



Common Interest Community Governing Documents

A General Discussion of Various Legal Issues

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About Adam H. Clarkson, Esq.

Adam Clarkson is the owner of The Clarkson Law Group, P.C. He is currently licensed and admitted to practice law in Nevada, Florida, California, South Carolina, Utah, the United States District Court of Nevada, the United States Bankruptcy Court of Nevada, and the United States District Court of Utah.

Mr. Clarkson's practice of law is dedicated to representing homeowner associations in corporate matters, including collections. Mr. Clarkson regularly serves as a speaker for education seminars sponsored by Community Associations Institute (CAI), Community Association Management Executive Officers (CAMEO), and Nevada's leading management companies. Mr. Clarkson is a member of the CAI Nevada Chapter board of directors.



Disclaimer

The *generalized positions taken within this presentation* are for educational purposes and *are not intended* to serve as legal advice, as a substitute for legal advice, or *to be utilized by you to provide legal advice to others.*

In the event you, your colleagues, or someone you know is faced with a specific problem calling for the exercise of trained legal judgment you should consult with a properly licensed attorney to obtain a recommendation for an appropriate course of action.

Overview

This presentation generally addresses legal issues related to community association governing documents.

Today's topics are organized as follows:

- 1) General Definitions
- 2) Governing Documents Require Reserve Studies
- 3) Reserve Underfunding
- 4) Use of Reserves for Items Not Specified in Study
- 5) Scope of Work Limitations
- 6) Reserves for Alternative Measures

General Definitions for Today's Discussion

Terms and association obligations vary from state to state. The following terms shall be utilized for today's discussion.

Reserve Funds: Funds set aside and held by an association for the repair, replacement, restoration, or other maintenance of real and personal property that an association is obligated to maintain.

General Definitions for Today's Discussion

Reserve Study: A study that analyzes the real and personal property that an association is obligated to repair, replace, restore, or otherwise maintain and establishes a funding plan the association may utilize to properly/adequately fund such reserve expenses for components that may arise within a 30 year period, which includes: identification of the reserve components, analysis of existing useful life, estimate of future component expenses, and an estimate of the amounts needed to fund such components.

General Definitions for Today's Discussion

“Governing documents” means:

1. The **declaration/CC&Rs** for the common-interest community;
2. The **articles of incorporation**, articles of association, articles of organization, certificate of registration, certificate of limited partnership, certificate of trust or other documents that are used to organize the association for the common-interest community;
3. The **bylaws** and **rules** of the association; and
4. Any other documents that govern the operation of the common-interest community or the association.

Governing Documents Require Reserve Studies

Governing Documents Require Reserve Studies

Duties and Powers of the Association. The duties and powers of the Association are those set forth in this Declaration, the Articles and Bylaws, together with the general and implied powers of an association" and a nonprofit corporation generally, *to do any and all things that such a corporation may lawfully do* which are necessary or proper, in operating *for the general welfare of the Owners*, subject only to the limitations upon the exercise of such powers as are expressly set forth in the Articles, the Bylaws, this Declaration. The Association may at any time, and from time to time *reconstruct, replace or refinish any Improvement* or portion thereof upon the Common Elements and replace destroyed trees or other vegetation and plant trees, shrubs and ground cover upon any portion of the Common Elements. The Association *may employ personnel necessary for the effective operation and maintenance of the Common Elements*, including the employment of legal, management and accounting services and/or other professionals. (exemplar provision CC&Rs).

Governing Documents Require Reserve Studies

Purpose. The purpose for which the Association is organized is to maintain, operate and govern a condominium common-interest community. The Association may engage in any lawful activity for which a corporation may be organized, and to promote or conduct any legitimate object or purpose which a corporation may promote or conduct. (exemplar provision AOI)

Governing Documents Require Reserve Studies

Power and Duty. *The power and duty to contract for and pay for maintenance, gardening, and common utilities services, and for materials and supplies and other common Expenses relating to the Common Elements, and to employ personnel necessary for the operation of the Residential Condominium, including legal and accounting services, and to contract for and pay for Improvements on the Common Elements.* (exemplar provision AOI)

Governing Documents Require Reserve Studies

Board Members are Fiduciaries:

“Condominium board directors owe a fiduciary duty to members of their association.” *Davis* at 712.

Governing Documents Require Reserve Studies

Duty to Properly Fund Reserves: It is a common law violation of fiduciary duty, and in many states a statutory violation, to fail to properly fund an association's reserves.

- “Defendant should have known that plaintiff's obligations could not be met without his contribution of reasonable reserve funds. Furthermore, as a fiduciary, defendant had the duty not to hinder ‘the ability of the corporation to continue the business for which it was developed.’ By leaving plaintiff underfunded, defendant violated his fiduciary duty to plaintiff. After careful review of the Notes, the case law, and ‘the relevant statutory provisions, we determine that the trial court did not err, as a matter of law, when it concluded that *defendant owed a duty to fund reserves* for plaintiff.” *Maercker Point Villas Condo. Ass'n v. Szymski*, 655 N.E.2d 1192, 1194-95 (Ill. 1995)(citations omitted)(emphasis added).

Governing Documents Require Reserve Studies

Business Judgment Rule: *The legal protection for director's actions under the corporate structure.*

- “Under the business judgment rule, ‘[a]bsent evidence of bad faith, fraud, illegality or gross overreaching, courts are not at liberty to interfere with the exercise of business judgment by corporate directors.’” *Davis* at 714.

Purpose: *To protect against honest mistakes.*

- “The purpose of this rule is to protect directors who have been diligent and careful in performing their duties from being subjected to liability from honest mistakes of judgment.” *Id.*

Governing Documents Require Reserve Studies

Due Care Required: *Due care must be exercised to obtain the protections of the Business Judgment Rule.*

- “[I]t is a prerequisite to the application of the business judgment rule that the directors exercise due care in carrying out their corporate duties. If directors fail to exercise due care, then they may not use the business judgment rule as a shield for their conduct.” *Id.*

Governing Documents Require Reserve Studies

Governing Document Require Reserve Studies Because Due Care Requires a Reserve Study: Directors must be informed of material facts necessary to properly exercise business judgment, which in the context of reserves would require a proper reserve study from a reserve study professional.

- “One component of due care is that directors must inform themselves of material facts necessary for them to properly exercise their business judgment. (directors “may not close their eyes to what is going on about them in corporate business, and must in appropriate circumstances make such reasonable inquiry as an ordinarily prudent person under similar circumstances”). Thus, the business judgment rule is defeated where directors act without “becoming sufficiently informed to make an independent business decision.” *Id.*

Recall of a Board

Recall of a Board

Removal. *Any Director may be removed from the Board, with or without cause, as set forth hereunder. Upon receipt of a written petition requesting removal of any Director, Signed by such Members as are required for the calling of a special meeting of the Members, the Board shall present said petition to the Members for vote. By a two-thirds vote of all Members present and entitled to vote at any duly noticed meeting of the Members at which a quorum is present, the Members may remove, with or without cause, any Director, other than a Director appointed by Declarant. (exemplar Bylaw).*

Recall of a Board

Why should you care?

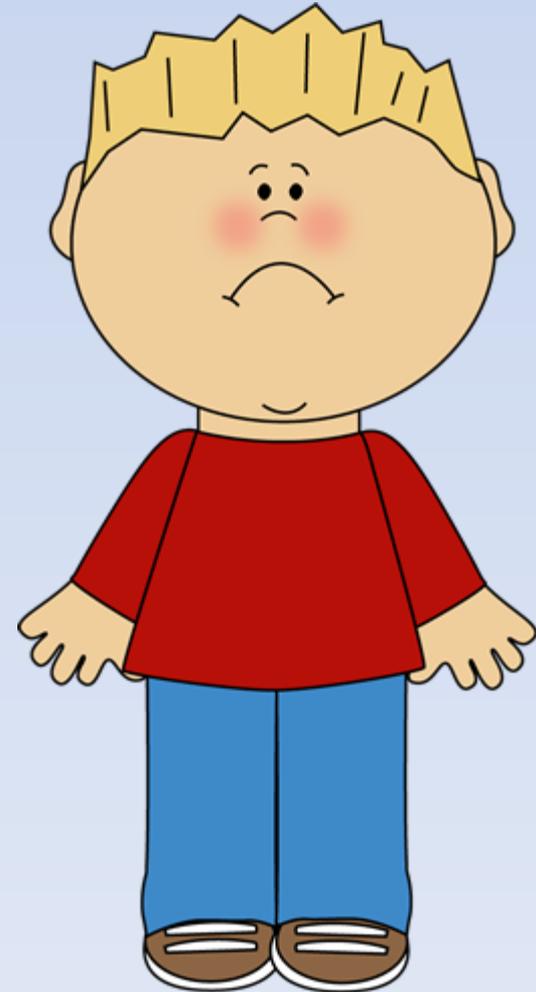
Recall of a Board

Large one-time Reserve Assessment

Billy's monthly assessments are \$100 a month.

The Association discovered that it is underfunded by \$100,000 in its reserve account and, upon the advice of its reserve study analyst, is imposing a one-time reserve assessment on each owner to immediately resolve the underfunding.

In addition to Billy's \$100 monthly assessment Billy receives a ***one-time reserve assessment of \$1,000***. Assuming everyone pays, the association becomes immediately properly funded under its reserves.



Recall of a Board



Recall of a Board

Why should you care?

Because someone's going to take the fall

Recall of a Board



Scapegoat

1: a person or group made to bear the blame for others or to suffer in their place.

Recall of a Board



Recall of a Board

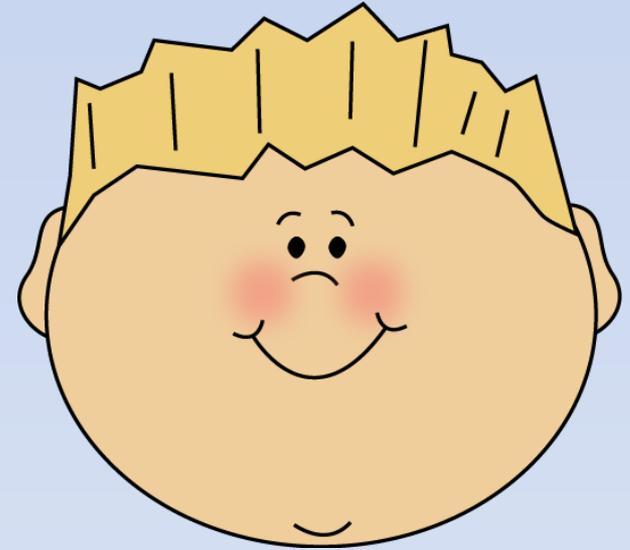
5-10 Year Reserve Funding Plan

Billy's monthly assessments are \$100 a month.

The Association discovered that it is underfunded by \$100,000 in its reserve account. However, in lieu of imposing a one-time reserve assessment on each owner to immediately resolve the underfunding, ***the Association's reserve analyst recommended a 5-10 year funding plan to cure the underfunding.***

Billy's \$100 monthly assessment is increased to \$110, but at least Billy does not have to pay \$1,000 today.

The association does not become immediately properly funded under its reserves, but it does eventually become properly funded.



Recall of a Board



Obtaining a Loan to Fund Reserve Expenses

Obtaining a Loan to Fund Reserve Expenses

Power to Obtain a Loan. Without the approval of the Owners, borrow up to Seventy-Five Thousand Dollars (\$75,000), and to *cause to be executed and delivered therefor, in the Association's name*, promissory notes, bonds, debentures, deeds of trust, mortgages, pledges, hypothecations or other *evidences of debt and securities therefor* and, in addition, *with the approval of Owners representing a majority of the voting power of the Association*, the power, but not the duty, *to borrow additional money* and to incur additional indebtedness for the purposes of the Association. (exemplar Bylaw).

Obtaining a Loan to Fund Reserve Expenses

UCIOA SECTION 3-112. CONVEYANCE OR ENCUMBRANCE OF COMMON ELEMENTS.

(a) In a condominium or planned community, portions of the **common elements may be conveyed or subjected to a security interest by the association if persons entitled to cast at least [80] percent of the votes in the association . . . agree to that action;** but all owners of units to which any limited common element is allocated must agree in order to convey that limited common element or subject it to a security interest. . . .

. . .

(c) **An agreement to convey common elements** in a condominium or planned community, **or to subject them to a security interest, . . . must be evidenced by the execution of an agreement,** or ratifications thereof, in the same manner as a deed, by the requisite number of unit owners. The agreement must specify a date after which the agreement will be void unless recorded before that date. **The agreement** and all ratifications thereof **must be recorded** in every [county] in which a portion of the common interest community is situated, and is effective only upon recordation.

. . .

(e) **Unless made pursuant to this section, any purported conveyance, encumbrance, judicial sale, or other voluntary transfer of common elements . . . is void.**

In short, association's generally need membership approval to lawfully obtain a loan.

Obtaining a Loan to Fund Reserve Expenses

States that have enacted a version of the UCIOA:

1982 Version: Alaska, Colorado, Connecticut, Minnesota, Nevada, West Virginia

1994 Version: Connecticut, Vermont

2008 Version: Connecticut, Delaware, Vermont

Notably, the act is based upon laws drawn from states throughout the nation and therefore its provisions are similar to the laws in most states

Amending CC&Rs

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Amendment By Members. Except as otherwise may be provided by this Declaration, the provisions of this Declaration **may be amended only** by Recordation of a certificate, signed and acknowledged by the President or Secretary of the Association, setting forth the amendment and certifying that such amendment **has been approved by both: (a) Members representing not less than sixty-seven percent (67%) of the total voting power of the Association,** and (b) the consent of a majority of the Board of Directors; and, in the case of those amendments which this Declaration requires to be approved by Eligible Mortgagees, (c) the requisite percentage of Eligible Mortgagees and Eligible Insurers. Such amendment shall be effective upon Recordation. **No amendment may change the boundaries of any Unit, change the uses to which any Unit is restricted or change the allocated interests of a Unit, without the unanimous consent of all Owners whose Units are so affected.** (exemplar CC&R provision)

Amending CC&Rs

UCIOA SECTION 2-117. AMENDMENT OF DECLARATION.

(a) . . . the declaration, *including any plats and plans*, may be amended only by vote or agreement of unit owners of units to which at least [67] percent of the votes in the association are allocated, unless the declaration specifies a different percentage for all amendments or for specific subjects of amendment. If the declaration requires the approval of another person as a condition of its effectiveness, the amendment is not valid without that approval.

. . .

(c) Every amendment to the declaration must be recorded . . .

(d) Except to the extent expressly permitted or required by other provisions of this [act], no amendment may create or increase special declarant rights, increase the number of units, change the boundaries of any unit, or change the allocated interests of a unit, in the absence of unanimous consent of the unit owners.

Notably, removal or addition of community components that are identified in an association's plats and plans will generally require a membership vote.

Condemnation & Termination

Condemnation & Termination



Condemnation & Termination

Condemnation. *Any condemnation award* affecting all or a part of the Common Area of the Project, which award is not apportioned among the Owners by court judgment or by an agreement between the condemning authority and each of the affected Owners, ***shall be allocated pro rata*** as set forth below; ***provided***, however, that the balance then due on any ***valid encumbrance*** of record with respect to a Lot affected by the condemnation shall be ***first paid*** in order of priority out of proceeds allocated to the Owner of the affected Lot. The Board of Directors shall allocate the award ***pro rata, based upon fair market value of the Lots affected by the condemnation.*** Such fair market value shall be determined by an appraiser selected by the Board. No member shall be entitled to participate as a party, or otherwise, in any proceedings relating to such condemnation. The ***Board shall have the exclusive right to participate in such proceedings on behalf of all Owners.*** (exemplar CC&R).

Condemnation & Termination

UCIOA SECTION 2-124. TERMINATION FOLLOWING CATASTROPHE. *If substantially all the units in a common interest community have been **destroyed or are uninhabitable** and the available methods for giving notice under Section 3-121 of a meeting of unit owners to consider termination under Section 2-118 will not likely result in receipt of the notice, the **executive board or any other interested person may commence an action** in [court] seeking **to terminate the common interest community**. During the pendency of the action, the court may issue whatever orders it considers appropriate, including appointment of a receiver. After a hearing, the **court may terminate** the common interest community or reduce its size **and may issue any other order the court considers to be in the best interest of the unit owners** and persons holding an interest in the common interest community.*

Questions

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The End!

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