Protecting Your Association's Assets

by Robin Manougian

Among the most important tasks a community association's board of directors is charged with is overseeing the financial well-being of its community. This is usually accomplished by careful budgeting of expenditures, maintaining the association to protect property values, and making investments to help ensure the long-term financial success of the community, but it is also accomplished through a properly designed insurance program.

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 gone to great lengths to educate and train their employees, the need still exists today for community associations to protect the financial assets of their community with properly written insurance protection, specifically Employee Dishonesty or Fidelity Bonds. While theft and embezzlement of community association funds is rare, the communities that have suffered losses in the past unfortunately either did not carry insurance to protect the association from this type of loss, or if they did, their policies did not extend coverage to protect funds in the care, custody, and control of a third party.

It is important to understand that most association's bylaws' requirements are written such that Employee Dishonesty (Fidelity Bond) coverage is a requirement and not an option. Even when bylaws are silent on this issue, boards should know that lending institution requirements, and the secondary lending institutions of Fannie Mae and Freddie Mac in particular, require that associations with 22 or more units have in place blanket fidelity bond protection for anyone who either handles or is responsible for funds held or administered by or for the association. This holds true for both professionally managed and self-managed communities.

While community association insurance

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professionals recognize the need for associations to carry Employee Dishonesty insurance, it remains a part of a board's fiduciary responsibility to make certain that the program being considered and eventually purchased does in fact include this form of insurance, and that the limit written adequately meets the needs of the community. No two insurance programs are created equal, and it is incumbent upon a board of directors to make certain that the program they purchase includes adequate limits of coverage and extends coverage to the managing agent if necessary.

How much is enough?

For the most part, the limit of Employee Dishonesty coverage to be carried is a business decision that a board makes in coordination with a review of the community's financial assets. In the absence of specific limit or formula guidelines as set forth in the association's documents, insurance professionals, Fannie Mae and Freddie Mac suggest that an association carry a fidelity bond equal to three months of the association's annual operating expenses, plus one years' reserves.

Because this computed limit can fluctuate throughout a policy term, it is important that the board and management notify the association's insurance agent or broker when any significant limit adjustments are required. Limit changes can easily be made via a policy endorsement. It is important, too, to inform your carrier, should the association decide to make a change in management companies, or bring on board the services of new, first-time professional management so that the policy will extend coverage to the newly appointed management company.

Our community is professionally managed and the management company carries a Fidelity Bond — so we don't really need our own bond, right?

Wrong. This is a common misconception among community associations and management companies alike. Consider that when a management company purchases a bond, the management company is the named insured and therefore the *management company's assets* are protected against theft by their own employees. The management company, then, usually selects a bond limit that it believes adequate to protect its own assets. Remember that only the management company is the named insured, not the association, and therefore a loss of any or all of the managed associations' funds would not be covered.

A second misconception, and one that stems largely from a premium standpoint, is a board's misunderstanding of third-party coverage: *We don't want to insure the management company, so why should we pay additional premium to name the management company as an additional insured?* This is a complaint that is often raised. In fact, naming a management company as an additional insured is *not* insurance for the management company, but a way of further protecting the community. Whenever an association turns over authority and control of its assets, the association funds that are in the care, custody, and control of the management company need to be insured by way of third-party coverage, since the management company is not an employee of the association, but rather an independent contractor. Failure to name the management company as additional insured can result in an uninsured loss if the loss can be attributed to the management company.

Remember that "who is an insured" can vary from form to form depending upon the carrier, but most often includes employees of the association, non-compensated directors and officers, and former employees, (whose "former" status does not exceed 30 days following termination). Since a property management firm is not included in this definition, make certain that your association's Fidelity Bond amends the definition of an employee to include "any one or more natural persons who are employees" of the management company.

The same holds true of smaller, self-managed associations that subcontract bookkeeping or accounting services. If these services are not true employees of the association (i.e., paid by W-2 filing and not on a 1099 form,) they are not protected by the association's bond and should be named an additional insured via a "named position bond." Again, do not rely upon the service provider to furnish adequate coverage. Even if the provider carries such a bond and names the associations he or she manages as additional insureds, the number of associations he/she works for may not be fully covered by the written limit.

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Reducing Your Association's Chances for Loss

While a properly written Employee Dishonesty bond can certainly provide a high degree of protection and security for an association's financial assets (money, securities, or other property,) the board needs to take steps to also make sure that total control of the association's funds is not foolishly entrusted completely to any one board member, employee, or even the management company. In all cases, community associations should establish financial controls and procedures as if there were no insurance available.

Placing too much dependence on insurance and bonded management of association employees and board members only addresses the problem after a crime has taken place. Community associations need to demonstrate to their insurance carrier that they are as concerned about preventing loss as they are about being paid when a loss has taken place. Board members leave the association open to risk when they allow the belief to prevail of, *"That's what insurance is for."*

Professionally managed associations, for the most part, turn over a substantial part of the financial operation of their associations to their management company, and in so doing, the board of directors rarely is in a position of writing checks for services. This becomes a matter of convenience, and a necessary function of the management company. However, a monthly review of the association's accounts, including a balance sheet, cancelled checks, receipts for services, and bank statements, as well as retaining signature authority on the reserve account is not only prudent, but nearly always a mandatory stipulation by insurance carriers.

Equally, management companies should make certain that the boards for whom they work remain actively responsible for supervising the financial affairs of the community. The communities most at risk for theft are those with complacent, disinterested, or extremely busy board members.

To reduce risk further:

- Keep the operating account balance low, maintaining just enough to cover the monthly budgeted expenses.
- Maintain a system for authorizing and approving vendors and the work they perform. Keep detailed records of voted upon, approved expenditures and their invoices.
- Establish a check-signing threshold for the management company or board member signature authority on the operating account. Checks over and above the set threshold should then be required to carry two signatures.
- Disallow signature authority by the management company on the reserve account, and designate different, but dual signatures on checks drawn from the reserve account.
- Carefully review original monthly bank statements, cancelled checks, and other month-end reconciliation statements.
- Voted, approved investment accounts also should be reviewed for any variances and discrepancies.
- Have a qualified, independent certified public accountant conduct an annual audit, certified or compilation.
- Make certain that the individual responsible for recording receipts is not the same person making deposits.
- Make certain that your association's funds are not "co-mingled" with those of any other association.
- Maintain good communication with your insurance agent or broker, and keep him/her apprised of any changes that may affect your policy, including bond limit change needs, changes in management, or the addition of a property management firm, if one was not utilized in the past.

While dishonest acts and theft from board members, employees, and management company representatives will never be completely eradicated, there are numerous steps an association can take to minimize the chance of loss. The security of your association's funds should never be left to chance. A system of checks and balances, together with an informed board and a well-written fidelity insurance program, can ensure that your community never has to endure the hardships of financial loss due to theft or embezzlement of funds or property. ■

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LEGISLATIVE ALERT

Residential Real Property Seller Disclosure Act, DC Law 12-263, Final Rulemaking and Disclosure Form

Final regulations and disclosure forms were released by the DC Department of Consumer and Regulatory Affairs (DCRA) by publication of Notice of Final Rulemaking in the August 27, 1999 DC Register. Compliance with the regulations and use of the prescribed form of disclosure statement became effective upon publication.

The retroactive effective date of June 8, 1999, established by DCRA Emergency Rulemaking in the July 16, 1999 DC Register, was vacated in the Final Rulemaking as advocated by a coalition of lobbying groups, consisting of the DC/LAC of CAI, the DC Cooperative Housing Coalition, and the Washington DC Association of Realtors.

Under the new law, a seller of a residential unit must disclose to the buyer, on a DCRA approved form, a "list of actually known defects or other information" concerning the structural systems, plumbing, electrical, and HVAC systems, appliances, fixtures and other element specified in the form. "Actually known defects" means *known* to the seller. The seller is not required to inspect the unit for defects of which he is unaware. Disclosure is required only if the buyer states in writing that the unit will be used as his personal residence.

The regulations and the disclosure form expressly limit the scope of the disclosure to the unit in a condominium or cooperative or the lot in an HOA. This limitation, which will make completion of the form less burdensome for sellers of such units or lots, is the direct result of intensive lobbying by the DC/LAC of CAI and the DC Cooperative Housing Coalition, with the support of WDCAR. ■

For further information, contact the Chapter office, or email us at info@caidc.org.