IGNORING YOUR RESERVE STUDY?

WEBINAR OUTLINE

by Robert M. Nordlund, PE, RS — www.reservestudy.com — September 2014
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What are my options?

- Selling Out (totally ignoring the advice in the Reserve Study)
- Settling (moving towards the Reserve contribution recommendation, but not following the recommendation
    - Making just a minor adjustment
    - Making contributions such that the Reserve Fund is designed to be cash-positive, but no margin for things to not go according to plan (Baseline Funding)
- Succeeding (following advice in the Reserve Study to be Fully Funded, meaning moving towards a Reserve Fund equal to the value of common area deterioration)

But First – Setting the Stage:

A Reserve Study consists of three parts:

Reserve Component List (disclosure of physical status of the components)
Reserve Fund Strength (a calculated disclosure of the size/strength of the Reserve Fund – revealing if the association is "behind" or "on track" with meeting its Reserve obligations)
Reserve Funding Recommendation (a multi-yr plan to offset irregular expenditures with a steady income stream, so every owner pays their fair share of ongoing deterioration)

RESERVE STUDY RESULTS

Our emphasis today will be on the Board's reaction to the recommended Reserve Funding Plan.

Also – today's discussion will address only national principles:

- National Reserve Study Standards
- Business Judgment Rule

(Individual state requirements may be more restrictive)

Boardmember Responsibility Overview:
Roles/Powers defined by Governing Documents
Fiduciaries Responsibility
Corporations Code

Business Judgment Rule Overview:
The three-part test against which boardmember decisions will be measured, if they ever need to be defended. Decisions need to be made:

1. In a good faith
2. After reasonable inquiry
3. In the best interests of the association

Actual Numbers to use today:

80-unit association
Presume association has a Reserve Study for upcoming Fiscal Year, prepared by a credentialed, independent professional

- Association has been contributing $2500/mo towards Reserves ($30/unit/mo)
- Full Funding Recommendation: $5000/mo ($62.50/unit/mo)
- Baseline Funding Recommendation: $4350/mo ($54.38/unit/mo)

What are the risks (consequences) in play?

- Special Assessments
- Deferred Maintenance
- Mortgage Difficulties
- Declining Home Values
- Boardmember Liability Exposure

Note: Reserve deterioration is an ongoing cost. It cannot be avoided. If Reserve contributions are less than deterioration, future owners will pay more than their fair share when they get hit with a special assessment, or their home values will not attain full market value due to deferred maintenance (lack of curb-appeal) or difficulty of obtaining favorable mortgage terms. And the homeowners? When they are unhappy, & when they've been treated unfairly, they are more inclined to sue.

So – it's not a future problem… it's a current problem. Boards can't ignore the reality of their responsibility to provide for the care of association assets.

So What's a Board to do?

Selling Out

Board sticks with prior Reserve contribution rate of $2500/mo.

- They cave in to thinking that the association can't afford appropriate Reserve contributions
- Denial of the reality of ongoing Reserve expenses
- Real Business Judgment Rule exposure
    - Ignoring professional counsel
    - Failing to act
- Thinking Reserve Study provider is "crazy" or "out of touch"
    - Ignoring Reserve Study rather than seek an adjustment
- Board bases care of the association on wishful thinking (c'est la vie), or honors election commitments ("No assessment increases!") over needs of association

Problem: expenses don't go away, and we are living in an increasingly more regulated and more litigious environment

Consequences: <u>all</u>

- Special Assessments
- Deferred Maintenance
- Mortgage Difficulties
- Declining Home Values
- Boardmember Liability Exposure

Settling

Board selects a "do-able" Reserve contribution, believing that they can't raise dues very much:

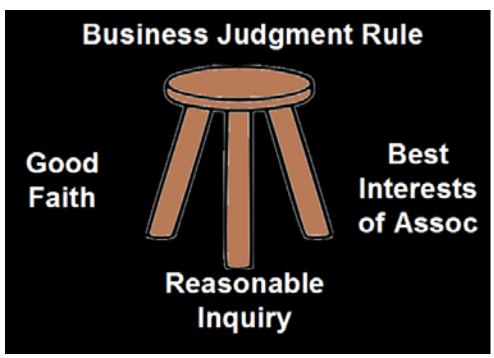
- $3000/mo (with the expectation to raise to $4000/mo next yr, and $5000/mo the yr after
- $4000/mo (that's as much as we can do!)

Is this either good or bad? It depends…

Good:
- Board trying to make steps of progress, doing what they can, bending but not breaking. Transitioning the association on a multi-yr plan towards financial stability.
- Board taking measured risks (deferring some projects)

Bad:
- Board foolishly over-ruling wise counsel
- Board "winging it", not acting in good faith, resulting in Business Judgment Rule exposure

Business Judgment Rule Considerations



Risks:
Deterioration cost is relentless & ongoing, underfunding will continue to grow.
Home values continue to stay at low end of market

Consequences:
- Special Assessments
- Deferred Maintenance
- ~~Mortgage Difficulties~~ (likely association making contribs more than 10% of total budget, eliminating this consequence)
- Declining Home Values
- Boardmember Liability Exposure

Success

Board adjusts budget for Full Funding contributions ($5000/mo)
Note: this is typically only a minor adjustment for well funded associations)

What drives this decision?

- Understanding that the future is built on decisions made today
- Understanding that Reserve deterioration is real, and needs to be paid
- Relying on wise counsel (because "what do I know?")
- Boardmembers taking seriously their responsibility (legally, and per Governing Documents) to protect, maintain, and enhance assets of the association

What's the worst that can happen?
Consequences:

- ~~Special Assessments~~
- ~~Deferred Maintenance~~
- ~~Mortgage Difficulties~~
- ~~Declining Home Values~~
- ~~Boardmember Liability Exposure~~
- Cost of home ownership got a little more expensive (by a few dollars/day)

Net result

- Home values go up by thousands of $

Every decision you make as a Boardmember is measured, and budgets are amazingly good records of the decisions you made while in office. Be wise, not foolish!

Bottom line – as a Boardmember (or a manager counseling Boardmembers), don't be afraid.

Don't be penny wise and pound foolish. Focus on the big picture, maximizing home values and quality of life at the association. Move your association in the right direction!

To view the recorded webinar, click this link:
https://www.youtube.com/watch?v=BXX-vDqCq_g

See more webinars on related Reserve Study topics at:
http://www.reservestudy.com/webinars

Ignoring your Reserve Study – Audience Questions:

Our association of 51 units and a clubhouse complete with pool, spa and club room has a reserve study that has expired. We did self-study for 3 years. The association does not have the money. We have spent over 500,000 in repairs in 4 years. We do not want to be involved at all, can we opt out of reserve study and if so what is the law.

> RN: 30 states have different regulations on the matter, but Reserve Studies are done because the board needs guidance and the homeowners need a clear disclosure on the status of their Reserve Fund and their Reserve Components. For the benefit of your association, regular Reserve Study updates are highly recommended.

What is the best way to estimate future costs?

> RN: Future costs are best estimated based on current costs, inflated for the appropriate # of years into the future, using a stable inflation rate.

What do you consider a safe reserve percentage?

> RN: Special assessments and deferred maintenance are frequent when the association's Percent Funded is in the 0-30% range. Those same Reserve cash flow problems are almost non-existent when the Percent Funded is in the strong 70-130% range.

How do you handle a condo association that claims that since they are not required by law to fund reserves, they can ignore their rational obligation to do so? I speak of a Washington State association that was formed before RCW 64.34 Condominium Act.

> AA: Without reserves, it's only a matter of time before large special assessments are levied followed by potential litigation. Members can either do nothing and wait for the inevitable or run for the board and change the misguided policy.

What are the pros and cons of straight line and pooling of reserve funds?

> RN: Pooling and Straight Line (or Cash Flow and Component methods, as they are known by their "National Reserve Study Standard" names) are just contribution calculation methods. They both calculate the <u>contributions</u> necessary to provide for the timely repair or replacement of <u>exactly the same set of components</u> (expenses). Note: those calculations are separate from Reserve Fund <u>strength</u> calculations.

Contributions calculated with the Cash Flow method are typically lower because they handle the scarce resource (cash) more efficiently, using it wherever it is needed because the cash is <u>not</u> restricted for use with a particular component (roof $, paint $, asphalt $, etc.). In addition, be aware of different <u>Funding Objectives</u> that might be in play. Cash Flow contributions for a Baseline Funding scenario (just barely keeping the Reserve Fund cash-positive) will always be 10-15% lower than Cash Flow contributions for a Full Funding scenario (where the Reserve Balance is designed to offset the value of Reserve deterioration at the association). Component Method contributions (which always yield a Full Funding Objective) will always be higher than Cash Flow contributions for the same Full Funding Objective, because of the inefficient way it handles the Reserve Funds and because Component Method contributions by nature tend to be front loaded (higher in the first few years then would be stable for the long term). Cash Flow contributions, on the other hand, can be more fairly distributed over the years.

If 10% of the HOA members are not paying dues and are in bankruptcy, what is the obligation for Reserve fund contribution? Full funding not possible under these circumstances? Note: the bankruptcy chapter 11 process in California has left our HOA holding a heavy bag. I very much like the suggestion if $10 per month per unit - doable- will recommend.

AA: Contributing something is better than nothing. It reduces the potential for a special assessment and reduces the likelihood of litigation.

Could you comment on how to handle the "Interest from Reserve Investments"?
1. Should Reserve Interest income stay in the Reserves or can it be used for operating income?

RN: I’ve seen it done either way. Most associations, however, let Reserve interest accrue to the Reserve Fund, because interest income can be irregular over the years (due to the ever-changing size of the Reserve Fund) and not be a stable income stream for the Operating Fund.

2. If it should stay in Reserves, should it stay in the Reserves even if the Reserves are, say, 80-85% funded??

RN: Absolutely. I don’t see how the % Funded of the association makes a difference in the association’s decision on this matter.

3. Can Reserve Interest Income be used to pay Reserve income taxes? Or should all taxes (Operating & Reserves) be paid by Operating?

RN: Taxes are generally due from interest earned, so it is appropriate to pay tax from where the income is being earned. So if interest is accruing to the Reserve Fund, transfer some funds from Reserves to pay the tax on that interest income. I wouldn't characterize that as a Reserve expense, I would characterize it as net less interest income earned.

Should paving a previously unpaved (currently gravel) road in our HOA be funded from our replacement reserve fund? All other roads in the HOA that are paved were funded via special assessment.

RN: Please see the graphic below, illustrating the National Reserve Study Standard four-part test (see pg 2 definition of "component") for determining if an asset is appropriate for Reserve funding. Note that the first test is that it must be a common area maintenance responsibility. An asphalt road cannot be a common area maintenance responsibility if it is currently a dirt road. It is a capital improvement (appropriately funded by a special assessment) to make it an asphalt road. Once it exists, the Reserve Study should be adjusted to show that it is now a Reserve asset, and funding established to offset its ongoing deterioration.

RESERVE COMPONENT "FOUR-PART TEST"

What is your suggestion or recommendation to include underground utilities (gas, elect, water and sewer) in our Reserve Study?

RN: See above. If the Useful Life cannot be identified, and if the Remaining Useful Life cannot be identified, and if the project cannot be identified (three typical problems with underground utility assets), the project is only a guess, and should **not** be funded through Reserves.

What if the assumptions are incorrect? Like showing no Remaining Useful Life for assets that have significant life left. This causes higher contributions then really necessary.

> RN: The Reserve Study should reflect the truth of the matter at the association. If assets have chronologically reached the end of their Useful Life, but have not physically reached the end of their Useful Life, the Remaining Useful Life (and possibly Useful Life) should be adjusted. Please see this article on the different ways assets can “fail”.

Any special advice for 55 and older communities with some persons on low fixed incomes?

> RN: In this situation, it is even more important to fund Reserves from ongoing budgeted contributions. It is the fairest way (spreading expenses over all the owners, over the years), least expensive way (it’s always nice to get interest income from the bank to offset the funds required of the homeowners), and it prevents special assessments that will be unsettling for owners on fixed incomes. If the association needs to adjust its budget, do it gradually over a few years, so that Reserve deterioration is being offset by Reserve contributions.

Can we pay for a reserve study update from our reserve account?

> RN: Reserve Studies are professional services, an expense more appropriate for your Operating Budget, not Reserves. Besides, a Reserve Study does not fit the National Reserve Study Standards four-part test definition of an appropriate Reserve expense.

How can your sample HOA raise monthly fees more than 20% a year in California if the homeowners won't approve a greater amount?

> AA: They can’t (unless there is an emergency). That means the reserves are built more slowly with a combination of board-imposed special assessments (5%) and dues increases (up to 20% per year).

Is it acceptable or are there any consequences to putting more $ in the reserve than the reserve study recommends?

> RN: It depends on your starting point. If your Reserve Fund is significantly underfunded, there is no clear problem accelerating the pace that you strengthen your Reserve Fund. If your Reserves are well funded, there is no good reason to accumulate Reserves in excess of what is required.

> AA: Remember that there may be tax consequences to over-funding (leading to surplus Reserves). Also, the membership may become unhappy with the board for unnecessarily taking members' money.

Is it advisable to change reserve study firms after two or three years to get a different look or perspective on the state of reserves?

> AA: There is no legal impediment to changing companies provided you don't have a multi-year contract with the first company. There may be additional financial expenses for a new company to recreate the database. In the end, it's a business decision by the board.

Is the slide showing special assessment risk vs % reserve funding available, and where do its statistics come from?

> RN: The graphic you mention was derived from over 20,000 completed Reserve Studies for our clients across the country, over the span of more than a decade. What we found most interesting was that the profile was very stable, no matter how we sliced the data (large vs small, old vs new, townhome vs condo, high-rise vs planned development, even regions of the country). If you wish a copy of the graphic, email me directly at RNordlund@ReserveStudy.com

Our dues are $80/year and the reserve study said to charge over $300/year in Reserve contributions alone. Our Board is not going to present that to our membership. Raising $10/month seems unreasonable for us.

> RN: It is possible the association has never been responsibly setting aside an appropriate amount of Reserves. Delaying the inevitable will only result in deferred maintenance and/or special assessments. Burying the truth of the size of the problem is likely not a wise tactic for the Board to pursue.

Our HOA culture is used to special assessments. We don't have huge common properties - just a park and office building. Are reserve study laws forcing us to change our culture for our almost 50 year-old development?

> AA: I can't speak to other states, but California does not require reserve studies for business parks. No "culture change" is mandated.

Should a reserve study always include a 20- or 30-year projection?

> RN: Yes. While it is common for many Reserve Study providers to present a 30-yr projection, National Reserve Study Standards require at least a 20-yr projection of Reserve income and expenses.

Majority of your audience is unit owners with boards that likely do not sufficiently fund reserves. How do WE compel the board to act?

> AA: Educate the directors, push them, be the squeaky wheel, rally the membership, run for the board in the next election.
>
> RN: If the board doesn't act, set aside your own Reserve Fund for the inevitable special assessment that will occur. $50 or more a month is a reasonable starting point for a condo unit.

We are a 164-unit condominium, our monthly HOA income is roughly $50,000. Do we need to make reserves contribution at least 10% of the total budget ($5000/mo)?

> RN: You need Reserve contributions to offset ongoing deterioration, so all owners pay their fair share of deterioration while they own homes in the association, and so the Board can fulfill its obligation to provide for the care of the common areas. Adequate Reserve contributions are typically 15-40% of the association's annual budget. Don't make Reserve contributions just because the mortgage industry says to make contributions "at least 10% of total budget". Do it to balance the ongoing cost of deterioration.

What if the board ignores severe termite issues?

> AA: If the board refuses to act, legal action may be necessary.

What, if any, are the legal aspects of not doing a reserve study, ever? Association is 30+ years old HOA… in California?

> AA: It depends on the particular association, the size of the special assessments that will inevitably occur, the disclosures made to the membership, and the particular judge and jury that eventually hears the case.

Does a Board prepared "reserve study" comply with California law? We just recently hired a professional to complete our study. Making the change was the result of a spirited discussion.

> AA: There is no legal requirement that an outside professional conduct the study. However, I advise all my clients against preparing the study internally. It exposes the association to potential litigation. While the association may eventually prevail, it's not worth the headache.

Full funding definition is not clear. If you project expenses, inflation, income, etc. and at no time in the future projection does the projection run out of money, aren't you fully funded?

> RN: “Fully Funded” is a Reserve Fund status, clearly defined by National Reserve Study Standards. An association is Fully Funded (100% Funded) when its Reserve Fund is equal to its Fully Funded Balance (the calculated value of deterioration of the Reserve components). When an association’s multi-yr Reserve Funding Objective is to “not run out of money”, that objective is called “Baseline Funding”. If an association’s Funding Objective is to become 100% Funded, that objective is called “Fully Funding”.

Help me convince our other board members of the importance of a Reserve Study and the best way to inform our association members of the need to increase the dues to support an adequate reserve account.

> RN: Sounds like time to repeat our “Four Reserve Rules”
>
> 1. Reserve expenses always happen
> 2. The Board is responsible to prepare the association for those expenses
> 3. Those expenses typically only get larger if ignored
> 4. Homeowners always get stuck with the bill.
>
> A Reserve Study tells an association what they are responsible to maintain and the condition of those assets (the Component List), where they are financially (Percent Funded), and what action is necessary to offset ongoing deterioration (the Reserve Funding Plan). Without adequate Reserves, the association will face deferred maintenance, special assessments, property values that aren’t optimized, and potential liability exposure for the boardmembers.

I would like to see a Webinar on the components and how they are determined.

> Already done. See: https://www.youtube.com/watch?v=3GXIfsDphDQ
> In addition, we have an eBook on the subject available for download at: http://survey.constantcontact.com/survey/a07e63wy6sqh47gaoae/start

We have a nonconforming club house on the Gulf of Mexico that cannot be insured for flood. How should we reserve for its total loss in a hurricane?

> AA: That is something you need to discuss with legal counsel familiar with the laws in your state, your CPA, and your reserve specialist.
>
> RN: Until you can predict the timing of the hurricane and the cost of reconstruction, it doesn’t fit the National Reserve Study definition of an

appropriate Reserve component. Unpredictable expenses are typically handled with a special assessment.

I need to know the approximate cost of a reserve study for our association in Florida. We are a 30 unit complex.

RN: Go to www.ReserveStudy.com and select “Request a Proposal”

Our annual budget and reserve study are very hard to comprehend. Where do I get a second opinion by a professional?

RN: Go to www.ReserveStudy.com and select “Request a Proposal”

Our Reserve Study is set for 2016. It is updated every 3 years. What is the typical cost of your reserve study?

RN: Reserve Study costs are influenced by size, complexity (common area assets the association is responsible to maintain), age, Fiscal Year End (if the Reserve Study needs to be done during the busy Jun-Nov time of year), and physical location. A Full Reserve Study is the most expensive, but only typically needs to be done once for an association. With-Site-Visit updates are typically 50-80% of the Full Reserve Study cost, and No-Site-Visit updates are typically 25-40% of the Full Reserve Study cost. I expect you will be surprised how inexpensive Reserve Study updates are. Many associations budget for a Reserve Study update annually.

Can you give specific detailed examples of times when a real HOA made a good or a bad decision on Reserve funding, such as legal consequences, inability to sell because buyers can't get mortgages, big special assessment because of inadequate funding for a necessary repair, etc., with the legal and financial consequences for Board members and homeowners, and how the consequences should have been handled and how much legal fees and other costs added up to for individuals and the Association.

RN: Please see: http://www.reservestudy.com/real-world-reserve-funds

Are we legally allowed to add items to the reserve study that have a longer than 30-year useful life?

RN: Yes. California law requires all components be included for funding that are projected to occur within 30 years. That does not restrict the association for (wisely) funding for components that can be reasonably anticipated, more than 30 years away. National Reserve Study Standards do not limit components within a particular minimum or maximum Useful Life.

If previous boards have not reserved funds properly, is the current board liable?

> AA: The current board is not personally liable for the actions of prior boards but the association could be.

How do you suggest calculating the monthly assessment? Our previous boards used total costs/expenses – income items ex clubhouse rental, RV lot rental. For example using total costs the assessment would be $221. However, subtracting out the items I mentioned above, the calculated assessment used is $213. This is the rate methodology previous boards have used.

> RN: Utilize standard budgeting techniques: anticipate the needs (expenses) at the association, and calculate the homeowner assessments needed (in addition to other income streams) to create a cash-positive budget.

Our current reserve is $1.8 million on a $4.0 million full funded balance. Roofs are 58% of the full funded amount and have a useful remaining life of 1-23 years. Our Reserve Study consultant suggests a 6.3% increase in reserve year over year with 2.5% bank interest rate and 2.5% inflation rate assumptions. Your thoughts on the sanity of this increase given current assumptions.

> RN: Not enough information to comment on this specific scenario. Please see here for more information on our hourly Reserve Study consultation services.

The principle of "ballot-restricted reserve funds" applies to funds raised via special assessments approved by membership ballot with a specific singular purpose. Does the same principle apply to unpaid loan principal if the loan was approved via membership ballot with a very specific and singular stated purpose (say roofing)?

> AA: Yes.

What do you mean by a "big" special assessment?

> AA: That is a relative term that depends on the wealth of the membership.

> RN: Larger than "small"

If the Board discovers something that wasn't identified as a reserve component at the previous on-site study can this be added before the next regular on-site reserve study?

> RN: Reserve Studies are prepared annually for disclosure and budget preparation purposes. Mid-yr adjustments are frowned upon. This is a good example of why No-Site-Visit updates are valuable to the association. No reason to wait for the next With-Site-Visit update.

What happens if there are restrictions in the CC&R's/Bylaws to how much HOA Dues can be increased each year?

> AA: I don’t know about other states but in California, the restriction is void.

Would following the % increase each year be considered a good faith effort and a reasonable path to restoring the reserve account.

> AA: Yes.

Are increases in HOA dues to restore the reserves voted on just by the Director's or should the membership have a vote in this decision?

> AA: In California, the board of directors votes on the issue unless the increase exceeds 20%.

What if the association is a POA with just a recreation area?

> RN: Then the assets the association is responsible to maintain should be a short list. If the total value of the assets is insignificant to the association, it may not be cost-effective to do Reserve planning. If there is a community center, pool, tennis courts, entry signage, parking lot, and perhaps roads, then the value of the assets (and potential for large repair and replacement expenses) is large and a Reserve Study and healthy Reserve Fund is highly recommended

What is the deciding factor when a Reserve Study is required in California? Is it based on number of units, annual budget, or something else?

> RN: In CA, Reserve Studies are not required when the association’s primary use is commercial (office or industrial usage), or when the total value of potential Reserve assets is less than one half the association’s annual budget (Civil Code 4201, 4202, & 5550).

What is the minimum threshold of cost of a reserve component?

> RN: For most associations, that is in the range of .5% to 1% of the association's annual budget. It is typically the boardmember or manager's signature authority for an expenditure, a value under which an expense is considered incidental to the association's annual budget, and can be readily absorbed into its ongoing operational maintenance budget.

Who do you sue if the current board did not make the decision to NOT collect for reserves, but there is now a special assessment? The decision was made by a prior board who have sold and moved on.

> AA: You would likely spend more in legal fees than you would paying the special assessment. You should seek legal counsel.

I belong to an association with their heads in the sand, leaving members powerless except for their vote which is always for the same people.

> AA: Sounds like it's time to move.

In the context of the Business Judgment Rule, can you please clarify one of the three elements, that the Board of Directors must act "in good faith"?

> AA: As fiduciaries, boards are held to a higher standard. To avoid personal liability for their decisions, the Business Judgment Rule requires directors to act in good faith, in the best interests of the association, and with reasonable inquiry. The good faith element is sometimes referred to as "bad faith" or "lack of good faith" when the requirement is violated by a director. An example of bad faith is for a board to knowingly cause a vendor to breach his contract so the association can cancel the agreement and enter into a less expensive one with another company. The board is arguably acting in the best interests of the association (saving money by reducing the cost of the construction project) but they are doing so in bad faith.

Note: "AA" indicates the question was answered by Adrian Adams. "RN" indicates Robert Nordlund.