



ASSOCIATION RESERVE ACCOUNTS & RESERVE STUDIES

Understanding the Importance of Properly Funding and Maintaining a Reserve Account

Introduction

“Always be prepared.” That simple phrase sums up the importance of funding and properly maintaining a reserve account. Accidents and surprise maintenance issues will inevitably pop up. When they do, the Association that has been properly funding and managing its reserve account will be prepared to do what is necessary to protect the interests of the Association and its members. This article covers the basics of reserve accounts and reserve studies, their importance, and the relevant obligations of an Association and its Board.

Having those funds available at the time they are needed helps prevent costly and potentially crippling special assessments or assessment increases.



THE RESERVE ACCOUNT

Purpose

Unfortunately, it is not uncommon for a Board to fail to understand how important it is to prudently manage its Association’s reserve account. The reserve account plays a critical role in the long term health and financial viability of the Association. The main purposes behind the funding of a reserve account are (1) to guarantee that the Association will have access to the finances needed to satisfy the Association’s common area maintenance obligations, and (2) to guarantee access to back-up funds in the case of an unanticipated emergency situation (e.g., the failure of a major common area component or litigation involving the Association).

Funding Requirement

There are numerous provisions in the Civil Code which place limitations on the transfer and borrowing from a reserve account. Uniquely, however, those provisions do not contain language explicitly requiring an Association to actually fund its reserve account. Despite that fact, the language within the Civil Code paired with relevant case law indicates that a Board does have a legal obligation to ensure that its Association’s reserve account is funded and maintained at a healthy level.

In the case of *Ravens Cove v. Knuppe*, (1981) 171 Cal.Rptr. 334, an Association brought a construction defect action against its developer. The complaint filed by the Association also named the initial Board members as defendants, citing their

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failure to properly fund the Association's reserve account as a breach of their fiduciary duties to the Association and its membership. In finding for the Association, the court held that the Board members had "abdicated their obligations as initial directors of the Association to establish [a reserve fund] for the purposes of maintenance and repair." The Board members were therefore held personally liable to the Association "for breach of basic fiduciary duties of acting in good faith and exercising basic duties of good management." The court's opinion confirmed that the proper funding and management of an Association's reserve account is indeed a key responsibility of Board members. That responsibility is echoed in the language of Civil Code Section 1365.5 which states that "[t]he Board shall exercise prudent fiscal management in maintaining the integrity of the reserve account." Accordingly, although there is no explicit funding requirement, case law and the language in the Civil Code illustrate the importance of funding a reserve account and thereafter maintaining it at a healthy level.

Borrowing from Reserves

Boards are able to, without a vote of the membership, borrow (transfer) funds from the reserve account to cover the Association's short-term cash flow needs. A Board's ability to borrow, however, should never be treated as a mechanism to avoid necessary increases in regular assessments over time. This is evidenced by the Civil Code's strict limitations and requirements with respect to borrowing from a reserve account, such as the fact that the Board must provide the membership with notice of the intent to borrow pursuant to Civil Code Section 1363.05 and must also develop a plan for restoring the borrowed funds within one (1) year. Boards should therefore consult with their Association's legal counsel to determine whether they have the authority to borrow and what procedural requirements will need to be satisfied in transferring the funds and then restoring the reserve account.

THE RESERVE STUDY

Purpose

The reserve study is the primary tool for determining the extent of funding necessary for the Association's reserve account. The reserve study provides a list of all the major common area components which the Association is obligated to maintain, as well as an estimate of the remaining useful life of those components based on physical evaluation performed by a third party. A financial evaluation is then performed of the

reserve account. The information obtained from both evaluations is then used to determine the Association's present and future reserve funding needs. The reserve study is further defined in Civil Code Section 1365.5.

Reserve Study Requirements

Unless an Association's governing documents contain stricter requirements, the Association is required to perform a full reserve study at least once every three (3) years. There are exceptions to this requirement where the Association has no common area or if the total replacement cost of the common area components is less than fifty percent (50%) of the Association's annual gross budget. Associations are also required every year to prepare and distribute (1) an annual update of the reserve study, (2) a reserve funding plan, and (3) an assessment and reserve funding disclosure summary. This information must be distributed to the membership thirty (30) to (90) days prior to the beginning of the Association's upcoming fiscal year.

ADDITIONAL CONSIDERATIONS

Level of Funding

A common question with regard to reserve accounts is "what level/percentage of funding is considered healthy?" 100% is an obvious answer; however, that situation is very rare. Numerous factors may impact what can be considered "healthy" for any particular community, and Boards and Association managers will undoubtedly hear differing opinions on this issue from industry professionals. As a general position, we advise our clients to keep their reserve funding at or above 80%.



Prospective Purchasers

Associations that plan ahead by projecting long term expenses and properly funding their reserve accounts will appear more attractive to prospective purchasers. A properly funded reserve account indicates that sufficient funds are in place to cover upcoming repairs, and also broadly reflects on the financial health and management of the community. As Community Associations become more prevalent, prospective purchasers are becoming more aware of these issues in their efforts to avoid financial pitfalls.

Emergency Funds

It is impossible to anticipate every situation that an Association may encounter. There are emergencies that arise—and sometimes those emergencies can involve



the failure of a major common area component such as a slope or roofing system. A properly funded reserve account can be a source to borrow the funds needed in emergency circumstances and thus prevent the need for an Association to levy a costly and potentially crippling special assessment.

Board Decision Making

A properly drafted reserve study will guide a Board in making maintenance, repair and assessment related decisions. It can therefore be useful in justifying the reasons why the Board may have taken an action which was unpopular with certain Association members (e.g., raising annual assessments). The reserve study itself indicates that the Board is upholding its fiduciary duties to the membership and exercising prudent business judgment in managing the Association's affairs.

Loans

There may be situations where it becomes necessary for an Association to take out a loan. Lenders often require a reserve study as part of the Association's loan application. Having an up to date reserve study can therefore make it easier for the Association to obtain a loan and possibly a lower interest rate.

SUMMARY

The reserve account plays a critical role in the long term health and financial viability of an Association. A poorly funded reserve account may hinder the Association's ability to carry out its responsibilities under its governing documents and may adversely impact the respective property values of the Association's members. The prudent management of the Association's reserve account is therefore one of the key responsibilities of the Board. Failure to uphold this responsibility may result in situations where the Association must levy costly and potentially crippling special assessments, and may even expose the Board members to personal liability in extreme cases.

The Board should therefore utilize the assistance of industry financial and legal professionals to help comply with the Civil Code's reserve study requirements, as well as its limitations governing when and how funds may be borrowed from a reserve account.



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