Community Association Management Insider®

Helping You Run Your Condo or Homeowners Association Legally and Efficiently

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FEATURE

We'll explain how to prevent —or in the worst case scenario, deal with—this white-collar crime.

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Put Plan in Place to Prevent and Deal with Fraud

Unfortunately, community associations—regardless of how well they are run—can fall prey to embezzlement or purposeful misuse of funds or resources. Association managers and board members should be aware of common ways that fraud is perpetrated and how to prevent—or in the worst case scenario, deal with—this white-collar crime.

Perfect Storm of Factors Leads to Problems

So how does the opportunity for fraud arise? Often it's a combination of issues that converge to create a weakness in the association that opens the door for fraudulent activity. "Normally the opportunity is due to lax controls, apathy, and limited financial background among board members to spot issues, which allows the board, committee members, or property managers to steal funds," explains certified public accountant Neal Bach, whose accounting firm regularly performs homeowners association audits and audit alternatives that can uncover this crime. The good news is that with even limited financial oversight and good management processes, it's very tough to get away with fraud at an association or property management company, he reports. But you have to know what to watch out for, and how to put this oversight and management into play. There are two levels where fraud commonly occurs.

Level #1: The management company. Fraud at the property manager level often occurs because one person has too much authority, there's not enough oversight, and standard accounting procedures aren't in place. For example, using a standard accounting system is a big deterrent to the misuse or theft of pre-paid cards or petty cash. Under such a system, the property manager approves the invoices, the accountant puts it on the books and writes the checks, and management signs the checks, Bach explains. That provides three levels of oversight, also known in the accounting field as "segregation of duties." Bach's firm has dealt with situations where a lack of segregation of duties led to a property manager's ability to steal from the

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association. Typically, in those types of cases, a property manager is performing all of the functions that should be split among several people.

Vendor favoritism is also a form of fraudulent activity. Bach says that associations should evaluate whether a proposed vendor really is the best, or whether it seems that there is some sort of side arrangement. Getting three competitive bids is one way around that problem.

Level #2: Board members. Fraudulent activity by board members is more common than management fraud, although there has been a steep decrease in this in recent years as property managers have been doing a better job of controlling boards. Expense fraud is the most common fraud variation to watch out for, as board members could be using debit/credit cards for personal use, or engaging in conflicts of interest with vendors, most notably in the form of kickbacks, or accepting free services such as house painting. While it's easier to stop one person, especially if he's careless in the way he engages in fraudulent activity, collusion among board members who can cover each others' tracks is much more difficult to discover and prevent.

An Ounce of Prevention Can Minimize Risk

Fraud prevention is the best way to protect an association. But, especially with new property managers and board members, it requires putting a plan in place. That includes long- and short-term tasks.

Short-term fraud prevention. Bach recommends completing these tasks in the near future:

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✦ **Daily.** Document all financial transactions. Review all invoices and receipts prior to processing. Make sure the work was authorized and completed.

✦ **Monthly.** Prepare a monthly financial package that includes financials, general ledgers, checks, and bank statements. Review this package prior to sending it to the board. But don't assume that the treasurer will give it the right amount of attention. A manager should also review the budget, taking a look at any variances and presenting an explanation to the board.

Long-term fraud prevention. Bach recommends an annual audit as a good backup to the short-term tasks above. Consider a more targeted review called an "agreed-upon procedures engagement," which is less expensive and just as effective. But staying vigilant on a monthly basis is actually the best long-term strategy to prevent fraud.

PRACTICAL POINTER: Bach says that accountants see more errors than fraud, such as when bills are paid for work that wasn't actually done, or money that was collected from other associations being accidentally used for a separate association. By being diligent, a manager can easily catch or avoid altogether these mistakes.

What to Look for in Statement Review

Reviewing bank statements can be one way of catching irregularities that are indicative of fraud. But what should a manager and/or the person tasked with reviewing statements look for? The manager and board treasurer should use reconciliation to ensure that the bank statement matches the books, says Bach. Making sure that the total on the bank statement matches the starting point on the reconciliation is a surefire way to catch fraud in process.

Likewise, reviewing invoices and work orders can uncover fraudulent activity. What should the manager and/or the person tasked with reviewing these documents look for? Bach suggests that invoices are good for backup, but to first look at the financial statements and go backward. For example, look at the P&L first and check variances between the actual outcome and budget, then look at major variances for the current month, and then look at the general ledger to determine the reason for the difference, he explains. "Start with the variances, or you probably won't see any discrepancies," he warns.

Work Together to Stamp Out Fraud

The board and manager both have roles in preventing fraud. Both groups should:

- Make sure all contracts are signed and updated, even auto-renewing ones;
- Document variances in writing so this can be reviewed in the future;
- Ensure that the manager works closely with the treasurer and board to explain variances.

Bach emphasizes that there needs to be open communication in order to get the variances resolved. "You can't prevent 100 percent of fraud," says Bach, "but make sure that the board has adequate employee dishonesty insurance, also

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known as 'fidelity insurance' that covers theft." He recommends an amount of one times the reserve study required balance, plus three times the gross monthly assessments.

What's Next for Suspected or Confirmed Fraud?

If there's a suspicion of fraudulent activity, managers and board members should jump into action. But how can you get the situation under control so you can start to deal with ramifications it might've already caused? And how should managers or board members deal with definite fraudulent activity when it has clearly been going on?

"The board is more likely to realize the fraud and at the first hint, it should contact the association's attorney," Bach notes. "If there's a concern with the property manager, also confirm with the attorney and then contact the owner of the management company—but let the attorney choose the course of action," Bach specifies.

Bach points out that, normally, a CPA will be brought in at some point. "If the CPA uncovers fraud, we're required to report to the senior level of the board; then the board would contact the attorney," he says. It's rare for the manager to suspect or discover fraud, but if she does, she should take immediate action to halt further activity and then report to the board. Again, the board should still contact its attorney. Unfortunately, sometimes members accuse the board or management company of malfeasance, which can be a publicity stunt, but the board and management company should take these allegations seriously. Members should go to the board, although they can also hire an outside lawyer or CPA if they pay for it. Remember that it's best for the board to conduct an audit or other financial engagement to resolve the dispute, Bach stresses.

A CPA's Expert Advice

"The board has to have at least one person with a financial background who understands financial statements and systems," Bach urges. "Without that, it becomes a tough task for the board or manager to detect fraud," he says. Remember that it's crucial for this person to review monthly financial packages, and proactively communicate with the management company to question any variances. If currently no one understands the financials, you need to find someone who does before it's too late, Bach advises. It's not just fraud that is dangerous—financial mistakes like double-paying invoices can actually be a much larger issue than fraud in the association's overall financial health," Bach concludes. ♦

Insider Source

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DEALING WITH MEMBERS

Inform Member that Assessment Payment and Grievances Are Independent Issues

Association members have agreed to abide by governing documents, which provide for payment of assessments that the association relies on to run the condominium building or community. But a member might feel like this gives him leverage when he's upset. That is, by withholding his monthly assessment because of a grievance he can force the association's hand in rectifying it. But grievances don't change the fact that the association must pay bills, management fees, and the cost of other services that keep things up and running. So what should you do if a member withholds his monthly assessment because of a grievance?

React to Common Problem

Most community associations have faced the tough situation of a member's withholding payment of his monthly assessment because he has some type of grievance against the association. For example, the member might be upset that the association hasn't repaired an allegedly defective condition in the common area, such as a broken treadmill in the fitness center. Or the member might disagree with a recent board action, such as a new rule restricting members' rights to lease their units. Often, the members' grievance isn't legitimate at all; he just claims to have a grievance as an excuse to avoid paying assessments.

Most states' laws don't allow members to withhold assessments because of a grievance. But in court, the law doesn't always get applied so clearly, and the association could get bogged down in a costly and time-consuming battle. That's why it's important to remind a member who withholds assessments that he must pay the assessments despite his grievance.

Governing Documents Come to the Rescue

Most associations' governing documents say that the members' obligation to pay monthly assessments is entirely independent of the association's obligation to fulfill its duties under the governing documents. This means that members must pay their assessments even if the association hasn't fulfilled its obligations, and that they cannot use a grievance against the association as a reason to withhold assessments. Courts have—by and large—upheld associations' rights to collect assessments being withheld because of a grievance.

But court cases don't always go smoothly. A court might acknowledge that, technically, it shouldn't consider the member's grievances regarding the association's failure to, say, make repairs or provide services. But, in the interest of efficiency, the court may agree to hear the member's grievance, rather than force the member to start a separate lawsuit against the association. If this happens

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Dealing with Members

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and the court feels the grievance is legitimate, it might deduct a certain amount of money from the amount the member owes in order to compensate him for the grievance. For example, it might say that the member must pay his assessment, less whatever value the court assigns to the grievance.

Avoid Ending Up in Court

So how can you avoid ending up in court with a member who withholds assessments because he has a grievance against the association? One way to prevent this is to send a letter to the member reminding him of his obligation to pay assessments despite his grievance. Like *Our Model Letter: Assessment Must Be Paid, Regardless of Grievance,* yours should do the following:

- Acknowledge receipt of the member's explanation of why he's withholding his assessments.
- Explain that the law doesn't permit the member to withhold assessments because of a grievance against the association. Emphasize that this is the case even if his grievance is valid.
- Say that even though the member isn't permitted to withhold assessments

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MODEL LETTER

Assessment Must Be Paid, Regardless of Grievance

It's important to take immediate action as soon as it becomes clear that a member is attempting to resolve a grievance by withholding assessments. Work with your attorney to adapt the following letter for your use, and to ensure it complies with the Fair Debt Collection Practices Act.

[*Insert date*]

Dear [*insert name of member*]:

The Shady Acres Community Association Board of Directors and manager have received your letter/email, dated [*insert date*], explaining that you have not yet paid your assessment(s) for the month of [*insert month(s)*] because [*insert reason*].

According to the law, the failure of an association to fulfill its duties under the governing documents does not give members the right to withhold payment of assessments. Your obligation to pay your monthly assessment and the association's obligations under the governing documents are entirely independent of each other. In other words, your grievance against the association doesn't affect your obligation to pay your assessments. This is the case even if your grievance is completely valid.

Regardless of this, however, the Board intends to investigate your grievance right away, and will try to work with you to resolve it if it's valid. But this is a different issue from your assessments, which must be paid regardless of the outcome of the investigation.

Finally, please note that the association will continue to take all legal steps to compel you to pay your assessments—including the imposition of fines, and the institution of formal legal proceedings against you for collection and/or foreclosure of the unit—until such amounts are paid in full.

Yours truly,
Jane Manager

Dealing with Members

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because of a grievance, the board will investigate the grievance and try to work with him toward a reasonable solution if the grievance is valid.

- Emphasize that the association will continue to take steps to compel the member to pay his assessments until they're paid in full, including possibly imposing late fees or suing for collection and/or foreclosure.

However, it's important to consult with the association's attorney to find out whether this letter must comply with the provisions of the Fair Debt Collection Practices Act (FDCPA), and to draft the letter according to applicable requirements. ♦

RECENT COURT RULINGS

➤ State Laws Determined Validity of Amendment to Declaration

FACTS: A planned community was developed in the 1990s. Prior to development, the developer recorded declarations and covenants that provided for the formation of a homeowners association. It stipulated that certain owners of multiple lots would be required to pay dues on only one lot. Several years later, a dispute arose concerning whether the association acted within its authority when it amended the declaration in 2012.

The declaration originally provided that any individual purchasing more than one contiguous lot "from the Developer" would be obligated to pay dues on only a single lot so long as the "exempt" lot was not sold or occupied by a dwelling or camping unit. For the first 15 years, from 1997–2012, the association not only billed those purchasing multiple contiguous lots "from the Developer" for one lot, but also only billed multiple lot owners who didn't purchase all their lots from the developer for one lot. In 2012, the association began billing the second group on a per-lot basis, and some in that group strongly objected.

These objections prompted the association to enact the 2012 amendment to the declaration to clarify that it was authorized to bill those who owned multiple contiguous lots *not purchased from the developer* on a per-lot basis (rather than only for a single lot), as it should have been doing all along.

The trial court concluded that the association acted within its authority in enacting the 2012 amendment. The homeowners financially affected by the amendment appealed.

DECISION: A North Carolina appeals court upheld the trial court's decision.

REASONING: The appeals court explained that the provisions of two state statutes apply to the association, empowering it to amend the declaration by a 67 percent vote. It noted that, here, the declaration provides that it may be amended by the developer. The declaration doesn't provide that it may be amended by the association, but only that the declaration may expire in 2021 by vote of the association.

However, two applicable state statutes provide for the process by which a

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Recent Court Rulings

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homeowners association declaration may be amended. Specifically, they provide that, "except in cases of amendments that may be executed by a declarant under the terms of the declaration … the declaration may be amended only by affirmative vote or written agreement signed by lot owners of lots to which at least 67 percent of the votes in the association are allocated, or any larger majority the declaration specifies or by the declarant if necessary for the exercise of any development right."

The laws further provide that for those planned communities to which the statutory provisions apply, even if not authorized by the declaration, a homeowners association may amend the declaration by a 67 percent vote and a declarant may amend the declaration if necessary to exercise a development right.

This grant of authority to a homeowners association to amend the declaration applies to the association in this case, said the appeals court, though the association was formed prior to 1999, because there is nothing in the declaration or articles of incorporation that "expressly provides to the contrary." And specifically, there is nothing in the declaration that expressly states that the association is not authorized to amend the declaration, the appeals court stressed.

So the statutes apply to pre-1999 formed planned communities where: (1) *either* the terms of the declaration or articles of incorporation do not expressly provide to the contrary pursuant to the laws; *or* (2) the association has adopted the terms of the North Carolina Planned Community Act (PCA). "Here, although the association has not adopted the PCA, there is nothing in the declaration or the articles of incorporation which expressly prohibit the application of those laws. Accordingly, the association is authorized to amend the Declaration by a vote of at least 67 percent, which it did," the appeals court concluded. ♦

- Kimler v. Crossings at Sugar Hill Prop. Owner's Assn., August 2016

RISK MANAGEMENT

Use Bylaw to Ensure Funds Are Ready for Repairs, Replacements

A well-funded reserve account is a clear indication of how prepared a community association is to deal with its long-range maintenance needs. Without a well-funded reserve account, most associations' only option to pay for repair needs that arise is to impose a special assessment on their members. Unless your state law or governing documents specify how your community's reserve is to be funded and managed, it's up to the board to create a policy that will bind future boards, so that the community remains protected.

So how can you set up an effective policy for your reserve fund? Make your policy, like ours, *below,* take the form of a bylaw that details these points: (1) how often reserve studies and updates must be conducted; (2) that a reserve account must be created and funded in accordance with the study; (3) what the account may be used for; (4) how the account may be invested; and (5) who can sign checks. ♦

➤ ➤ ➤ *Model Bylaw follows* ➤ ➤ ➤

MODEL BYLAW

Set Policy for Creating, Funding, and Managing Reserve Account

To make sure your association has enough funds to deal with its long-range maintenance needs, set a policy governing a reserve account. Show the following model policy to your attorney before taking steps to adopt it as a bylaw to your governing documents.

POLICY FOR CREATING, FUNDING & MANAGING RESERVE ACCOUNT

In order to sustain Shady Acres Community Association (Association) in good repair, and to sustain the market values of members' units, the Board of Directors (Board) establishes a policy as follows:

1. **Periodic Reserve Studies Required.** No less frequently than every five (5) years, the Board shall commission a qualified reserve study analyst to conduct a reserve study (Study). The Study shall:
   - **a.** Identify all common area components that have a useful life of three to 30 years, and that are the Association's responsibility to repair or replace. (The Study may, but is not required to, consider components with useful lives exceeding 30 years.)
   - **b.** Assign a reasonable cost of repair or replacement to each component based on current costs for the area.
   - **c.** Assign a reasonable useful life to each component based on local conditions.
   - **d.** Set forth a 30-Year Repair and Replacement Schedule that identifies the years when work will be performed on each component, and which, in calculating the cost of each repair or replacement, takes into account the cost of inflation.
   - **e.** Establish a 30-Year Funding Plan (Plan) for a reserve account (Account), which plan takes into consideration the costs of repairs and replacements (adjusted for inflation), contributions from members, interest income on the Account, and taxes owing on interest income. The Plan shall include monthly contributions from members adequate to meet projected costs without the need for special assessments.
2. **Annual Updates.** In each year that a Study is not conducted, an update shall be commissioned from a qualified reserve study analyst to reflect prevailing conditions, including changes in costs, inflation, interest yield on invested funds, as well as modification, addition, or deletion of components. It shall also reflect any unexpected variations from the most recent Study.
3. **Funding of Reserve Account.** The Account shall be funded in accordance with the results of the Study and any subsequent updates.
4. **Permitted Uses of Reserve Funds.** The funds in the Account are to be used only for the repair and replacement of the specific common area components identified in the Study. Components that fit the definitions included in the Study may be added in any given year in the annual updates.
5. **Investing Reserve Funds.** In order to minimize the amount of member contributions, the Board shall invest the funds in the Account so as to generate interest revenue that will accrue to the Account balance. All investments shall be in the name of the Association, shall not be commingled with the Association's general operating account, and unless otherwise approved by [*insert required majority*] percent of the membership, shall be Federal Deposit Insurance Corporation (FDIC) insured or otherwise guaranteed by the United States Government. Investments should take liquidity into consideration, such that funds are available to meet the Repair and Replacement Schedule. The Board may hire an investment counselor to assist in formulating an investment plan. The Board shall review the Account investment plan at least annually to ensure that the funds are receiving competitive yields, and shall be authorized to make prudent adjustments as needed.
6. **Two Signatures Necessary.** All checks drawn on the Account shall require the signature of no fewer than two authorized members of the Board.