

Minding or Missing the Store?

By Robin Manougian

Diane Fullerton, former CEO of Southern California-based Mercury Management (later Marquis Management), and one of the founders of the California Association of Community Managers (CACM), went to trial on January 3, 2005, in U.S. District Court in Santa Ana, California. Fullerton is charged, along with other defendants, of submitting grossly inflated loan applications for homes in the Palm Springs area, supported by false W-2s, false income statements, false payroll records, false verification of employment forms, and false verification of deposit forms dating back to 1996.

Although Fullerton took home a reported \$50,000 each month, lived in upscale Laguna Beach, and socialized with local politicians, she filed for bankruptcy in early 1996 amid accusations that the owners of Mercury Management levied bogus fines and late charges against homeowners, used homeowners' funds for personal cars and shopping sprees, and lied about the company's financial health. She reorganized just one day later to form Marquis Management, explaining to the 110 communities she managed that the name change was nothing more than that, a new name.

The full story has yet to come to light, but it's believed that several months before, Fullerton had taken out a \$750,000 loan from Harbor Bank—which she later claimed she couldn't repay. An inquisitive board member of the Loma Vista Homeowners Association, which Mercury managed, approached Harbor Bank seeking specific information about the situation; Harbor Bank refused to provide any details. It's known, however, that Fullerton was running millions of dollars through Harbor Bank from the communities' monthly homeowner assessments.

As of this writing, Fullerton's trial is expected to last two to three weeks. The good news, if any, is that this case is happening 3,000 miles

away. The bad news is that without proper controls in place, this story could just as easily happen here.

While the vast majority of community associations in our area are well-managed and run by honest, upstanding board members and management companies that have extensively trained and educated their managers, the need still exists to protect a community association's funds through a properly-written insurance policy. Such a policy, which can be referred to as crime insurance, employee dishonesty coverage and fidelity bond protection, serves to protect the assets of an association from theft by any member of the community's board of directors, employees, or volunteers, as well as the association's professional management firm.

As few as 10 years ago, our area saw the downfall of two well-known community management firms, Cameo and Benchmark, following the theft of funds belonging to communities they managed. Further compounding these cases was the discovery that many of the affected communities were inadequately insured; their fidelity bonds hadn't been written to extend third-party coverage to the community management firms who handled the associations' monies.

Despite the recent cases in California, the lesson learned, hopefully, is greater vigilance on the parts of carriers, insurance agents, and community managers who want to ensure that the management firm, including its principals, is covered to the same extent as their associations.

As experience continues to be the best teacher, today's crime policies are extremely well-written and include as named insureds those individuals charged with handling association funds. And while insurance carriers accept a premium in exchange for protecting these funds, carriers

are still looking to policyholders to remain vigilant by applying a system of checks and balances that will help to reduce the chance of loss and thus keep premiums lower.

In order to extend third-party coverage to professional management firms, insurance carriers still want boards of directors to have in place check-signing controls that limit the check size a management firm can write without a co-signature requirement. In addition, carriers want to ensure that boards are reviewing canceled checks, that checks drawn from the operating account are budgeted or written for approved line items, and that funds drawn from the reserve account are accessed only by board members, and even so, require dual signatures. In addition, to assure that boards are taking the proper precautions to protect their own funds, many carriers have placed a ceiling on the amount of coverage that will be extended to a third party. It is important that you review your policy carefully to see if such a ceiling on third-party coverage exists.

What Else Can You Do?

Marquis Management and California community association lawyers allegedly refused to allow board member Jim Troutman see the financial records of Loma Vista Homeowners Association. Remember that as a board member, you have hired your service professionals (community manager, attorney, insurance agent, etc.) to work for you—to perform a service for your community in exchange for payment of that service. Regardless of what responsibilities you turn over to these individuals and companies, legally you have the right to gain access to your own information—and remaining an integral part of the process, rather than blindly handing over total control, will serve the board and the community well in the future. Good record-keeping should continue to be part of the board's responsibility to ensure that maintenance tasks are being performed, chosen investments are being made and monitored, purchases are not only paid for—but are accounted for—and that what should be in your accounts is also accounted for.

Protecting Your Community's Assets

Most association bylaws are written such that carrying crime/employee dishonesty/fidelity bond coverage (again, all are synonymous) is a requirement and not an option. Even when the bylaws are silent, the secondary lending institutions (Fannie Mae and Freddie Mac) require that associations with 22 units or more carry crime coverage naming as an additional insured anyone who handles or is responsible for association funds. This holds true for self-managed and professionally managed communities.

Providing third-party coverage (i.e., including the management company as a named insured under the association's crime policy) is crucial. If funds are stolen by the management company and management isn't included as an additional insured, no coverage exists for the insured association.

Professionally managed communities need to carry crime coverage even if their management companies also have their own coverage. In most cases, management companies carry crime coverage to protect their own assets; unless a community is named an additional insured under their policy, coverage for a loss to an association's funds wouldn't be triggered under the management company's policy.

Even if your community is not professionally managed, if you hire an independent bookkeeping or accounting service, include these individuals/firms as additional insureds under your crime coverage, as the definition of an insured includes board members, true employees (W-2 status), and volunteers of the association. Hired services or contractors paid on a 1099 basis need to be added as additional insureds. →

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How Much Is Enough?

Fannie Mae and Freddie Mac use the following formula to calculate an acceptable, minimum bond limit:

Three (3) months' worth of the association's annual operating expenses + one (1) year's worth of reserves = minimum bond limit.

Certainly an association's bylaws may call for a different (higher) calculation and the limit carried should satisfy your bylaws' recommendation, but not less than the formula above. Carrying too much bond coverage isn't necessary, since any loss paid cannot exceed what your association has in terms of funds (i.e., a bond written for \$750,000 will never pay the full limit if your association's maximum loss is only \$250,000).

Reducing Your Community's Chance of Loss

The old saying goes, the best offense is a good defense. Establishing a system of checks and balances and knowing how your funds are being spent will reduce the chance of loss—even though a properly written crime policy is certainly the best safety net available. By following these key points, you'll be doing your part to make certain that your funds are kept safe:

- Establish a check-signing threshold for the management company or board member with signature authority on the operating account. Checks over and above the pre-determined threshold should require two signatures.

- Maintain control over your reserve account by allowing only board members to sign checks drawn from the reserve account, and only through a dual signature policy.
- Carefully review original, monthly bank statements, cancelled checks (if your bank provides them), and other month-end reconciliation statements. If your community opens an online banking account, control over this account should be carefully monitored.
- Voted, approved investment accounts also should be reviewed for any discrepancies. Hiring a separate investment advisor is wise.
- Have a qualified, independent certified public accountant conduct an annual audit (certified or compilation if expense is an issue).
- Make certain that the individual responsible for recording receipts isn't the same person making deposits.
- If professionally managed, make certain that your association's funds are not co-mingled with those of any other association. Your association should maintain a fully separate account.
- Maintain good communication with your insurance agent/broker, and inform him of any limit changes that might be required. In addition, should you elect to change management companies, inform your agent of the change, not only for mailing address changes, but also to include the new management firm as an additional insured under your crime policy. 

Robin Manougian is an insurance agent with the John Manougian Insurance Agency, Inc., in Silver Spring, Maryland. She also currently serves as council chair of WMCCA's publications, marketing, and Web site committees.

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