Lessons learned from the January 1994 Northridge earthquake

by David C. Swedelson, Esq.

As the aftershocks continue to roll through the southland, it is clear that we do not live on "terra firma." January's Northridge earthquake had a devastating impact on community associations in the Los Angeles area and it raised a multitude of issues to which no one was fully prepared to respond. To find some answers we have had to blow dust off the sections of governing documents which delineate the process to follow after an association has suffered major damage and destruction.

This article addresses many of the issues we have confronted since the earthquake. It is for associations still grappling for answers and also for the many other associations who may in the future have to respond to these same concerns. The article should not be considered a substitute for professional review of each association's governing documents; each association's circumstances are different and professional counsel experienced in this area can be of vital importance to the associations and their boards in recovering from an earthquake.

Repair responsibility

The earthquake allowed many homeowners to meet their neighbors for the first time, and sometimes those meetings turned into divisive forums for debate over repair responsibilities. In many cases, the predominant damage to associations consisted of cracks in interior unit walls and ceilings. Even associations fortunate enough to have earthquake insurance learned that they were not necessarily in a financial position to repair such interior unit damage.

Each association's governing documents specify varying levels of responsibility for maintenance, repair and/or replacement of the different components of unit interiors. For example, merely because the walls and ceilings are common area does not mean that they are the association's repair and/or replacement obligation. The CC&Rs and condominium plan must be reviewed and interpreted to determine these responsibilities. Because all CC&Rs require that owners be responsible for painting their unit interiors, and it is the unit owners' obligation to patch and paint, most associations have taken the position that the primarily cosmetic damage of cracks, repairable by patching and painting, is the homeowner's maintenance and repair obligation. Associations are not landlords.

Some homeowners, association managers and attorneys have taken the alternate position that crack repairs are the association's obligation because the cracks penetrate a wall which is common area (not all walls are common area according to many CC&Rs). While this may be true in those limited circumstances where the repair requires that the wall itself be replaced, the repair of a cosmetic crack is done on the surface of the wall in the interior of the unit, which is the homeowner's responsibility. Let us not forget than an earthquake is an act of God, and associations do not put away money in reserves for earthquake damage.

With respect to those associations that were partially or fully destroyed, there are provisions in their governing documents which require the vote of the homeowners as to whether or not to rebuild. Certain associations, and even some associations with earthquake insurance, have decided not to rebuild.

Earthquake insurance

Earthquake insurance is not required by either California law or governing documents, and only about half of the associations in the Los Angeles area were covered. Even then, coverage did not necessarily equate to a recovery. High insurance deductibles combined with the various degrees and subtleties of coverage pose questions and difficulties regarding funding of repairs.

The high deductible in earthquake insurance is often misunderstood. The typical 10 percent deductible is not 10 percent of the damage, but 10 percent of the value of each of the association's buildings. For example, in an association with seven differently configured buildings, the insurance company might place a total value of $7 million on all of the structures and other improvements. At the time of loss, however, the insurer places a separate value on each of the buildings, plus an additional value on common areas such as walls, pools and recreational buildings. Therefore, if the damage to a $1 million building (with a $100,000 deductible based on 10 percent of value, not the amount of damage) was $110,000, the association would receive $10,000.

There is currently some debate as to whether associations were/are undervalued for the purpose of insurance coverage. Whether it be destruction by fire, earthquake or other disaster, each association should review the replacement cost valuation placed on its buildings. Notwithstanding the stated replacement cost valuation, if an association has obtained "guaranteed" replacement cost insurance, and if it costs $7.5 million to replace a building valued at $7 million, the insurance company is on the hook for $7.5 million.

One interesting quirk of insurance coverage has been with respect to

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"betterments and improvements." Most governing documents only require that the association obtain coverage for damage from the bare wall out (owners have responsibility from the bare wall in). However, FNMA (Fanny Mae), the government agency that guarantees most home mortgages, has a policy that insurance for associations will provide, in addition to the bare walls, coverage for betterments and im-

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provements. This generally includes the paint, wallpaper, plumbing fixtures, cabinets, and appliances but not the personal property of the owner. FNMA's policy is based on their belief that many borrowers will not obtain their own unit insurance. This is true.

An association will not receive enough money from the insurance company to make all repairs in its claim, which includes betterments and improvements. A conflict has arisen around the fact that the association does not necessarily have repair responsibility for betterments and improvements.

Homeowners believe that the association should make betterments and improvements repairs because they are part of the covered claim, even though some owners sustained less damage than others. These owners believe that the association should spread the cost of repair of all damage among all the owners. Because the earthquake was an act of God and because the association's CC&Rs control, others have taken the position that the association has no obligation to repair the betterments and improvements.

Some associations have chosen to repair the betterments and improvements. The association will then have the administrative headache of collecting delinquent special assessments, actually making the repairs, and handling complaints from homeowners.

Other associations have determined that the insurance coverage did not expand the association's repair responsibilities under the CC&Rs. They are taking the proceeds from insurance, applying them to the common area for association repair responsibilities, and then apportioning the remaining monies to the homeowners in proportion to their damage.

Each association's circumstances and options are different, and decisions are based on factors such as the nature of the damage, repair responsibility and the amount of money available.

Funding the cost of repairs

There are alternative sources of funding for the many associations that did not have earthquake insurance and for those that did not receive enough (or any) money through insurance to pay for repair of the damage. One of the first options is to use or borrow the monies from reserves, depending on alloca-

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tions. If, for example, an association with reserves allocated for painting now needs to patch cracks and paint the building, the association can use the allocated funds for that purpose. Pursuant to California Civil Code Section 1365.5, the board can borrow from reserves as long as it establishes a method of repayment within three years (or longer under certain circumstances).

Another option is for the board to levy a special assessment(s) to pay for the repairs. It should be remembered that pursuant to Civil Code Section 1367, a special assessment is the debt of the owner of the unit on the date levied, even if the payments are spread over a long period of time. It may be better to levy a number of smaller assessments.

A loan through the Small Business Administration (SBA) is another source of funding. The association may use these U.S. Government loans to pay for repairs. They are typically provided to associations at a four percent interest rate, with a payback of up to 30 years in some cases. There is a loan cap of $1.5 million, and the association can only receive an amount determined by the SBA to be necessary for earthquake repairs above and beyond insurance coverage. Despite the rumors, these SBA loans are secured against the association's future assessments and not against the individual unit owners' property. Neither the board nor the owners are required to sign personally.

Insurance claims

Associations are still resolving their claims with the insurance carriers. While it is not the obligation of the insurance company to find every element of damage, it is the insurer's obligation to fully adjust the association's claim. Associations would be well advised to hired both legal and engineering/architectural professionals to assist them in the evaluation of their claims. Because an association may not know the full scope of the damage until it uncovers portions of the building, the association's insurance carrier may pick up the cost of an engineering expert as the insurers' adjusters are not capable of determining the full scope of the damage.

Board responsibility

The responsibility for making repairs, settlement with the insurance company, contracts, SBA loans, special assessments and the like falls on the board. While many owners will come out of the woodwork and try to take control so these issues are resolved "their way," it is the board that is given this responsibility both in the association's governing documents as well as in the civil and corporation statutes. Boards must seize this power, as it is their fiduciary obligation to make these decisions. Boards carry out this duty by relying on the advice of professionals.

Contracts and contractors

Many associations are in the process of getting bids and contracts from contractors for the actual repairs and reconstruction. Remember that it is typically too late to reverse a contract once it has already been signed and that a typical prefabricated contract submitted by a contractor is designed to protect the contractor and not the association. Prefab contracts usually will not include important provisions, including a well defined scope of work, a termination clause or the warranties that associations are anticipating. These are only a few of the many important clauses of a contract that should be included to protect an association in the event the contractor fails to perform.

Construction defects

The earthquake has further demonstrated what we all knew, which was that many condominiums were not properly constructed. Many associations' buildings failed where they should not have. We have discovered that where there should have been shear walls, there were none; where there were shear walls, they were not nailed properly; where there were anchor bolts, there were no nuts attached to those bolts. In many cases, the associations are well beyond the 10 year statute of limitations and can do nothing about these defects. Those associations that are less than 10 years old from the date of substantial completion should investigate these types of defects and consider whether or not the cost of repair validates a lawsuit. Insurance companies will not pay for upgrades to correct these defects, although many savvy associations are working with their experts to classify the work as part of necessary repairs.

Other issues

This article only mentions some of the many issues that we have been dealing with since the earthquake. Every day we confront an entirely new

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issue or a sub issue. As an example, a recent case decided by the Court of Appeal held that insurance companies are not required to offer earthquake insurance to HOAs. This means that in the future, some will find it difficult to find coverage (see inset). Fortunately, associations are relying on legal counsel to assist them in determining responsibility, adjusting claims, working out specifications for reconstruction, negotiating and preparing construction contracts, and providing general counsel and guidance.

Those associations that did suffer damage, and those that did not or have not yet experienced an earthquake such as that which was experienced in Southern California in January, should consider many of the issues that have been raised in this article so they can be a little more prepared when the next big one hits.

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