Top 10 Myths About Small HOA's

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For purposes of this article, a small HOA refers to properties that are comprised of 2-5 units. This article attempts to dispel several myths about small HOA's, all of which are driven by the faulty premise that statutory regulations either exempt them or simply do not apply to them.

"Small HOA's" are typically defined as homeowner associations comprised of 2-5 units. Small HOA's are unique in that the owners must interact with each other frequently to address any HOA-related matter, and disagreements can become highly personal in a small HOA, especially when the owners live in close proximity with each other. In the case of a 2-unit HOA, all HOA decisions must be unanimous, meaning any disagreement between the two units requires a formal dispute resolution procedure such as arbitration as a tie-breaking vote. HOA issues can range from the paint color of the building to regulation of pets or even the right to lease the units.

The primary principle that every HOA and condo owner must understand is that a HOA of any size, including one that is as small as two units, is required to abide by the same body of law, including all the provisions of the Davis-Stirling Act. In effect, there is no distinction in the Davis-Stirling Act for a HOA comprised of two units versus a HOA comprised of 100 units. All HOA's are required to comply with the same provisions of the Davis-Stirling Act.

The following is a summary of the top 10 most significant myths of "small HOA's" that stem from this common misunderstanding regarding the applicability of the Davis-Stirling Act.

1. MYTH: A small HOA is not required to have an operating account.
2. MYTH: A small HOA is not required to have reserves or conduct a formal reserve study.
3. MYTH: A small HOA is not required to establish an annual budget.
4. MYTH: A small HOA is not required to have an annual meeting or formal minutes.
5. MYTH: A small HOA has no reporting requirements to any state or local agency.
6. MYTH: A small HOA can make informal decisions on HOA-related matters so long as all owners agree.
7. MYTH: In a small HOA, the members can make decisions by email, where there is a written record of everybody's "vote" and a record of HOA decisions.
8. MYTH: Because the HOA is unincorporated, the HOA is exempt from many formalities, such as having Board members or following formal election requirements.
9. MYTH: One owner in a two-unit HOA cannot force the other owner to perform common area repairs because a unanimous vote is required.
10. MYTH: All HOA-related disputes are resolved out of court, typically in arbitration.

Myth #1: A small HOA is not required to have an operating account.

The Davis-Stirling Act mandates that HOAs must maintain operating and reserve accounts. Civ. Code §5500 *et seq.*. HOA's must also review and reconcile the operating and reserve accounts on a monthly basis. In addition, the HOA must review the current year's actual reserve revenue and expense compared to the current year's budget, the latest account statements of the financial institution where the association has its operating and reserve accounts, income and expense statements for the association's operating and reserve account, the check register, monthly general ledger, and delinquent assessment receivable reports on a monthly basis. Civ. Code §5500.

Myth #2: A small HOA is not required to have reserves or conduct a formal reserve study.

While some parties take the position that the Civil Code does not explicitly require reserves, Civil Code Section 5550 expressly states:

"At least once every three years, the board shall cause to be conducted a reasonably competent and diligent visual inspection of the assessible areas of the major components that the association is obligated to repair, replace, restore, or maintain as part of the study of the reserve account requirements of the common interest development . . ." (emphasis added).

This language indicates that not only is a reserve study required (e.g. a "reasonably competent and diligent visual inspection"), but the reserve study is intended to determine "the reserve account requirements." The reference to "reserve account requirements" suggests that a reserve account must in fact exist, and that therefore, the HOA must raise an appropriate amount in reserves, based on the reserve study required in Civil Code Section 5500. If the Civil Code did not so require, then even large HOA's would not be required to raise reserves, which would have disastrous consequences. Civil Code Section 5560 provides further guidance on how HOA's are required to earmark those reserves. Most significantly, the Davis-Stirling Act does not differentiate HOA's based on number of units – a two-unit HOA is subject to all the same requirements as a HOA of 100+ units. Therefore, Civil Code Section 5500, as all other provisions of the Davis-Stirling Act, apply to every HOA, regardless of size.

It is also good business practice for small HOA's to abide by the same reserve requirements as large HOA's. If they fail to do so, they expose themselves to liability for failure to comply with statutory requirements. And if the HOA attempts to enforce assessment obligations against any one member in order to defray the costs of common area maintenance/repair, the HOA's hands may be tied by the fact that it has not strictly complied with reserve requirements in the past. A HOA may also have limited ability to enforce delinquent association dues against a homeowner if the HOA has not strictly complied with its budgeting and accounting requirements.

For all of these reasons, even small HOA's should conduct a reserve study every three years and raise reserves based on the reserve study pursuant to the Davis-Stirling Act.

Myth #3: A small HOA is not required to establish an annual budget.

The Davis-Stirling Act requires every HOA to establish an annual budget, distribute an annual budget report to its members, and review the accounting for the HOA on a monthly basis. Civ. Code §§ 5300, 5500. There are also several disclosures to be distributed to members on an annual basis. The governing documents may impose more stringent record-keeping and disclosure requirements.

Myth #4: A small HOA is not required to have an annual meeting or formal minutes.

A board or the HOA it represents may not take action on *any* association business outside of a meeting. Civ. Code Section 4910. What that means is the board is basically rendered ineffective if it does not hold meetings. There can be no association business without the board conducting a proper meeting with adequate notice, including proper voting on any HOA business. The procedures for a proper meeting, including proper notice, are specified in Civil Code Section 4900 *et seq.*, but the governing documents may also set forth additional procedural requirements. If the HOA is incorporated, there may also be additional statutory requirements. The HOA is also required to provide formal minutes to all members within 30 days of a meeting. Civ. Code § 4950. Violation of any of these procedural requirements exposes the HOA to liability to its members, including attorney's fees and costs. Civ. Code § 4955.

Myth #5: A small HOA has no reporting requirements to any state or local agency.

While no public report to the Department of Real Estate is required for most properties with 5-6 units or less, that does not cover all the HOA's reporting obligations. There are additional reporting requirements required by the CA Secretary of State. Also, if the HOA is incorporated or has an income of $75,000, the Franchise Tax Board will require specific reporting.

Myth #6: A small HOA can make informal decisions on HOA-related matters so long as all owners agree.

Small HOA's must follow the same Civil Code requirements relating to meetings and decisions. As referenced in Myth Number 4 above, the HOA cannot make any decisions outside of a HOA meeting. While an informal arrangement may seem innocuous, especially in a two-unit HOA where all owners are in agreement, the informal arrangement has no legal, binding effect on the property, its owners, and particularly future owners. In addition, any change to the governing documents requires a proper amendment in compliance with Civil Code Section 4270.

Myth #7: In a small HOA, the members can make decisions by email, where there is a written record of everybody's "vote" and a record of HOA decisions.

The Davis-Stirling Act does not allow meetings to be conducted via email, except in cases of emergency. Even in an emergency, all members must agree in writing that the meeting may be conducted by email, and minutes shall still be prepared in accordance with the statutory requirements. Civ. Code § 4910.

Myth #8: Because the HOA is unincorporated, the HOA is exempt from many formalities, such as having Board members or following formal election requirements.

While it is true that an unincorporated HOA may not be subject to all the same regulations as that of an incorporated HOA due to its lack of corporation status, unincorporated HOA's are equally subject to the Davis-Stirling Act. In addition, all HOA's, regardless of incorporated status, may exercise the powers afforded to a nonprofit mutual benefit corporation as set forth in Section 7140 of the Corporations Code, unless provided otherwise in the governing documents. Civ. Code § 4805. The Davis-Stirling Act also sets forth election and voting requirements, which apply to all HOA's regardless of incorporated status. Civ. Code § 5100 *et seq.*

Myth #9: One owner in a two-unit HOA cannot force the other owner to perform common area repairs because a unanimous vote is required.

The HOA has a duty to maintain common areas of the property. Civ. Code Section 4775. The scope of necessary work and associated costs are HOA matters that require the requisite approval of the members, and in the case of a two-unit HOA, one owner could stymie the maintenance/repair project by refusing to approve or pay for the work. However, the Davis-Stirling Act has an exception for "emergency assessments," to repair and maintain a common area. Civ. Code § 5610. If the holdout owner refuses to pay the emergency assessments, the HOA may be able to enforce its rights to foreclose on the delinquent owner for failure to pay the emergency assessments to address the necessary repair work. The refusal to perform necessary common area repairs would also be the subject of an enforcement action.

Myth #10: All HOA-related disputes are resolved out of court, typically in arbitration.

The Davis-Stirling Act requires some form of alternative dispute resolution (ADR) before a HOA or a HOA member pursues an enforcement action in court. Civ. Code § 5930. There are some stated exceptions to that rule, such as a small claims action or a foreclosure action. ADR typically means mediation or arbitration, or some other nonjudicial process in which a neutral attempts to facilitate a settlement for the parties. If the governing documents are silent on ADR requirements, then the Davis-Stirling Act requires only one form of ADR, such as either mediation or arbitration, as a prerequisite to a lawsuit, but it does not require both. Therefore, if the parties have already participated in mediation and failed to resolve their dispute, they may need to resolve their case in court, and not arbitration.

What makes Jeanne Grove at KDV unique?

Jeanne Grove has been handling real property disputes for the past 15 years, including TIC and HOA/condo matters. Jeanne has extensive experience taking cases to trial and arbitration for TIC and condo/HOA disputes, and is also adept at resolving conflicts between parties. She focuses on finding cost-effective solutions for owners in a dispute, and can also implement strategies to leverage the best outcomes for clients in litigation. At KDV Law, our real estate practice group routinely handles cutting-edge matters for clients involved in a range of complex real estate issues, including those that involve a TIC or condo.

We engage closely with our clients to ensure that we have a comprehensive understanding of their needs, goals and limitations. We form collaborative relationships and maintain a transparent communication style, thus giving our clients the opportunity to discuss their concerns openly with our team. Our demonstrated success in achieving our clients' objectives gives us a substantial advantage over the competition.

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