

Is Reserve Funding Mandatory?

Can an Association legally defer the funding of reserves necessary for repairs and renovations?

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There is a continuing debate in community associations over how much cash an association must set aside to adequately fund its operations and reserve accounts, and at what level the assessments must be set to obtain that cash from the members. Boards of directors frequently face the dilemma of whether to raise monthly assessments in the face of member resistance, or to defer funding certain budget line items--typically reserve funds--to a later time.

California has a mandatory funding statute for community associations. Civil Code Section 1366 says: "Except as provided in this section, the association shall levy regular and special assessments sufficient to perform its obligations under the governing documents and this title." 1 It uses the term "shall" and that means assessments adequate to do the job are mandatory up to the limits of the board's authority. In California, the board has the authority to increase regular assessments up to 20% over the prior year and can impose a special assessment of up to 5% of the gross budget, all without a vote of the members.2 So the authority is there. But does the board have to use it?

Legislators use the word "shall" when they want to eliminate options. So as used in Civil Code Section 1366(a) it is the intention of the legislature that boards of directors of community associations are legally obligated to assess as necessary to fully meet the "obligations" of the association. But what, exactly, are those obligations? In terms of the association's operating expenses, it's a pretty easy call. Such expenses as water, garbage, management, pool maintenance, and insurance bills are current ongoing expenses. If you want the service, you have to pay the bill, usually monthly. The discussion of those obligations begins and ends during budget committee meetings each year, and once those expenses have been projected, there can be little argument but that they must be paid currently, from monthly assessments. If the board does not want to raise the amount of the assessments over the previous year, its only legal option is to insure that the expenses in the budget match the projected income. Obviously, directors can decide to cut certain expenses and make other adjustments designed to keep the overall cost of ownership low if they so choose. But once they agree on a budget, the obligations are clear and the law requires them to assess as necessary to meet those monthly obligations.

Reserve funding is another matter. Until it's time to put on a new roof or paint the buildings, expenditures from the reserve fund are not required, so the question that usually arises is: "Why is it necessary to fund these obligations now?" This question feeds into the debates mentioned above--should assessments be raised currently to save enough for future reserve obligations, or should we simply wait until it's needed and then look to the owners for a special assessment, or apply for a bank loan?

Recent surveys indicate that most associations are doing some of each--saving some money but relying on a special assessment or a loan to fund the balance. We say "relying" as if that were part of a conscious plan because these surveys also reveal that the average association has only 50% of the cash in reserves that its reserve study calls for. So if it is now time to replace the roof and the association only has 50% of the cash it needs, then some alternate sources of funding will have to be tapped, or the project will have to be deferred until the cash is available. Whether that is truly the plan or not is unknown.

The most commonly used alternatives are special assessments, bank loans, or deferral. Special assessments can work to fund a big construction project if the owners have the wherewithal to pay them. It also depends on the law of the state. In some states, there is no restriction on the amount that an association can specially assess. The only limitation is political resistance, but the basic authority is there if the association chooses to use it. In California, however, special assessments that exceed 5% of the “budgeted gross expenses for that fiscal year”³ require approval of the members of the association. This has the effect of taking control out of the hands of the board of directors and placing it in the hands of the members. And while this may be the Populist's choice, it complicates things immensely because self-interest, and not the community's interest, often influences the vote. If the board and management do an excellent job of explaining the need, if the members can afford the assessment, if all of their long-term interests are reasonably similar, and if they have been adequately warned, over the years, that this was indeed the plan, it might pass. But what if it doesn't? Given all of the hurdles above, that is always a distinct possibility.

Seeking a loan from a bank to fund a major repair project is a common alternative chosen by boards. In some states, that is the preferred alternative to both special and regular assessments. One argument for using borrowed funds is that the owners who will most enjoy the improvement are the ones who will pay for it, since repayment will be spread over the life of the new roof. In most years, such loans would be readily available, but we have to question whether it would be the best choice in a down economy when lending is more restricted. Moreover, the cost of the project will increase using borrowed funds--not just because of the interest paid on the money borrowed, but also the interest lost on the savings from assessments that would otherwise be earned. Finally, the long-term debt load assumed by the association will limit the association's access to capital for other purposes.

The last ditch alternative would be deferring necessary work to a later time. This has the obvious drawbacks of raising near term repair expense, decreasing property values, and causing owner inconvenience due to an increase in the incidence of leaks or other damage. Also, in an inflationary economy, the cost of the job increases each year it is deferred. This can induce a downward spiral: the association lacks the cash to perform the work because reserves have not been funded adequately over time; a special assessment to bridge the gap will add significantly to monthly assessment payments and so the owners will not approve the special assessment to fund the job or to make the payments on a bank loan; the work is deferred; the price of the work goes up and becomes less affordable; deteriorating conditions causes loss of market value; owners perceive a loss of investment and are even more reluctant to approve the injection of new capital; condition and market value continues to decline, and so on.

So do the provisions of Section 1366(a), that a board of directors “shall levy regular and special assessments sufficient to perform its obligations...” specifically include the obligation to currently fund reserves? Unlike some other states, like Hawaii, there is no express mandate in California law but there are strong arguments to be made that funding from assessments is what the legislature intends. The only evidence of a contrary intent is Civil Code Section 1365(3)(C) which requires a board to give owners notice of: “The mechanism or mechanisms by which the board of directors will fund reserves to repair or replace major components, including assessments, borrowing, use of other assets, deferral of selected replacements or repairs, or alternative mechanism.”⁴ The argument is that since these alternates are acknowledged, they must be authorized. It is important to note, however, that an obligation to disclose the use of an alternative funding scheme is not tantamount to an endorsement of or authority for the use of, the alternative.

Section 1365(C)(3) is also at odds with the reserve study section of the code which requires that a board adopt a funding plan, and which mentions only the use of regular or special assessments for that purpose. It states: "The plan shall include a schedule of the date and amount of any change in regular or special assessments that would be needed to sufficiently fund the reserve funding plan."⁵ It is also at odds with Section 1366(a) itself which obligates the board to levy regular and special assessments, but says nothing about using other alternative funding sources.

We also have to look at the board's fiduciary responsibility to the association and given the political and economic vagaries, pitfalls, and additional expense that would accompany reliance on special assessments, bank loans, or deferral, it is likely that a board which elects to assess at a level less than the funding requirements set by the reserve study could very well face a future legal challenge to that decision. We are aware of at least one matter where that has already happened. A judgment obtained on such a claim most probably could not be avoided by the association or its members, and it is questionable whether the association's liability insurance would indemnify the association against such a loss.

Our recommendation is what you probably have come to expect from our treatment of these subjects in the past: prudence, fiscal responsibility, and a board's fiduciary obligations to its members, require something more than just waiting until the roof needs to be repaired before looking for funds. Meeting the funding levels in the association's reserve study by gradual accumulation through regular assessments, along with periodic inspections, is the safest, most predictable method yet devised for meeting future repair obligations.

1 California Civil Code Section 1366(a)

2 California Civil Code Section 1366(b)

3 California Civil Code Section 1366(b)

4 California Civil Code Section 1365(3)(C)

5 California Civil Code Section 1365.5(e)(5)