pieces will be discussed?

I had hoped to get you my comments earlier; however, I wanted the benefit of a response from some of the members of CACM's reserve specialist roundtable. We applaud your decision to use a first step to combine scattered parts into single sections; however I do have some concerns as to wording and sections that do not appear to be part of the proposal. My comments are below. Please do not hesitate to contact me with your thoughts, concerns, questions, etc. The references below are to the sections noted in the staff draft dated August 8, 2006.

1. Section 5555(c): The use of the term "desired balance" may be subjective without a definition. What is "desired balance", who decides what this is, etc. We suggest a reference to the formula currently in 1365.2.5(b)(4).

2. Section 5555(c)(3): Many reserve specialists are ready and willing or already providing tables that extend out the full 30 years. The tables suggested would have the following columns: starting reserve balance, fully funded balance, percent funded, annual reserve contributions, special assessments or loans, interest income, reserve expenses, and average amount per unit short. These tables easily fit on one page and can be blocked so that they are easily read in five year periods. The concern with providing information over only five years is that the dips and negative years will not be noted, thereby leaving surprises. It is my understanding that the desire to eliminate surprises was a major reason behind AB 2100. I'll be happy to provide a sample.

3. Section 5555(c)(4): There is some confusion in the reserve industry as to which year the term "current" applies to. Is this the year within which the study is prepared or is it really the fiscal year that is about to begin. (5) is assumed to be the fiscal year about to begin.

4. Section 5555(c)(7): Providing information on loans may confuse homeowners. These numbers may already be incorporated in the calculation required for the determination of the assessments.

5. Section 5555(c)(9): The table referred to in 2 above provides an easily understood visual response to this request.

6. Section 5555(f): We are concerned about the definition of "capital asset." Does this include "an asset that has an expected life of more than one year and that is not bought and sold in the usual course of business. Buildings and machinery are examples of capital assets" (dictionary.com) which is a layperson definition? If so, the required list of components may be so broad that the reserve specialist will need a special crystal ball. Is this the time and place to use the term "major components" and provide a definition that would include the large components such as roofs?

Thank you for providing the opportunity to respond to the CLRC memorandum. I look forward to meeting you on Friday.

Nancy

Nancy Salzman, Esq.  
Director of Education  
California Association of Community Managers, Inc.  
23461 South Pointe Drive, Ste. 200  
Laguna Hills, CA 92653  
Phone: 949.916.2226, ext. 20  
Fax: 949.916.5557  
nancy@cacm.org