

# WHEN THE EARTH SHOOK

By: Gary A. Porter, CPA

Early on the morning of January 16, 1994, the earth shook in the normally quiet Los Angeles suburb of Northridge. Those few seconds transformed the San Fernando Valley countryside. Los Angeles is used to earthquakes. We have about 40 every week. Most are under 2.0 on the Richter Scale, and are not even felt by humans. They are only recorded on the very sensitive equipment that monitors the earth's tremors. Some earthquakes reach 4.0 on the Richter Scale, which means we feel them. But, each point on the Richter Scale represents an increase in intensity of ten times more than the prior point. So a 5.0 earthquake is ten times more powerful than a 4.0 earthquake. The Northridge quake came in at 6.9 on the Richter Scale, or 1,000 times more powerful than the normal earthquake that we would feel. Since the last major earthquake in the area was the 1971 Sylmar earthquake, for many people this was the first major earthquake of their adult life. Most were unprepared. Although the California Uniform Building Code requires earthquake resistant construction, not much can stand up to a 6.9 earthquake. In addition to the dozens of people killed in the quake, thousands found their lives destroyed by losing everything they owned. Successful businesses ceased to exist.

There are some 12,000 condominium, cooperative, and homeowners associations in the Los Angeles basin. Many of them were affected by those few seconds of tremors in the early morning of January 16, 1994. The Northridge earthquake not only caused some \$32 billion of damage in Southern California, it also caused severe disruptions to the lives of many homeowners and has caused lingering financial consequences that are still unresolved. Some associations were completely leveled by this earthquake, or rendered uninhabitable because of the severe structural damage sustained. Thousands of homeowners were forced to vacate their homes and find new living space that day. There was a mad scramble for every vacant rental home, apartment, and mobile home in the Los Angeles basin.

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At the precise time that affected associations were faced with their most significant cash flow needs during their entire existence, many, for the first time, had tremendous difficulty collecting association dues. If the association was no longer habitable, many residents wouldn't pay because they were unable to enjoy the benefit of the amenities or even to live in their own home. In addition, there were a large number of foreclosures by financial institutions as individuals stop paying on their mortgages. And the lenders did not pay dues either. After all, was the association going to foreclose on heavily damaged property with little resale value? Individuals that had their own insurance coverage in addition to the association's policy were probably able to continue paying both their dues and mortgage in addition to rent at their temporary living location.

Some uninsured associations immediately levied special assessments against their members of as high as \$ 50,000 per unit. This caused even more people to abandon their homes. But, without these special assessments against the unit owners, the repairs and rebuilding could not begin. Some associations elected not to rebuild, but to dissolve and sell the land. Some development, or units within developments, could not be rebuilt under the building code. Some reconstruction costs proved so high as to make reconstruction infeasible.



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For those associations that had earthquake insurance coverage, there was some relief in sight. However, many of these also suffered major problems and delays. Most insurance companies advanced some funds against the damage so that the associations could begin to pay contractors and start the reconstruction process. These emergency distributions were often made with no documentation at all, and recognition that it would all get sorted out later. Without these emergency distributions, many associations could not have started. Often, their bank records were not available because their bank suffered the same type of damaged that they themselves suffered.

Many associations were still required to make special assessments because of the huge gap between their insurance coverage and the projected reconstruction costs, or the large deductibles that existed in their insurance policies. Many earthquake insurance policies contained a 10% deductible. Ten percent of \$20 million is still a very large amount. And when you realize that you typically paid an independent claims adjuster 10% of the proceeds to argue your claim with the insurance company, even if you got a fair settlement, you were 20% short of the amount required to reconstruct the project.

Construction costs spiraled out of sight overnight (literally). There weren't enough contractors to fill the need. Contractors "cherry picked" the best (highest profit) jobs, leaving the lower profit jobs for others. After all, if there is so much work that there is no one to do it all, the laws of supply and demand dictate that the cost will go up. This was also a significant factor in reaching settlements with the insurance companies, because the pre earthquake costs were not valid in a post earthquake environment.

An real example of this for one large condominium project is:

- Initial estimated damages \$32,000,000.
- Policy coverage (for total destruction) \$80,000,000.
- Policy deductible \$8,000,000.
- Insurance company's settlement offer \$12,500,000. This was reached more than six months after the earthquake. Remember, the insurance company's goal

is to minimize losses. The association's goal is to maximize its recovery under the policy.

- Ultimate insurance company settlement \$24,000,000.
- Cost paid to independent claims adjuster \$2,400,000.
- Ultimate reconstruction cost \$28,000,000.
- Special assessment against members \$5,500,000 (approximately \$7,000 per member).
- Transferred from reserves for reconstruction \$1,600,000. This was easily justified, as because of the reconstruction of major portions of the development, the clock was effectively reset to 0 for many large common area components for which significant funds had already been set aside.

While the insurance companies were quick to hand out initial cash up front, some became notable conservative in their damage estimates later on. Hundreds of insurance adjusters from across the United States were rushed to California to begin assessing the damage. Many associations ended up first working with, then negotiating with, then finally fighting with their insurance company to obtain an adequate settlement from the insurance company. Remember that the insurance company goal is to minimize the damages in the settlement costs, which is exactly the opposite the goal of the association which is to maximizes the losses to cover as much reconstruction cost as possible. For many this meant a two or three year battle with the insurance company to obtain funds to begin the rebuild process. A part of this was caused by the fact that many of the adjuster had never adjusted an earthquake claim, and were unprepared for the hidden structural damage that such a disaster creates.

The earthquake is now five years back in the history books. Since building a house generally takes just a few months, you would think that everything would have returned to normal by some time in 1995. The harsh fact is that many associations are still not done with reconstruction of their projects. Delays were caused by:

- Lack of earthquake insurance,
- Uncertainty of the extent of damage (much structural damage was hidden inside walls),
- Lack of available quality contractors to perform the work,
- Construction costs significantly in excess of estimates,



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- Inability to find a qualified claims adjusters,
- Inability to settle with the insurance company,
- Inability to collect regular or special assessments,
- Embezzlement of part of funds,
- Shoddy reconstruction work performed.

The reconstruction period for some associations stretched out for a four-year period before construction was completed. Even now we still see associations where individual members are suing the associations for a perceived lack of adequate financial compensation for the damages they suffered and their settlement under the insurance policy for their losses.

The area of course continues to be plagued by aftershocks from that major earthquake as well as new earthquakes on different fault, however none of the magnitude of the Northridge earthquake which was a 6.9 on the Richter Scale event. Most aftershocks don't even reach the 4.0 level on the Richter Scale and anything under a 2.0 is generally not even felt by people living in the area. A 4.0 earthquake is something that simply causes rattling of dishes on the shelves and your pictures to hang askew on the wall.

The reconstruction of so many properties created its own set of problems because the limited number of construction companies available to handle such projects. Many contractors were attempting to capitalize on this event during what was very sluggish California economy. There were "small time" contractors who found themselves thrust into very large-scale jobs they were not administratively equipped to handle. Costs were at premium because all contractors were immediately stocked up with more work than they could handle. Inevitably, some of the reconstruction work completed was defective. There are already construction defects lawsuits arising out of reconstruction of the Northridge earthquake damage.

Numerous financial issues arose for associations as a result of this huge natural disaster. These range from the expected to the bizarre, but all point out the need to carefully consider carefully how such large financial projects are handled. This is a huge special financial event for the association, and special care needs to be

given to avoid possible negative effects. Unfortunately, too many associations did not seek either financial (in the form of a CPA) or construction (in the form of a construction manager) advice up front. As a CPA firm, we've dealt with a number of associations on the issues discussed below, cleaning up the messes created by those who didn't plan ahead. Unfortunately, sometimes there are no good answers because we were brought in so far after the fact that we can't get answers because adequate documentation does not exist. The common issues arising from this event were:

**Administrative issues** - Do you have a construction manager to manage the project? How does this event affect your reserve study?

Most associations should hire a construction manager. Usually, neither a paid manager or volunteer board members will have the expertise to manage a project of this scope. Even if they do possess the expertise, you should rely upon an independent, paid consultant to avoid any possible conflict of interest (more on this later). And, you should rely upon expert advice, not just the contractor who is performing the work. This principle should also be applied to large repair or replacement projects that are unrelated to natural disasters.

Many associations have been funding their reserves for years, and for instance, find that they have funded 15 years of a 20-year roofing replacement cycle. But with reconstruction caused by an earthquake, they no longer need 15 years of funding. Their roof is brand new, and was paid for by insurance proceeds, so they get to start over again on the roof replacement funding. This frees up reserve cash and makes it available for other components or projects. An association needs to revise its reserve study when such an event occurs.

**Accounting for the event** - This seems like a very straightforward issue, but many found that it was not by the time they finished with it. Should the proceeds and costs of this event be added to the association financial statements? And, if so, should it be in a separate fund? Are you even doing fund accounting? What about that SBA (Small business Administration) or FEMA (Federal Emergency Management Act) loan that you got? Is it assessable against each unit, or just the association as a



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whole. Is the board involved in dealing with issues or money? Or is it delegated to the management company? Are your internal accounting controls sufficient to handle these unusual types of transactions?

There is no real guidance for association financial practitioners on these issues. Common sense should prevail, which dictates that for a large project that can span several fiscal years of an association, a separate fund within the association's financial statements is the dead minimum requirement. Accounting for it as a completely separate entity is better still. Since this is a single event issue, it must be accounted for not only on an annual basis, but also on a project basis. Most associations did not establish separate funds in their financial statements, although they may have maintained separate bank accounts. But, they often borrowed reserve funds, and this has often gotten lost in the shuffle of funds over a four-year period. As a result, many associations don't know how much their earthquake reconstruction cost, or if that amount was an appropriate cost.

SBA and FEMA loans helped many associations through this crisis. SBA loans are made at the association level, but are a lien against individual units. Most associations gave owners the option of paying their share of the loan immediately to avoid interest costs, paying on transfer of the unit, or paying on a monthly basis over a 30-year period. This itself created an accounting nightmare. Does this constitute a special assessment? How do you account for payments paid early by owners with no corresponding principle reduction of the SBA loan?

Many boards managed this event themselves, without professional assistance. This created the opportunity for embezzlement of association funds. There were large dollar amounts going through the reconstruction accounts, it was generally not well accounted for, there was no outside oversight, and some contractors were all too eager to offer cash kickbacks for the award of a multi million dollar contract. Human failings being what they are, some people took advantage of this situation.

**Taxation issues arising from the event** - Is loan interest paid deductible? Who gets the deduction, the association, or the individual homeowner? Who pays the tax on the

temporary investment of funds, the association, or the individual homeowner? How does this affect the unit owner's basis of his property? Is there a casualty loss deduction? Who gets it?

Again, there is little authoritative guidance. In a single family, detached home situation the rules are clear; the homeowners get an interest deduction. But, in an association setting, the association actually borrows the money and pays the loan. There are no pass-through rules allowing transfer of the deduction to the individual homeowner, except for cooperative under Internal Revenue Code (IRC) Section 216. So in most cases, the deduction stays at the association level. Interest appears to be deductible on Form 1120, but may not be deductible on Form 1120-H. In California, there is case law prohibiting interest deduction for a membership organization, so no California deduction is allowed.

The unit owners may be entitled to a casualty loss deduction, and only they can make that determination. In addition, the association may, in certain limited circumstances, also be entitled to a casualty loss deduction.

**Other issues arising out of the earthquake** - Was a fair settlement received? Did you make a fair allocation of common area costs vs. separate property interest costs under the earthquake policy? Did you encounter legal problems with your contractors?

Many associations and homeowners have determined that in their rush to reach a settlement with their insurance company, they settled for less than a fair amount. So strong is the sentiment against the insurance companies in California that class action bad faith lawsuits have been filed against several insurers. The California State Insurance Commissioner recently ordered one insurer to reopen 20,000 claims. Again, associations should seek competent professional advice from individuals knowledgeable in association matters. Settling a claim involving hundreds of owners is far different than settling a claim involving a single corporate owner.

Some associations are still battling lawsuits from their own members regarding the damage allocations for



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damage to their units. Adequately documenting claims adjuster and contractor estimates of separate property damage is a daunting task, and builds a mountain of paperwork.

Some associations also ended up in legal battles with their contractors. I know of one association that used three different contractors to effect its reconstruction program, and another that used four. Inevitably, someone is going to sue if they don't feel they got all the profits they were entitled to. Some contractors working with out the supervision of an independent construction manager "front loaded" the contracts to receive all profits up front. This left the association to deal with change orders, a substantially increased project cost, and a special assessment in order to finish up the project. A good construction manager will help an association avoid most of the pitfalls that could be encountered here.

However one of the most bizarre developments occurred very recently to an association located some fifteen miles from the epicenter of the earthquake. This association had hired a contractor to perform the reconstruction project. The Board of Directors later determined that the contractor was not performing as they thought he should, so they fired him. Allegedly, they also told others that they felt the contractor's work was of poor quality. The association was sued by the contractor for breach of contract and defamation related to alleged statements made. The contractor was successful in obtaining a \$7 million judgment against the association, so the association declared bankruptcy. The bankruptcy court rejected the bankruptcy bid, saying that the association had the ability to pay the debts and therefore required that the association pay the judgment previously rendered against it.

Further, the receiver in bankruptcy had begun making substantial payments from assessment income against the judgment which seriously diminished the association's ability to pay its current and ongoing bills for such things and trash service, landscaping service, utilities, insurance etc. Since the residents who were paying these dues could not get the basic services for which the assessments were made, they decided to form a new, separate association to take over the operating affairs of the association.

The board for the new association then began collecting assessments for the operating needs and care of the common property of the association. The residents stopped paying dues to the old association. Needless to say, this ended up back in court. The judge that not only ruled was the old association responsible for paying the judgment against it, but also that the individual unit owners were directly responsible for their share of the judgment, a cost of approximately \$40,000 per unit. Since there are a number of retired and fixed income individuals living in the association, this would result in a huge financial burden for the individual residents, probably in the form of a special assessment. The judge, in his ruling, indicated that the formation of the new association and the failure to continue to pay dues to the old association was "fraudulent on its face" in its attempt to escape the debt of the former association. The saga is ongoing. Only one week after the judge's ruling, the Superior Court removed the judge from the case, and the matter is still pending in the County Superior Court.

Meanwhile, we have to deal with the Association's annual audit. California association law is embodied in the Davis-Stirling Common Interest Development Act, which in some instances requires an annual audit. However, with the formation of the new corporate association, the question becomes "which association is subject to audit?" The "old" association has the governing CC&R's that run with the ownership of the land that would appear to require the audit. But, that is not the legal entity which has been paying the operating expenditures of the association for some time. Those expenditures are being handled by the "new" association formed midway through the last fiscal year. A final legal ruling on this matter would be nice so we can determine which corporation should be audited, or should it be a combination of the two corporations? The uncertainties created five years ago for the residents of this small community continue.

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