



4 Reasons Why Boards Underfund Reserves:

#1 Difficulty Collecting Assessments

- High delinquencies
- Poor collection practices
- Foreclosures

#2 Desire to avoid unpopular decisions (on their watch)

- Raising regular homeowner assessments to increase reserve contributions
- Passing reserve deficit-reducing Special Assessments

#3 Misguided attempt to keep assessments low (on their watch)

- Attract buyers
- Pacify homeowners
- Save money

#4 Lack of planning (head in the sand)

- Failing to determine current Reserve funding requirements
- Hiring a Reserve Specialist to conduct a Reserve Study, but ignoring the findings
- Relying on the findings of an outdated or inaccurate Reserve Study
- Deciding “we just can’t afford” to fund reserves and “doing nothing”

5 Consequences of Under-reserving:

#1 Special Assessments (to eliminate or reduce the reserve deficit)

- Unpopular
- Unfair to brand new or future homeowners

#2 Deferred maintenance (because of the reserve deficit)

- Necessary repairs are postponed
- Property is unsightly
- Reserve projects (when they do happen) wind up being more expensive

#3 Ineligible for federally-backed* mortgages

- New Buyers face difficulty getting loan approval
- Existing Homeowners face less preferred loan terms when refinancing

* Fannie Mae, Freddie Mac, and FHA require reserve contributions to be at least 10% of total budget, although adequate reserve funding usually represents 10-40% of total budget

#4 Property Values Decrease

- Property is unsightly (when there's obvious evidence of deferred maintenance)
- When disclosures reveal inadequate Reserves and history of Special Assessments
- When new Buyers face difficulty getting federally-backed mortgages

#5 Boardmembers exposed to personal liability

- Current Boardmembers become targets for lawsuits* questioning the Board's underfunding decisions

* brought by new owners, faced with deficit-reducing Special Assessments to pay for deterioration that occurred long before they became members of the Association

“Business Judgment Rule”

The Business Judgment Rule (BJR) is an important national legal principle that provides volunteer Boardmembers protection from personal liability if it turns out their decision is challenged in a court of law. However, it is possible for well-meaning Boards to stray outside its protections.



California law specifies a standard of care for corporate directors of non-profit mutual benefit corporations under Section 7231(a) of the CA Corporations Code. Similar language can be found in Corporation Codes throughout the United States. Generally speaking, to enjoy protection under the “Business Judgment Rule”, there must be sufficient evidence (as determined by a judge or jury) to demonstrate that the...

1. *Boardmember acted within their authority*
2. *Boardmember acted “with good faith”*
3. *Boardmember’s action was in the “best interests “ of the entire Association”*
4. *Boardmember made “reasonable inquiry” prior to taking the action as an ordinarily prudent person in a like position would use under similar circumstances*

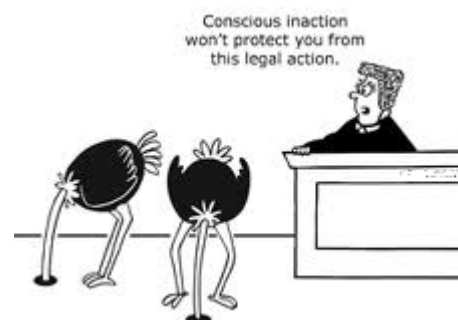
Important BJR Limitations

Case law has made it clear that Boardmember discretion under the Business Judgment Rule is not unlimited. There are three things that a Board cannot ignore:

- The law
- Their Association’s Governing Documents
- Their Problems (inaction)

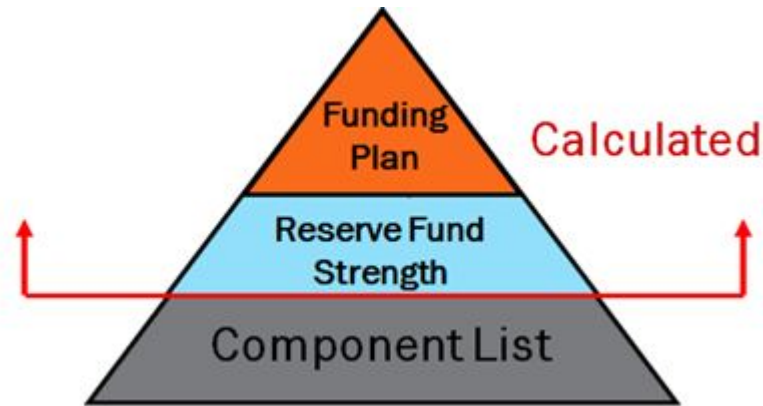
“Refusal to make a decision” is not a legitimate defense

“We’re broke” is not a legitimate defense



How can Boardmembers know whether their Association is adequately funded?

Reserve Fund adequacy can only be determined by a current-year Reserve Study.



where:

- “Component List” serves as the foundation by spelling out the scope & schedule of all necessary repairs & replacements
- “Reserve Fund Strength” (aka % Funded) is a calculated ratio that measures how well the Association has kept pace with past deterioration
- “Funding Plan” is the combination of monthly assessments and Special Assessments necessary to perform timely repairs & replacements

Review your current-year Reserve Study (an outdated study is outdated)

Find your Association’s “% Funded”, where,

% Funded	0-30% Funded	Weak	Expect a high incidence of deficit-reducing Special Assessments and/or deferred maintenance
	30-70% Funded	Fair	Reserve cash flow problems, deferred maintenance, and Special Assessments are less likely
	70-130% Funded	Strong	Very low probability of Reserve cash flow problems due to inadequate reserves
	Over 130% Funded	Surplus	Time for the Association to gradually under-Reserve to deplete the surplus over a number of years

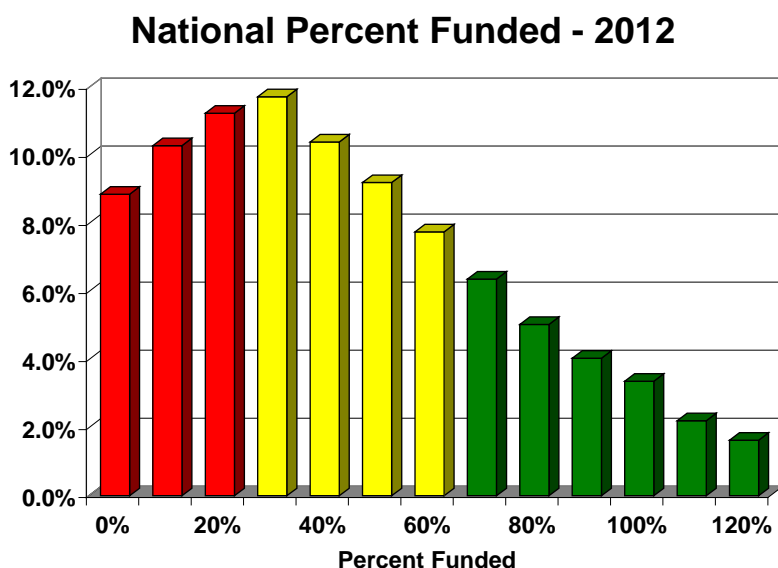
Q&A session (at the end)

Q: What is the least expensive way to minimize Reserve contributions?

A: Ongoing, budgeted contributions spread over the time the asset is in service to the Association. The compounded interest earned by Reserve Funds on-deposit means that homeowners consistently pay less than the cost of repair/replacement. Your financial institution makes up the difference! The opposite is true. When an association takes out a loan (if it can qualify), the “cost” of that loan, in “points” and interest paid, results in homeowners paying much more than the cost of the repair/replacement. There’s a related article [here](#).

Q: How many associations across the country are underfunded?

A: There are approximately 300,000 Associations across the country. In the process of preparing over 30,000 Reserve Studies nationwide, here is what we’ve learned about Reserve Fund strength:



As you can see, many Associations have “weak” Reserves (in the 0-30% range), with the national peak in the “fair” 30-70% range.

Q: What’s the best way to collect from owners reluctant to pay?

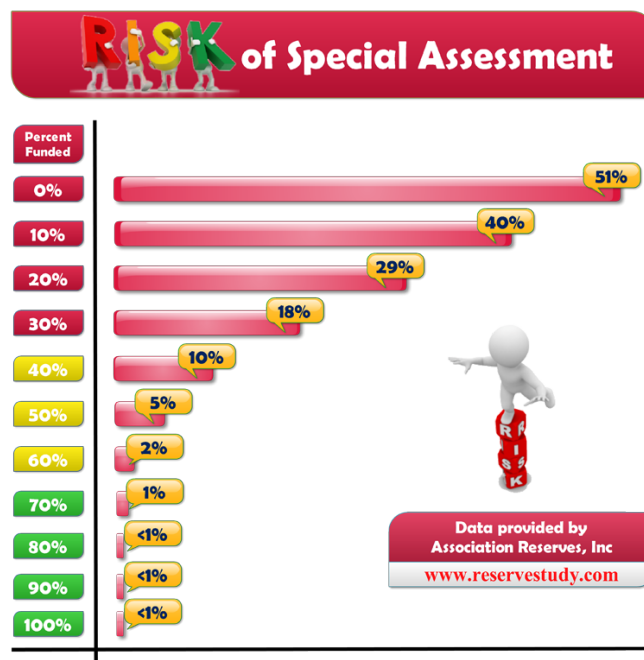
A: Typically there are legal or collection services available to the Association to accomplish these tasks, with expertise, often at no cost to the association (because any collection fees are charged to the delinquent owner). So the process should not be difficult or confrontational.

Q: What if a Boardmember recommends an assessment increase, but that increase is voted down by the Board majority, or (in Florida) the Reserve contributions are waived by a homeowner vote? Does the Board have liability?

A: Boardmembers cannot be expected to act outside of the authority provided them in the Association's Governing documents or by State law. If a Board or individual Boardmember position is overruled, that information should be clearly noted in meeting minutes to protect the Board or Boardmember from any future liability.

Q: What are the actual numerical risks of deficit-reducing Special Assessments associated with underfunding Reserves?

A: The illustration below shows the correlation between Risk of Special Assessment and Reserve Fund Strength (% Funded).



Q: How much difference is there between “Full” Funding and “Baseline” Funding?

A: Full Funding is defined as when the cash in Reserves exactly equals the deterioration of the Reserve components. That means when the Association is new and the assets have little deterioration, it doesn't take much Reserves to be “Fully” Funded. Baseline Funding is defined as maintaining the Reserves in a cash-positive manner, so that scheduled projects can be accomplished on time without relying on future Special Assessments. It takes a lot of money to accomplish all the Association's Reserve projects in a timely manner, so the reserve contributions to be “Fully Funded” typically average only 10% higher than “Baseline Funded” contributions. There is a related article [here](#).

Q: What if a Board decides to not do a Reserve Study update and/or not fund Reserves at the Association?

A: If the Board's decision is legally challenged, it will be up to a judge or jury to decide whether there is sufficient evidence to demonstrate that actions of the Board are protected under the Business Judgment Rule (BJR). Remember, the BJR requires the Boardmember to:

- Act within their authority
- Act in "good faith"
- Act in the "best interests of the entire Association"
- Make "reasonable inquiry" prior to taking the action

For more information, please refer to your state's Corporations Code or consult your Association attorney.

Q: In trying to avoid being underfunded, how do we know if we are Reserving for all the right components?

A: National Reserve Study Standards (NRSS) include a 4-part test for what should be funded through Reserves.

1. The component must be an Association maintenance responsibility
2. The component must have a limited Useful Life (UL)
3. The component must have a predictable Remaining Useful Life (RUL)
4. The projected expense must be above a minimum threshold of significance (typically above .5% - 1% of an Association's annual budget)

There is a more thorough explanation [here](#).

But what about surprises?

A: The best chance of reserving for all but "true" surprises means that the Component List should include all components that meet the NRSS 4-part test. True surprises are quite different from known patterns of repairs & replacements. For example, with plumbing problems, sidewalk failures, hillside erosion or hillside slippage, you might be surprised by "where" an expense might occur, but you may have a multi-year history showing a pattern of expenses that would be prudent to prepare for through Reserves.

Q: What if the expense is a true surprise (like the one-time failure of our underground pipes)?

A: Unfortunately, that sounds like a true surprise, which may be covered under the Association's insurance policy. If not, it will likely require a Special Assessment at your Association. Repair & replacement costs for components that do not have a Useful Life or a predictable Remaining Useful Life cannot be expected to be included in the Reserve Study. In such a case, the Board and Reserve Specialist should have no liability for failing to have a crystal ball!

Q: Can landscaping assets (trees, shrubs, etc.) qualify for Reserve designation?

A: For an Association with extensive landscaping, these assets pass the NRSS 4-part test to qualify for reserve funding.

Q: Was there a State that warned about underfunding Reserves?

A: Underfunding of Association-governed communities is a nationwide problem. The Department of Real Estate in the State of California took the unprecedented step of issuing a special announcement in Sept 2012, warning consumers (specifically buyers of homes in Community Associations) about the dangers of underfunding Reserves. You can read it [here](#). It is likely that other states will soon follow suit.

Q: If actual experience in repair costs for a particular reserve item exceed the amount in the Reserve Study, should the Board advise the Reserve Specialist of the actual cost so it can be adjusted on the next Reserve Study?

A: Absolutely. The Reserve Study professional is reliant on reliable feedback from the Association client, who provides "benchmark" information such as when projects were done, how long they've been lasting, and "actual" expense history at the Association.

Q: Can we use Reserve funds now to pay for a new reserve project (not listed in our current Reserve Study) if it meets the National Standard 4-part test for Reserve Funding, or do we wait until our Reserve Study Update is completed listing the new component?

A: If the Component List (detailing the scope & schedule of all reserve projects) in your Reserve Study has been well-established, you should expect the list to remain very stable over time. However, Reserve Funds are intended for Reserve projects as defined by National Reserve Study Standards (NRSS), so you should go ahead and make the necessary repairs or replacements using Reserve Funds on any newly discovered items. Be sure to update your next Reserve Study with the new component... and expect correspondingly higher Reserve funding contributions.

Q: You mentioned that Reserve contributions at 10% of the association's total budget were just a minimum necessary to facilitate mortgages. What typically is needed by an Association?

A: In our Reserve Studies across the country, we find that associations typically need to be setting aside 15-40% of their total budget towards Reserves in order to be keeping pace with ongoing deterioration. (providing adequate Reserves).

Q: Should you budget for components expected to have a Useful Life over 20 years (or 30 years)?

A: Yes. Note there is no "window of opportunity" limit, either at the low end or high end, for a component to be appropriate for Reserve funding designation. If a roof is expected to last 40 years, it is fair and appropriate for all 40-years of owners who enjoyed the protection of that roof to pay for their fair share of deterioration cost. It would be inherently unfair for the entire replacement cost to be borne by just the last 20 or 30 years worth of homeowners.

Q: What if repair work is needed before major repair & replacement? Is it best to pay from the maintenance budget or wait to finance from reserves?

A: In general, if a small portion of the asset needs to be repaired, treat it as an operational budget maintenance project. If it is a task that substantially extends the life of the entire asset (i.e., a new coating on a roof or an overall paint touchup project), that is more appropriately treated as a Reserve expense.

Q: What is a reasonable time period over which to target getting our Reserves into the strong (over 70% Funded) category from our current weak (22% Funded) level?

A: The answer depends on the scope and schedule of Reserve expenses at the Association. Reserve Studies prepared in accordance with National Reserve Study Standards include Funding Plans that avoid penalizing one set of owners over another whenever possible. That means "deficit reduction" Reserve contributions should be spread out over as much time as possible and Special Assessments are only recommended when needed. A 5 year to 15 year strengthening period is normal (dodging any cash flow problems as necessary through that time period).

Q: What does a Reserve Study look like? We're a new association, and not sure what one looks like, and what information we'll be getting in a Reserve Study?

A: Welcome to the world of Community Association living! We have many different sample Reserve Studies posted on our website at www.ReserveStudy.com. You may view sample Reserve Studies by logging into our "Client Center" (top right corner of the screen) as a guest, or simply navigate to the regional office closest to your Association and click on "View Sample Reports".

Q: Are there any recommended or suggested methods to "kick start" an underfunded account? Is it different for slightly underfunded vs. grossly underfunded?

A: Every Association requires a custom multi-year Reserve Funding Plan. For Associations in a weak or precarious status, it is appropriate for the Funding Plan to guide the Association towards adequate Reserves. Such a Funding Plan may consist of a reasonably increased Reserve contribution rate in Year 1, with annual 20% (or higher) increases to the Reserve contributions over a period of a several years. The goal is to grow reserve funding contributions to a level where they finally offset ongoing deterioration and are providing for the reserve needs of the association. It's like an "exercise plan"... gradually increasing the challenge until the Association is strong enough to sustain itself!

Q: Where is the tipping point between raising Reserve contributions to what is needed by the Association, and raising them too high to the point that they push owners into defaulting on their assessments (causing a net decrease of Association income).

A: This is a very difficult question. Most homeowners have the ability to tighten their belt before they lose their homes. The "exercise plan" strategy described above should allow the Association to move forward responsibly and the homeowners to ease into any financial adjustments they need to make.

Q: What do you do about special components? We care for a private lake, our most valuable asset?

A: Most major assets have key component sub-elements. A lake may have cyclical Reserve projects like weed abatement, dredging, liner care/maintenance, aeration system repairs or replacement, etc. So it may be one lake, but caring for it appropriately may take the form of many reserve components.

Q: What should an Association do if they think the Reserve Study underestimates costs in the Component List, leading the Board to think they might be under-prepared?

A: First, discuss your concerns with your Reserve Study provider. The Component List should be an accurate projection of the scope and schedule of Reserve expenses at the Association. Typically, Reserve Specialists are eager for insights from the Board regarding cost expectations or life cycle histories. ON the other hand, you may discover some new information that the Reserve Specialist has taken into consideration.

Q: We are severely underfunded (18.2% Funded) with many components at where Remaining Useful Life (RUL) = zero. What projects do we address first?

A: First, choose the components that will get more substantially more expensive if delayed. Secondly, choose repairs & replacements that will do the most to boost curb-appeal (for prospective buyers) and the spirits of current owners. The goal should be to address the projects with the biggest payback. Boosting optimism at the Association by showing that Reserve contributions are being used wisely to save money, prevent further deterioration, and make improvements is always a successful strategy.

Q: You talk about % Funded. How is that calculated?

A: It's not all that complicated.

$\% \text{ Funded} = \text{Reserve Fund Balance (actual)} / \text{Fully Funded Balance (computed)}$

Where $\% \text{ Funded} = 100$ (ideal) when the Reserve Fund Balance is equal to the Fully Funded Balance

Please see [this detailed article](#) on our website.