

First Supplement to Memorandum 2007-55

**Statutory Clarification and Simplification of CID Law
(Comments on Tentative Recommendation)**

The Commission continues to receive comments on the tentative recommendation on *Statutory Clarification and Simplification of CID Law* (June 2007). The comments are attached in the Exhibit as follows:

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| | <i>Exhibit p.</i> |
| • Mel Klein, Santa Monica (11/27/07) | 1 |
| • Donald W. Haney, Haney Inc. (12/2/07) | 3 |

Mr. Klein’s letter raises objections to existing law, rather than any change introduced by the proposed law. **His comments have been noted for possible future study.**

Mr. Haney argues against a change proposed in Memorandum 2007-55, relating to the commingling of funds by a managing agent. His comments are discussed below.

This memorandum also includes discussion of two other matters relating to the current study.

COMMINGLING OF FUNDS

Proposed Section 4905 provides rules for the management of an association’s funds by a managing agent. Proposed Section 4905(g)-(h) would continue existing law, prohibiting commingling of association funds, but providing a “grandparent” clause for a managing agent who commingled funds before February 26, 1990:

(g) The managing agent shall not commingle the funds of an association with the funds of any other person, except as provided in subdivision (h).

(h) A managing agent who commingled the funds of two or more associations on or before February 26, 1990, may continue to do so if all of the following requirements are met:

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). Other materials can be obtained by contacting the Commission’s staff, through the website or otherwise.

(1) The board of each affected association has given its written assent to the commingling.

(2) The managing agent maintains a fidelity and surety bond in an amount that is adequate to protect each association and that provides each association at least 10 days notice before cancellation. The managing agent shall provide each affected board with the name and address of the bonding company, the amount of the bond, and the expiration date of the bond. If there are any changes in the bond coverage or the company that provides the coverage, the managing agent shall disclose that fact to the board of each affected association as soon as practical, but in no event more than 10 days after the change.

(3) The managing agent provides a written statement to each affected board describing any benefit received by the managing agent from the commingled account or the financial institution where the funds will be on deposit.

(4) A completed payment on behalf of an association is deposited within 24 hours or the next business day and does not remain commingled for more than 10 calendar days. As used in this subdivision, "completed payment" means funds received that clearly identify the account to which the funds are to be credited.

A note following proposed Section 4905 asked whether there was any continued need for the provision.

The feedback all favored repealing subdivision (h) as obsolete and unnecessary. The staff recommended that the provision be deleted. See discussion in Memorandum 2007-55 at page 35.

Donald Haney writes in favor of preserving subdivision (h) or, in the alternative, deleting Section 4905 entirely and replacing it with a bonding requirement. He explains that commingling, within the constraints of subdivision (h), is a beneficial and harmless practice that is necessary "to facilitate certain check clearing and money movement activities." See Exhibit pp. 3-4.

The staff is persuaded by Mr. Haney's letter that deletion of subdivision (h) could cause problems for some managing agents. **For that reason, the staff now recommends that subdivision (h) be retained.** It would be better to preserve an obsolete provision, which causes no harm, than to delete an *apparently* obsolete provision that in fact serves a continuing purpose. **Mr. Haney's suggestion for improvement to existing law (by deleting the section entirely and replacing it with a bond requirement) has been noted for possible future study.**

Attorney Fee Shifting

There are two provisions of existing law that provide a specific judicial remedy to enforce a provision of the Davis-Stirling Act. See Civ. Code §§ 1363.09 (enforcement of open meeting requirements and election rules), 1365.2 (enforcement of record inspection requirements).

Each of the existing provisions allows for an award of attorney's fees to an association that prevails in an enforcement proceeding, but only if the court finds that the enforcement action is "frivolous, unreasonable, or without foundation." The staff was unsure of the meaning of that standard, particularly the language regarding an action that is "without foundation." Initial research did not turn up any cases that explained the meaning of the standard.

A note was added to the tentative recommendation (after proposed Civil Code Sections 4555, 4685, and 4735) asking whether the meaning of the standard was sufficiently clear and whether it should perhaps be replaced with more familiar language describing frivolous claims.

All of the feedback on the issue favored changing the standard to more familiar language on frivolous claims. As a result, the staff recommended that the standard be revised. See discussion in First Supplement to Memorandum 2007-47 at page 39.

However, the staff has since had a chance to do additional research. As it turns out, the standard at issue is used in a handful of other statutes.

Most notably, Elections Code Section 14030 uses the language to similar effect. Under that section, a prevailing plaintiff enforcing specified provisions of the California Voting Rights Act can be awarded attorney's fees and costs. However: "Prevailing defendant parties shall not recover any costs, unless the court finds the action to be frivolous, unreasonable, or without foundation." See Elec. Code § 14030.

It therefore seems likely that the Legislature was intentionally paralleling that language, in order to provide the same standard in an election contest, whether a public election or a CID election. That intention should not be disrupted, without some indication that the standard is causing practical problems. **The staff therefore recommends that the standard be preserved unchanged in the proposed law.**

CID ENFORCEMENT AGENCY

In Memorandum 2007-55, at page 28, the staff notes that there is a pending bill that would create a CID enforcement agency. The memorandum was intended to provide a citation to the bill, but an editorial oversight left a placeholder in the text (“xxxbill”) rather than the citation that was meant to replace it. The intended citation is AB 567 (Saldaña). The staff regrets the mix-up.

SCOPE OF EXECUTIVE SESSION

The existing and proposed law allow a board to meet in closed executive session to consider “personnel matters.” See Civ. Code § 1363.05(b); proposed Civ. Code § 4540(a). The term “personnel matters” is not defined.

The staff received a telephone call inquiring whether the term includes a meeting to discuss disciplining a board member for misconduct as a board member. The question had arisen in a large association and the community was divided on the answer. Some felt it was limited to matters involving paid employees. Others felt it included volunteer staff (including directors). One might also ask whether it applies to contractors.

The staff has noted this issue for possible future study.

Respectfully submitted,

Brian Hebert
Executive Secretary

EMAIL FROM MEL KLEIN
(11/27/2007)

To the CLRC -

I have just now, for the first time, read the several parts of your Tentative Recommendation that I wanted to get to first. (I hope I've understood what I've read; I rushed through my reading and did not review.) Please consider the following comments, respectfully submitted:

1. The code for member elections is still fatally deficient. As you have it, selection of an inspector of elections shall be as provided for in the governing documents. In many cases, and virtually all cases involving associations that are Corporate in structure, the governing documents give the Board authority to select the inspector, possibly because that is how the inspector is chosen under the Corporation codes (I believe).

If a Board lacks integrity, and that Board has authority to select the inspector, how can an association ever be assured of a fair member election? The members cannot even attempt to amend the bylaws to change the way an inspector is chosen, because that election can also be perverted in the same way.

There must provisions for members to go to (Small Claims) Court to demand an inspector chosen not by the Board, but by some other means: eg. by one of the arbitration organizations staffed by retired judges, or the right to demand that the League of Women Voters conduct the election. This right must be available without demonstrating cause, though perhaps a requirement that the demand must be supported in a petition by 5% or 10% of members would be in order. If additional costs are entailed, the code should figure a way to determine who should pay these additional costs.

The fundamental requirement - the bedrock - of every democratic society is fair elections. If the code fails to assure members of fair elections, you have absolutely nothing. The code, as it now stands, does not assure members of a fair election. A corrupt Board can still arrange for a corrupt election. That is terribly, terribly, dismaying.

2. The proposed code orders that ballots shall remain in the hands of the inspector for one year, after which time they shall be returned to the Association. Why must they be returned to the Association? What purpose does that serve? Why not leave them with the inspector for as long as they have to be kept?

Please allow me point out, in this connection and as a general point of interest, that in many CIDs different interests have different voting power. That being the case, there is no guarantee of confidentiality in the ballot provisions of the code. It is possible to look through the ballots long after the election, checking the voting power of each ballot to determine whose ballot it is, and you can come up with a fairly good idea of how each member voted.

The ballots should never be returned to the association. (Of course, if the inspector can be selected by an errant Board, this confidentiality measure is of no use whatsoever.)

3. The ADR rules still have a long-standing ambiguity - which party has the right to choose the type of dispute resolution that is to be used? The problem is, a party acting in bad faith can always insist on mediation, and mediation is entirely meaningless if one of the parties has no interest in arriving at a settlement.

Since the ADR requirement is essentially a requirement that falls on the party intending to initiate a lawsuit, the right to choose the type of ADR should be a right of the party receiving the request for ADR, or, perhaps, the receiving party should have the right to exclude one of the 3 types, and the requesting party then choose between the remaining 2 choices. (mediation, binding arbitration, non-binding arbitration.)

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I wish I had more time to devote to reviewing the recommendations of the CLRC staff, but the corruption in my HOA is devouring all my time. I am now the subject of 3 lawsuits by the association, with the singular objective of silencing me. Another member actively campaigning for a fair and honest election and removal of the current Board and Management is now the subject of two lawsuits by the association. We have not had a Board meeting in over 18 months. The association refuses to allow access to Corporate records. The association denies members nomination without any stated cause. The CEO started a RE business, now conducting business in the Association, and with the Board controlling whether or not a buyer is approved, the CEO has a virtual monopoly on RE transactions here. The CEO and one member of the Board are now subject of a (derivative) lawsuit alleging embezzlement of \$2 million, and that amount is just what is known. The Board is supporting these alleged embezzlers in Court. The last time we had anything that could even be called an election, in 2004, a retired judge serving as inspector, the judge went off with all the voting materials following the election, in the company of two association attorneys. He held the ballots for 9 days, and came back with results disqualifying 24% of the ballots (proxies) opposed to the sitting Board, while never even telling any of those whose votes had been disqualified the reason why. We now have a lawsuit in the Superior Court asking for some kind of Court supervision of the 2007-2008 election. The association Board is insisting that the same judge that served in 2004 be the inspector once again. The cost of the lawsuit, to those of us demanding a fair election, is anticipated to be \$150,000 or more. The association will have a like bill. Now why would the association Board choose to spend hundreds of thousands of dollars in defending a lawsuit, just to see to it that the LWV, or some other retired judge acceptable to all sides, is not the inspector? Can you see any reason other than an intention to commit election fraud? If we could simply go to Small Claims Court and demand that the LWV conduct the election, who would suffer from it? Whose legitimate rights would be violated?

One of the sorriest aspects of all this - the fact that the State of California is essentially complicit in permitting this corruption - is that it completely devastates one's trust in government to do the right thing, and that is a very, very, serious loss.

November 27, 2007

Mel Klein
Santa Monica

Note: As I wrote earlier, I haven't really spent all that much time reading the TR, but the parts I read (the introduction mainly) are wonderfully elegant and reasoned.

Memorandum

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TO: Brian Hebert, Executive Secretary, CLRC

From: Donald W. Haney, CPA

COPY: CAI-CLAC and other interested parties

Date: 12/2/2007

SUBJECT: PROPOSED SECTION 4905-TRUST FUND ACCOUNT

Proposed deletion of 4905 (h)

On page 35 of Memorandum 2007-55 in response to four comments (Cahn, a HOA member; Morrison, a community manager; Milton, an attorney for the California Association of Realtors (CAR); and Sproul, an attorney) the commission is considering deleting paragraph (h) of **§4905**. The issue is the commingling of association funds for a short period under an extremely controlled environment to facilitate certain check clearing and money movement activities. The respondents suggest that paragraph (h) is obsolete and should be deleted. As a CPA with over 45 years as a working professional, as a former CFO of a national bank, and with 30 years of providing accounting services to HOA's, I respectfully disagree with their recommendation. As more fully discussed below I suggest that either paragraph (h) remain or the entire **§4905** be deleted and replaced in the insurance section, **Article 4**, with a mandatory fidelity bond provision which to the best of my knowledge does not exist in any of the CID body of law.

Rational for deleting the entire §4905

As I have indicated in the past, the California legislature is ill equipped to establish accounting standards or business process rules. Their legitimate goal and role on this matter is to minimize associations' risk of monetary loss of funds due to defalcation and fraud (stealing of money) by its directors (the most frequent event), its manager(s) or others.

This issue arose in the '80s with a high profile case of a management company that absconded with Association funds over a long period of time using a commingling technique that housed multiple association funds for long periods of time in the same account for bookkeeping purposes. As usual there was a knee jerk legislative reaction to this event and, based upon the notion that the commingling technique was the problem, the legislature (as sponsored by CAR) produced **§1363.2** of the Davis-Sterling Act (the Act).

The commingling technique was not the problem. This technique has a long standing tradition and credibility in banking, the law, and real estate brokers managing real property. It is not illegal, immoral or fattening – it is a legitimate routine accounting process. The lawyers have their client trust account and the real estate brokers have their property management account – both large and complex commingled accounts. The entire banking industry is a commingling process. There have been abuses of this technique by attorneys, real estate brokers and banks. However, the California legislature has not eliminated this business process for those professions and I doubt that it could if it wanted to.

There are a number of ways for fraud and defalcation to occur. In this case the clients failed to perform even rudimentary oversight and control processes over the manager's activities and failed to secure fidelity bond insurance that named the manager as an additional insured – a clear breach of fiduciary duty by the Association directors, their legal advisors, and their insurance agents.

Proposed Fidelity Bond Insurance Requirement

Insert new §5695 (or some other number between §5680 and §5699)

§5695. Fidelity Bond Required

5695. (a) An association shall acquire and maintain a fidelity bond in an amount, terms, and conditions as reasonably determined by its board of directors in consultation with its insurance agent of record.
- (b) The bond shall also include any “Managing agent” as defined at §4155 as an additional named insured if the Managing agent has any care, custody and control over association assets.

Rational for Required Fidelity Bond

1. It is consistent with the legislative intent to minimize association’s loss risk due to defalcation and fraud;
2. It is simple;
3. It is affordable;
4. It sets an appropriate fiduciary standard;
5. It establishes an “ascertainable standard of care”
6. It scales well for all sizes and classes of associations;
7. It responds well to inflationary effects and to ever changing technology initiatives;
8. The insurance company, an independent professional entity, must consider the association’s and the managing agent’s business processes as part of establishing its terms and conditions. Therefore, market forces will flush out “best practices” and providers over time; and
9. Failure to comply exposes the directors to personal liability.

Full Disclosure

My firm, Haney Accountants, Inc., has been providing accounting services to HOAs for the last thirty years using a client deposit trust clearing account.

Our clients’ books have been audited and review by a number of different CPAs over the years. There has never been a problem with this process. It has been fully disclosed to client prospects prior to their selecting our service. We have all the appropriate bonds in place.