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The Case for Adequate Reserves (2020)

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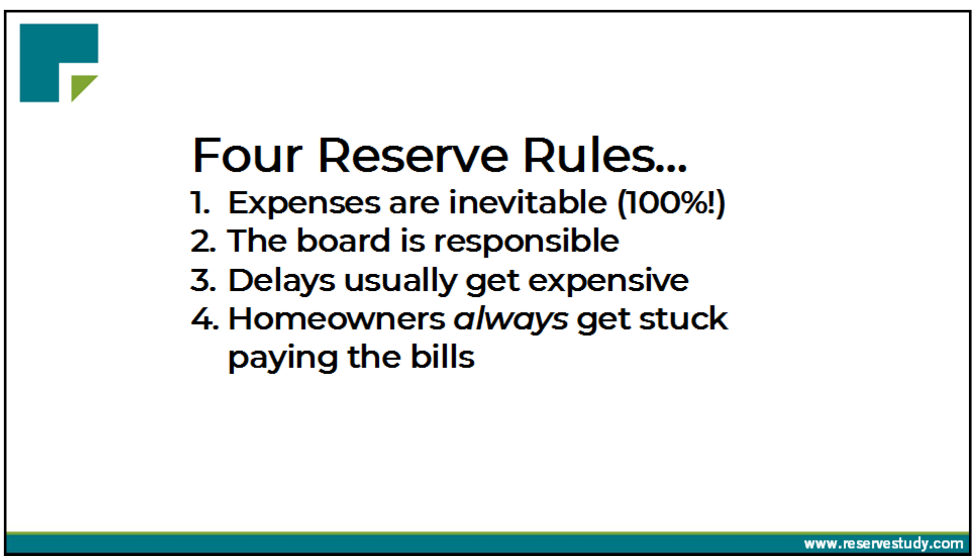
Approximately 70% of associations have “underfunded” Reserves, threatening the sustainability of the association and damaging the market value of the homes. In an industry where the majority of boards successfully budget to pay their bills, secure insurance coverage, enjoy the assistance of professional management, and manage regular elections of new leadership, why does such a glaring blind spot persist? Most boards have heard about Reserve Studies, boards are commonly told to “get a Reserve Study”, boards have regularly have been advised to set aside funds in Reserves, but there was always a key missing element. They weren’t taking any of that to heart and making adequate Reserve contributions! In this webinar we clarify that adequate Reserve contributions are not just “a good idea”, they’re required as part of a board member’s responsibility to the association.

First, understand the situation, summarized in the “Four Reserve Rules”:



How did we get here, even though the board has always clearly been responsible to run the business of the association, and delays usually cost the homeowners more money?

- Indifference (the roof doesn't send a "deterioration" bill each month)
- Short term thinking (Reserves mistakenly characterized as "for the future"… someone else's problem, not a <u>bill to be paid</u> to offset the cost of ongoing deterioration.
- Boards have **mistakenly** focused on minimizing assessments, not budgeting for the needs of the association.

What are boards missing?

- "Proper" or "adequate" funding of Reserves <u>is the board's obligation</u> (often per their Governing Documents).
- Reserve expenditures are <u>inevitable and predictable. They are not accidental occurrences</u> and will not be covered by insurance.
- Willful decisions to ignore Reserve contribution obligations may be considered a "wrongful act" in light of a board's obligation to "Protect, Preserve, and Enhance" the assets of the association. Such actions may be defended by the association's D&O insurance, but association members still need to come up with the money for those Reserve projects. There is no neglecting the fact that the roof bill needs to be paid.
- Willfully underfunding Reserves in pursuit of low assessments is unsustainable and indefensible. The roof will still need to be replaced! Underfunded Reserves lead to deferred maintenance and special assessments, both of which depress home values more than the temporary attractiveness of low assessments.

The Board has a Fiduciary Obligation to Adequately fund Reserves

- The board has a duty of care and a duty of loyalty: to make informed decisions to act in the best interests of the corporation. Thus the board's question should be "how much is necessary to fund?" not "should we fund? or "how much can we afford?"

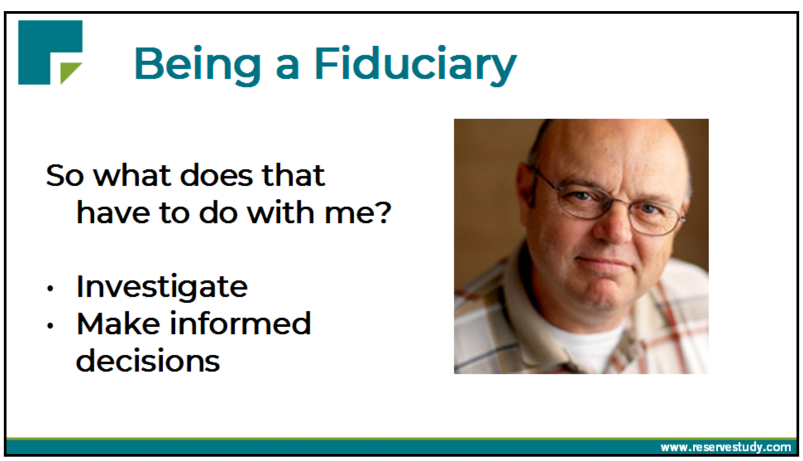
- Board decisions will be measured against the Business Judgment Rule (BJR)

- The board needs to follow the BJR process in order to minimize their liability!

- The board is a Fiduciary (the important "F" word!), and that carries responsibilities:

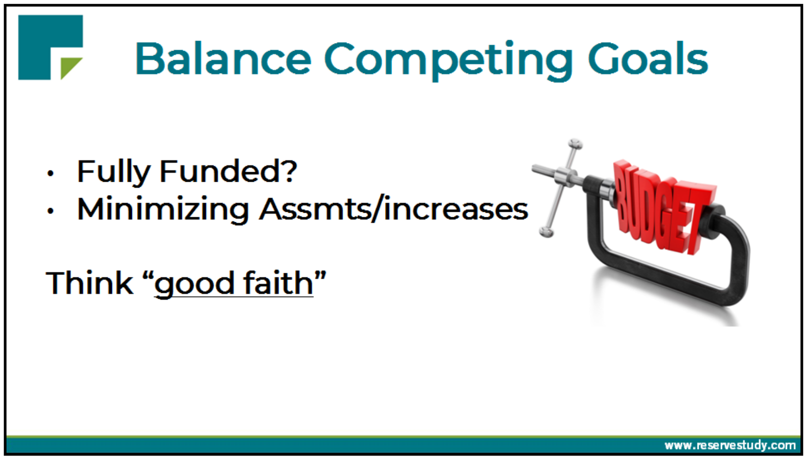
    - To act in good faith
    - Keep confidences
    - Disclose conflicts
    - Not use power for personal gain

- Common to BJR and Fiduciaries is "acting in good faith", which means investigating and making informed decisions.



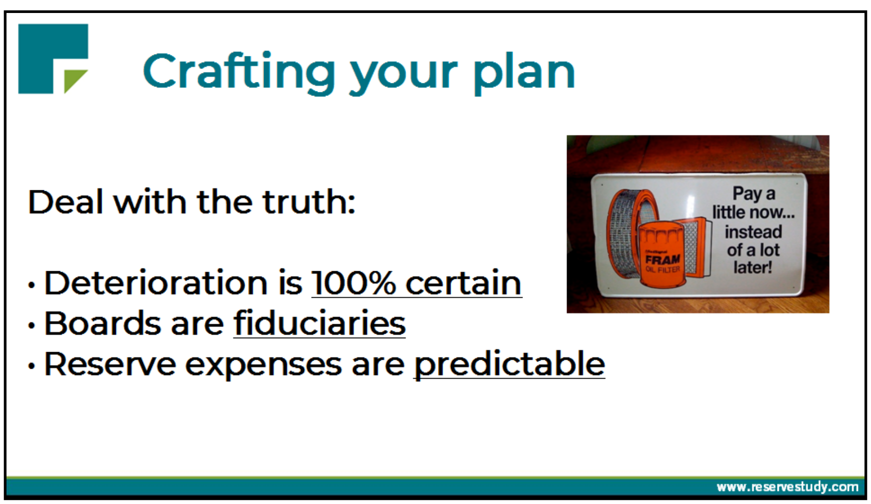
What does this actually look like?

- Update your Reserve Study. Find out what size contributions are needed.
- Balance those competing goals in setting your budget, careful to ensure that your actions will be described as "in good faith", acting loyally to what the association needs.

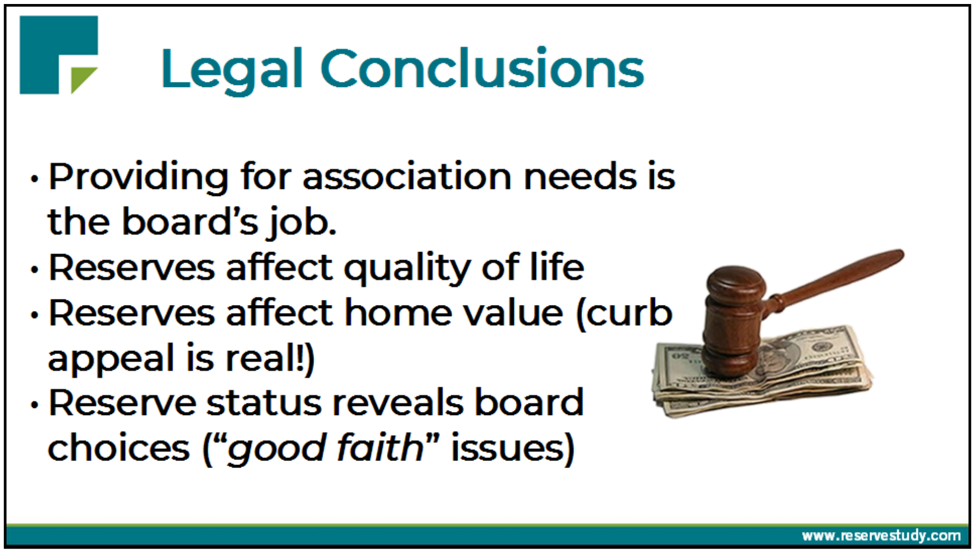


- Safety is found in budgeting sufficient Reserve contributions to provide for the predictable needs of the association, without reliance on future supplemental funding (future special assessments or loans).
    - Demonstrating the board has made informed decisions is essential
    - Budgeting so the funds exist to accomplish Reserve projects on time is essential
    - Providing funds so the association is "Fully Funded" is not essential

So assemble the facts (an updated Reserve Study) and "craft your plan".



Conclusions:



Wise, informed decisions and "paying the bill" to offset predictable, ongoing deterioration moves your association towards a great future where special assessments are rare, home values are maximized, and board liability is minimized!

Contact one of our experts for further information:

Webinar Questions Asked by Attendees

Q: **We have a current Reserve Study. The 4 other members of my Board refuse to accept the results and want to substitute their judgement for that of the specialist. We have liability insurance for errors and omissions by the Board. Would this kind of coverage protect against a civil suit by the membership?**

A: Joel:

- Based on the statement that "[t]he 4 other members of my Board refuse to accept the results and want to substitute their judgement for that of the specialist" leads me to presume that there are four members plus the questioner as the fifth.
- I am not quite sure what is meant by the other four board members "refuse to accept the results and want to substitute their judgment for that of the specialist." The Reserve Specialist is an expert for the purpose of conducting a reserve study. If what the other board members mean is that they do not agree with the funding recommendation of the expert, or are there other items in the study that they do not agree with. Have they had the Reserve Specialist come and sit with them to discuss this? Are the four board members experts?
- The directors and officers liability policy provides defense and or indemnification to an Insured(s) when a written demand by a claimant for monetary on non-monetary relief arising from an alleged "Wrongful Act. The short answer is "it depends." First, some D&O policies do not provide coverage for "non-monetary relief." Accordingly, it must be determined what the definition of "Claim" in the applicable policy provides. Second, a "Claim" requires a "written demand" that the Insured(s) do or not do something. Third, there must be an alleged "Wrongful Act." If what is being alleged as a "Wrongful Act" is the failure to fund reserves recommended by the expert, and the demand is that the assessments be adjusted to fund reserves based on the expert's recommendation, the insurer would provide a defense as long as a "Claim" includes "non-monetary relief." As indicated, not all policies provide that within the definition of a "Claim." What is clear is that no insurer under a D&O policy would provide indemnity for the reserves failed to be funded based on the board's decision.
- It should be noted that the decision by the other four board members could be claimed to be a "conflict of interest" by failing to follow the expert's recommendation, especially if they do not want to fund it, because they do not want themselves to have to pay. The board's duty is to put the "association's interest above their individual interests.

Q: **I have a BOD that is steadfast paying down a bank loan for a major road project 4 years ago but in doing so they are not setting aside money for the recommended reserves for 3-4 years. Can you comment?**

A: Robert - On the surface, it sounds inappropriate. But if after the loan is paid off they can use all that cash flow to (re)build their Reserve Fund, it may "pencil out". Best to discuss with your Reserve Study professional to develop a plan.

Q: **What is the "personal" board member liability if determined that proper reserves have not been funded?**

A: Joel

- This is a deceptively simple question. As George has discussed, the board has a duty of good faith, a duty of care and a duty of loyalty.
- If there is a D&O policy, if it is determined that the personal board member breached any of those obligations, the individual board member again would be defended under the circumstances and analysis above.
- The insurance policy would not provide the failure to provide proper reserves. In this case, the association would be responsible to pay in a self-insured capacity and association funds or a special assessment would be required. The chance that this would fall on an individual board member is unlikely, but is a possibility.
- If there was no insurance, and the board member's conduct was not grossly negligent or willful, the board member would be indemnified pursuant to the governing documents. If there was no insurance, and the board member's conduct was grossly negligent or willful, there is a possibility that the individual board member may be personally liable.

Q: **Our association was turned over from developer/bulk assignee back in 2017. However, we only started partially funding our reserves in 2019. Furthermore, the partial funding has been based on 10% of the operating budget rather than the reserve study. Is partial funding based on a percentage of the operating budget acceptable per statute?**

A: Robert - As we mentioned in the webinar, the purpose of Reserve contributions are to provide for the upcoming expenses of the association. Don't get distracted with just looking at statutory requirements! Besides, most associations need to set aside 15-40% of their budget to offset ongoing deterioration (not just 10%). Follow the recommendations in the Reserve Study!

Q: **We are planning to get a new reserve study after turnover from developer control. Once completed, is the board responsible to share the reserve study with membership?**

A: George - That more of a political question than a legal one. Responsible to share? No. But why not? I have heard the answer "because some members of the Board don't agree with it." What is there to disagree with? Isn't it more that some members do not like to confront the reality of the information?

Q: **How often is recommended for a board to update their reserve study?**

A: Robert - With contributions often needing to be 15-40% of total budget, such a large budget line item deserves regular (annual) attention. We note that the frequency of special assessments drops significantly among clients who update every 3 yrs instead of every 5 yrs, and it drops again for clients who update annually instead of just every 3 yrs. Boards who review and update their Reserve Study more frequently save their owners from special assessments that occur due to budget "drift". See more here.

Q: **Does Reserve Study update frequency depend on the size and nature of the buildings?**

A: Robert - No. Reserve Study updates are necessary due to the passage of time, knowing that Reserve balance, Reserve contributions, the rate of deterioration, and replacement costs are never quite as expected. Adjustments need to be made on a regular (annual is best) basis to keep the budget on-track for these large, predictable expenses.

Q: **Is it still a violation of Fiduciary duty if owners select a less than adequate funding plan knowing Special assessments are probable?**

A: George - Sorry – this is a fact-based question, and I'm unable to answer.

Q: **Few states have requirements for Reserves … Will more states join them?**

A: Likely, but remember you prepare a Reserve Study to get the budget and disclosure information you need to run the association and keep your owners informed. You don't prepare a Reserve Study or fund Reserves to fulfill statutory requirements.

Q: Can a reserve "general account" be used for unexpected legal bills?

A: George - A general reserve account is by its name, a reserve account for general expenses. It is an Association's savings account. Unless there is a restriction placed on the use of a general reserve fund, it can be used for unexpected bills.

Robert – note that if Reserve funds are spent on *unexpected* legal bills, you'll need *unexpected* increases to your Reserve contributions to make up for those spent funds… the roof will still need to be replaced.

Q: I disagree with Robert -- I think there should always be an "Unanticipated" or "Contingency" line item in reserves… because we all know that something new comes up that they did not realize SHOULD be in the reserves.

A: Robert - I totally understand. I am bound as a Reserve Study professional to follow National Reserve Study Standards, and those standards require Reserve Components to pass a four-part test (meaning no "miscellaneous" line items). That way your Reserve Component List is not full of "guesses" that can be easily discounted or discarded. The way you protect your association against surprises is by choosing a conservative funding goal (for instance "Full Funding"). That gives the association some "margin" for the inevitable unexpected.

Q: Are more HOAs getting earthquake insurance now? We are in CA

A: Joel - I believe that more are getting this as they understand the impact of catastrophic EQs. I personally opine that boards should obtain such coverage as best they can and seek community association insurance professionals who can help them create solutions such as EQ.

Q: We have a board member who wants to eliminate landscape from our budget and do it themselves. They will get 1 million in liability insurance, purchase their own equipment and the association will pay only $200 month instead of $900. I don't agree with this. What is your input legally? I'm in Washington state

A: George - Do not do it. First, you get what you pay for. Beyond that, what is the person's qualifications? Will there be a contract? Will the person be held to the same standard? I have never seen an association-member employment agreement work out.

Joel – no no no no no no no no! Did I say no?

Q: The reserve study says we need to be 100% which would take our monthly contribution from $23,000 to $41,000 - can we look at 70% to avoid special assessment then increase it gradually over 5 years to reach the 100% level?

A: Robert - Absolutely. 100% Funded is typically described as the "bulls eye". Ask your Reserve Study professional for an alternate Funding Plan along the lines of what you describe. Association Reserves clients can do it themselves with our new online Reserve calculator tool "uPlanIt", testing various "what-if" scenarios.

Q: Our past property manager also owns a unit in our community. Total conflict of interest… can we sue her or the prior board?

A: George - Sorry – this is a fact-based question, and I'm unable to answer.

Joel – Anyone can sue anyone for anything whether they have the right to sue or not.

Q: Can a current board sue a prior board or prior management company for being fiscally irresponsible? We are in FL

A: George – please consult with your Florida attorney. As a general answer, a suit for fiscal irresponsibility is the opinion of one group of members about the decisions of another group. I had this example. A group alleged fiscal irresponsibility. They said the Board had spent X dollars on a supply of light bulbs. They found light bulbs for a much lower price on the internet. The board was irresponsible because it did not get the best deal. That you can almost always find a better price is not the issue. Was the price paid reasonable? Customary? Is it a good use of a board members time to look for a better deal? How long must the person search to find the best deal?

Joel – short of showing fraud or a conflict of interest, and as long as they comply with their duty of care and duty of loyalty, the Business Judgment Rule defense will probably protect them.

Q: Can you talk about pooling the reserves?

A: Robert - Absolutely. We discuss the comparison between the Straight Line method of calculating Reserve contributions (officially called the "Component Method") and the pooling method of calculating Reserve contributions (officially called the "Cash Flow Method") in our Reserve Studies 103 webinar found here. Very simply, both fund exactly the same expenses. The Cash Flow method uses your Reserve cash more efficiently and thus is more advantageous to the associations and its owners.

Q: Our association is about to increase the annual contribution so that it will cover expenditures for the next 13 years based upon a reserve study. Is it acceptable to do this on a straight-line basis whereby the reserve balance will vary year to year based upon yearly expenditures but never go below $0?

A: Robert - You're mixing a couple concepts. First, why 13 yrs? National Reserve Study Standards require a minimum projection of 20 yrs of Reserve income and expenses. Next, the "straight line" (Component) method is an elementary way to calculate Reserve contributions and it is not advantageous to the association. Cash Flow (sometimes called "pooled") is more sophisticated and more advantageous. Regardless, designing the goal of only barely keeping the Reserve Fund "cash positive" is the most risky funding goal, as it regularly results in special assessments when expenditures don't occur exactly as planned. It is best to design some margin into your Funding Plan. Discuss the value of Threshold Funding or Full Funding with your Reserve Study professional.

Q: Who on this panel handles D&O insurance?

A: Joel Meskin. Joel is the Managing Director for Community Association Products for McGowan Program Administrators. See more here.

Q: If major capital repairs are needed and reserves are underfunded, is it better to take out a loan or do a special assessment?

A: Robert - Special assessments are significantly less expensive. It's not good, but it is the lesser of the two evils. If the association qualifies, a loan allows the association to spread the payments out over a longer period of time. But that gets expensive, as during that time you should also be setting aside sufficient Reserve contributions to avoid getting into an identical program a few years down the road!

Q: What % of HOA's are funded adequately?

A: Robert - See here. Approximately 30% of all associations are above 70% Funded, which means they have no measurable risk of an upcoming special assessment due to insufficient Reserves.

Q: What if owners, via a vote, refuse to adequately fund the reserves?

A: George - Shame on them. If the Board presented an adequate plan and did its best to explain the pros and cons, then the Board did its job.

Q: What is Board liability if owners vote "no" to adequately fund reserves?

A: George - Again, the Board discharges its duty by proposing an adequate reserve contribution. The Board should do its best to educate the membership that the need is in the present, not the future. But, at the end of the day if the spendthrifts who will not be in the community when the funds are needed have their way, it is a decision of the membership, not the board.

Q: Can you prove to owners of an HOA that the value of their asset is improved by adequate reserves?

A: Robert - We concluded in a study for condo associations, where Reserves more significantly influence the market value of the unit. That study found (no surprise) curb appeal is real, and home values increased approximately 12.6% in associations with a strong Reserve Fund. See more here.

Q: What if owners are wealthy and therefore say they can afford any assessment that may be put upon them?

A: George - Talk is cheap, no pun intended. That they say they can afford a lump sum payment means they can afford smaller payments. What if the wealthy members move before the assessment? The duty of the Board is to obtain a reserve study and fund for the demonstrated needs of the association.

Q: How do you propose explaining the balance between higher monthly assessments and special assessments from the perspective of a lender or potential buyer?

A: Robert - Real Estate agents and buyers are trending to understand that low homeowner assessments is actually a bad thing… indicating the likelihood that the association is gradually falling behind financially. Remember that the board's job is to run the association, not guess at what assessments buyers might want to see. Budget for the association's needs.

Q: Do higher dues or special assessments have the greatest negative on property values?

A: Robert - Neither. First is curb appeal, just plain how the association is maintained. Buyers and Real Estate agents are more commonly asking for the special assessment history, which as you know is a significant negative factor. It is safest to "do your job" as a board member and budget for what the association needs.

Q: **How should Boards address insurance deductibles? As a special fund??**

A: Robert - Every association should have some margin in their Operating fund, holding 2-3 months of assessments on-hand. If that is insufficient, a special assessment is required. Reserves should not be tapped, as those funds are already designated towards predictable, upcoming expenses (roofing, painting, asphalt, etc.).

Q: **How many years can someone go back to sue a Board regarding the economic loss rule?**

A: George - Please check with an attorney in your state.

Q: **What happens if the board increases the HOA dues to cover reserves as fully funded and the increase is over 40%? Legally can you increase the HOA dues by that much in a year?**

A: George - I take from the question you mean a 40% increase without a vote of the members. That depends on your state law and your documents.

Q: **In an investor heavy building, if the HOA dues are increased substantially would it lead to foreclosures?**

A: Robert & Joel - The board's job is to run the association, but this may require extra-special skills of communicating the need (and benefit) to the owners of raised assessments. Fundamentally, the association appears to be on an unsustainable budget and that needs to be communicated to the owners.

Q: **My question is related to the "sometimes people have to move" statement. But what if majority of the building is investor based? Won't the building be in big trouble if a lot of units foreclose together? The 40 actual home owners that live in the building will be responsible to pay the full HOA?**

A: Robert - See above. Sometimes being a board member requires excellent communication and "salesmanship" skills. Sometimes there is no "easy" answer, and your choices are between the lesser of two undesirable outcomes.

Q: **Doesn’t the board need a membership vote to fund reserves partially, fully or not at all?**

A: Joel & George – That answer is state dependent. Ask your association’s legal counsel.

Q: **George - do you practice in AL?**

A: George - No

Q: **I sell property on the coast and most agents have no idea what a reserve study is. Can boards be held responsible for underfunded reserves which impacts financing as well as continual special assessments?**

A: George - That would depend on the specific facts. Remember, the board members are elected owners of the community. I doubt no member has sufficient familiarity with reserve studies. Further, the matter is addressed in the FHA lending guidelines. FHA requires information on reserves (minimum 10% of total budget going towards Reserve contributions) and can require a reserve study that is less than 24 months old.

Joel - Ignorance of the duties and obligations of the governing documents is not a defense.

Q: **Our current reserve study assumes 3% increase per year in reserve contributions. Our building is only 3 years old... Why wouldn't reserve contributions be flat level over 30 year life cycle?**

A: Robert - One of the four National Reserve Study Standard Funding Principles are that the Funding Plan be “equitable” over the years. That is accomplished when the contributions roughly float upward with inflation, so every owner pays their fair share over time, with the same “buying power” of those Reserve contributions (even though the dollar amount may change over the years).

Joel – inflation changes costs. Would you want your salary to be the same for the next 30 years?

Q: Please put definition of adequacy slide up again or repeat the definition.

A: Robert - "Adequate Replacement Reserves" is defined as a Replacement Reserve Fund and stable and equitable multi-yr Funding Plan that together provide for the timely execution of the association's major repair and replacement expenses as defined by National Reserve Study Standards, without reliance on additional supplemental funding. See more here.

Q: How are the Reserve levels established?

A: Robert - The funds in Reserves are a simple matter of adding up the various association Reserve bank balances. Typically those are compared to the value of Reserve component deterioration at the association to determine if that Reserve balance is weak, fair, or strong. The recommended contribution rate is calculated by either the Cash Flow or Component method to provide sufficient cash in Reserves so the anticipated Reserve projects can be accomplished in a timely manner (with varying levels of "margin" left in the Reserve fund).

Q: How do we educate members concerning the necessity of levying sufficient dues?

A: Robert - Send them the link to this webinar recording, and remind them that a strong Reserve Fund minimizes special assessments, minimizes board liability, and maximizes home values.

Q: Are there resources for members who can't afford the continual dues increases?

A: George – Not that I'm aware of.

Q: Can reserve funds be comingled?

A: Robert - Reserve Fund should not be co-mingled with Operating Funds. Those accounts/funds should be separate and distinct. Within the Reserve Fund, in the Cash Flow method there are no separate categories for separate "buckets" of money (for roof, paint, asphalt, etc.). It is one fund, to be drawn from for the scheduled Reserve projects. Another advantage of the Cash Flow method is that it avoids all the trivial accounting for various Reserve component fund balances.

Q: **What is an estimated cost for a reserve study?**

A: Robert - The typical cost for a "Full" Reserve Study is often at or below 1% of the association's total budget. Update With-Site-Visit and Update No-Site-Visit Reserve Studies are significantly less expensive than the original "Full" Reserve Study.

Q: **If a reserve is Fully Funded, when are you required to do the actual work?**

A: Robert - Reserve projects should be done when needed, which is hopefully close to when they were scheduled.

Q: **Your presentation presumes the board has the power to simply raise dues or an assessment. In my HOA, the board needs member approval to raise annual dues. We plan to rip the band aid off, but what if they do not vote for increasing dues to properly fund the reserves? We just completed a reserve study and the dues would have to at least double immediately! (We had 10 years of no increases!) I'm a property manager in Florida.**

A: Robert - Polish your communication skills to "sell" the increase to the members. The increase is likely distasteful, but you need to make the case that it is better than the alternative. A more palatable idea to consider may be to handle the increase over a few years instead of "all at once".

Q: **We are conducting our first reserve study in 10 years. Turnover just occurred and the developer was keeping costs low to entice sales. If the budget is increased by more than 15% because of the increase in reserve funding, will this still require membership vote?**

A: George – Yes, if that is what your documents say. The reason for the increase is not relevant to the limit.

Q: **How can I trust the reserve study? I have 4 properties in different condominium complexes. In 2019, the reserve study for my main residence showed a $5K special assessment for 2023. There was nothing in our financials to indicate the special assessment. But the Board came out with $9K special assessment for each homeowner in 2019. How is it possible? No, that wasn't an emergency case. Can be this a liability for HOA when new buyers buy properties in this complex?**

A: Robert - It sounds like there was a board or management disconnect between the Reserve Study and their budget, or some circumstances changed after the Reserve

Study was prepared. Boards should always disclose upcoming, planned special assessments.

Q: What if a member vote rejects a board's research and decisions, or votes to only partially fund the necessary level of Reserve contributions?

A: Joel- The board has the obligation to investigate, consult experts, and where required, get approval by the association unit owners. If they have advocated why this is necessary and what the consequences are, that is the best a board can do. The board needs to clearly communicate to association members that if they underfund their Reserves, at some point they will need to pay what is tantamount to a balloon payment (a "catch-up" special assessment).

Q: I believe that our owners have a vote on whether to approve an assessment. So we have the responsibility to "sell" the idea to the owners?

A: Robert - Yes. Generally boards know what is best based on their understanding of how the association operates, where the financial needs are, etc. Understand that owners typically "vote their pocketbook". If owners have a voice in the budget process, *do all you can* to convince them what is in their own best interest (and contrast that with undesirable consequences of making a different decision).

Q: While our % funded continues to be in the 40% to 50% range, we have enough money in our reserve to cover any near-term expense without a special assessment. Why should we be concerned about being 40% to 50% funded?

A: Robert - It is all about risk management. The risk of a special assessment is measurably lower when your Reserves are stronger (above 70%). The future is uncertain. It is always best to have some margin. See more here.

Q: Is there available software that would produce a graph like the one just shown?

A: Robert - Yes. In 2020 Association Reserves introduced uPlanIt, our online Reserve calculator. It is free for our Full, Update With-Site-Visit and Update No-Site-Visit clients. All others can purchase a subscription for just $149/yr. See more here.

Q: **How about a half-way reserve approach where accounts are set up for various categories and planned out for ten years? No reserve study and no reserve fund lock box. Plan is based on well known expenses but ignores many components that are not identified. When an unexpected expense comes up a loan becomes the solution.**

A: Robert/George - Governing Documents don't require boards to do a marginal job. They require boards to act responsibly, with a duty of care and a duty of loyalty. That means don't try to shortcut it and do a poor job yourself. Hire a Reserve Study professional and get it right. In making the decision as described, the board is admitting it is not acting in the best interest of the members and perhaps <u>not</u> acting in good faith.

Q: **In our 228 unit townhouse condominium we have had several fires. Our insurance company has raised the deductible from $25,000.00 to $250,000 per claim. Does this seem to be a trend of very high fire deductibles?**

A: Joel - Yes. You may want to seek counsel from your insurance professional about alternatives such as deductible buy backs coverage.

Q: **When a community owns things like their sewers, potable water, etc., how do you determine condition, remaining useful life, etc.?**

A: Robert - When assets are beyond the Reserve Study professional's ability to ascertain the condition and potential future costs, we consult with knowledgeable parties (the vendors maintaining those assets at the association).

Q: **What is the appropriate reserve % for a luxury mid rise condo set of buildings with complex mechanical systems? If 30-70% is a "moderate" level, 30% seems way too low for expensive mechanical systems. Is 50-60% more appropriate? What should our goal be?**

A: Robert - A good goal is 100% (Full) Funding. Percentages are based on the <u>value</u> of your assets, so 30% means the same for an association with significant assets as it does for one with minimal assets. And agreed… 30% is risky. 100% is better. The contribution difference between a 30% goal and a 100% goal is surprisingly small. Reserve projects are expensive. The "margin" is just the icing on the cake.

Q: What do you think of balancing larger reserves with rather periodic (every 5 years) assessments?

A: Robert - Bad idea. The board's job is to provide for the needs of the association, not put critical infrastructure repairs at risk of an owner vote. Besides, owners will pay for it one way or the other, and it is always best to deal with the true costs of living in the association and insulate your owners from unpleasant surprises (that weren't really surprises!).

Q: Do owners have to vote for an increase in monthly HOA dues?

A: George – The answer depends on your Governing Documents and State Law.

Q: Should future obligations, such as potential cost of the future requirement to do water augmentation, be included in the Reserve Study and reserve requirements?

A: Robert - No. Capital Improvements fall outside the definition of a Reserve expense (see more here, p6). That said, boards should always be open to doing what is needed to improve the association, making appropriate decisions along the way allow the association to thrive. There is no responsibility for boards to keep the association "the way it is".

Q: What is the difference between working capital and the reserve funds?

A: Robert - Working Capital typically defines the "Operating Fund" (checking account). It is common that this holds two to three months of assessments so boards can pay the ongoing and sometimes seasonally irregular bills of the association. Reserve Fund are funds specifically set aside for future projects defined in the Reserve Study. They have special IRS tax protection (these "retained funds" are not considered "profit").

Webinar Questions Asked in prior years

Q: Our managing agent deposits our reserve assessments and operating assessments in the same bank account. Do you recommend this practice?

A: (All) No! Best practice is to have Reserve funds separate from Reserves in their own account, not co-mingled with Operating Funds or Reserves from other associations.

Q: We recently had a reserve study done but do not agree with everything that's in it. As an association can we tweak it to make a better fit what we feel should be done regarding assets and asset life? For example: building painting every 10 years instead of eight years.

A: (Nordlund) A Reserve Study done by a credentialed professional is their recommendation for your association. Feedback from clients is generally encouraged, in order to gain client insights and make the Reserve Study as accurate and effective as possible. But be prepared that the Reserve professional may not agree with and incorporate all your suggestions. In those cases, they may run a "test case" to allow you to see the effect of the changes you suggest, or provide software so you can test the effects yourself.

Q: People seem to make an argument for special assessments versus higher reserve contributions. How do you balance that out?

A: (Nowack) Planning on special assessments means kicking the can down the road and just like Congress, the implementation depends on a vote of the members. What if the vote fails? It is also inequitable for those who purchase at the time the assessment is imposed. Those living in the community should pay for the deterioration of the components they are using.

Q: There appear to be two different methods for calculating reserve contributions. Straight line or a pooled approach often referred to as cash flow. We are having a little bit of a difficult time understanding why the contributions can be so much less utilizing the pooled approach.

A: (Nordlund) See our Reserve Studies 103 webinar here or an article here where we discuss that subject. The answer is due to two factors:

1. With the Cash Flow method, funds are shared between Reserve projects so funds are used more efficiently.
2. With the Cash Flow method, often a lower Funding Goal ("Baseline", which means being just barely cash positive, instead of the more conservative "Full Funding") is being pursued. Pursuing Full Funding with a Cash Flow methodology is a great combination, using your precious Reserve funds most effectively while pursuing a conservative Funding Goal.

Q: Unless our insurer or a judge orders our Board to strengthen our reserves (we are only funded 20.1%) the monthly fees will not be increased. When is our State legislature going to pass a law requiring Boards to meet the Reserve Study recommendations? Without a legal requirement our Board will not meet their fiduciary responsibility.

A: (Nowack) I do not believe any legislature will ever adopt that type of legislation. CC&R's are considered specialized contracts. State governments cannot interfere with contracts.

Q: What are typical costs for a Reserve Study?

A: (Nordlund) Costs vary depending if you desire a "Full" Reserve Study (created from scratch… usually only needs to be done once), an "Update With-Site-Visit" Reserve Study, or an "Update No-Site-Visit" Reserve Study. Even so, often a Full Reserve Study is available for around or under 1% of your association's total annual budget.

Q: What is proper process for Boards to take if the members elect/vote to not fund the figures that are suggested to get above the Baseline? Just document it and move on and await the Special Assessments?

A: (Meskin): Budget decisions are commonly made by the board. In your case, it sounds like owners/members have budget authority. Even so, such a significant decision such as proper funding of a reserve fund, deserves advance planning. Accordingly, before the call for decision, I recommend that the board give notice of a special meeting for the entire community to discuss Reserve funding. I further recommend that you bring in your Reserve Specialist and your Attorney. They should help explain what the funds are for, and the consequences for not funding adequately. Once this is accomplished, and once the members have an opportunity to ask questions and express their opinions (a limited timed opportunity), then the members can make their decision. Make sure the board's recommendation on the matter is clear for the record.

Q: I am crying out for evidence to provide to owners that the RE (real estate) market DOES respond and yield higher pricing for homes inside an HOA (not a condo) that have a higher % funding. Especially since no RE agent I have ever spoken to ever have their client obtain anything form the HOA prior to closing about the health of the HOA. Are HOAs required to provide their studies and asset assessments to potential owners?

A: (Meskin) This is a huge issue in my opinion. Many states have some form of Real Estate Disclosure requirement. The problem is twofold: the association has no relationship with prospective buyers (the association only has a relationship with the seller), and the documents the association provided to the seller are commonly not provided until the 11th hour while keys are being dangled in front of the buyers. Please see our association home-Buyer Checklist at the end of this document. Good practice is for the buyer(s) to do their due diligence in getting useful information from the seller. One of the single biggest factors behind many claims by or against unit owners is the failure of these individuals to read the governing documents prior to moving into the association.

A: (Nordlund): Please see our article on the significant positive effect of Reserves on condo sale prices here. The effect is less significant for HOAs (as the common areas are not as intimately intertwined with the home as in a condo). Note that our condo study was based entirely on curb appeal effects, not documents that were provided to buyers. And remember that associations have no relationship with buyers. Only sellers have relationships with buyers. Associations typically provide documents only to owners, or to prospective buyers only with clear instructions from the owner

Q: Can a board member who is out voted by other board members be held liable for very bad decisions that others have made?

A: (Nowack) The answer to questions about liability always depend on the specific facts of the matter. A Board member who disagrees with a decision should make sure the minutes reflect his or her disapproval. As discussed in the webinar, the standard of conduct on which a Board member will be judged is the good business judgment rule.

Q: What percentage of operating budget is generally recommended to keep in reserve?

A: (Nordlund) The actual Reserve Fund will vary significantly in size over the years depending on the proximity of upcoming major projects, so there is no consistent ratio between Reserve Fund size and the association's budget. See an article here to read that Reserve contributions typically need to be 15-40% of an association's total budget in order to provide adequately for ongoing deterioration. Note that the FHA requires at least 10% of total budget going towards Reserves in order to qualify as an "FHA approved" association (a budget rule being adopted by other lending-related organizations).

Q: One presenter stated that Reserve contributions commonly need to be between 15-40% of total budget to provide sufficient Reserves exist to accomplish scheduled Reserve projects on time. My question is how you calculate that ratio? Is it on an annual basis; the amount of annual funding to the reserve as a percentage of the operating expense budget? Or is it the total reserve balance to date as a percentage of the current operating budget?

A: (Nordlund) You can calculate that ratio a number of ways. For a homeowner who pays $350/mo in assessments, commonly 15-40% of that should be Reserve contributions. Or you can look at it on an annual budget basis… if the association has a total annual budget of $500,000, commonly 15-40% of that should be Reserve contributions. The resulting Reserve balance due to those stable contributions will fluctuate significantly through the years, growing in years where there are few Reserve expenditures and dropping in years where there have been large expenditures. So as stated above, there is no reliable ratio between association budget and Reserve balance.

Q: I have read that D&O insurance alone is not sufficient to protect Board Members. Is that accurate?

A: (Meskin): You read correctly. Although Board Members may be liable for challenges to their decisions and or conduct in their capacity as a Board Member, people can sue anyone for anything in this great country of ours. However, like any other insurance policy, not everything is "insured" and not everything is "insurable." Things are not insurable either because it would be against public policy, would be a "moral hazard" or it is something such as "wear and tear" that is not insurable. On the other hand, some board members choose to purchase policies that may not be as robust as others. For example, some people may chose a policy based on "price" as opposed to coverage. D&O policies try to provide as broad coverage that people are willing to purchase to protect as much as possible. Other people believe it is more important to consider policy price rather than policy coverage (or "value"). Not all policies are created equal. Accordingly, it is wise to receive counsel from your insurance professional regarding which policy is most suitable for your association.

Q: I understand that a reserve fund is for predictable maintenance expenses. What does the board do for unpredictable expenses such as plumbing, electrical, drainage, etc.?

A: (Nordlund) Generally an association's budget is divided into three categories: Operating, Reserves, and Surprises. The job of a Reserve Study is to minimize surprises by identifying predictable major expenses (meeting the National Reserve Study Standard four-part test). Even so, some surprises will occur. The remedy for a true surprise is a special assessment, if it is not an insurable loss.

Q: What are the risks or benefits to transferring responsibilities for specific expenditures to association unit owners for funding? For example: unit exterior painting.

A: (Nowack) The risks and benefits are the same. Someone other than the Association is responsible for performing and paying for the work. It is successful if the person is diligent and has the money. It fails if not.

Q: Do you advise setting reserve replenishment rates based on the useful life and some inflation factor based on the current expected replacement costs or would the replenishment rate best be set at the inflated cost at the end of the asset's life?

A: (Nordlund) Best practice is to base your Reserve contributions on projected future (inflated) expenses, taking into account the effects of compound interest on those Reserve contributions over the years.

Q: Can you give me a link to the National Reserve Study Standards?

A: (Nordlund) Please find them here.

Q: What if, by doing their fiduciary duty, the Board causes financial issues for owners on set incomes? In this case, over 50% of homeowners are retired or on set income and could not afford even a 50¢ increase.

A: (Nowack) There is no way to avoid appearing uncaring, but the personal finances of individual members of an Association is not the Board's concern in setting the assessments. The Association is a business/non-profit corporation, and the Board is charged with setting the budget, including reserves at the proper amount. As Americans age in place, the reality is the same as in an apartment or assisted living facility. If the rent is no longer affordable, the person has to move. Think of assessments as rent in this instance

Q: Do you have information or recommendations on investing reserve funds for long-term purposes (roofs, etc.)?

A: (Meskin) The primary purpose of investing the reserve funds is to protect the principal for use at the time the improvement or repair is required. Safety and conservative investments are appropriate for these funds. The Board should seek the advice of a community association accounting professional and a community association banker. This is an area where the board will not be protected for either defense or indemnity.

Q: Is there a tool, for example an Excel Workbook with macros, to determine if a community's reserve fund is adequately funded?

A: (Nordlund) Adequacy is defined here as both the present condition of the Reserve Fund and the funding plan in place to provide for anticipated future Reserve expenses. A 20-yr or 30-yr projection found in your annual Reserve Study update or disclosure should be sufficient to demonstrate adequacy. Association Reserves provides such tools (online software or Excel file) to its clients so they can test their own "what-if" scenarios.

Q: Is a Reserve Study the only way to get a true idea of Reserve contribution size?

A: (Nordlund) Yes. Each association is unique by virtue of its age, construction, size, common area facilities, maintenance over the years, size of their Reserve Fund, and board philosophy (conservative or aggressive financial style).

Q: Does a reserve study tell how much a HOA is funded?

A: (Nordlund) Yes. Percent Funded is the National Reserve Study Standard measure of Reserve fund size. Read more here. Find out why your Percent Funded is significant here.

Q: What are good sources to verify the remaining life of items like roofs, roads, siding, etc.?

A: (Nordlund) Of course your credentialed Reserve Study professional is a solid resource. You will find that information in your Reserve Study. For do-it-yourselfers, consult your association vendors or a national construction cost estimating tool (which often has information on typical life expectancies).

Q: Is a "follow up" study, say after 5 years, less expensive than the initial study if you use the same company?

A: (Nordlund) Yes, update Reserve Studies (an Update With-Site-Visit or an Update No-Site-Visit) are significantly less expensive than an initial "Full" Reserve Study. With-Site-Visit updates are often in the range of 50-80% of a Full report, while No-Site-Visit updates are often in the range of 25-50% of a Full report. If done by a credentialed Reserve professional, another credentialed Reserve professional will often update that prior report. While there is benefit to familiarity and using the same provider, sometimes a "second opinion" is of value.

Q: When rating an Association's financial soundness how "official" or current does a Study need to be?

A: (Nordlund) See article here. Reserve information (physical condition of the components, economic factors, and the association's Reserve fund size) are in a constant state of change. Revisiting a budget line item that typically comprises 15-40% of your association's total budget on an annual basis is wise. For instance… special assessments occur on average among 21.1% our "annual" clients. That number jumps to 29.8% of our clients who hire us every third year, and it jumps to 32.5% of our clients who only retain our services every fifth year. Keeping your eye "on the ball" with annual updates has a measurable benefit to the association.

Q: We have a wide range of talent in our community. Is an "In House" Reserve Study considered viable for a plan?

A: (Meskin) No. The Reserve Specialists are experienced professionals in their area of expertise. The Reserve specialist will have its own professional liability insurance. The board members are elected to make decisions to Protect, Preserve and Enhance the community association assets (not "do" all the tasks of running the association). D&O insurance covers board members with respect to their conduct and decision-making. Many association members and board members are undoubtedly talented, but they have an inherent conflict of interest with respect to any professional services they may be capable of performing. Professional Services are generally expressly excluded under most D&O policies. Accordingly, they may give great and accurate information and advice, but if it is challenged this clearly falls outside their capacity as a board member. Just because a board member does something during his or her tenure as a board member, it does not mean he or she is acting in his or her capacity as a board member.

Q: The Reserve Study tells us the proportion of full funding we have attained. What is the distribution of all condos in their amount of full funding? I would assume it must be a standard bell shaped curve around some reasonable percentage.

A: (Nordlund) Yes. See article here summarizing our findings. The actual profile of Percent Funded drawn from over 45,000 associations across the country is, as you presume, a well-behaved bell-shaped curve, skewed towards the underfunded end of the spectrum.