Study H-855 October 11, 2010

First Supplement to Memorandum 2010-47

Common Interest Development: Statutory Clarification and Simplification of CID Law (Comments on Definition Provisions)

We have received another letter from Kazuko K. Artus on the issues discussed in Memorandum 2010-47. The letter is attached as an Exhibit.

The letter also comments on issues discussed in Memorandum 2010-29 (which was considered at the August 2010 meeting) and Memorandum 2010-48. Her comments on Memorandum 2010-29 will be discussed in this supplement. Her comments on Memorandum 2010-48 will be discussed in a supplement to that memorandum.

Except as otherwise indicated, all statutory references in this memorandum are to the Civil Code.

COMMENT ON PRIOR MEMORANDUM

Ms. Artus urges the Commission to reconsider a decision that was made at the August 2010 meeting. The Commission had approved a revision of proposed Section 4035 to permit personal delivery of notices to an association, provided that the association has assented to the use of personal delivery. See Minutes (Aug. 2010), pp. 6-7. Ms. Artus believes that association assent should not be required. See Exhibit pp. 1-2.

The staff is not inclined to revisit prior decisions that were made after a discussion of the merits. However, if any Commissioner wishes to reopen the issue after reviewing the arguments in Ms. Artus' letter, that can be done at the October meeting.

DEFINITION OF "BOARD MEETING"

Proposed Section 4090 would define "board meeting" as follows:

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.

The Commission welcomes written comments at any time during its study process. Any comments received will be a part of the public record and may be considered at a public meeting.

> 4090. "Board meeting" includes any congregation at the same time and place, of a sufficient number of directors to establish a quorum of the board, to hear, discuss, or deliberate upon any item of business scheduled to be heard by the board, except those matters that may be discussed in executive session.

Ms. Artus expands on her comments about that provision, as discussed below.

Meaning of "Scheduled to be Heard by the Board"

Continuing existing law, the proposed definition of "board meeting" means a gathering of a specified number of directors to "hear, discuss, or deliberate upon any item of business scheduled to be heard by the board…." See Section 1363.05(j).

Ms. Artus believes that the meaning of "scheduled to be heard by the board" is unclear. She suggests that the provision be revised to instead refer to an item of business noted on the agenda that is provided prior to a board meeting, as part of the statutory notice required by proposed Section 4920. See Exhibit pp. 2-3.

That would be more precise than the current language, but it would seem to achieve that precision by narrowing the scope of the open meeting requirement. The existing language simply requires that a matter be "scheduled to be heard" in order to be covered by the open meeting requirements. That language is not expressly restricted to matters scheduled for the *next* meeting. Although it may often be the case that boards only schedule their business one meeting at a time, the law does not require that they do so.

Suppose that a board announces at its July monthly meeting that it will consider a controversial topic at the October meeting. Under the existing language, there is a strong argument that the board has scheduled the matter for consideration and therefore cannot discuss the topic outside of an open meeting during the entire period between the July and October meetings. Under the approach recommended by Ms. Artus, director discussion of that topic would not be a "board meeting" (and therefore would not be subject to open meeting requirements) until delivery of the formal notice for the October meeting (which could be as late as four days before that meeting). During the entire months of August and September, the open meeting requirements would not apply to that topic.

The staff sees no good policy reason for narrowing the scope of the open meeting requirement in that way and recommends against doing so. The

existing "scheduled to be heard" language may not provide a bright line test, but it does put boards on notice not to discuss pending business outside of an open board meeting. It is possible that the language could be improved, but care would need to be taken not to make any inadvertent change in its substantive meaning. **For that reason, the staff recommends preserving the existing language at this time.**

Ms. Artus also renews her suggestion that the "scheduled to be heard" language is unnecessary and should be deleted. See Exhibit p. 3.

The staff does not agree that the language is unnecessary. It is a substantive element of the definition of "board meeting," which is pivotal in prescribing the scope of the open meeting requirements. Deletion of the language would substantively alter the scope of the open meeting requirements. **That substantive change would be too controversial for inclusion in the proposed law.** See Memorandum 2010-47, p. 3.

Finally, Ms. Artus informally pointed out a typographical error on page 3 of Memorandum 2010-47. A reference there to Memorandum 2007-17 was erroneous. It should have referred to Memorandum 2007-47. The staff appreciates her assistance in pointing this out.

Exclusion of Executive Session

Both existing law and the proposed law would exclude from the definition of "board meeting" any discussion of "matters that may be discussed in executive session." See Section 1363.05(j). Ms. Artus raises a technical concern about the absolute nature of that language.

She is concerned that the exclusion of executive session topics from the definition of "board meeting" might mean that boards may *never* act on those topics, since they can only act at board meetings. See Exhibit pp. 3-4.

That strikes the staff as a strained construction. The definition of "board meeting" used in the Davis-Stirling Act is only relevant in defining the scope of the Davis-Stirling Act provisions regulating board meetings. See proposed Sections 4900-4955 (open meeting, notice, and minutes requirements). The term is not used in the Davis-Stirling Act to define the board's general authority to act. That authority must be found elsewhere. See, e.g., Corp. Code § 7211(a)(8) & (b) (which is not affected by the Davis-Stirling Act's definitions).

In short, the staff does not believe that the exclusion of executive session topics from the Davis-Stirling Act's definition of "board meeting" has any effect on the board's authority to act on such topics.

The intended meaning of the provision seems clear: open meeting requirements do not apply to director discussion of matters that can be lawfully discussed in closed session.

As discussed on page 4 of Memorandum 2010-47, there are probably a number of improvements that could be made to the existing open meeting requirements of the Davis-Stirling Act, but that topic is too controversial to be addressed in the current proposal.

Ms. Artus also expands on her argument for deleting the executive session exception language. See Exhibit pp. 4-6. Without judging the policy merits of her argument, the staff remains convinced that any substantive change to the scope of the existing open meeting requirements would be too controversial for inclusion in the proposed law.

DEFINITION OF "MANAGING AGENT"

The staff received informal comment, from a person who asked to remain anonymous, suggesting that the definition of "managing agent" should be revised to include an uncompensated volunteer who acts as an association's manager.

This person reports that in many smaller, self-managed associations, a member may volunteer to assume the duties of a property manager. In those cases, this person suggests, the volunteer should be required to comply with the provisions regulating a "managing agent."

Because this would be a substantive change, which has not been fully analyzed or circulated for public comment, the staff is reluctant to include it in the proposed law. **Rather, the issue should be noted for possible future study.**

DEFINITIONS OF "RESERVE ACCOUNTS" AND "RESERVE ACCOUNT REQUIREMENTS"

Proposed Sections 4177 and 4178 would generalize the existing definitions of "reserve account" and "reserve account requirements." The definitions read as follows:

> 4177. "Reserve accounts" means both of the following:

(a) Moneys that the board has identified for use to defray the future repair or replacement of, or additions to, those major components that the association is obligated to maintain.

(b) The funds received, and not yet expended or disposed of, from either a compensatory damage award or settlement to an association from any person for injuries to property, real or personal, arising from any construction or design defects. These funds shall be separately itemized from funds described in subdivision (a).

4178. "Reserve account requirements" means the estimated funds that the board has determined are required to be available at a specified point in time to repair, replace, or restore those major components that the association is obligated to maintain.

Ms. Artus expands on her concerns about those provisions.

Existing Language Problematic

Ms. Artus believes that the existing language used in these definitions is flawed and needs to be revised in order to avoid problems. See Exhibit p. 6.

As noted in Memorandum 2010-47, on pages 31-32, the Commission intends to conduct a full review of the accounting terminology used in the Davis-Stirling Act, as a separate study. For that reason, the staff is reluctant to make changes to that terminology now, without the benefit of input from experts in the field.

Restore Limited Application

If the Commission is concerned about the phrasing of the existing definitions, their existing limited scope could be preserved, rather than generalizing them. Under that approach, the definitions would only apply to proposed Sections 5500-5560, which would continue the existing provisions that are governed by the definitions.

The effect of generalizing the definitions is discussed below.

Record Inspection

Proposed Section 5200(a)(7) would provide that records subject to member inspection include:

> *Reserve account* balances and records of payments made from *reserve accounts*.

(Emphasis added.)

The staff does not see any harm that would result from applying the definition of "reserve accounts" to that provision. To the contrary, it would

probably be helpful to have the same definition of "reserve accounts" in this provision and in the substantive provisions that govern the maintenance and use of reserve accounts.

Reserve Funding Summary

Proposed Section 5570(a)(3) would require that the association's reserve funding disclosure summary answer the following question:

> Based upon the most recent reserve study and other information available to the board, will currently projected *reserve account* balances be sufficient at the end of each year to meet the association's obligation for repair and/or replacement of major components during the next 30 years?

(Emphasis added.)

Again, the staff does not see any harm that would result from applying the definition of "reserve accounts" to that provision. Instead, it would seem to be helpful to have the same definition of "reserve accounts" in this provision and in the substantive provisions that govern the maintenance and use of reserve accounts.

Resolution of Construction Defect Claim

Proposed Section 6000(k)(1)(E)(iii) would require that a specified notice be sent to members discussing possible ways to resolve a construction defect dispute. The notice is required to indicate whether payments for the various options "are expected to be made from the use of *reserve account* funds or the imposition of regular or special assessments, or emergency assessment increases." (Emphasis added.)

As before, the staff believes it would be unproblematic and potentially helpful to define "reserve accounts" in this provision in the same way it is defined elsewhere in the Davis-Stirling Act.

Conclusion

The staff recommends against limiting the application of the definitions.

Respectfully submitted,

Brian Hebert
Executive Secretary

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4 October 2010

Mr. Brian Hebert
Executive Secretary
California Law Revision Commission

Re: Memoranda 2010-29, 2010-47 and 2010-48

Mr. Hebert:

I am troubled by your response to some of public comments. You appear to be reading them a little too fast—perhaps in your effort to have the Commission review all public comments by end-2010. You should keep in mind the saying, "Devil is in the detail."

I have been in favor of this Statutory Clarification and Simplification of CID Law project because the existing Davis-Stirling Common Interest Development Act (the "DSA") can use much clarifying and simplifying. But I would object to some of the proposals because they entail the risk of working against the interest of CID association members. That includes proposals to retain any ambiguous or poorly crafted existing provisions which can be improved or eliminated without changing the law in substance.

As it was pointed out on page 96 of Exhibit attached to Memorandum 2010-36, a large number of people, among them CID association members including directors, who are generally not lawyers—let alone CID lawyers—would have to consult the proposed Act, if enacted, as is the case with the present DSA. What is more important is that they would have to read it on their own and try to figure out what their rights are and what their CID association or its board is required or permitted to do or prohibited from doing, without the benefit of fair and reliable expert opinion because, first, there still is no state agency designated to support and supervise CID associations and, second, published court opinions interpreting DSA provisions are very scarce.

Proposed § 4035(b)(3) (Personal delivery to an association). I wish to urge the Commission to reconsider its approval of the language giving all associations the option not to accept documents by personal delivery (Minutes of the meeting held on 19 August 2010, p. 7). Associations which engage in "sloppy or dishonest practices," i.e., the kind on account of which you initially excluded personal delivery (First Supplement to Memorandum 2010-29, p. 2), would tend to choose, if the option is available, to discontinue the practice of accepting documents by personal delivery and avoid the

obligation to issue written receipts, thereby depriving members and other occupants—including seniors and electronically or physically challenged persons—of the convenience of personal delivery they have now. It is from associations of that kind that the law should protect members.

You proposed to allow associations the option not to accept personal delivery out of the concern for the possible administrative burden a receipt process could impose on directors in small associations in which personal delivery might be effected by handing documents to a director at the director's home (*id.*). But the risk you envisaged is confined to associations which maintain no business office, which is personally managed by volunteer directors and of which some members are inconsiderate. There is no such risk in an association that maintains a business office or a paid managerial or administrative personnel—whether the association's employee or agent. Those associations should be required to accept personal delivery in their business office or to the paid manager or administrator and to issue a written receipt.

Proposed § 4090 ("Board meeting"). In my earlier communication to you regarding this section, I urged, before expressing my preference for the version in the Tentative Recommendation of June 2007, that two issues (other than the replacement of "means" for "includes") be clarified if the language proposed in the February 2010 Tentative Recommendation were to be retained (Memorandum 2010-36, Exhibit pp. 51-52). You seem to have overlooked it. I have since concluded that the language should be adjusted.

- Scheduled to be Heard by the Board. First, the words "scheduled to be heard by the board" is ambiguous. (Here, I am not arguing that this qualification should be removed, even though I continue to prefer its removal.) Your parenthetical remark, "presumably at the next scheduled board meeting" (Memorandum 2010-47, p. 3), reveals that it is ambiguous. If you have to speculate, so does everybody else. It is fraught with the risk of inviting disputes.

Senate Bill 528 (Aanestad) (2007) should have harmonized the language of § 1365.05(j) (then-pre-existing § 1365.05(f)) with that of § 1365.05(i). The forthcoming law should correct the Legislature's past oversight.

The board is now generally prohibited from discussing or taking action on any item at a nonemergency meeting "unless the item was placed on the agenda included in the notice that was posted and distributed pursuant to subdivision (f)" (§ 1363.05(i)(1)), and proposed § 4930(a) preserves that general prohibition. Therefore, "any item of business scheduled to be heard by the board" must be placed on the agenda of the forthcoming meeting. An item placed on the agenda of a board meeting is obviously scheduled to be heard by the board at that meeting. Thus, under the proposed law, an item "scheduled to

be heard by the board" is equivalent to an item "placed on the agenda included in the notice that was posted and distributed pursuant to subdivision (a) of Section 4920." Whether a subject is on the agenda is a question to which there can be only one answer—there is no room for speculating. I urge replacing "any item of business scheduled to be heard by the board" by "any item of business placed on the agenda included in the notice that was distributed pursuant to subdivision (a) of Section 4920."

Both § 1365.05 and proposed § 4930 permit the board to act upon any item that does not appear on the statutory agenda, on the condition that the board follows the procedures prescribed by § 1363.05(i)(4) and proposed § 4930(d) and (e), respectively. I am inclined to believe that the definition of "board meeting" need not say that a board meeting continues while directors act upon an item not on the agenda in compliance with proposed § 4930(d) and (e).

Incidentally, there is a typo in proposed § 4930(a): "paragraphs (b) to (e)" would be "subdivisions (b) to (e)." In case you have not spotted it . . . .

I wish to note that the 2007 discussion regarding whether to remove the "scheduled to be heard" language, to which you referred on page 3 of Memorandum 2010-47, took place before the present § 1363.05(i) came into effect. You reported that six members of the public commented negatively and another six, affirmatively (First Supplement to Memorandum 2007-47, pp. 29-30). Five of the first six dated their comments before 26 September 2007, the date on which Governor signed SB 528.

Some of the first six with negative comments expressed their concerns that the language then proposed might interfere with social or informal gatherings of directors. The addition of the present § 1363.05(i) has eliminated the possibility they were concerned about because that subdivision prevents directors from acting as the board on matters not on the agenda included in a proper notice to members; directors constituting a quorum can no longer act as the board in their informal gatherings, and hence a director cannot be accused of participating in an illegal board meeting by socially meeting other directors. (In 2007, I and some of my fellow directors were troubled by the possibility of such accusation, as the "scheduled to be heard" language was vague.) Therefore, the "scheduled to be heard by the board" is unnecessary. I disagree with your view that there is no reason to revert to the language proposed in the 2007 Tentative Recommendation (Memorandum 2010-47, p. 3).

- Exclusion of Executive Session. Second, the words "except those matters that may be discussed in executive session" should be modified, even if for whatever reason "board meeting" is to be defined to exclude executive session. That language excludes more

than actual executive session from "board meeting" and represents an extremely bad policy, as explained below.

The board is required to adjourn to executive session only to do three things, which have implications for the privacy of an association member in an unusual situation: (1) to consider a possible disciplinary action against a member, but only if the subject member requests a closed session; (2) to discuss a payment plan; or (3) to decide whether to foreclose on a lien for assessment delinquency (§§ 1363.05(b) & 1367.4(c)(2); proposed § 4935(b)-(d)).

The board is permitted, but not required, to adjourn to executive session to consider matters which it could be in the association's interest not to expose to the public—litigation, contract formation with third parties, member discipline or personnel. The board is free to consider them in open meetings, in the presence of members in general with their participation.

However, the language "except those matters that may be discussed in executive session" in § 1363.05(j) and proposed § 4090 removes from a board meeting any discussion of and deliberation on these matters in open meetings; when a board chooses to consider litigation, contract formation with a third party, member discipline which the subject member has not requested to be considered in executive session or a personnel matter in the presence of members in general and so proceeds, that part of the proceeding would not be a board meeting under the "except those matters that may be discussed in executive session" language, and the board would be unable to make a decision as a board.

This is an unacceptable policy. As Justice Louis D. Brandeis said in *Other People's Money, and How the Bankers Use It*, "[p]ublicity is justly commended as a remedy for social and industrial diseases." Public policy should promote, not inhibit, board considerations of association businesses in open meetings. I urge that at a minimum the language "except those matters that may be discussed in executive session" be revised to "except those matters that the board is mandated by law to discuss in executive session or the matters which the board is not required but is permitted by law to consider in executive session and which it chooses to do so."

Regarding the issue of whether "board meeting" should be defined to exclude executive session, I have no recollection of any comment from a CID association member in support of exclusion. The definition of "board meeting" proposed in the Tentative Recommendation of June 2007 (then-proposed § 4090) did not include the "except those matters that may be discussed in executive session" language, while a comment noted, "The exception for matters considered in executive session is continued in Section 5030."

It appears that the Commission did not focus on that section at its October or December 2007 meeting, but, the December 2007 Pre-Print Recommendation defined "board meeting" to mean "a congregation of directors constituting a quorum at the same time and place to hear, discuss, or deliberate upon any business scheduled to be heard by the board," and comment to it noted, "The exception for matters considered in executive session is not continued" (p. 41). Assembly Bill 1921 (Sardaña), as introduced in February 2008 and also as amended on 7 May 2008, retained the same definition.

It was the 22 May 2008 amendment to AB 1921which brought back "except those matters that may be discussed in executive session." You said on page 4 of First Supplement to Memorandum 2008-12:

> The proposed law would have included an executive session in the definition of "board meeting." Consequently, meeting notice requirements would have applied to any part of a meeting that is held in executive session. This was opposed by the California Association of Community Managers ("CACM") as an unwarranted and burdensome new requirement.
>
> AB 1921 was amended to reverse that change. . . . .

Whether "board meeting" should be defined to include executive session is an issue for CID association members, as members and as potential directors. It is hardly an issue the resolution of which has to take into consideration what CID industry says. Please keep in mind that a large number of CID associations operate with no input from the CID industry. What was the reason for CACM's allegation that notice requirements applied to executive session were "unwarranted and burdensome" and from whose view point did it say so"? (I have not located the CACM comment referred.)

The "burden" argument makes no sense. Executive session has *de facto* been subject to notice requirements. The board has been permitted under § 1363.05(b) only to <u>adjourn to executive session</u> and so will be under proposed § 4935. It has to hold an open meeting before adjourning to executive session. The open meeting the board has to hold before adjourning to executive session is subject to notice requirements (§ 1363.05(f); proposed § 4920(a)). Therefore, exclusion of executive session from "board meeting" does not mean that nonemergency executive session can be held without advance notice to members. It has long been the practice in my association to include the words "executive session" in the agenda of board meetings whenever directors are expected to adjourn to executive session, and I am aware of nobody who felt it inconvenient, let alone burdensome.

I am rather concerned that a board may not be able to act as the board (and make any valid decision) in executive session if the latter is not a board meeting. Corp. Code

§ 7211(a)(8) provides, "[A]n act or decision done or made by a majority of the directors present at a meeting duly held at which a quorum is present is the act of the board" (underline added). Executive session described by proposed § 4935 does not assure whatever directors do in executive session constitutes the act of the board described in § 7211(a)(8), for, *inter alia*, that section fails to require the presence of a quorum.

Proposed §§ 4177 ("Reserve accounts") and 4178 ("Reserve account requirements"). I strongly disagree with your view that a full definition of a term and the defined term need not be perfectly interchangeable (Memorandum 2010-47, p. 32). A definition must be perfectly interchangeable with the defined term; a definition which fails this test is useless at best and very dangerous at worst. This is not a legal issue. However, a bad definition generates legal issues. Proposed § 4177 reminds me of a contract a dispute over which caused one of the contracting parties to lose over USD 1 billion and collapse. I and my colleagues in diverse fields (a lawyer included) reviewed the contract and reached the consensus that the dispute was caused by the imprecise definition of one term, which had allowed different parties to understand the term differently, and as a consequence the crucial part of the contract, in many different ways.

It is unreasonable to define "account" to mean "money" or "funds" because it simply is contrary to the way in which these words are used. A project intended to clarify the DSA should eliminate these two very bad existing definitional provisions. Defining "account" in this context to mean any money or funds is like defining "box" to mean "cookies for afternoon tea" while describing someone's arrangement to keep cookies for afternoon tea in boxes. I would endorse the RPLS Working Group's suggestion for the definition of "reserve fund" because it is sensible. But I am not persuaded that "reserve account" should be defined as any account in a financial institution. A reserve account is something more abstract—a conceptual box into which funds designated for use in replacement, repairs, etc., of major components of the common area are placed, and in which such funds are managed through one or more accounts in financial institutions.

I recommend that, instead of defining such terms as "reserve accounts" and "reserve account requirements" at this time, a few sections in Article 2 of Chapter 1 be kept in reserve for definitions to be formulated after a proper model is developed for CID associations' financial management and accounting.

Proposed § 4360(b) (Approval of rule change by board). I first urged you in 2009 to make it clear that the board had to consider members' comments in an open meeting (Memorandum 2009-44, Exhibit pp. 62-63). You said, "The staff does not believe that this change is needed" because the board was not allowed to discuss a rule change in executive session (Memorandum 2009-44, p. 21). Your reason was right, and your conclusion would have been right on the assumption (which was invalid) that all DSA

users knew what the board was permitted or required to consider or do in executive session.

There is no question that § 1357.130 requires the board—not individual directors—to consider members' comments before making a decision on a proposed rule change relating to certain subjects. Section 1357.130(b) provides, "A decision on a proposed rule change shall be made at a meeting of the board of directors, after consideration of any comments made by association members." The party which is to make a decision on a proposed rule change at a meeting of the board and the party which is to consider "any comments made by association members" before making the decision are both the board, not individual directors. The board as the board can "consider" members' comments only in an open meeting because, as you had noted, the board is not permitted to do so in a closed session.

Under your Scenario 1 (Memorandum 2010-48, p. 31), individual directors read members' comments but the board does not "consider" the comments to form the board's position regarding the comments. Therefore the board does not make a decision "after consideration" of members' comments—it makes a decision without considering the comments as the board, which is a violation of § 1357.130(b). The resulting rules are invalid and unenforceable under § 1357.110 because they were not "adopted, amended or repealed in substantial compliance with the requirements of this article."

It is no micromanaging to make it easier for CID association boards to know what the law requires. As you suggest on page 5 of Memorandum 2010-46, "the typical CID homeowner is not a Davis-Stirling Act expert," and directors are only a subset of CID homeowners. They typically consult the DSA, if at all, only "when they need to answer a specific question" (*id.*). You can rest assured that very few CID association directors will remember that they are not permitted to consider members' comments on proposed rule changes in executive session when they look at proposed § 4360(b) to find out what they must do to change operating rules properly. The law should not leave them wondering whether the board is required to consider members' comments in open meetings—with the possible result of the board being called to the court for attempting to enforce an invalid and unenforceable operating rule.

Proposed (revised) § 4365 (Reversal of rule change by members). I am happy with the proposed revision; it is appropriate and necessary. But I believe that the word "vote" you underlined (Memorandum 2010-48, p. 34) should be "election." Please recall that the language of § 1363.03(b) provides:

> [E]lections regarding assessments legally requiring a vote, election and removal of members of the association board of directors, amendments to the governing

> documents, or the grant of exclusive use of common area property pursuant to Section 1363.07 shall be held by secret ballot in accordance with the procedures set forth in this section."

Underline added. This provision continues in proposed § 5100(a) without any substantive change. It is a special election by ballot, not a special vote, which § 1363.03(b) has replaced for a special member meeting under Corp. Code § 7510(e) with respect to amending the governing documents.

Sincerely,

Kazuko K. Artus