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WHAT WE LEARNED AT CAI's NATIONAL LAW CONFERENCE

Despite the wind, rain and cold weather that followed us from Southern California, Swedelson & Gottlieb attorneys David C. Swedelson, Stephanie M. Rohde and Alyssa B. Klausner recently attended the 31st Annual CAI National Law Seminar in Tucson, Arizona. The seminars were excellent, and we learned a great deal.

During the **Case Law Update,** we learned that "just as a door is not a wall, a gate is not a fence." With nearly 50 cases reviewed over two days, we learned to appreciate that many case outcomes at the trial court level are, to some extent, based on the sympathy factor of the owner. Fortunately, the appellate courts don't seem to be as swayed by sympathy. We were also reminded that the "F" word...fiduciary duty, is still misused, overused and misunderstood by owners, board members and even judges. Not all of a board's maintenance and repair responsibilities, for example, are subject to their fiduciary responsibilities.

We also attended a **Legislative Update Session**, in which the speaker addressed the new legislation impacting community associations that was passed last year and is now new law. Although the new legislation addressed a wide range of issues, the common themes of energy and water conservation, manager licensing, internal governance, and dealing with the bad economy came up repeatedly, indicating that these are issues of concern across the country.

One of the sessions that we attended focused on **Rental Restrictions** and the right of associations to restrict or prohibit owners from renting their units or homes. This discussion began with a summary of pertinent cases from across the country, which, although they are not controlling on California courts, are instructive of sentiments throughout the country.

Woodside Village VIII Condo. Ass'n. v. McClernan, 806 So. 2d 452, (Fla. 2002), involved a restriction on rentals which allowed short term rentals without association consent, and longer term (over one year) leases with the consent of the board. Ultimately, the board sought to allow rentals for only nine months of a year. New purchasers could not lease their units until they had owned for a year. An investor continued to rent in violation of the restriction; the association sued and the defendant counterclaimed. The lower courts held for the defendant/owner; the state Supreme Court reversed and found the restriction on rentals enforceable.

In *Seagate Condominium Association v. Duffy*, 330 So.2d 484 (4th District Ct. App. 1976), a challenge arose in connection with an allegation that the rental

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restrictions unduly "restrained the alienation" of units. The rental restriction had been passed by 96% of the units. One unit owner rented to college students; a lawsuit ensued. Florida had limited only absolute and near absolute restrictions; the restriction on leasing was not absolute. The court indicated that these amendments would be reviewed in the context of reasonableness; impliedly, at least, the 96% sentiment was significant.

Breene v. Plaza Tower Ass'n, 310 N.W. 2d 730 (N.D. 1981) involved CC&Rs that prohibited almost all leasing. Breene sued and prevailed at the trial court, and the association appealed. The Court of Appeals precluded any amendment with a retroactive effect or any effect on current owners; presumably, they considered these rights too significant to allow change of rights as to existing owners. Of course, this case contrasts sharply with the controlling case in California which came to a contrary conclusion (*Villa De Las Palmas,* summarized below).

Shorewood West Condo. Ass'n v. Sadri, 992 P.2d 1008 (Wash. 2000) involved a challenge from investor/buyers to an amendment to the association's bylaws that implemented a rental restriction, but the lower court precluded the retroactivity of the provision. The Court of Appeals reversed, and it was further appealed to the state Supreme Court. The change in the bylaws was found to be invalid; had the amendment been in the declaration, owners would have notice of the change. (In Washington, bylaws, unlike CC&Rs, can be amended without a vote of the owners.)

Charter Club on the River Home Owners Ass'n v. Walker, (Unreported, Georgia Court of Appeals, 2009 Ga. App. LEXIS 1397) involved another challenge by a unit owner who was renting, and continued to rent after the rental restriction amendment. Georgia's statute opposed amendments which restricted "use" without the owner's consent. Georgia's court started out by asserting that restrictions in declarations will be strictly construed. Leasing property is a type of "use"; hence the statute precluded the restriction. The unanswered questions arising from this case are whether it can be applied to those who voted in favor of it (yes, according to a Georgia lawyer at the seminar) and whether it can be applied against those who didn't vote (no, according to the same lawyer).

Villa De Las Palmas Homeowners Ass'n v. Terifaj, 121 Cal. Rptr. 2d 780 (Court of Appeal 2002), the only California case discussed during this session. This case did not actually involve a rental restriction. But this case did involve a (pet) restriction adopted by rule; the owner challenged the rule and the trial court questioned the validity of the rule. The association then made the rule into an

amendment to the declaration by putting the matter to vote by the homeowners, and the court's inclinations shifted. The court not only found the amendment enforceable, but also held it was retroactive and applies to all owners, even those that owned their unit or lot prior to the amendment.

Apple Valley Gardens Ass'n v. Machutta, 763 N.W.2d 85 (WI Sup. Ct. 2009) involved a Wisconsin developer who retained some units; the association amended the bylaws to prohibit them from being rented. The declaration, from the outset, had impliedly allowed rentals through such provisions as one providing that the lease of a unit would not relieve the buyer of an obligation to pay the assessments. The bylaw amendment was held to be acceptable and not contrary to the declaration, and the limitation was held to not be an unreasonable restraint on alienation.

Villas West II v. McGlothin, 885 N.E.2d 1274 (IN Supreme Ct. 2008) involved a Fair Housing Act challenge to a rental restriction. The purchaser bought after the rental restriction was in place; the McLaughlins both moved from the house. The daughter attempted to rent the house and alleged that the no-lease provision had a disparate effect on minorities. The rental restriction was held to have had an adverse impact on minorities; in response to a showing of disparate impact, the association could respond only by showing a good reason for the rule. It is anticipated more of these fair-housing based challenges to rental restrictions will arise in the future.

This session concluded with a list of "tips for the practitioner" regarding rental restrictions:

- Include a hardship exception, to make the amendment seem more palatable to owners and the courts;
- Make the hardship exceptions objective, to protect against arguments respecting arbitrariness;
- Don't even try to take away vested rights (e.g., such as terminating an existing lease);
- Better in the declaration than the bylaws (or even worse, a rule or regulation).

There was an interesting discussion about whether or not grandfathering is acceptable, and if so, how to do it. There's a practical side to this, both in connection with getting votes and avoiding lawsuits. In California, based on the *Villa De Las Palmas* case, grandfathering may not be required in California. But

it may help get the owners to approve the amendment if they know that they would be excluded from the rental restriction.

We attended a session on negotiations, entitled "**Helping Your Associations Preserve Relationships**". In this session, the speakers focused on interest-based rather than position-based negotiations in order to help associations reach agreements in the types of conflicts that they encounter most. The two examples used were a dispute between the residential and commercial components of a mixed-use association and a battle between the board and an owner regarding a violation of an architectural regulation.

The speakers emphasized the importance of maintaining relationships in these types of negotiations - after all, everyone remains neighbors when the matter has ended. In order to accomplish this, they recommended taking the following steps:

- Agree on the process of the negotiations, including timing;
- Identify the issues, and the parties' interests (why do they want what they want);
- Develop potential options (including face-saving options, which can be important in some cases);
- Develop standards by which the options can be considered;
- Judge the options with the standards;
- Achieve an agreement where both parties' interests are met.

Although a solution cannot always be reached, if parties keep in mind their best alternative to reaching a negotiated agreement (which is often spending a lot of time and money in litigation), there are often solutions to be reached which also allow the parties to peaceably coexist in the future.

We next attended a program on **Fraud in Associations**; there were perhaps two hundred people at this program, and a show of hands revealed that a large majority – probably 90% – of the audience has experience with or knowledge of an association that was victimized by fraud. Clearly, it's happening a lot, and it is probably only being discovered some of the time. The speakers ran through a list of examples, spanning from large management companies to small local managers:

Multivest Management was a major case of embezzlement; one of the principals of the company managed to embezzle $3.4 million from about 50 associations

over a 7 year period by falsifying bank statements, skimming owner payments and failing to provide any kind of bank reconciliations to the boards.

One association in the state of Ohio suffered a $650,000 loss in another case of a large company committing management fraud. One of the red flags in this case was the fact that the manager had unlimited authority to withdraw on accounts.

Another association was victimized by a management team where the maintenance man, in connection with the accountant, was fabricating maintenance reports and getting paid on them. Several associations have been victimized by improper use of credit cards.

Another association was taken over by a disgruntled owner who gained the trust of other recent immigrants and got himself voted onto the board, later becoming the president. The individual obtained control, took over the management duties, embezzled and stopped paying his assessments. The 95-unit association lost over $130,000.

An association with a volunteer owner/treasurer who had unsupervised use of the association's bank accounts resulted in the loss of more than $80,000 from a 75-unit association.

The speakers presented several prevention issues.

Segregation of duties:

- First, make certain there is no comingling of your association's funds. Have them tied to your association's tax ID number;
- Use a lockbox system for receipt of assessments;
- Require dual signatures for all withdrawals
- Segregate and (carefully and regularly) monitor the association's reserves.

Oversight:

- Require duplicate bank statements from the bank and make sure that the person reconciling the account is other than the one writing the checks;
- Enable online account review;
- Compare invoices with the corresponding checks;

- If the association allows a credit card, have a low limit and monitor the invoices.

Third Parties:

- Get banking services from reputable lenders;
- Consult with a qualified insurance agent and get adequate coverage (and remember that D & O coverage is not the same as fidelity coverage);
- Hire a qualified third party CPA to conduct reviews at a minimum, and better yet, audits.

When obtaining insurance, make certain that everyone with access to money is covered. Be aware of what the discovery requirements are, and what will invalidate your coverage. The secondary mortgage market is requiring coverage for three months worth of assessments; there is no penalty for noncompliance, but noncompliance will complicate the ability to finance units.

We attended another session warning against management companies' overstepping their bounds, entitled, "**Management Companies and the Unauthorized Practice of Law**." Of course, all managers should be aware that they are not able to represent an association in court (other than small claims court in California). However, there are some acts that are closer to the line of what constitutes legal practice and what does not.

The exact definition of what is considered to be the practice of law varies from state to state. In California, it is considered the unauthorized practice of law for a non-licensed person to draft legal documents, give legal advice or represent a party in legal negotiations. There are certain acts that require a lawyer in some states but can be conducted by a manager in others, such as representing the association in arbitration, providing certain forms of legal advice, and drafting certain basic legal documents such as assessment liens. A heated debate took place as to whether an attorney could provide form documents to an association and allow the managers to fill in certain blanks, the resolution being that this may be permitted in some states but not in others.

Sometimes this unlawful practice of law can involve not only the association's management, but also an attorney who assists the manager in taking the actions. The speaker provided a warning to attorneys to not be tempted to help out managers with whom they work by providing generic opinion letters on common

topics for the managers to provide to each of their association clients if and when the topic arises. Because unique issues arise under each circumstance, allowing managers to decide if an opinion letter applies to any given situation would likely be considered the unlawful practice of law. The practical reason for this distinction is that the manager could miss important legal issues, and could end up getting the association into a much more difficult situation. Even a manager who carefully monitors all community association law will not have knowledge of all other related laws, such as insurance law, general real estate and contract law, and anti-discrimination law.

The consequences for allowing this rule to be broken can be severe: attorneys can be disbarred, managers can be subject to civil and criminal penalties, and the board can be left unprotected under the business judgment rule, which requires reliance on experts; relying on a manager for legal expertise does not fulfill this requirement. The moral of the story was, when in doubt, ask a lawyer.

We next attended a program entitled, "**Keeping Out the Riff-Raff**" which addressed an association's ability to keep out all different types of undesirable owners, from sex offenders and other felons to smokers, renters and people with poor credit history.

The speakers did a nice job talking about various prohibitions. They began with a discussion of sex offenders and cases that have dealt with this issue, which have ranged from moderate restrictions to more severe. A New Jersey court upheld a bylaw restriction prohibiting only third level (the most severe) sex offenders from residing (although they could still own property) within the association. Some associations in Texas and Kansas have imposed much stricter restrictions, prohibiting all sex offenders from ownership and residence. These restrictions have not yet been challenged, so we do not know whether a court would uphold them. However, there are also logistical considerations that come with such restrictions. For example, a total prohibition, imposition of fines and certification from sellers is required under a restrictive covenant that prohibits sex offenders.

There was a discussion of rental bans and the difficulty of creating same. This was the second of many times that rental restrictions were discussed at the seminar. The speakers suggested a checklist for any board considering this change as there are multiple interests involved.

There was then a discussion of smoking and the possibility of banning smoking in individual units. An association can ban smoking in common areas, but case law is still unclear as to whether smoking can be prohibited in individual units.

In general, when it came to imposing these types of prohibitions, there was strong support in favor of amending the governing documents as opposed to imposing a rule.

What about a ban on speculators, or on those with a certain credit score? There are a number of undesirable owners and occupants that associations would like to keep out but which restrictions they have hesitated to pursue. Although these matters have not yet gone to court, and we don't know whether such restrictions may be upheld, we do know some of the factors that a court would consider. Any restrictions to these items are clearly going to be subject to a test of the reasonableness of the restriction. The challenges to these restrictions are based upon unreasonable restraint on alienation of property. Courts will look at various factors in making this determination. Further, legal implementation also needs to be considered with various fair housing issues and any potential discriminatory impact of such restrictions.

We also attended a session entitled "**Unintended Consequences of Reserve Studies**". With the continuing trend of statutory requirements for reserve studies, there may be unintended consequences for some communities. Reserve studies often reveal deferred maintenance and highlight poor past funding, which can result in lawsuits against the association and reduce property values.

A Reserve Specialist spoke at this session, and advised that reserve studies need to be understood fully. Attorneys may be necessary to make sure the items included are legally the obligation of the association. Associations should also make decisions about maintenance and repair capabilities and philosophy and share these with the reserve study provider before the study is completed.

It was also stressed that funding decisions take into account the impact of special assessments or a decision to not fund fully or even at all.

We also attended a session on "**Attorney Audit of Community Association Insurance"**. The attorney's role includes reviewing governing document requirements and state requirements, and evaluating exposures and policies covering the exposures. The speaker advised that while many insurance agents are very good, some do not specialize in community association insurance triggering an important role for the association attorney.

We attended a program on the **Federal Fair Debt Collection Practices Act**. It was stressed that no one wants to end up being sued for a violation of the Federal Fair Debt Collection Practices Act. The speakers suggested several ways to ensure this does not happen:

1) Attorney demand letter should say the owner has 30 days from receipt of the letter to dispute the debt and send letters by certified mail;
2) Make sure paralegals, assistants and collectors clearly identify their positions on the phone and in emails;
3) Consider whether the least sophisticated consumer would be mislead or consider your communications false or deceptive;
4) Demand principal balance separately from attorney fee and cost demand;
5) Be cautious about adding "costs" that management company charges the association for each account it handles if there is nothing that obligates the owner to pay such "costs".

We also attended a session entitled "**War Stories From the Trenches**", in which three association attorneys shared their most challenging stories. After hearing 3 horrific war stories of situations that have gone on from 5 to over 10 years, this session made us wonder:

1) How far should an attorney go for their client if you really fear for your life?
2) How do you deal with a truly "crazy" owner?
3) When is enough, enough?
4) Do you really want to say "sure, I can cover the meeting for you"?

The speakers provided a list of things to be worried about that may tip you off that you may be headed for the case from hell, which include:

- An owner with 20+ parakeets;
- Receiving a call from the Bureau of Alcohol, Tobacco and Firearms that an owner has requested a license to sell firearms from their unit;
- Discovering that an owner sends letters under an alias;
- An owner who moves into the community to avoid tax evasion issues whose best friend is a disbarred tax attorney serving time in prison.

While this session had a humorous tone, it reminded us that these types of situations do exist in this field, and the attorneys and other professionals who work with community associations should be prepared for anything.

David Swedelson was a speaker on a panel regarding Collecting Delinquent Assessments in a Troubled Economy. David spoke primarily about the non-judicial foreclosure process and provided some ideas and tips for collecting delinquent assessments using the non-judicial process. David Swedelson and Stephanie Rohde prepared an article on this subject. David Swedelson was also on a Panel of Pundits. This panel of experienced association attorneys fielded questions from the audience. Almost all of the questions related to assessment collection, clearly showing that the Great Recession is having a significant impact on community associations throughout the country.

Finally, we attended a town hall session on the new Fannie Mae, Freddie Mac and FHA guidelines. Although there are three different sets of requirements, there are basic elements that must be met in all three, which include a certain percentage of the units being sold, an adequately funded reserve budget, residency requirements and insurance requirements.

Much of the conversation on this topic centered around what exactly is the association's responsibility with respect to establishing that it meets these guidelines. The concern was that lenders would request that the association fill out certain forms affirming the truth of statements that the manager (or other person filling out the forms) may not know are true. Although this session left a number of questions unanswered, we were left with the impression that as these guidelines become implemented more regularly, uniform procedures will be established.

Our ongoing commitment to our community association clients and our industry was the reason for our attendance at the National Law Conference. We thought sharing a bit of what we learned with you would be of great value; we hope you agree.