

THE LEGAL SIDE OF RESERVE STUDIES:

PART I: WEBINAR OUTLINE

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1. Why are Reserve Studies done and how do they fit into a Board's responsibility?

The Primary duty of the Board is to protect and maintain the association's common areas. Some common area repair/replacement projects are so expensive that they take years of preparation. A Reserve Study identifies the projects that need to be done, how much should ideally be in the Reserve Fund and recommends a funding plan to provide for the timely repair/replacement of those projects. Failure to plan for ongoing deterioration leads to costly special assessments and potential litigation.

2. Is there potential liability if an association does not set aside reserve funds?

If the laws in a particular state require certain levels of funding and the association does not meet those requirements then there is potential liability for the statutory violation. If there is no statutory requirement, the association could be open to litigation under negligence and breach of fiduciary duty causes of action. Caring for the financial needs of the association is the Board's overall fiduciary responsibility, and an adequate or sufficient Reserve Fund is required by most Governing documents. A plan which identifies components, identifies current deterioration and provides funds for the repair/replacement of those components is fiscally prudent.

3. What funding level in the reserve account is "adequate"?

There is not a clear right or wrong. There is a clear correlation between Reserve Fund strength (% Funded) and special assessments. The lower the % Funded, the higher the risk of cash flow problems like deferred maintenance or special assessments. 0-30% Funded is the high risk range, where Reserve cash flow problems are common. 70-130% is the "strong" range, where special assessments and deferred maintenance are rare.

4. How do you know when is the right time to replace something?

There are different types of component failures, and different definitions of failure, depending on community standards and the type of component. Generally component failures fall into five different categories:

- Inconsequential – wait until failure to replace
- Re-Evaluate – re-evaluate and delay as appropriate, before failure
- Obsolescence – replace once old or unsightly, as it never truly “fails”
- Protection – a project necessary to do on time because it protects another expensive asset
- Catastrophic – a failure to be avoided (do the project prematurely if possible), since failure would jeopardize life/safety or the safe enjoyment of the property.

5. What is the Board’s responsibility to make these decisions?

Governing Documents typically empower and require the Board to maintain the assets of the corporation. The above categories, and the effect of those components being visible or hidden, affect how proactive the Board should be.

6. Which components should appear in the Reserve Study?

Reserve Components are defined by association maintenance responsibility, not ownership. Consult your Governing Documents, your association’s maintenance matrix (if such a document exists), or your attorney.

In addition, [National Reserve Study Standards](#) dictate a four-part test to determine if an asset is appropriate for Reserves:

- #1. Common area maintenance responsibility
- #2. Limited Useful Life (UL)
- #3. Predictable Remaining Useful Life (RUL)
- #4. Above a minimum threshold repair/replacement cost.

7. How do state laws affect National Reserve Study Standards (and vice-versa)?

National Reserve Study Standards define terms used by State Laws (Percent Funded, Update With-Site-Visit, Update No-Site-Visit, etc.), and provide the “RS” professional credential. There are no conflicts between State laws and National Reserve Study Standards. For a list of State Laws, see <http://www.reservestudy.com/legislation>

8. Who should be doing Reserve Studies?

It depends of course on the laws in your state. Even so, an independent, credentialed Reserve Study professional is desirable for three reasons:

- Expertise. Boards rarely have the expertise to evaluate the condition of a component, its remaining life and the cost to replace it.

- Liability. Boards should not take on the potential liability. It's cheap insurance to have an independent, credentialed Reserve Specialist prepare the study.
- Politics. Having a specialist prepare the study also saves the board a lot of grief. Homeowners who dislike the Board will challenge the study and threaten the board. A specialist deflects the rhetoric.

Note 1: that the arguments for an independent professional are stronger when the association is in need of a "Full" or "Update With-Site-Visit" Reserve Study. Less sensitive "Update No-Site-Visit" Reserve Studies projects tend to be much simpler.

9. Does having a Manager prepare the Reserve Study complicate anything?

- Managers serve as agents of the board and take their direction from the board. They therefore lack the independence from board direction necessary to make the candid evaluation and harsh recommendations that may be necessary.
- There is a conflict of interest, as the manager feels pressure to soften the results of the Reserve Study, especially if it reflects poorly on the management company's financial guidance and controls.
- Management contracts typically require "hold harmless" and "indemnification" clauses by the Association. As a result, the association (not the management company) would be forced to defend the management company for any litigation created by a flawed Reserve Study.

10. Whose Reserve Study is it?

If the Reserve Study is the work product of an independent expert, that person's, or firm's, findings should be in the document. In that case the Board has effectively asked the expert for their opinion, and it is wrong for the Board to believe they control the outcome. If the Reserve Study is edited by the Board, the association takes on potential liability.

National Reserve Study Standards dictate that the Reserve Study is to reflect the realistic status of the physical and financial assets of the association. The Reserve Study documents the physical and financial status of the association, the Budget is the document the board uses to communicate their plan to association members.

Note: Management and Board input is valuable in the process of preparing the Reserve Study, to assemble the factual information (dates and costs of projects, most recent Reserve balance, etc.). Management and board direction/control of the Reserve Study is ill-advised.

11. What happens when there are factual errors in the Reserve Study?

Hopefully a Reserve Study gets more accurate each year through the updating process. If there is anything about the report that is not accurate, it should be revised.

12. What happens if the Board ignores findings/recommendations in the Reserve Study?

It depends on the circumstances. If it is a recommendation to perform a Reserve project and it is one of your inconsequential, re-evaluate, or obsolescence type projects, that recommendation can likely be safely ignored. If the Board chooses to not fund Reserves as recommended, they incur potential liability if funds are not available to accomplish a significant project.

Note: Board decision-making is typically held to the Business Judgment Rule, a corporate law premise which means a Board must act:

- In good faith,
- In a manner which the director believes to be in the best interests of the corporation,
- and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances

13. How often should a Reserve Study be done?

It depends on local State laws, but state laws aren't the only things you need to think about. Annually updating your Reserve Study is a good idea simply for planning and disclosure reasons. Reserve projects are the largest expenses your association will face, and becoming prepared takes annual adjustments. In addition, annual updates help the Board make accurate disclosures to the members, minimizing misinformation and surprise.

14. Is the Board responsible to distribute the entire Reserve Study to the owners?

It depends on local State Laws, but normally a summary is sufficient, with the entire document on file available for review by members.

15. Is the Board responsible to provide that information to prospective buyers?

Again, it depends on local State laws. But even if not mentioned in a statute, full disclosure by the seller is always the best policy. The Association is not party to the transaction (they are neither seller nor buyer), but upon request they should provide the seller with the information they need to provide to the buyer.

16. Are there FHA compliance issues having to do with Reserves?

At this time, the 2009 FHA standards remain intact. With respect to Reserves, to be compliant an association must have at least 10% of its budget going towards Reserves. With "adequate" Reserve contributions at most associations in the range of 15% - 40% of total budget, complying with the 10% requirement should not be a problem. "Percent of total budget" does not measure Reserve Fund size or strength; it only reveals a minimum standard of a good habit. The FHA currently has no minimum "% Funded" requirement.

To view California laws related to Reserves, visit www.davis-stirling.com.