

THE LEGAL SIDE OF RESERVE STUDIES-

PART II: WEBINAR OUTLINE

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1. Who decides on Reserve Study issues – the Board or homeowners?

Boards have a general duty in all states to oversee the affairs of their associations. In many states, the duty to establish reserves and reserve funding plans is set by statute. A reserve specialist can make suggestions but it's the board's duty to approve a plan that meets the needs of their particular association. Running the association is not a democratic process requiring homeowners to agree to the funding plan or Reserve expenditures. Boards have a duty to act in the best interests of their associations. Moreover, directors are aware of other business issues such as maintenance needs, insurance, potential litigation and the financial condition of the association. As a result, directors are in a better position to make decisions about reserves and how best to finance them.

Moreover, as "fiduciaries," directors must put the needs of the association ahead of their own interests and follow the Business Judgment Rule, which requires them to make decisions:

- 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.

2. Can a Board go against an accountant's recommendation to not fund things like painting from Reserves because they do not fit IRS definitions of a capital project?

Preparing a Reserve Study and tax planning are two different subjects. Prepare your Reserve Study according to National Reserve Study Standards, and prepare your taxes according to IRS standards. These documents have different purposes and can/should be prepared according to different standards.

3. Is a Board responsible to always replace "like for like" in their Reserve Components?

No. "Appropriate Replacement" is the guide. That may mean upgrading a key-based entry system to a telephone/keypad system, or replacing the pool table in the recreation room to exercise components or a big-screen TV, changing to more energy-efficient light fixtures, converting one of two (rarely used) pool area bathrooms to a storage room, or changing to more cost-effective materials. The board's job is to manage the affairs of the community, not just "keep it the way it is".

4. Can Reserve Funds be used to make Capital Improvements?

Generally, "No." With some exceptions, boards have no authority to use reserve funds for capital improvements. For example, an association has a club house but no swimming pool. The board cannot, without membership approval, take funds from the reserves and build a swimming pool (an asset that previously did not exist). There are a few exceptions to the prohibition against capital improvements:

- Safety Improvements (such as installing speed bumps)
- Government Mandated Improvements (installation of a fire control system ordered by local fire authorities, or safer drains in the pool and spa)
- Different Materials (old materials are no longer available or advisable)

Minor upgrades to existing assets are rarely considered capital improvements. For example, installing bird spikes would be an accessory to the roofing system, and installing speed bumps would be an accessory to the road or parking lot system.

5. What are "Adequate Reserves"? How can we as a Board demonstrate we are responsibly providing for the Reserve needs of our association?

Adequate means having enough cash to repair and replace in a timely manner. "Adequate Reserves" are required by some governing documents. "Adequate Reserves" are not required by statute in California. Special assessments, a consequence of having inadequate cash, are common among associations which are under 30% funded. The stronger the association's Percent Funded, the more likely the association is to find they have "Adequate Reserves". Special Assessments are rare (under 2% of the time) for associations over 70% Funded.

6. What is "Percent Funded"?

Percent Funded is one of the three results from a Reserve Study (the other two are the Component List and the recommended Funding Plan). Percent Funded is the ratio of Reserve Fund cash to the value of the deterioration at the association at a particular point in time (typically the first day of the Fiscal Year). It reports, on a year-by-year basis, if Reserve cash is keeping pace with deterioration at the association. When the Reserve Fund equals the deterioration of the Reserve components, you have balance, and the Reserves are 100% Funded. Note that Reserve contributions do not affect the current Percent Funded. The size of an association's Reserve contributions will cause their Percent Funded rating to rise or fall in future years.

7. How often should you update your Reserve Study?

Different states have different minimum requirements. In California, associations are required to update their Reserve Study annually, and perform that update on the basis of a “diligent visual site inspection” at least every third year. In general, annual updates allow boards to stay on top of their physical and financial Reserve assets. An annual update is their status check on their Reserve components, Reserve Fund, and the contributions needed to keep everything in balance. Annual updates provide boards with the information they need to do their job.

7. Can't a board just refer to a Reserve Study from a prior year?

Beyond the issue of state laws, you need to decide if there is anything right about distributing outdated information.

8. Is the manager qualified to prepare the Reserve Study update?

Preparing the Reserve Study update is part of the annual budgeting process. Since a manager typically lacks the independence and expertise of a professional, it is advisable to engage a Reserve Study professional at least every few years to ensure the association is still “on track”.

9. What liability exposure does a board have if it doesn't maintain adequate reserves or if they don't set adequate contributions (like less than the 10% required by the FHA)?

The association and the board could be sued for mismanagement and breach of fiduciary duties that could result in a money judgment for the plaintiff. This is normally triggered when the board levies a huge special assessment to make repairs that were not adequately reserved for. Owners who are outraged by the assessment or cannot afford it, will be inclined to sue. If the Plaintiffs can prove that the association was negligent and/or in breach of its fiduciary duties, the association could be hit with a second large special assessment.

10. What if the board feels the association can't afford adequate reserve contributions?

Most associations find it takes reserve contributions of 15-40% of their total budget to maintain their common areas. Maintaining the common areas is a duty of the board, not a suggestion. The board is required to set a budget appropriate to meet the needs of the association. Members, in buying a home in the community, have agreed to pay their fair share of the income needed by the association. If the board does not fund the needs of the association, they will experience decay or special assessments, property values will decline, loans will be difficult or impossible to obtain, and the risk of litigation will increase.

If the board strategically believes it is in the best interests of the association to temporarily reduce reserve contributions, it still faces these problems and it must clearly communicate their decision to the membership so owners can properly disclose that information to potential buyers. As painful as it may be, the board should continue to fund reserves, offsetting ongoing

deterioration, even if some owners are forced to move because they can no longer afford to live in the community.

11. Who can see the Reserve Study?

Homeowners have a right to see the Reserve Study or at least a summary of the Study as part of the annual financial package they receive. In a Real Estate transaction, the association is not a party to the transaction between buyer and seller. The association has no obligation to give reserve studies to realtors or lenders until the property is in escrow and a document package has been requested. If the seller wants to distribute the study, he/she has every right to do so.

12. What if the Reserve Study is wrong (replacement cost estimates too high compared to the bids they're receiving, or "missed" components)? Is it improper to attempt to influence an independent Reserve Study provider?

A great Reserve Study uses the background of the board or homeowner, and the skills of both the manager and the Reserve Study professional. It is wise for board or management to offer information that might be helpful to the Reserve Study professional (historical cost information, dates, etc). On the other hand, it is meddling if they require a particular result, or take the report and change the numbers. In that case, it is no longer the professional's report, it becomes the report of the person who dictated the results or made the adjustments.

13. Are special assessments "wrong" (compared to ongoing budgeted contributions)?

The Board has the responsibility to care for the assets of the association. This is an issue of fairness. It is most fair to collect the money gradually from the owners who are using those assets while the assets are deteriorating. If the association falls short of funds, they have special assessment power to collect needed funds from owners (who likely are now being forced to unfairly pay for deterioration that occurred prior to their becoming owners). Generally, special assessments should not be a planned reserve funding strategy if it can be avoided.

14. What about waiting for something to fail due to severe weather (hailstorms, windstorms, etc.), in order to have projects paid by insurance instead of Reserves?

If your roof is damaged by a storm, that is an unplanned event. That is covered by your insurance, not your reserves. The board has a responsibility to plan for the care of the association. The board cannot responsibly rely on storm damage to get the common areas repaired.

15. Can a board reverse or change a prior board's multi-year plan (to fund or not fund Reserves)?

Yes. Hopefully it is a wise decision to change from inappropriate funding of Reserves to responsible funding of Reserves. Each board has authority to run the affairs of the association.

That said, all of a board's decisions should be reasonable and wise, serving the association before their own selfish interests.

16. Can associations move surplus money from operations to reserves at the end of a year?

Yes, but contact your CPA to make sure you do it correctly.

17. What if the board doesn't take a manager's recommendation to raise dues or perform a Reserve Study?

The manager should make sure their recommendations are in writing. The board is not bound to take a manager's advice. But to protect themselves from liability should misfortune befall the association due to ill-advised actions, managers should make sure they have a written record of their recommendations.