



THE RISKS OF SERVING AS AN HOA OR CONDO BOARD MEMBER

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YOU'VE BEEN AN ACTIVE MEMBER OF YOUR HOA, CONDOMINIUM OR COMMUNITY ASSOCIATION.

You've raised your hand when volunteers were needed to help with events or committees. Now, a sitting Board Member has asked you to consider running for a seat on the Board and you are strongly considering taking your community association volunteerism to the next level by serving on the Board. You enjoy being an active member of the association but should you serve on the association Board? Have you ever wondered what possible risks and liability await you? After all, you are not just volunteering any more. You are thinking about becoming a director of the non-profit corporation that is your community association.

I spoke with several HOA and condo industry veterans to discuss potential risks volunteer leaders face once elected and seated on the Board of Directors for their association. The goal of this article is to inform you of these potential risks BEFORE you raise your hand and run for the Board. I feel that an informed candidate is a better candidate for both the association and the individual volunteering to serve.

First, almost all associations carry an insurance called Directors and Officers Insurance, better known as D&O insurance. This insurance indemnifies the association and its directors from being sued directly for most business decisions that the Board makes. There is also insurance for



Errors and Omissions, which also helps protect the association from claims if honest mistakes are made. However, there is personal risk associated with the individual Board member that these insurances may not cover. For instance, if a Board member openly discriminated against a resident of the association, that resident may bring civil charges and a lawsuit against the director that neither insurance would offer indemnification protection for the Director. This is an extreme example but one that most certainly exists.

Additionally, all Board members must practice “good business judgment” which sounds simple enough but isn’t always cut and dry. The Board, in its entirety, has a fiduciary responsibility for protecting the association’s assets. Depending on the size of the association, that could be hundreds of thousands of dollars or more. Embezzlement is a primary concern for associations and the Board is entrusted to put in place checks and balances to make sure that the funds remain safe and secure. If the funds were to go missing and the Board had been particularly lax in its handling of funds and banking procedures, Board members could be sued by association members trying to get their money back.

They say money is the “root of all evil”. While that may or may not be true, money is at the heart of what it means to serve on the Board of the association and the risk that comes along with guardianship of those funds. Whether professionally managed or self-managed, the Board and its members are ultimately responsible for the money. Self-managed associations, in particular, can be at particular risk as they are going it alone and relying on their own business acumen to guide them. Many HOA and condo associations turn to a third-party for help, such as my company, *Community Financials*, because they value the service we provide without the cost of a full-time property management firm. It is a great way to minimize risk because it is the only work my company performs and, as you would guess, not only are we particularly good at it, we are fully licensed, bonded, and insured to do so.

There are other benefits to using a third-party financial company to handle the association’s finances. Chief among them are assistance to the time-consuming task of proper accounting for the association. This task is typically delegated to the Association’s Treasurer. The association risks burning out its Treasurer quickly if the association accounting becomes so burdensome as to feel like a full or part-time job. Additionally, on those occasions when a unit owner becomes delinquent, using a third-party service provider prevents neighbors from having to become collection agents against their own neighbors. Of course, whoever prepares and handles the association’s financial records is ultimately accountable for those records. There are times when it just isn’t feasible to ask one volunteer member of the association to take on the task. Keep in mind that this volunteer will not be paid for this work. I think that hiring a third-party firm such as *Community Financials* to handle this work is a great example of how the Board can show they are using “good business judgment”. They have reduced liability for themselves and their association by hiring a professional to get the important job of keeping an eye on the money handled.

Another common risk an association can and should avoid is the risk of being sued from injury to either residents, guests, or even vendors. Residents and guests expect safe use of the association’s common elements and amenities. As long as the common elements

and amenities are properly cared for and kept free from hazardous obstacles like snow and ice, most common claims against the association should be covered. However, when an association hires an outside contractor to perform work on the property, it is critically important that the association vet the contractor to make sure they have proper insurance coverage for the work they are performing and the workers that are performing the work.

In a conversation with David Jeranko, of *Association Services Network* (www.asn4hoa.com/comfi), he told me of one horror story where an association had hired a contractor to trim association trees. The association had not taken the time to fully vet the contractor. When one of their workers fell from a 15-foot tall ladder and broke his arm, the worker sued the contractor and the association. The contractor did not have adequate insurance so the association also had to pay their share of the damages sought by the worker. This situation could have been avoided by using a service like *Association Services Network* to make sure all association vendors are fully compliant with both licensing and insurance coverage.

I also asked Greg Pater, CEO of *HomeWiseDocs.com*, since his firm deals with real estate disclosures and refinance disclosures, for some examples of hidden risk to Board Members that he and his firm have encountered. Not surprisingly, there were quite a few risks to association Boards that “go it alone”. Most states throughout the U.S. have promulgated state statutes that delineate the requirements needed to take place when selling a home within a Common Interest Development (or HOA). These can be broken down into disclosure to the buyer, the financial condition of the unit owner and the condition of the unit itself (as defined by the restrictions within the declarations). Additionally, there are other selling functions not regulated by state statute that need to be performed by the HOA or its management company, that when performed are associated with **considerable risk**. Having a qualified professional community management company performing these critical tasks adds a significant layer of risk mitigation that every HOA board should consider.



Quite often, penalties for not adhering to disclosure performance guidelines are built into state disclosure statutes. These risks are not insignificant and typically fall into the categories of penalty fees or forfeiture of fees earned. The real risks associated with the disclosure process revolve around inaccurate, incomplete or missing information or documentation. Here is where the courts play a significant role. If any of the aforementioned conditions exist a buyer may cancel the sales contract or may execute the sales contract on bad information. Both events have significant negative consequences.

If the disclosure information is inaccurate and the buyer cancels the contract the seller has every right to review the information provided by the board to determine its accuracy. A court could determine the amount of damages to that seller may include the value of the

home, time spent researching the information, costs already incurred for the expected move, etc. Board of Directors insurance and HOA insurance may cover any damages awarded by the court, but will almost certainly result in higher premiums and deductibles in the future. HOAs should review their policies to ensure that they cover this risk including exclusions and endorsements within the policies.

When a buyer acts on inaccurate or incomplete disclosure information and purchases a unit, this may come with even more risk than the example above. If key deed restriction information is not correctly disclosed to the prospective buyer, they may now own a unit they have no desire to live in. Again, the courts are the buyer's recourse here and if it can be proven that the disclosure was faulty the HOA and board are at significant risk. Following is an actual example of such exposure.

Earlier this year a buyer purchased a large home near the State Farm Stadium in Glendale, Arizona for the express purpose of short-term rentals during the frequent sporting events hosted at the stadium. The home was purchased for just under a million dollars. Subsequently, the owner started to rent the unit as he originally intended. The management company discovered this was happening and cited the owner for a violation of the declarations that clearly state the number of rentals is limited and no rentals less than 30 days were allowed. The buyer stated this information was never disclosed to him and then decided to sue the association, management company and the board for just under a million dollars. Fortunately, the management company used the disclosure services of a third-party entity that could **independently** prove that the required disclosure information was sent, disclosed and actually opened by the buyer. When this information was shared with the homeowner the suit was ultimately dropped saving the board, HOA and the management company significant time, money and effort, while at the same time mitigating disclosure risk almost completely. Most disclosure and closing services provided by part time, self-managed HOA volunteers would be incapable of providing the independent proof required to oppose this legal action. In addition to disclosure requirements for HOA unit sales, self-managed HOAs must also disclose accurate financial information to respective closing agents within their market. For HOAs with annual fees where the owner is current and has no violations against the unit this is a fairly straightforward process, but complicate the sale with covenants identified in the declarations, required Working Capital Contributions, special assessments, move-in or move-out fees, violations, penalties or fines, the process can become very complex. If this information is not presented **clearly and accurately** to the closing agent, required funds may not be collected at closing and can be very difficult to collect after closing. The consequences of such actions could be loss of ancillary revenue to the association or worse, an underfunded budget. In the latter case, the membership of the entire association will be required to make up that deficit.

For those HOAs that are condominiums or cooperatives, an additional risk the HOA or board members may undertake is to complete a Lender Questionnaire Letter required to obtain unit financing by a homeowner. Many condominium homeowners don't understand that the lender must underwrite the financial and market risk of the condominium or HOA as well as the loan applicant risk. Once lenders underwrite that risk, they make representations

and warranties to the agencies that buy mortgage loans (like Fannie Mae and Freddie Mac) indicating that the condominium meets the lending requirements established by those agencies. Many of the data elements required by lenders can only be provided by the HOA, its board or a management company familiar with the HOA. Not knowing what you're getting into by completing one of these forms can be quite risky.

There have been many instances where the data about the condominium will prevent a lender from approving a loan and the homeowner will pressure a board member or HOA volunteer to change seemingly inconsequential data in order for their loan to become approved. While the board member or volunteer believes they are helping the homeowner, they are actually committing loan fraud. If identified this can be considered felony wire fraud because loans are purchased by wire transferring funds through the Federal Reserve system. Additionally, mortgage fraud can be punishable by a prison term and fines up to \$10,000 per occurrence.

Assuming that an HOA believes that fraud is a risk that can be avoided, it doesn't mean that the risk of completing a Lender Questionnaire is abated. Do the board members or HOA volunteers understand the risks of answering specific questions within the Lender Questionnaire? Some of the answers may not be fraudulent but, may in fact be inaccurate or should have never been answered at all! Take this question for example; "Is the budget adequate to cover the costs of operations and capital improvements of the condominium project"? A board member, HOA volunteer or management company should never answer this question. This question was meant for the lender to complete after they reviewed the condominium's budget, the unit appraisal and current financials. Many factors can influence the financial performance of a condominium including unforeseen items. Why would the HOA put themselves at risk to answer a question that really shouldn't be answered?

Quite often individuals completing the Lender Questionnaire don't understand that the answer to each question contained within the Lender Questionnaire is the responsibility of the lender to obtain and analyze. These same individuals usually don't have the expertise to complete the document. Like any disclosure document, inaccurate information provided by the HOA within the Lender Questionnaire is subject to the same legal risks as outlined before. If Fannie Mae or Freddie Mac audit a condominium loan they purchased and discover that information within the Lender Questionnaire is inaccurate, they may require the lender to repurchase the loan. That means the lender will have to use their own funds to buy the loan back. This action carries negative financial implications for the lender and they will use any means possible to get the loan off of their books. This could be accomplished by selling the loan to another agency or suing the HOA for the inaccurate data contained within the Lender Questionnaire.



The question a board has to ask themselves is why would they take on resale disclosure risk when it is unnecessary? How do you prove that you have done everything correctly? Can you rely on individuals that have no real experience and systems that are not built specifically for resale purposes to accomplish these tasks? The risk can be mitigated by employing the services of a licensed, qualified community management or financial management company. At a minimum there is an additional layer of risk avoidance garnered, but HOAs should request that the financial /management company's E&O insurance has an additional insured endorsement that is primary and non-contributory, meaning the financial /management company's insurance will be the only policy affected if a claim is used to settle a lawsuit. At best, you have professionals that handle the resale disclosure function regularly and are proficient at meeting your association member's needs, while mitigating all of the risks associated with this increasingly litigious process.

No discussion about risk and the potential fallout for homeowner's associations would be complete without referring to the body of work published by Joel Meskin, Esq., a CAI Certified Insurance and Risk Mitigation Specialist and a member of the College of Community Association Lawyers. He is also the Managing Director of *McGowan Program Administrators*, one of the largest community association insurers in the nation. You can learn more at: <http://mcgowanprograms.com/products/community-association-insurance/>. One of their case studies involves a seemingly simple gutter repair at an HOA in California that went terribly astray.

In this instance, a worker for an association-hired gutter repair contractor, fell while working on the gutters. However, this was no ordinary fall. This worker also struck a power line on the way down and received a permanent disability injury. Turns out the vendor didn't have a license for the work nor did they have any insurance to cover this injury. The family of the disabled worker sued and a court granted an \$18 million-dollar award to the plaintiff! The lawsuit named the contractor, the association, and the management company. The end result was a contractor who quickly went out of business, a property management firm that also went quickly out of business, and a hefty special assessment levied against all unit owners within the association to cover the association's share of the verdict. Just one more example of how Risk is lurking around every corner.

Attorney Meskin has some very strong thoughts on the risk all associations take on. He is especially cautious with self-managed associations who he feels are at additional risk because they tend to "go it alone", often to find out that experience can be a very expensive teacher! He points to some of the following reasons he feels self-managed associations are at even more risk than managed associations:

- They are lulled into a false sense of informality. The community association is a business and must be dealt with as a business.
- They often lack the requisite or highly recommended checks and balances.
- They tend to avoid the use of community association professionals who know the special needs for these "Not For Profit" voluntarily managed associations.

- They need the requisite financial advisor and or a CPA specializing in community associations.
- They need a community association insurance professional. They need to understand the necessary coverages that often do not exist on your run of the mill package policies. Are the directors and officers within the definition of “employee” on the package policy? Does the coverage provide “wire transfer fraud” and “computer fraud” coverage? Does the policy provide coverage for “social engineering (false pretense)”?
- Do they have the requisite checks and balances in place? Everyone trusts “Bob”, the volunteer treasurer who is a retired CPA. What if his retirement was due to losing his license? What if he has a gambling problem? Did they do a background check?
- How does the Treasurer handle unit owner personally identifiable information? Do they have a cyber liability/data breach response services coverage?

My business, *Community Financials*, is intimately involved with the financial and corporate dealings with the associations we serve. Since we specialize in this one area, we know the “ins and outs” of the financial risks and liabilities that associations face. Volunteer leaders from within associations tend to rely on professionals such as my firm or a Property Management company to provide them guidance to avoid costly mistakes and protect both the association and themselves from liability. With or without professional guidance, you should be aware that there is personal liability when serving on a corporate Board, even a non-profit corporate Board as most HOA and condo associations are.

Obviously, all community associations face risk. Avoiding risk is the duty and obligation of all officers and Board Members of any community association. Self-managed community associations clearly have fewer professional resources at their disposal as they have made the decision to avoid professional management. There is no way to avoid 100% of the risks that your community association will face. It is my hope that this article has adequately informed you of some of the risks you may not have considered before raising your hand to become a community association volunteer leader. It is also my hope that you will see you don't have to “go it alone” all the time. Businesses like mine, *Community Financials*, can help you keep your risks minimized while still allowing you to self-manage your association.