

USE OF HOMEOWNER ASSOCIATION FUNDS

What Can the Homeowner's Association Do With That money in the Reserve Account or Recovered Through Construction Defect Litigation?

By Robert E. Aune, Esq.

INTRODUCTION

Every association faces the problem of raising funds for the repair and replacement of major components, sometimes including the repair of construction defects. However, after funds are collected, through assessments or otherwise, the board is faced with the question of *how* these funds are to be spent. What restrictions are there on the expenditure of such funds? Where are these restrictions found? How does the Board go about determining how to spend the money? These and related issues will be discussed below.

USE OF RESERVE FUNDS

Once funds are designated as reserve funds, their use is severely restricted. Civil Code §1365.5(c) provides that reserve funds can only be used for:

1. The repair, restoration, replacement, or maintenance of major components which the association is obligated to repair, etc., and for which the reserve fund was established;
2. Litigation involving repair, etc., of the above described major components; or
3. A temporary transfer of reserve funds to the operating account to meet short-term cash-flow requirements or other expenses, provided that the board gives notice to the owners of the intent to transfer funds and other details of regarding the transfer and repayment, board minutes reflect the reasons for the transfer and when and how the money is to be repaid the reserve fund, **and** (with some exceptions) that the funds are restored to the reserve account within one year.

In every case where reserve funds are to be expended, the board should specifically consider these restrictions. It is also suggested that the minutes of the meeting where the expenditure is authorized reflect all the reasons that permit the expenditure.

If there is any question as to whether the proposed use of reserve funds is allowed, an opinion of counsel should be obtained. For example, suppose the justification for the use of the reserve funds is the repair or replacement of major components “for which the reserve fund was established.” [Civil Code §1365.5(c)] Although beyond the scope of this article, the issue of whether this requirement is met can create a problem. For example, can these funds be used in the repair of structural components, where reserve funding is generally not established?

USE OF FUNDS RECOVERED THROUGH CONSTRUCTION DEFECT LITIGATION

Duty to Use Funds to Correct Specific Defects

Must the association use the funds recovered to correct the specific defects for which the money was paid?

Although there is no statutory requirement that funds recovered through construction defect litigation be used to correct specific defects, association boards and members often believe that such funds cannot be used for any other purpose. However, in many cases it will not necessarily be in the best interests of the association to use, automatically, all of these funds to correct construction defects.

Note, however, that as soon as practical after settlement of a construction defect lawsuit that the association is required to disclose to each member a general description of the defects that the association believes will be corrected or replaced, as well as other details regarding the plans for correction of construction defects. [Civil Code § 1375 (a)] This statute, however, permits the association to amend the disclosures, which may well be necessary after further analysis of how the settlement funds should be used.

In connection with, or after the initial disclosure described immediately above, the board should consider numerous factors. For example:

1. What was the net amount of the recovery after payment of attorneys fees and costs?
2. What is the total estimated cost of repairs?
3. What critical defects exist, e.g. structural, fire and safety, that will probably require immediate repair?

4. What effect will repair and/or replacement have on required reserves, and how does this relate to the amount of reserve funds currently held?
5. Are there items of deferred maintenance of major components which are more significant than some of the construction defects?

Only after a thorough review of the situation, with the assistance of the association manager, attorney, construction defect experts, and perhaps others, can the board make informed decisions as to how the money recovered should be utilized, and thereby discharge its fiduciary duty to do that which is in the best interests of the association. This analysis may well result in a decision to use part of the money for immediate repairs to construction defects, part of the money for specified future repairs, part of the money for other deferred maintenance, part of the money to repay reserves, and part of the money to increase reserves. And in making these decisions, the board should carefully document its reasons in the event there are any questions later.

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Expenditures to Avoid.

As suggested above, the board has discretion to use funds recovered through construction defect litigation for several different purposes. However, the board of directors should absolutely avoid using these funds for operating and routine maintenance expenses in order, for example, to avoid raising regular assessments. Although perhaps politically popular, this would appear in almost every case to be a violation of the fiduciary duties of the board members, subjecting them to criticism and possible liability.

POTENTIAL LIABILITY OF THE ASSOCIATION AND BOARD MEMBERS

Failure to Expend Association Funds Appropriately

Duty of the Board of Directors – As discussed above, there are specific statutory restrictions on the use of “reserve funds.” [Civil Code §1365.5] There also may be other restrictions on the use of association funds in the association governing documents. The failure of the board to adhere to these restrictions will expose the association and the board members to potential liability. Therefore, before any significant expenditure of funds the board should carefully review the governing documents and the relevant statutes and consider obtaining an opinion of the association attorney as to the appropriateness of the expenditure.

In addition to the above restrictions, the board members have a fiduciary duty to the association and its members to act in good faith and in the best interests of the association. [Corp. Code §7231] To satisfy this duty, the board members must act in accordance with what is commonly termed the “business judgment rule.” This rule, contained in the Corporations Code (it is assumed that the association is a corporation), requires that the duties of the director be performed: 1) in good faith; 2) in a manner the director believes to be in the best interests of the association; and 3) with such care, including reasonable inquiry as an ordinarily prudent person in a like position would use under similar circumstances. [Corp. Code §§7231(c); 7231.5]

Note that the business judgment rule requires “reasonable inquiry” in making decisions. And the Corporations Code specifically authorizes board members to rely upon the opinions of “counsel, independent accountants” and other experts. [Corp. Code §7231(b)] Therefore, in order to comply with the requirements of the business judgment rule, discharge its fiduciary duties and protect itself from liability, the board should utilize these experts, including the professional association manager. Moreover, the minutes of the meetings where such decisions are made should reflect the fact that these opinions were sought and are being considered in making the decisions.

CONCLUSION

Some of the most important duties of the board are reserve funding and the maintenance/repair of major components. However, because of political pressure to keep assessments low, a failure to take the advice of experts, and other factors, boards too often fail to use reserve and other funds appropriately. This can and does result in extensive deferred maintenance, insufficient reserves, repeated special assessments, lowered property values, potential liability and disgruntled members.

To prevent these problems, the board should first be willing to take the political heat of increasing dues, if necessary, to maintain reserves at a reasonable level. In addition, boards should be extremely careful when expending funds, particularly reserve funds, to be sure that legal restrictions are adhered to.

With regard to funds recovered through construction defect litigation, the board should carefully review the situation with the assistance of experts to be sure that the funds are used in the best interests of the association. And virtually **never** should these funds be used for operations or routine maintenance.

Finally, the board should utilize outside consultants, beginning with the association manager, and including attorneys, accountants and others, in order to comply with the requirements of the business judgment rule and its fiduciary duty to the association. Only by doing so will the board members do that which is in the best interests of the association—and avoid possible liability for their actions.