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LAW GROUP

AB 2912: NEW PROTECTIONS AGAINST THE MISUSE OF HOA FUNDS

UNDERSTANDING THE NEW FINANCIAL REVIEW REQUIREMENTS AND FUNDS TRANSFER RESTRICTIONS

INTRODUCTION

Assembly Bill 2912 ("AB 2912") was recently enacted by the California Legislature. Its changes to the law, which take effect **January 1, 2019**, are intended "to protect owners in a [HOA] from fraudulent activity by those entrusted with the management of the [HOA's] finances." To that end, AB 2912 (a) significantly increases the financial review requirements of HOA boards of directors, (b) limits the ability for automatic transfer of HOA funds without board approval, and (c) imposes a requirement for the HOA to purchase and maintain a fidelity bond. In the wake of AB 2912's passage, questions and concerns have surfaced as to how HOAs and their management companies may need to adjust their current operational procedures to comply with the new state of the law. The purpose of this article is to address some of those questions and to clarify some of AB 2912's key components.

REQUIREMENT FOR WRITTEN BOARD APPROVAL OF ACCOUNT TRANSFERS ABOVE $10,000

AB 2912 amends existing Civil Code § 5380 to prohibit the automatic/electronic transfer of funds greater than $10,000 or 5% of a HOA's total combined reserve and operating account deposits (whichever is lower), without prior, written approval from the HOA's board of directors. This requirement is also reiterated in new Civil Code § 5502. HOA boards that previously gave blanket consent to their managing agent for such electronic/automatic transfers should expect the need to now give written approval for such transfers (e.g., large payments to vendors of the HOA) each time a transfer is required, or at least approval for all transfers to a specific vendor who provides significant, ongoing services to the HOA.

"Does this apply to transfers in the truest sense (e.g., electronic transfers) and not to checks?"

There is nothing in the Code's language or the Legislative Analysis surrounding AB 2912 that suggests it applies to written checks. The intent of AB 2912 is to guard against substantial transfers of which the board has no knowledge. Those concerns are not present in situations where a check is presented to the board for its signature and approval.

"Would HOAs and their management companies violate the spirit of the law if larger invoices were split into two (2) or more payments so as to not exceed the $10,000 threshold?"

Yes, they would. AB 2912's intent is to create more Board oversight to prevent fraudulent activity, and states that further action/regulation by the Legislature may be necessary to address this issue. Structuring payments in a manner designed to avoid AB 2912's requirements violates the spirit of the law and will only invite further regulation and action by California lawmakers.

"What about contracts for monthly services (e.g., management services) that exceed the $10,000 threshold? Is management expected to get secondary approval each month to pay these invoices?"

As an alternative to monthly approvals, management may simply include language in its contract allowing for it to deduct its monthly payment for management services and disclose this fact to the board. We suggest that only the base management fee, as disclosed in the management company's contract, be authorized by the board for automatic payment. Any reimbursement expenses, ancillary fees or "extras" the management company charges should be separately invoiced and approved by the board. This is considered a "best practice" that should be utilized for all HOA contracts with its vendors. Accordingly, we recommend that for any contract which requires monthly payments greater than $10,000, the board should, at the time the

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contract is signed, execute a written Board resolution memorializing the board's consent to have the regular monthly payment be automatically deducted from the HOA's account. We also recommend that this resolution be re-executed by the board any time there is a change in the board's composition (e.g., any time there are new persons elected or appointed to the board).

> *"…execute a written board resolution…to have the regular monthly payment be automatically deducted…"*

"If authorization must be given, can the board assign the authority to an officer (e.g., the board Treasurer) to help facilitate a timely approval process?"

In areas where the new law discusses approval, it refers to approval by the "board." Again, the intent of AB 2912 is to guard against fraudulent activity. If only one director is reviewing and approving transfers, the door remains open for that director to engage in dishonest conduct or to fail to identify problematic activity. While an argument can be made that a director or executive committee of the board could approve transfers (which would in theory then be ratified by the board and documented in its next meeting minutes), we do not believe that this arrangement comports with the underlying intent of AB 2912.

FINANCIAL REVIEW BY THE BOARD MUST NOW BE PERFORMED ON A MONTHLY BASIS

The law previously required the board to review the financial information of the HOA on at least a quarterly basis. Civil Code § 5500 has been amended to now require that review to be performed on a **monthly** basis. Moreover, it now requires the review to include the HOA's check register, monthly general ledger, and delinquent assessment receivable reports. Previously the Code did not specifically include these documents/records as part of the board's financial review requirements.

"But what about HOA boards that only meet quarterly?"

Fortunately, new Section 5501 was added to the Civil Code to address this issue. It provides that the financial review requirements may be met "when every individual member of the board, or a subcommittee of the board consisting of the treasurer and at least one other board member" reviews the financial information "independent of a board meeting" and that review is (a) subsequently ratified by the board at its next meeting and (b) the ratification is memorialized in the board's meeting minutes. For HOA boards that meet on a quarterly basis, there will likely be a need to form an executive finance committee of the board as contemplated by Section 5501. Those boards should work with their management and legal counsel to draft an appropriate charter for such a committee.

NEW REQUIREMENT FOR EVERY HOA TO PURCHASE A FIDELITY BOND

A fidelity bond is a form of insurance protection which covers losses that the policyholder incurs as a result of fraudulent acts by individuals. It is used by a HOA to insure losses caused by the dishonest acts of the HOA's employees, managers, board members or officers. Previously there was no legal requirement for HOAs to purchase fidelity bonds; however, many HOAs do so either because their CC&Rs require it and/or because it makes good business sense.

New Section 5806 is added to the Civil Code to formally require HOAs to purchase a fidelity bond. Unless a HOA's governing documents require

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greater coverage amounts, the fidelity bond must be purchased and maintained in a coverage amount that is equal to or more than the combined amount of reserves of the HOA and total assessments for three (3) months. The bond must also include computer fraud and funds transfer fraud. Additionally, for HOAs that contract with a third-party managing agent or management company (which is most HOAs in California), the HOA's fidelity bond coverage must also include coverage for dishonest acts by the managing agent or the management company and its employees.

"Does the fidelity bond coverage amount apply separately to computer fraud and fund transfers fraud, or may those components be carried in lesser amounts?"

The fidelity bond coverage must be at least equal to the combined amount of HOA reserves and total assessments for three (3) months ("Coverage Amount"). Section 5806 further states that the fidelity bond "shall also include computer fraud and funds transfer fraud." There is no language suggesting that the computer fraud and funds transfer fraud components may be carried in any lower amount(s). In other words, the Coverage Amount should extend to standard embezzlement/theft, as well as to losses resulting from computer fraud or funds transfer fraud. If, for example, a HOA purchases a fidelity bond for the required Coverage Amount, but a component of that insurance product reduces the coverage for computer fraud or funds transfer fraud, we do not believe that such an insurance product would satisfy Section 5806's requirements.

SUMMARY & RECOMMENDATIONS

As HOAs grow in size and significance, so too does the temptation for unscrupulous actors to target the substantial financial deposits of HOAs. The California Legislature has identified several high-profile incidents where those entrusted to control a HOA's finances have embezzled significant amounts of money. AB 2912 is the Legislature's response to those incidents; it imposes what the Legislature believes is necessary to protect the millions of homeowners living in HOAs across California. In doing so, the Legislature feels that AB 2912 requires only "very minor changes to how [HOAs] manage their collective funds."

We agree with the Legislature's perspective. The steps HOAs and their management companies must take in the wake of AB 2912 make sense and are not overly burdensome. To summarize those steps:

- Board approval of ongoing monthly transfers may be addressed via board resolutions. Such resolutions may be drafted by the HOA's legal counsel in a template format for use by the HOA when required.
- With respect to financial review requirements which must now be met on a monthly basis, the Code provides a feasible accommodation to boards who meet only on a quarterly basis: forming an executive committee to review financial information independent of the board's next quarterly meeting.
- The fidelity bond requirement is already being met by many HOAs who have fidelity bond requirements in their CC&Rs. For HOAs that do not, purchasing a fidelity bond provides a valuable and relatively inexpensive benefit to the HOA and its membership.

We anticipate that additional action will be taken by the California Legislature with respect to this issue—especially if more incidents of HOA embezzlement surface and attract media attention. HOA boards and industry professionals should therefore expect that, if any further legislation is enacted with respect to this issue, such legislation is likely to increase HOA financial review requirements and responsibilities, not relax them.

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