SENATE JUDICIARY COMMITTEE
Senator Thomas Umberg, Chair
2021-2022 Regular Session

AB 1101 (Irwin)
Version: June 9, 2021
Hearing Date: June 29, 2021
Fiscal: No
Urgency: No
TSG

SUBJECT

Common interest developments: funds: insurance

DIGEST

This bill clarifies and strengthens a series of existing legal requirements relating to homeowner association (HOA) finances that are designed to combat fraud.

EXECUTIVE SUMMARY

Most HOAs are led by a small group of all-volunteer directors. These boards frequently turn over management of the HOA's finances to an individual board member or the property manager. Oversight tends to be limited. As a result, HOAs are especially vulnerable to financial malfeasance, as a raft of recent incidents has highlighted. To begin to address the problem, California enacted legislation in 2018 that required HOA board members to review the HOA's financial documents more frequently, obligated HOAs to carry fidelity bond insurance, and set a maximum amount of money that could be transferred out of an HOA's accounts without prior board approval. According to the author and sponsors, implementation of that legislation has revealed a number of areas in which clarifications and modifications are needed. This bill seeks to make those adjustments. Specifically, the bill clarifies the types of insurance the HOA must carry against financial malfeasance, revises the limitation on transfers of funds without board approval to account for variation in the size of HOA budgets, and specifies the types of accounts in which HOA funds may be held.

The bill is sponsored by the Community Associations Institute – California Legislative Action Committee. Support comes from HOA managers. Opposition comes from homeowner advocates who are not convinced the bill's provisions will protect adequately against financial malfeasance in the HOA context. The bill passed out of the Senate Housing Committee by a vote of 8-0.

PROPOSED CHANGES TO THE LAW

Existing law:

1) Establishes the Davis-Stirling Common Interest Development Act, which provides rules and regulations governing the operation of residential common interest developments and the rights and responsibilities of HOAs and HOA members. (Civ. Code § 4000 *et seq*.)

2) Specifies that a managing agent of a common interest development who accepts or receives an association's funds shall deposit those funds that are not placed into an escrow account with a bank, savings association, or credit union or into an account controlled by the association, into a trust fund account maintained by the managing agent in a bank, savings association, or credit union in this state. Requires that all funds deposited by the managing agent in the trust fund account be kept in this state in a financial institution 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. (Civ. Code § 5380 (a).)

3) Provides that, 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:
   a) the account is in the name of the managing agent as trustee for the association or in the name of the association;
   b) all of the funds in the account are covered by insurance provided by an agency of the federal government;
   c) 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 as specified;
   d) 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;
   e) 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; and
   f) transfers of greater than $10,000 or 5 percent of an association's total combined reserve and operating account deposits, whichever is lower, shall not be authorized from the account without prior written approval from the board of the association. (Civ. Code § 5380 (b).)

4) Requires the managing agent of a homeowner association to maintain a separate record of the receipt and disposition of all funds described in this section, including any interest earned on the funds. (Civ. Code § 5380 (c).)

5) Specifies that, unless the governing documents require greater coverage amounts, the association shall maintain fidelity bond coverage for its directors, officers, and employees 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. (Civ. Code § 5806.)

This bill:

1) Specifies that if HOA funds are deposited into a credit union, the institution must be insured by the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration Insurance Fund, or the Securities Investor Protection Corporation.

2) Prohibits an HOA managing agent from:
   a) depositing HOA funds in an account that does not protect the principal; or
   b) investing HOA funds in stocks or high risk investment options.

3) Modifies the amount of HOA funds that can be transferred out of an HOA account without prior board approval as follows:
   a) for HOAs with 50 or fewer units, the lesser of $5,000 or 5 percent of estimated annual income;
   b) for HOAs with 51 or more units, the lesser of $10,000 or 5 percent of estimated annual income.

4) Clarifies that, to comply with the requirements for insurance against financial malfeasance, an HOA must maintain crime insurance, fidelity bond coverage, employee dishonesty coverage, or their equivalents.

COMMENTS

1. Background on HOAs and their finances

Common interest developments are self-governing groups of dwellings that share common spaces and amenities. They come in a wide variety of physical layouts: condominium complexes, apartment buildings, and neighborhoods of detached, single-family residences, for example. Some consist of thousands of units. Others are made up of just a handful. Dwellings within common interest developments currently account for approximately a quarter of the state's overall housing stock, meaning that the laws covering such developments have a large impact on the population. In California, common interest developments are governed by the Davis-Stirling Act. (Civ. Code Secs. 4000-6150.)

The Davis-Stirling Act sets forth a system for common interest development self-governance. The owners of the separate properties within the common interest development are the members of the homeowners association. Association members

vote for the board of directors of the association that oversees operation of the common interest development. The board manages the common interest development, frequently by hiring an individual or entity to do so on its behalf.

To pay for common expenses, homeowner associations charge annual assessments to each member of the association. While the board is ultimately responsible for how the association's money is safeguarded and spent, in practice, property managers often handle much of the day-to-day financial operation of an association.

Collectively, the estimated 52,000 homeowners associations in California have roughly $12.4 billion dollars of homeowner assessments on deposit. This money makes a very tempting target for unscrupulous actors and, perhaps not surprisingly, several large scale fraud and embezzlement schemes involving homeowner association funds have come to light over the past decade.

The Davis-Stirling Act contains several provisions regarding association accounting and financial oversight. In 2018, to try to cut down on incidents of fraud and other financial malfeasance in the HOA context, the author of this bill brought legislation designed to fortify those existing laws. That bill, AB 2912 (Irwin, Ch. 396, Stats. 2018) required board members to review association financial documents monthly, prohibited large transfers of funds from associations' financial accounts without prior board approval, and required associations to maintain fidelity bonds to cover the amount of association reserves plus three months' worth of assessments.

According to the author and proponents of this bill, since enactment of AB 2912, implementation has revealed modifications that are needed to make those provisions more workable. This bill seeks to provide the necessary modifications. Specifically, the bill clarifies the types of insurance the HOA must carry against financial malfeasance, revises the limitation on transfers of funds without board approval to account for variation in the size of HOA budgets, and specifies the types of accounts in which HOA funds may be held.

2. <u>Clarifying the type of insurance the HOA must carry to protect itself against financial malfeasance</u>

Where the existing law simply states that HOAs must maintain fidelity bond coverage for their directors, officers, and employees 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, this bill more broadly spells out the insurance products that might fall within the general rubric of fidelity bond coverage, including crime insurance and employee dishonesty coverage. According to the proponents, these additions are helpful because coverage denominated specifically as fidelity bond coverage may not be available in every instance.

To build further flexibility into the language, the bill also allows HOAs to obtain the fidelity bond coverage, crime insurance, employee dishonesty coverage, "or their equivalent." It makes sense to provide this flexibility since it matters little what the coverage is called so long as it achieves the aim of protecting the HOA's core financial position against financial malfeasance. However, the inclusion of the phrase "or their equivalent" opens up the possibility that HOAs could self-insure. Self-insurance would not achieve the purpose behind the statute, since whoever might steal from the HOA accounts would presumably have access to the self-insurance fund as well, and could make off with that money just as easily as any other money sitting in the HOA accounts. To foreclose this possibility, the author proposes to offer an amendment in Committee that specifies that self-insurance does not meet the insurance requirement in the bill.

3. Specifications regarding the types of accounts in which HOA funds may be held

Existing law describes the type of accounts that managing agents may use for holding HOA funds. (Civ. Code § 5380(a) and (b).) That existing law allows for these accounts may be accounts at credit unions and such accounts must be backed by government insurance. There are some credit unions that are privately insured, however. To incorporate credit unions of this type, the bill requires that if HOA funds are deposited with a credit union, the account must be backed by the Federal Deposit Insurance Corporation, the National Credit Union Administration Insurance Fund, or a qualifying private insurer. At the same time, the bill specifies that HOA funds may only be deposited in accounts that protect the principal and cannot be invested in stocks or "high-risk investment options."

Although the opposition apparently objects to this component of the bill, they raise arguments that actually appear to support the need for it:

> homeowners are reporting that -- without the consent of owners -- boards and property managers – acting under the advice and urging of industry law firms – are moving the cash from insured financial institutions and putting it at risk in unsecured financial products. The investment "plan" of one senior community shows the systematic transfer of $1.2 million from an insured reserve account into the control of two broker-dealers. Accounts managed by dealers are not federally-insured and pose a huge risk to homeowners, because association boards can demand that they make up – through special assessments -- any losses in the capital markets and to pay dealer fees.

Since the bill appears to prohibit taking precisely these sorts of risks with HOA funds, it is not immediately clear why the opposition finds this aspect of the bill objectionable.

Assuming the bill advances, however, the author may wish to investigate the whether a transition period should be added to the bill for those HOAs that currently have their funds invested in ways that would not fully comply with this bill. Without such a transition period, there could be instances in which HOAs would face penalties for withdrawing their funds from accounts or investments prematurely.

4. Modifying the formula for determining when prior board authorization is need to transfer money out of HOA accounts

One way to mitigate against the risk of fraud is to prevent money from being transferred out of HOA accounts without the knowledge and prior approval of the board. At the same time, if the manager of an HOA had to obtain prior approval of every HOA expenditure, no matter how small, HOA operations would quickly get bogged down. To strike a balance between these two policy considerations, AB 2912 required prior board approval for transfers of greater than $10,000 or 5 percent of an association's total combined reserve and operating account deposits, whichever is lower. (Civ. Code §§ 5380(b)(6) and 5502.)

The proponents of this bill assert that this formula does not adequately take into account the wide variation in size among HOAs and their budgets. A very small HOA might have an annual budget of just a few thousand dollars. On the other end of the spectrum, some large HOA communities have budgets in the millions of dollars. To better account for this variation, this bill breaks the formula into two parts: one applicable to a small HOA with 50 units or less and the other applicable to large HOAs composed of more than 51 units. Transfers of funds out of the accounts of a small HOA would only require board approval if they are greater than $5,000 or five percent of the HOA's estimated income, whichever is lower, while transfers out of the accounts of larger HOAs would require board approval if they are greater than $10,000 or five percent of the HOA's estimated annual income, whichever is lower.

The opposition to the bill criticizes these formulas as "arbitrary." While the exact figures are necessarily arbitrary (the line between a large HOA and a small HOA must be drawn somewhere), there is reasonable underlying rationale. The finances of large and small HOAs differ dramatically and the bifurcation of the formulas responds to that fact.

As they appear in the bill in print, however, these formulas are mashed together in a single, complex sentence. To make them easier to read and follow, the author proposes to offer an amendment in Committee that recasts the formulas into separate paragraphs.

5. Clarifying the type of insurance the HOA must carry to protect itself against financial malfeasance

Where the existing law simply states that HOAs must maintain fidelity bond coverage for their directors, officers, and employees 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, this bill more broadly spells out the insurance products that might fall within the general rubric of fidelity bond coverage, including crime insurance and employee dishonesty coverage. According to the proponents, these additions are helpful because coverage denominated specifically as fidelity bond coverage may not be available in every instance.

To build further flexibility into the language, the bill also allows HOAs to obtain the fidelity bond coverage, crime insurance, employee dishonesty coverage, "or their equivalent." It makes sense to provide this flexibility since it matters little what the coverage is called so long as it achieves the aim of protecting the HOA's core financial position against financial malfeasance. However, the inclusion of the phrase "or their equivalent" opens up the possibility that HOAs could self-insure. Self-insurance would not achieve the purpose behind the statute, however, since whoever might steal from the HOA accounts would presumably have access to the self-insurance fund as well, and could make off with that money just as easily as any other money sitting in the HOA accounts. To foreclose this possibility, the author proposes to offer an amendment in Committee that specifies that self-insurance does not meet the insurance requirement in the bill.

6. Opposition concerns

The opposition shares the proponents concern about fraud and financial malfeasance in the HOA context. They take issue with the bill nonetheless. At times, however, the opposition's criticisms appear more directed toward existing law, rather than anything the bill proposes to do.

a. Allowing managing agents to control association financial accounts

As it did during consideration of AB 2912, the opposition asserts that Civil Code Section 5380 allows the managing agent of a homeowners association to open a bank account in the managing agent's own name and deposit association funds into that account. The opposition believes this is an invitation to fraud and embezzlement because it gives the managing agent primary control over the association's money. The opposition also maintains that this provision violates federal regulations requiring banks to exercise due diligence in ascertaining whether or not an account is titled in the name of the owner of the funds within.

It is not crystal clear that the statute permits what the opposition alleges, however. It does appear that the managing agent can title the account in the managing agent's name, but presumably the title must also expressly indicate that the account is held in trust for the association. If that is not the case, then it is unclear what the statute means when it says the account must be a "trust fund account."

Regardless, it may be worth questioning why there is a need to give managing agents the option of opening accounts in trust for the associations they manage. Arguably, it would make better sense to require the account to be under the complete control of the association, which could then add or remove the managing agent as a signatory on the account as necessary and appropriate. If the Legislature were to consider such a change, however, it would seem prudent to do so in the context of a bill dedicated to that proposal, so that it can be more thoroughly vetted.

b. Allowing commingling of funds from multiple associations

Existing law generally forbids the managing agents of homeowner associations to commingle association funds with money belonging to anyone else. (Civ. Code § 5380(b)(3) and (d).) There is a narrow exception, however, for managing agents that already commingled funds among multiple associations as of February 26, 1990, so long as those agents carry adequate surety and fidelity bonds pursuant to a written agreement with the association, among other things. The opposition seizes on the existence of this exception to argue that this bill allows HOA managers to commingle funds.

Whatever utility this exception may have had in the past, it seems unnecessary today. There is no obvious policy reason to allow any managing agents to commingle funds and the continued existence of a narrow exception permitting such commingling only serves to further fuel the suspicions of those, like the opposition, who already appear to mistrust HOA managers. With this in mind, the author proposes to offer an amendment in Committee that would eliminate the exception, thus prohibiting all managing agents from commingling HOA funds.

c. Alleged lack of enforcement mechanisms

The opposition alleges that there are inadequate enforcement mechanisms to back the components of the bill relating to where HOA funds must be kept and where they may be invested. This argument does not seem to have merit. An existing provision within the same section of law states that: "[t]he prevailing party in an action to enforce this section shall be entitled to recover reasonable legal fees and court costs." That provision would be meaningless if no one could sue in court to enforce the section. It therefore appears that the bill does in fact provide for the enforcement of its terms.

7. Proposed amendments

In order to address the issues set forth in the Comments, above, the author proposes to incorporate amendments into the bill that would:

- remove a little-used exception to the general rule that prohibits HOA property managers from co-mingling funds;
- clarify that self-insurance does not satisfy the insurance requirements in the bill; and
- recasts the formulas for calculating when prior board approval is needed for a transfer of HOA funds to provide greater clarity.

A mock-up of the amendments in context is attached to this analysis.

8. Arguments in support of the bill

According to the author:

> AB 1101 will provide clarity on existing requirements for Homeowner Associations in California. In past years, HOAs have been a target for fraud from nefarious individuals who work closely with or are on HOA boards. In 2018, I authored a bill that updated the tools available for HOAs to prevent fraudulent activities and it was signed into law. Two years since its passage, we have heard about the need for specifications on some of the terms that were in the original bill. AB 1101 is technical clean-up bill that directly responds to implementation concerns from HOAs. This bill will ensure that our efforts to combat fraud are clear so that HOAs can effectively protect their funds.

As sponsor of the bill, the Community Associations Institute – California Legislative Action Committee writes:

> AB 1101 […] provides greater clarity on existing financial requirements and provides protection to homeowners of homeowner associations (HOAs) from fraudulent activities by those entrusted with managing the finances of HOAs. In 2018, AB 2912 (Irwin) was passed, which required HOAs to secure additional insurance and review financial documents on a more regular basis in order to curb fraudulent activities. Since passage, it came to the attention of those implementing the law that clarity was needed to ensure compliance and provide greater protections for HOAs to guard their funds. AB 1101 provides this clarity […].

9. Arguments in opposition to the bill

In opposition to the bill, the Center for California Homeowner Association Law and the California Alliance for Retired Americans jointly write:

> [We] oppose this measure for the financial risks that AB1101 poses to owners -- seniors in particular -- who are not in a position to restore monies lost through mismanagement of association reserves. At risk are enormous sums of money: by the association industry's own calculations, California associations now control upwards of $13 billion in cash – all of it collected from and owned by homeowners.

Specific concerns raised by the opposition are addressed in the relevant comment sections above.

SUPPORT

Community Associations Institute – California Legislative Action Committee (sponsor)
California Association of Community Managers

OPPOSITION

California Alliance for Retired Americans
Center for California Homeowner Association Law

RELATED LEGISLATION

Pending Legislation: None known.

Prior Legislation:

AB 2227 (Irwin, 2020) was nearly identical to this bill. AB 2227 was held in the Assembly Housing and Community Development Committee due to COVID-19-related restrictions on bill hearings.

AB 2912 (Irwin, Ch. 396, Stats. 2018) required HOAs to purchase fidelity bond insurance, required more frequent reviews of financial statements by HOA boards, and prohibited electronic transfers of HOA funds without prior approval of the board if the transfer is over a certain amount.

AB 690 (Quirk-Silva, Ch. 127, Stats. 2017) required a CID manager or management company to disclose certain information before entering into a management agreement with a homeowners association, and required the homeowners association annual budget to contain information relating to charges for certain documents.

PRIOR VOTES:

Senate Housing Committee (Ayes 8, Noes 0)
Assembly Floor (Ayes 75, Noes 0)
Assembly Judiciary Committee (Ayes 10, Noes 0)
Assembly Housing and Community Development Committee (Ayes 7, Noes 0)

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Amended Mock-up for 2021-2022 AB-1101 (Irwin (A))

Mock-up based on Version Number 97 - Amended Senate 6/9/21
Submitted by: Griffiths, SJUD

THE PEOPLE OF THE STATE OF CALIFORNIA DO ENACT AS FOLLOWS:

SECTION 1. Section 5380 of the Civil Code is amended to read:

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, or is a guaranty corporation subject to Section 14858 of the Financial Code, 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 account in a bank, savings association, or credit union in this state that is insured by the Federal Deposit Insurance Corporation, National Credit Union Administration Insurance Fund, or a guaranty corporation subject to Section 14858 of the Financial Code, 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 or a guaranty corporation subject to Section 14858 of the Financial Code. Those funds may only be deposited in accounts that protect the principal. In no event may those funds be invested in stocks or high-risk investment options.

(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.

(6) Transfers of funds out of the association's reserve or operating accounts shall not be authorized without prior written approval from the board of the association unless the amount of the transfer is less than the following:
(A) The lesser of five thousand dollars ($5,000) or 5 percent of the estimated income in the annual operating budget, for associations with 50 or less units.
B) The lesser of ten thousand dollars ($10,000) ~~or greater~~, or 5 percent of estimated income in the annual operating budget, ~~whichever is less,~~ for associations with 51 or more units. ~~, and transfers of five thousand dollars ($5,000) or greater, or 5 percent of the estimated income in the annual operating budget, whichever is less, for associations with 50 or less units, shall not be authorized from the association's reserve or operating accounts without prior written approval from the board of the association.~~

(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 ensure 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.

SEC. 2. Section 5502 of the Civil Code is amended to read:

5502. Notwithstanding any other law, transfers shall not be authorized from the association's reserve or operating accounts without prior written approval from the board of the association unless the amount of the transfer is less than the following:
(A) The lesser of five thousand dollars ($5,000) or 5 percent of the estimated income in the annual operating budget, for associations with 50 or less units.
(B) The lesser of ten thousand dollars ($10,000), or 5 percent of estimated income in the annual operating budget, for associations with 51 or more units. ~~transfers of ten thousand dollars ($10,000) or greater, or 5 percent of the estimated income in the annual operating budget, whichever is less, for associations with 51 or more units, and transfers of five thousand dollars ($5,000) or greater, or 5 percent of the estimated income in the annual operating budget, whichever is less, for associations with 50 or less units, shall not be authorized from the association's reserve or operating accounts without prior written board approval.~~ This section applies in addition to any other applicable requirements of this part.

SEC. 3. Section 5806 of the Civil Code is amended to read:

5806. Unless the governing documents require greater coverage amounts, the association shall maintain crime insurance, employee dishonesty coverage, fidelity bond coverage, or their equivalent, for its directors, officers, and employees 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. The coverage maintained by the association shall also include protection in an equal amount against computer fraud and funds transfer fraud. If the association uses a managing agent or management company, the association's crime insurance, employee dishonesty coverage, fidelity bond coverage, or their equivalent, shall additionally include coverage for, or otherwise be endorsed to provide coverage for, dishonest acts by that person or entity and its employees. Self-insurance does not meet the requirements of this section.