HOA MINI REPORT

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A quarterly newsletter providing legal news and analysis of interest to homeowners associations in Eastern Washington. Please contact me at nick@gnbergh.com with any comments or suggestions.

Happy Spring!

With the appearance of green shoots outdoors, I am pleased to report green shoots indoors as well—things are going as well as I had hoped and planned at my new law office. Many thanks to all of you who stayed with me in the changeover. I look forward to many years of writing this Mini Report and to working with each of you as need arises.

I have a favor to ask. Postage and handling for mailing this newsletter is expensive and time consuming. If you would provide me with your email address, I will send future issues to you in PDF format rather than by US mail. I will not share your email address with others. If you would like to receive past issues or would prefer not to receive this newsletter, please let me know.

Boards Gone Wild?

A recent HOA battle in Alexandria, Virginia ended badly for the Association. The battle was opened when homeowners placed an Obama for President sign in their front yard. The sign was four inches larger than allowed by the covenants. The board had previously been very proactive on covenant enforcement issues and feared that chaos would result if they allowed the sign to stay. The homeowners responded by cutting the sign in half and claiming that each of the two signs complied with the covenants. The board was not amused, and voted to fine the homeowners. The ensuing lawsuit took four years and it cost the Association nearly $400,000 in legal fees to learn it did not have authority to issue fines, a result that was not obvious from then existing law in Virginia. Annual assessments increased from $650 to $3500 to cover the costs. The association filed for bankruptcy, and was ordered to sell community common area to cover its debt. The case has been widely criticized in news accounts as an example of boards gone wild.

What should the board have done differently? Did the board have a duty to enforce the covenants? Under Washington law, an association's officers and board are required to follow the "business judgment rule." The business judgment rule requires officers and directors to perform their duties in good faith and in a manner they believe to be in the best interests of the Association, and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. In doing so, the board may rely on information or opinions presented by other officers, committees appointed by the board, and counsel, public accountants, or other professionals, so long as the board members reasonably believes the information and opinions to be reliable.

There is no doubt that a board has the authority to enforce the covenants of its association, and to determine the appropriate means of enforcement. However, this authority does not necessarily require the board to act anytime a violation is alleged. Under the business judgment rule, the board must act in the association's best interest, and has a duty to act prudently. This means the board has a duty to inquire into alleged violations, but in appropriate cases, the board has discretion on whether and how to enforce. The Virginia case described above provides a good example. There is no doubt the Virginia board had the authority to enforce the covenants, and decide how enforcement should be conducted. On the other hand, it was also within their authority to overlook the relatively minor violation, or seek another means of enforcement, such as seeking a court order to remove the sign. The business judgment rule offers a board the flexibility to select what it believes the best alternative course of action, to weigh the potential costs against the probable benefits, and even to change course in mid-stream, so long as the decision is prudent and in the best interest of the association.

Budgeting Do-over. The capital reserves law that became effective just over a year ago has changed budgeting by adding complexity, but has also made it easier to put new budgets in place. RCW 64.38.020 sets out the basic budgeting scope and authority of the Association:

> *Unless otherwise provided in the governing documents, an association may . . . [a]dopt and amend budgets for revenues, expenditures, and reserves, and impose and collect assessments for common expenses from owners.*

RCW 64.38.025 clarifies that the board is to propose a budget and submit the proposed budget to the full Association membership for ratification. Within 30 days after adoption of a proposed budget, the board must set a meeting of the membership to consider ratification. The board must send a summary of the proposed budget to the members, and notice of the meeting must be sent not less than fourteen nor more than sixty days after mailing of the summary. Under RCW 64.38.035 the notice of the meeting must contain a general description of "*any budget or changes in the previously approved budget that result in a change in assessment obligation.*" RCW 64.38.025(4) elaborates on this requirement by requiring the budget summary to disclose:

> *(a) The current amount of regular assessments budgeted for contribution to the reserve account, the recommended contribution rate from the reserve study, and the funding plan upon which the recommended contribution rate is based;*
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> *(b) If additional regular or special assessments are scheduled to be imposed, the date the assessments are due, the amount of the assessments per each owner per month or year, and the purpose of the assessments;*
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> *(c) Based upon the most recent reserve study and other information, whether currently projected reserve account balances will be sufficient at the end of each year to meet the association's obligation for major maintenance, repair, or replacement of reserve components during the next thirty years;*
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> *(d) If reserve account balances are not projected to be sufficient, what additional assessments may be necessary to ensure that sufficient reserve account funds will be available each year during the next thirty years, the approximate dates assessments may be due, and the amount of the assessments per owner per month or year;*
>
> *(e) The estimated amount recommended in the reserve account at the end of the current fiscal year based on the most recent reserve study, the projected reserve account cash balance at the end of the current fiscal year, and the percent funded at the date of the latest reserve study;*
>
> *(f) The estimated amount recommended in the reserve account based upon the most recent reserve study at the end of each of the next five budget years, the projected reserve account cash balance in each of those years, and the projected percent funded for each of those years; and*
>
> *(g) If the funding plan approved by the association is implemented, the projected reserve account cash balance in each of the next five budget years and the percent funded for each of those years.*

Complying with these disclosure requirements will be impossible if the Board has not obtained a reserve study, as required by the capital reserve law beginning in 2012. If your

association is not exempt and your board has not already commissioned a reserve study, it should do so as soon as possible so that appropriate and complete budget summary are distributed. While the board has no legal liability for failure to prepare a reserve study, failure to do so is probably not consistent with the board's duty to the association and in any event, a vote of 35% of the members can override a decision not to prepare a reserve study. If proper notice is not given or the proposed budget is not ratified, the existing budget will remain in effect.

The process for ratification of a proposed budget is a dramatic change from common practice. Instead of requiring a set percentage of affirmative votes to approve a proposed budget, RCW 64.38.025(3) dispenses with any requirement that a quorum be present at the vote on the budget and also provides that the budget will be deemed approved, unless the required percentage votes against the budget. In the absence of a vote requirement in the governing documents, the statute sets a majority vote as the requirement to reject a proposed budget. Most governing documents, if they set a voting threshold, state a requirement for approval rather than rejection. Because the statute reverses the customary voting paradigm, I believe that in these cases the inverse of the approval requirement should be used in order to preserve an intended supermajority voting power stated in governing documents. For example, if the governing documents state that approval requires a 60% vote, the statute would require inversion of this percentage, so that the budget would be deemed approved unless 40% of the members vote to reject it.

One effect of these changes is to make it more likely that budgets will be approved. Most boards have experienced how difficult it is to get a quorum to attend a meeting, let alone a supermajority that is often required for major decisions such as approving a budget that increases assessments. The result is that many important decisions are simply not made because of member apathy. Because the new budget approval process allows budgets to be deemed approved unless a requisite number of members vote to disapprove, the default is approval of budgets (even in the absence of a quorum), unless the requisite number of members take action to reject.

The full text of the statutes cited above may be found at http://apps.leg.wa.gov/rcw/. The actual language of the statutes can be difficult to follow and you should consult the statutes to determine the interplay between them and your governing documents. In case of doubt, you should consult your attorney for advice.

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