

UNDERFUNDING RESERVES & THE BUSINESS JUDGMENT RULE: WEBINAR OUTLINE

by Robert M. Nordlund, PE, RS
& David Firmin

www.reservestudy.com
www.HindmanSanchez.com

Feb 27, 2013

Problem: Most associations have underfunded Reserves. This means they have more deterioration than Reserve funds. That deficit becomes critical when an association doesn't have enough money for a large Reserve project, and the association needs to levy a special assessment on the current owners. Those current owners are unhappy to be caught paying the bill for deterioration that happened long before they became members of the association, and are looking for someone to blame. That means suing prior boards for the fiscally irresponsible behavior of failing to collect adequate Reserves.

1. What is the Business Judgment Rule?

The Business Judgment Rule is an important legal principle founded in "common law" (different states may have slightly different statutes on the matter) that provides immunity from personal liability for boardmembers or managers if they should be sued for their work in the process of serving the association. D&O insurance may pay for the defense, but the Business Judgment Rule is the key argument the attorney will make in the defense of the Boardmember.

For a Boardmember to enjoy immunity under the BJR, three things must exist:

1. The person must be acting within their authority and power
2. The person must have made reasonable inquiry (prudent man theory) and relied upon such information
3. The person must be acting in good faith, in the best interests of the association.

All three must exist for there to be a sturdy Business Judgment Rule defense.



2. Can you break the “Business Judgment Rule” Law?

No. The Business Judgment Rule is usually not itself a law that you worry about following or breaking. It is the principle against which your decisions as a boardmember will be measured. Following the laws of your state with respect to boardmember action and Reserve Studies is part of demonstrating Business Judgment Rule behavior: that the boardmember has acted within their power as defined by their Governing Documents, after reasonable inquiry, and in the best interests of the association (which includes following the laws in your state, like laws that say “you must get a Reserve Study update every X years”).

3. What are the Limitations?

Board 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)... thus
 - “Refusal to make a decision” is not defensible
 - “We’re broke” is not defensible

4. Does the Business Judgment Rule deal with “right vs wrong” decisions?

No. For most actions or situations there is a range of decisions that can be made. All decisions range somewhere from being wise, to casual, to foolish. The key with the business judgment rule is that if your actions and your motives are pure and in good faith, even if the decision is not necessarily the best, a judge will not second guess your decision and rule against you. So the Business Judgment Rule doesn’t measure the rightness or the wrongness of the decision, it measures if your decision process was wise and well-intended.

5. What if you don’t know what to do in a situation?

Boardmembers are not expected to be experts in every field. They are volunteers. Where they have no specific expertise, they are required by the Business Judgment Rule to make a reasonable inquiry, reaching out to get advice to help make a wise decision. That means getting a Reserve Study update that provides a current evaluation of the components comprising the association, the Reserve Fund Strength, and an appropriate Reserve contribution rate. Failing to update the association’s Reserve Study is defenseless. It is a boardmember’s job to get the information they need to make a wise decision. Failing to act is not protected activity under the Business Judgment Rule.

6: What about failing to follow advice found in the Reserve Study?

In that case, they've made reasonable inquiry (good), but in ignoring it they have effectively set themselves up as knowing more than the expert (bad). When you say "I know better than the expert, and choose to do differently", you may lose your ability to be fully defended for that decision because you've put yourself in a position of higher knowledge than the expert you went to for advice.

7: What if you flat out can't afford the contribution recommendations in the Reserve Study?

Sometimes a boardmember may have to choose between imperfect choices (adequate Reserve contributions that would be more disruptive than helpful, and bearable but inadequate Reserve contributions). Remember the process: make reasonable inquiry into the problem, and take courageous action that is in the best interests of the association.

8: What does it mean to act in good faith, in the best interests of the association?

It means to place the interests (needs) of the association higher than your own. Boards that delay necessary repairs, or push off assessment increases or special assessments to future years will look to a judge as if like they were putting their own interests (low homeowner assessments) first.

Good faith also means honestly confronting the facts, and sharing those facts to involved parties. Boardmembers need to tell the truth to homeowners and prospective buyers about the strength of the Reserve Fund (Percent Funded). If you know something, and if you hide it, it will eventually be exposed and you'll look foolish at the least, and be found liable at the worst.

9: What about Full Funding or Baseline (Marginal) Funding Goals and liability?

Both provide Reserve Funds for the exact same expenditures. Full Funding is designed to provide for the Reserve needs of the association on pace with Reserve deterioration, while Baseline Funding is all about providing just enough to avoid running out of cash. Because Full Funding provides some margin for Reserve expenses that don't occur exactly as predicted, Full Funding associations enjoy measurably lower special assessments. Full Funding contributions average 10-15% higher than Baseline Funding contributions. If you wish to avoid special assessments, it is better to Fully Fund your Reserves.

10: What's the Bottom Line?

You're not going to get every decision exactly right. Having liability protection under the Business Judgment Rule means not just following the minimum requirements of the law in your state, but having a decision-making process that a judge will review and say "that was reasonable".

Actions	Low Risk Behavior	High Risk Behavior
Within Authority and Power	1) Setting budget per State Law and Gov Docs 2) Collecting \$ from owners in proportion dictated by Gov Docs 3) Protecting common areas from deferred maintenance	1) Failing to set a budget that collects "adequate Reserves", or as required by Gov Docs 2) Deciding to not fund some components 3) Planning to special assess future owners
Making reasonable inquiry (Prudent Man Theory)	1) Relying on a credentialed Reserve Study expert 2) Updating your Reserve Study regularly	1) Relying on your own expertise when not an expert 2) Guessing 3) Ignoring Reserve issues 4) Getting a Reserve Study, but ignoring it
In good faith and in best interests of Association	1) Getting projects done on time 2) Fairly spreading out Reserve contributions over current & future owners 3) Maximizing appearance and property values 4) Follow spending & funding recommendations in Reserve Study 5) Raising Reserve contributions as necessary	1) Thinking "we can't afford to..." 2) Deferring decisions to future years 3) Not disclosing Reserve Fund strength to owners 4) Not disclosing Reserve Study results to owners 5) Delaying necessary projects 6) Jeopardizing property values 7) Forcing future owners to pay more than their fair share

Q&A session after the Webinar

Q - Is underfunding Reserves illegal?

A - Not really. This is a free country, and boardmembers are typically free to underfund Reserves, without breaking a specific state law. But that doesn't mean it is "ok". There are consequences to underfunding Reserves, and boardmembers will answer to those consequences. Association meeting notes are typically clear who served on the board each year, and what budget that board set. So it is usually well documented who was involved in setting the financial course of the association, for better or for worse.

Q - Is it inappropriate to let the homeowners vote on the budget?

A - Only if it is the appropriate process described in your Governing Documents or State Law. Generally it is the Board's job to set the budget for the association. In FL, for example, my understanding is that the Board is responsible to recommend Full Funding of Reserves, and the homeowners can vote to accept that recommendation in full or part.

Q - If a Reserve Study is incorrect, is it typical that you'll need to pay to get it corrected?

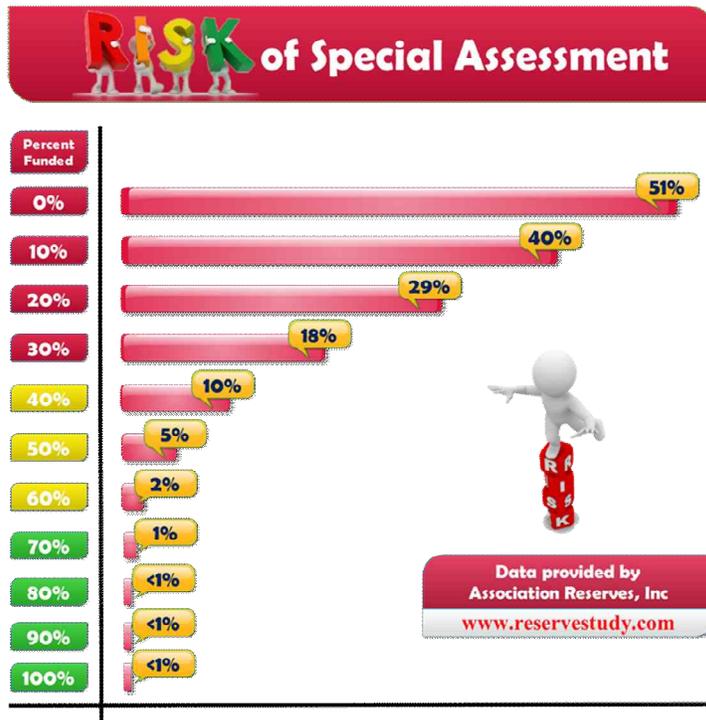
A - No. Most Reserve Study providers have a policy of correcting errors quickly, at no charge to the client.

Q - Are there credentials in the Reserve Study field, so we know if we're getting wise advice about our Reserve Study situation?

A - There are two credentials. Both are essentially identical. One is the Reserve Specialist, or RS, administered and promoted by the Community Associations Institute, or CAI. The other is the Professional Reserve Analyst, or PRA, administered by the independent Association of Professional Reserve Analysts. One credential is essentially the same as the other. A few people have both, just because their clients may be more familiar with one or the other.

Q - What does Reserve Fund Strength tell you? How is it measured?

A - It is measured in terms of Percent Funded, where 100% Funded means there is as much cash in Reserves as there is Reserve component deterioration. Percent Funded is a clear indicator of special assessments, because special assessments occur much more frequently among associations with a low percent Funded (0-30% range) than high percent Funded (above 70%). See graphic on the next page.



Q – What does Colorado law say about Reserve Studies?

A - Colorado Law (Colorado Revised Statutes, or CRS) 38-33.3-209.5(1)(b)(IX) provides that a Reserve Study Policy must exist and include the following:

1. Whether there is a funding plan for any work recommended by the reserve study;
2. If the association has such a funding plan, the projected sources of funding for the work; and
3. Whether the reserve study is based on a physical and financial analysis.

Q- Is requesting an audit appropriate if homeowners feel reserves are being neglected?

A – No, an audit is an appropriate tool for determining the location of association funds, not establishing budget priorities.

Q – Is an engineering study the same as a Reserve Study?

A – No. A Reserve Study is a focused document that provides three results:

- A listing of components defining the scope and schedule of upcoming Reserve projects
- An evaluation of the current Reserve Fund, establishing Reserve Fund Strength
- A recommended multi-yr funding plan (min 20 yrs) that provides for the timely repair or replacement of Reserve projects

An Engineering Study may be many things: a “building envelope” analysis, an evaluation of the HVAC system, the earthquake-readiness of the structure, an evaluation done at the time the association is being handed over to homeowner control from the developer, etc. An Engineering

Study is a broad definition. A Reserve Study is a specific document that may or may not be prepared by an engineering firm.

Q - What if covenant restrictions on fee increases do not allow the Board and management to fully fund the reserve study?

A – Then fund Reserves to the limit of the Board’s ability to increase assessments, then do it again the next year, and again the next year, until Reserve contributions grow enough to offset ongoing Reserve deterioration.

Q - What if a Reserve Study and the funding of same is put before the general ownership and they vote against it?

A – In a situation where that is an appropriate step (as required by Governing Documents or State Law), then underfunding Reserves is not the fault of the Board. The homeowners bear the consequences (special assessments, deferred maintenance, difficulty getting refinancing, etc.). If setting a budget is the responsibility of the Board and they put it out to homeowner vote, then it should be considered an “opinion only” vote, not binding. Regardless, it is the Board’s job to lead the association successfully to the future. Sometimes it requires some political savvy to achieve a good objective. Don’t give up easily!

Q - What can a dissenting minority Boardmember do if the majority of the Board is not using sound business judgment?

A – Make sure your name and dissention is clearly noted in the association minutes.

Q - Are pooled reserves a good idea? Shouldn't association monies collected be itemized on the balance sheet (or somewhere) instead of shown as one lump fund?

A - Once all the components have been identified in the Reserve Study, “pooling” is one of two types of funding strategies. In pooling, there is no such thing as Roof dollars or Paint dollars. Reserve expenses for each year are added, or “pooled” together for a total Reserve expense for that year. Reserve income is designed to offset those annual Reserve expense totals, not on the basis of separate contributions to separate component needs.

Remember that these are just different ways to fund Reserves. Both are funding the repair or replacement of exactly the same expenses through the years. I recommend the pooled method (called the “cash flow” method in NRSS terminology) because it offers more flexibility. It also eliminates the silly situation where an association has enough Reserves to accomplish a project, but has to pass a special assessment because those funds were allocated to Roofing or Painting and so were not available to be spent on an Asphalt project that failed early.

Q – Our new board is using reserve contributions for operating expenses. The board’s explanation is that since the funds have not been transferred to the reserve account they are not yet Reserves, and so they are not yet dedicated to Reserve projects.

A – If the budget is based on those funds going to Reserves, they are meant for Reserve projects whether they have actually hit the Reserve Fund or not. The Board is shortchanging future owners by derailing those funds towards other projects and underfunding Reserves.

Q - Is there a specific fraction of the Operating Budget that is a recommended amount to contribute towards Reserves.

A - No. Every association's Reserve needs are different, based on the physical assets eventually needing repair/replacement, when those expenses are projected to occur, and how much currently exists in the Reserve Fund. Reserve contributions are based on association needs, not the Operating Budget.

Q - What % of annual budget are typical Reserve contributions?

A – Typically we find that it takes between 15-40% of an association's total budget going to Reserves to offset ongoing deterioration.

Q – Is there a specific fraction of the Operating Budget that is recommended to exist in the Reserve Fund (how much is “enough”)?

A – No. The magnitude of Reserve projects and the timing of those projects (are they close or many years away) dictate the Reserve “needs” of the association, independent of the Operating Budget.

Q - Can the BOD spend monies for Reserves without a membership vote? Our bylaws specify the board can spend up to \$15,000 from the Reserve Fund without membership approval.

A – In your case, it sounds like your Governing Docs limit you to spending no more than \$15k at a time without membership approval. It is more common that the Board does not have such limitations, and is able to spend Reserve funds as needed by the association (of course, as authorized by Gov Documents and State Law, after reasonable inquiry about best course of action, and if done in the best interests of the association).

Q - To save money, we are considering Reserve Study software rather than a professional. If not required by statute, what is your opinion?

A – It depends on the complexity of the task and the capabilities of the Board. It is typically prudent to retain the services of a credentialed Reserve Study professional for a significant “Full” Reserve Study (create from scratch when one has never been done) or “With-Site-Visit” Reserve Study update (if one has not been done for many years). For minor “No-Site-Visit” Reserve Study updates a year or two after a professional Reserve Study has been performed, a software tool may be a very cost-effective Reserve Study update strategy.

Q - Are there clear Accounting Rules & Regulations how Funds from the Reserve can be used?

A – No black-and-white rules. The purpose of Reserve contributions is so that Reserve projects can be accomplished in a timely manner. The use of Reserve funds should be guided by the components already appearing in the Reserve Study, and the National Reserve Study Standard four-part test for a Reserve component:

- The component is a maintenance responsibility of the association
- The component is life limited
- The component has a predictable Remaining Useful Life
- The expenditure is above a minimum threshold cost (typically .5% - 1% of the association's annual budget)

Q - Who determines the Component List? Can a boardmember choose to eliminate an asset (tennis court, irrigation, etc.) from the list?

A - If the Reserve Study professional prepared the Component List, they take responsibility for the accuracy of the list (it is, after all, their name on the cover of the report). We trust clients will review the Component List for accuracy. If the tennis court belonged to a neighboring association, we would hope the Board would tell us so it could be rightfully removed. If the Board asked us to remove the tennis court because they didn't want to fund for its replacement, that would go against National Reserve Study Standards (tennis court resurfacing meets the four-part test mentioned previously) and we would decline. If it is a major common area asset, the Board does not have the power or authority to arbitrarily ignore paying the "bill" for that asset's deterioration, and push that expenditure onto the shoulder of future homeowners.

Q - How can I tell which type of funding our reserve study currently appears to be using?

A – Per National Reserve Study Standards, the Funding Objective is to be clearly disclosed in the Reserve Study. If not, observe the Reserve balance through the years. If it approaches zero at one or more points, the objective is "Baseline Funding", where the objective is to simply stay cash-positive. Full Funding means the objective is to offset ongoing deterioration, which typically results in a higher standing Reserve balance.

Q - What happens when your homeowners won't pay the increase in dues because of added Reserve contributions?

A – That sounds like a normal delinquent account issue. Normal collection processes apply.

Q – Is there a significant difference between paying for things from the Operating fund or Reserves?

A – Classically the Operating Fund is for daily/weekly/monthly expenditures. Funds collected and deposited into Reserves can be rolled over from one year to the next without concern for being considered "profit" by the IRS, and can grow towards large projects without boards being quite so tempted to spend those funds on non-Reserve projects. It is more direct when the

Operating Budget is designed to offset Operating expenses and the Reserve Budget is designed to offset Reserve expenses.

Q - Can you be held personally liable for improperly funding reserves even after you're no longer on the Board?

A – Yes. Your actions as a boardmember are part of the record of the corporation. It often takes years to develop a Reserve underfunding problem at an association, and many boards over many years typically share responsibility for that problem.

Q - Is there a statute of limitations for (former) board members after 7 years?

A – Not necessarily, however each state will vary.

Q - What has changed in the Reserve Study field that complete asphalt replacement is now recommended vs. the less expensive mill and overlay shown in prior Reserve Studies?

A – Two things. Asphalt binder chemical composition is not as effective as it was years ago due to environmental concerns, so overlays are not lasting as long as they did years ago. Second, asphalt is largely being recycled nowadays. A woven fabric mat (Petromat) that was key to the longevity of an overlay project now is considered un-recyclable, significantly increasing disposal fees and raising the life-cycle cost of an overlay project. So because overlay projects don't last as long as they used to and they cost more than they used to, "remove and replace" is now more cost effective in most situations.