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THE PRACTICAL GUIDE TO HOMEOWNER ASSOCIATION MANAGEMENT

HOA Reserves, Special Assessments, Loans & More:

A Homeowners Association Board Member's Guide to HOA Funding Options

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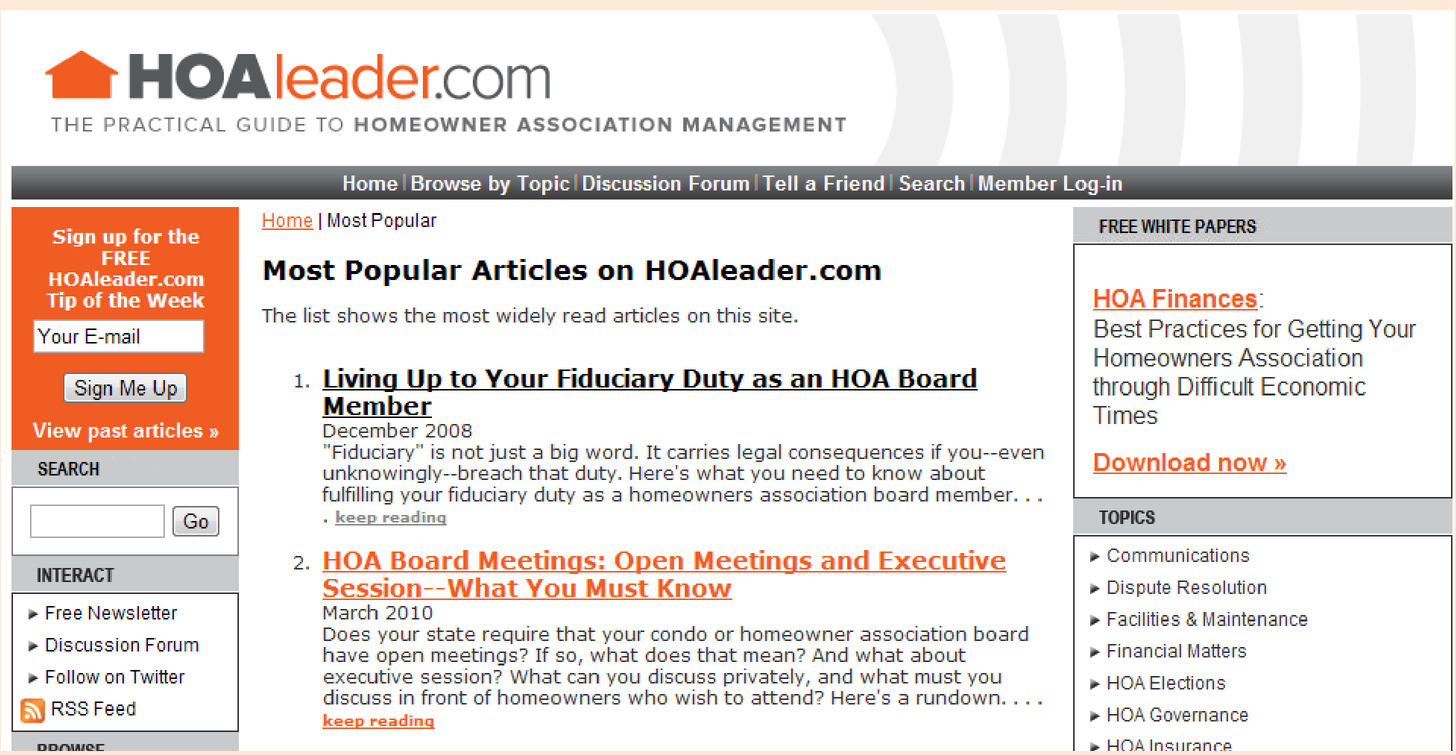

A Message from the President

Dear HOA Leader,

The best-run HOAs have boards that are smart with money. Those boards manage their owners' money with care, and when they have unplanned projects that require additional funding, they're equally methodical and thoughtful.

What do those boards do that's so smart? They explore *every* funding option, starting with well-known ideas like drawing on reserves, taking out a loan, or passing a special assessment. Then they unearth funding options that few HOA board members know about, like contractor funding and government grants. They know the factors to consider when weighing each option and how to present each choice in a way that allows owners to also make educated decisions if they're involved in the decision making. If they run into roadblocks in funding HOA projects, they regroup and try again because they understand their fiduciary duty to operate in the best interest of the HOA, even if the members are reluctant to dig into their pockets for necessary funding. Finally, they have a pulse on their reserves so it's always available for that rainy day, even if the HOA has just emerged from a financial storm.

In this special report, you'll discover tips and guidance on funding options from HOAleader.com's expert contributors—professionals who've devoted their careers to serving and advising homeowners associations. Governing documents and state laws vary, but this information will give you a baseline understanding of how your association can meet its financial needs and thrive.

Best Regards,
Matt Humphrey
President/Founder

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HOA Finances: 8 Options for Funding Expensive Projects

Roof need replacing? Balconies need work to strengthen their structural supports? Lobby and halls need to be dragged into the 2000s?

If it looks like your HOA's going to spend some big-time money soon, your first step is identifying all of your options for funding the work. In addition to the old standbys—reserves, loans, and special assessments—you may have options you hadn't known were available. Here, we run through eight possibilities and discuss the pros and cons.

1. Reserves.

If you've set aside reserves for the type of project you're facing, dipping into the reserves is an obvious option. "Unfortunately, associations aren't reserving anywhere where they should be," says Lisa A. Magill, a shareholder and association attorney at Becker & Poliakoff PA in Fort Lauderdale, Fla. "In Florida, owners can vote down the association's funding of any reserves. Continually, you'll have owners who aren't in a position to pay any assessments. So if an association is collecting reserves, it's usually only about 10 percent of what it should be collecting. When projects come up, they're either paid for by a special assessment or some other means, usually a loan."

2. A special assessment.

A special assessment is a common fallback option for HOAs that need money immediately and have no other or better way to raise it. (More on special assessments on page 5.)

3. A loan.

"An institutional loan usually entails pledging as collateral the HOA's lien rights in terms of collecting assessments," says Andrew Lewis of Eisinger, Brown, Lewis, Frankel & Chaiet PA in Hollywood, Fla., who specializes in representing community associations.

"Lenders look at all kinds of factors when considering HOA loans," explains Magill. "Are you capitalized? Do you have reserves? What's your percentage of delinquencies? What other maintenance items have to be performed? For example, with the loan, are you funding only one of 10 projects that need to be done? They also look to make sure you have all the appropriate insurance, which associations should have, anyway, but sometimes don't. But really, the delinquency rate is the most important thing. Some lenders won't approve a loan if your HOA has 7-8 percent delinquencies, but the benchmark is 15 percent."

4. Quickly built savings.

If you have a little time to come up with the money, a quick-savings plan may be a way to ease the shock and burden your owners would feel if you opted for a special assessment. "If your HOA can afford to wait for monthly payments over, say, the next year, to cover the project, an option is to add a line item for the project to your budget and significantly increase your annual budget," says Lewis.

5. Fundraising.

"I've seen where HOAs that want to do smaller projects might do fundraising or take donations," says Kristen L. Rosenbeck, a partner at the Mulcahy Law Firm PC in Phoenix. "They might sell raffle tickets, do a special event in their common areas that people can purchase tickets for, or host a concert to which they sell tickets. Or they might go out to vendors and ask for donations and raffle off those donations. Those have been more for clients that don't have any reserves or maybe they do have reserves but have a special project for something like buying furniture around the pool and don't want to dip into their reserves.

"One of my associations wanted to switch the pool access from a key to a key fob," adds Rosenbeck. "It was too much for the HOA to handle, and a lot of members voluntarily donated funds so they could have the key fob. Some members just felt like it was something they really wanted."

6. Government programs.

"In some cases, there may be grants or financing options available as a result of government programs," explains Magill. "There are very few, and they are usually related to energy efficiency or renewable energy improvements. For example, there are mitigation grants where the government will fund a portion of the weatherization of buildings and individual homes, which includes window replacements, installing white roofs, and installing water recapture items."

Rosenbeck has also seen HOAs pursue government grants. "Around here, it's mostly related to landscaping," she says. "We're out in the desert, so a municipality might give a grant for an HOA to convert a grass area to a xeriscape—though in this economy, that's kind of drying up."

7. Contractor financing.

"Many contractors offer financing through a few different models," explains Magill. "If the project is designed to achieve energy efficiency, reduce water consumption, or otherwise reduce operating expenses, the contractor may consider a performance contract in which the HOA pays for the project with the monthly or year-end savings. I'm seeing performance-based contracting quite frequently when it comes to water valve systems and even replacing cooling towers that aren't energy efficient."

But be careful when entering into a performance contract, advises Magill. "There's a difference between design standards and performance standards," she explains. "While an improvement may be *designed* to reduce your bottom line by X percent, how it actually performs is really what matters to you from a cash-flow operating basis. If your contract is based on a design standard, not a performance standard, you're really shooting yourself in the foot. You're still on the hook for payments to the contractor. But your HOA may not get the savings it intended so you may not be able to meet your cash-flow needs because you were basing your ability to pay on savings."

8. Act like a municipality.

Sounds crazy, but some HOAs are so large and have such massive projects that they can act like mini-municipalities.

"There's one avenue associations here in Minnesota have explored," says [Matthew A. Drewes](), a partner at Thomsen & Nybeck PA in Edina, Minn., who represents associations. "It's a statutory alternative available through June 30, 2013, made available to community associations that are able to work with their municipality to create a housing improvement area. The idea is that the association is going to do an important improvement to enhance or maintain the value of properties within the community. The city can make advances or issue bonds to fund those improvements and to cover the city's administrative costs.

"However, that option isn't free by any means, and the projects are discretionary to the city," adds Drewes. "Also, by statute, it's a means of last resort. It requires that the association was unable to make the proposed improvements without this assistance. I'm not aware of anybody who's done it successfully yet. For HOAs not in Minnesota, this is a reminder that there might be outside-the-box thinking they're not considering."

Other HOAs are considering government-like tactics like issuing bonds. "Some HOAs have to do major improvements, like roads," says Magill. "If they don't have the ability to have owners pay for those major projects, there are even people talking about issuing bonds like in a government-type financing program. I've heard of a couple of situations where HOAs formed a community development or layover taxing district so they could get government money to fund their project. Those are few and far between. But if you have a $10 million project and can't pay for it, you have to think outside the box."

HOA Funding Options: Is It Time for a Special Assessment? 4 Factors to Consider

Is a special assessment your best option for funding an HOA project? Here, our experts offer four factors to consider.

1. Know the basics of, and the twists on, special assessments.

The requirements governing special assessments in both state laws and governing documents could practically reach to infinity (OK, maybe not that far, but sometimes it feels that way). Be sure you understand the intricacies of special assessments.

Florida offers just a sample of the quirks that come up. "In Florida, in general, special assessments aren't much different than regular assessments," says Andrew Lewis of Eisinger, Brown, Lewis, Frankel & Chaiet PA in Hollywood, Fla., who specializes in representing community associations. "They must be assessed in the same percentage of the members' share of common ownership, and the association has the same lien rights as for regular assessments. The difference is that the board has to mail 14 days ahead of time notice of the meeting in which it's going to consider the special assessment so people have an opportunity to come to the meeting to voice their concerns about or support for the special assessment. In addition, usually the board sets the guidelines of the payment schedule by deciding whether owners can pay the special assessment over time or in a lump sum. The board has to give the same repayment options to everybody.

"In condos," Lewis adds, "funds collected for special assessments can be used only for the specific purpose for which they were passed. Boards need to give written notice of the specific purpose to all members and then can use the money only for that purpose. That's, of course, a major difference for regular assessments, where you collect the money and can use it for any association common expenses that come up even if they weren't in the budget and you didn't anticipate them. Finally, if you have special assessment money left over after the project is complete, the board has the discretion of returning money to owners or applying it to future assessments on a pro rata basis."

2. Figure out the hurdles you'll have to clear to pass a special assessment.

Can your board just pass a special assessment? When do you need owners' approval? And is it true that sometimes, you can't pass a special assessment no matter what?

That last part is true, at least under Minnesota law, which restricts HOAs' ability to pass special assessments. "Our statutes haven't historically provided the right to pass special assessments," states Matthew A. Drewes, a partner at Thomsen & Nybeck PA in Edina, Minn., who represents associations. "That right has been purely created by governing documents, and we've had boards pass special assessments when their declarations didn't allow them to.

"Under Minnesota law, if an HOA was created before Aug. 1, 2010, our statute doesn't authorize those associations to pass special assessments," explains Drewes. "So if those HOAs' declarations don't say they can pass a special assessment, our interpretation is that they can't. HOAs created after that date are authorized to pass special assessments. But even then the statute says those special assessments may be levied 'if so provided in the declaration.' So either way, a Minnesota HOA's right to pass a special assessment comes down to the declaration."

In Florida, the rules are more relaxed. "In most cases in Florida, a special assessment is a board decision, but you have to look at your governing documents," says Lewis. "Yours may require membership approval. Or there may be parameters, say, if you're going to special assess for more than a certain amount, you need member approval."

3. Consider the mood among owners.

"Whether you should pass a special assessment is going to be an association-by-association issue," says Lewis. "It'll depend on the HOA's political and economic landscape. You may need to take the temperature of your members at a board or membership meeting to see what everybody feels about it.

"Even if your documents require only board approval of special assessments, you still need to take your members' temperature," adds Lewis. "It may be board suicide for you to do something members may not want if your membership on the board means something to you or you want to answer to the interests of the majority of your membership. But if you think it's extremely important to do this project and voting for it falls within your fiduciary duty, even if that's a not a popular decision, you'll want to do it, anyhow. In that case, though, you may need to do a grassroots, door-to-door campaign to rally the troops and gather up proxies to vote for it."

4. Check whether you can pass a special assessment even if owners reject it.

"Some, but not most, governing documents allow the board to have approval and just pass a special assessment," says Kristen L. Rosenbeck, a partner at the Mulcahy Law Firm PC in Phoenix. "Let's say you have a roofing issue, and need to approve it now, but you can't get approval from the membership. Where are you supposed to get the funds? That can create significantly liability on the association if you have to maintain the roof and don't have the money to do it."

Lisa A. Magill, a shareholder and association attorney at Becker & Poliakoff PA in Fort Lauderdale, Fla., agrees. “Community association boards usually have the power and authority to adopt or levy a special assessment to fund necessary maintenance and repair projects without membership approval or vote. Limitations on board authority to attend to the maintenance needs of the community are dangerous.”

Helping Owners Fund a Special Assessment

One reason owners may oppose special assessments is that HOA boards can sometimes be "uncreative" in providing financing options. If you can go beyond the "pay it in full—now!" method by offering alternative financing, you're likely to get less resistance when you propose a special assessment.

Here, we hear how condominium and homeowner association boards crafted creative financing that helped them pass a special assessments and offer tips for funding your own special assessment.

Special Assessment Payment Options

No matter how big or small your special assessment, it may not be easy for all your owners to pay up. That's why many associations have offered a range of payment options.

"All kinds of payment options are being evaluated by associations," says Lisa A. Magill, a shareholder and association attorney at Becker & Poliakoff PA in Fort Lauderdale, Fla. "I've seen associations divide special assessments into 12-month, 3-year, or 5-year payments, or half now, half later. They understand that owners may not have sufficient cash flow to pay a large special all at once."

James R. McCormick, Jr., a partner at Peters & Freedman LLP in Encinitas, Calif., who represents associations, has also seen clients offer staggered payment terms. "They might say, 'The special assessment is due on this date. However, we'll permit owners to pay over 12 months, interest-free, in this manner,'" explains McCormick.

"Another option is to break up the payments, with each due on a certain date. That changes who's responsible for payments if the unit is sold while payments are being made, which would normally be whoever owns the unit on the date the payment is imposed."

For example, if you allow owners to make payments once every three months over nine months, consider the ramifications. "Do you want to have the due date be a single date or three separate due dates?" asks McCormick. "Are a lot of units likely to be transferred or involved in foreclosure or bankruptcy? If properties are likely to be transferred, have a single date but an option to pay over time so you'll be paid a lump sum when they eventually transfer.

"If there's potential for foreclosures, consider having three separate due dates so you don't lose the entire amount due, only the amounts imposed before the foreclosure," McCormick adds. "Subsequent payments would be the responsibility of the bank or whoever the property is transferred to. Determine what makes sense for your association, and what makes sense might not make sense across the board for all owners."

Before you offer payment terms over several years, check your governing documents. "In Arizona, some documents drafted years ago might state the assessment can't be extended for more than a year," says Kristen L. Rosenbeck, a partner at the Mulcahy Law Firm PC in Phoenix, which represents associations. "An association may be limited in collecting a special assessment only during the year it was assessed."

Offer Discounts for Early Payments

Another way to make owners feel more comfortable with a special assessment is to give them time to pay while offering a discount for paying in full. That may also allow your association to collect interest without running afoul of your state's usury laws, which dictate the maximum amount of interest that can be charged on a loan.

"It's possible to pass an assessment and say, 'Here's the amount due. If you pay it right away, you pay $100. If you instead take the time the board allows, you'll pay $115,'" explains Matthew A. Drewes, a partner at Thomsen & Nybeck PA in Edina, Minn., who represents associations. "Or you might want to set milestones: It's $100 if you pay today, $105 if you pay within six months, and $115 if you pay a year from now.

"In Minnesota, if the payment is structured in that way, it allows the association to avoid the application of Minnesota's usury laws, which say you can't charge more than 8 percent interest based on a written agreement," explains Drewes. "If there's no written agreement, the maximum interest is 6 percent. That provides greater flexibility because you can allow owners to pay over time but incentivize them to pay on time."

Because lending laws may be implicated in that type of program, consult your lawyer. "It's possible to structure the assessment so that people who pay right away pay less, but you have to structure it so you're not violating usury laws and truth-in-lending disclosures," says Drewes. "It's not something people should try to do without a lawyer's help."

Leave Yourself Special Assessment Flexibility

If you're not sure how big a special assessment you'll need to pass or when you'll need the funds, consider passing a special assessment and requiring it be paid in amounts or increments to be determined.

"We've had associations pass special assessments in which a full assessment of, say, $1,000 is approved but only $250 is due at the time the assessment is passed, with certain triggering events and later amounts to be called due at the appropriate time," explains Drewes. "That way, boards don't need to pass a special assessment every time they need an additional $250 per unit. That makes it easier if you a have a capital improvement project planned and you generally know what you're going to need. Technically that's what HOA reserves are for, but it may be helpful if a project is unexpectedly expensive or reserves haven't gotten the attention they need and project payments are due. Then you can call the special assessments in. It can also be helpful in litigation because it's hard to know how long litigation will go on and what it will cost."

If you choose the open-ended special assessment, you can set no limit on when the payments can be called in, or you could promise that payments would be collected, say, only at certain times. "You're more likely to get support from owners if payments are no more frequent than, say, once a quarter," says Drewes. "But it could be set up at the board's discretion if it's approved in a way that complies with the association's governing documents."

Ease the Way for Owners to Get Loans

Another option is to work with local lenders to lay the groundwork for owners to get personal loans. "An association we represent imposed a special assessment of $80,000 per unit," recalls McCormick. "That's a chunk of change to be writing a check for."

McCormick's client consulted with local banks. "The board went to the banks and said, 'We might have owners who need to borrow. Can we set up a deal for those who want to come in?'" he explains. "Then the association told owners, 'We've greased the wheels, and these lenders are aware of our situation. But we can't guarantee your credit will qualify you for a loan.'"

Get an Association Loan

Another option is for your association to get its own loan. "Many financial institutions offer favorable loans to the association, giving the association immediate funds to complete a project and allowing members to pay for the project over 5-10 years or more," says Magill. "I've seen terms as long as 15 years on several-million-dollar loans. Owners might not have $7,000, but they probably can pay that amount over several years as part of their monthly assessment payments."

There are benefits to owners with association loans. "Members have the benefit and enjoyment of a completed project," says Magill, "and aren't paying for something that may never happen or advance funding for something they may not benefit from if they relocate."

The catch is that if your association doesn't have sound collection practices, its ability to borrow may be weak. "People need to appreciate that the nature of financing is really about the cash flow of the association, and the pledge of the income stream of its assessments is going to be the most important collateral the association has," says Drewes. "You need to show some level of stability in the collection of assessments, which is just another reason to stay on top of your collection issues."

Ask Your Vendor for Financing

In a slow economy, vendors may also be willing to let your association make payments over time. "I've seen that start to happen more frequently now because of the economy and venders needing the work," says Rosenbeck. "They might permit payments to be made over time, but if several owners go into foreclosure, the association is still on the hook for the full payments."

HOA Communications: Tips for "Selling" a Special Assessment

Any marketing or sales expert will tell you that to get what you want, you have to "sell" your request to those making the "buying" decision. Funny as it sounds, a special assessment falls into that "buying" and "selling" paradigm.

If your board is convinced your condo or homeowners association needs a special assessment, it must take the process of getting buy-in seriously. Here's how to "sell" a special assessment by being transparent, having community meetings that allow members to understand the issues and ask questions, and knowing how to overcome objections.

Watch Your Language

"Unfortunately I've had much experience in this arena," says Debra A. Warren, principal of Cinnabar Consulting in San Rafael, Calif., which provides training and employee development services to community association management firms and training and strategic planning sessions for association board members. "I've had associations that have listened to the advice of the professionals and done special assessments right, and I've had those who've decided not to do their special assessment right and have had problems."

First, don't use the term "special assessment" until it's needed. "There's nothing more divisive than the words 'special assessment,'" says Duane McPherson, the San Rafael, Calif.-based division president at RealManage, an association management firm that oversees properties in Arizona, California, Colorado, Florida, Louisiana, Nevada, and Texas. "Be very careful about using that term until you know that's an absolute necessity. Then when you do know you need a special assessment, have the proper backup that adequately explains the reason for the special assessment."

Keep in mind that owners will need to process the idea of a special assessment. "Give the owners lots of time to catch up and understand what the needs are and why," says Warren. "Give yourself a nice time frame, say six months. Most boards say, 'Oh, my gosh, we can't wait that long!' But to be successful, if it's not an emergency, you have to give yourself that time."

That's true, says Elizabeth White, a shareholder and head of the community associations practice at the law firm of LeClairRyan in Williamsburg, Va. "This is one area where the longer the rollout, the better," she says. "Some boards think that's a bunch of hoo-hah. They say, 'Let's just do our job. We don't have time to meet with all the homeowners.'"

That's a mistake because owners must process their feelings about a special assessment. "Owners have to go through that same five-step process that happens in grieving," says Warren. "First they'll be in shock, then they'll be angry, and then they're going to blame somebody before they're willing to say, 'OK, I'm ready to look at the options and make the reasonable decision.' It's important to give them that time. If you try to have the meeting for the vote too soon, owners will still have the anger and won't vote for it."

Show, Don't Tell, the Need for a Special Assessment

During that rollout period, you'll need to patiently explain to owners over and over your reasoning on the potential special assessment. "I prefer illustration over explanation," says McPherson. "Show where the association is financially, the reasons you need this special assessment, and what it's going to do for owners in the end. Typically the special assessment is a major component that's gone out or not budgeted for that will severely take away from owners' property values. In a lot of cases, the board fails to get enough information to adequately present its case. Most times residents are reasonable and will understand if this problem is going to affect their property values or lenders won't lend on the property."

Provide as much information as possible. "Give owners lots of complete and well-written information about why this is happening, who are the experts you've turned to, and how the board got to this decision," says Warren. "You do it in writing, and you have open meetings. It's really important to go through all those steps."

Be prepared to have as many meetings as necessary to build your case. "Things need to be disclosed and discussed at least three times," says McPherson. "You'll need at least one open meeting, if not two, and plenty of information needs to be sent to owners so they can make up their mind."

Include in that information well-thought out financing options. "Consider how you're going to implement the assessment," advises McPherson. "How big will it be, and what kind of payment plans are you going to offer?"

Rely on a Team of Advisors

Many associations that have been successful in passing difficult special assessments have leaned on experts to help make their case. "It's usually a team that helps the board go through the process," says Warren. "Depending on the reason for the special assessment, you probably want to include your management company, or if you didn't have one, a management consultant to help you with the communication pieces. Then you'll have your experts, such as construction experts, and your attorney to make sure you're going through the legal requirements properly."

One association White worked with assembled a strong team that was critical in the success of the special assessment. "I recently experienced a great example of a board handing a special assessment," she explains. "The board masterminded the whole thing, and I was so impressed with the manager and the leader of the board."

The property was on the Chesapeake Bay, and its siding wasn't standing up to the gusts coming off the bay. "They kept doing patchwork, but there were continual cracks and water seepage," says White. "Nobody wanted to go with recladding because that would have been a special assessment, even with a loan." In the end, the board decided it needed entire recladding at a cost of $40,000 per unit, and the units' values ranged from $200,000-$250,000. "A lot of the owners were widows on a fixed income," says White.

"The board added weekly board meetings, and some board members groaned but went," says White. "They overcommunicated to get the message out that they'd identified the problem and were in the process of identifying solutions. Initially, they had homeowners who didn't know the facts and ranted and raved about how they didn't want the assessment. In the end, they got 80 percent of the owners to approve."

The team that explained the special assessment to owners included White, an architect, and an independent engineer who'd never done the building's annual inspections—and had no vested interest in the outcome of her testing. "The engineer was incredible," says White. "She'd explain the issue at meetings. If she didn't feel comfortable answering a question asked there, she'd take the member's name and phone number and call back later with an answer."

White also credits the board for its patience and a thick skin. "They were very impressive in the way they handled it," she recalls. "The board president truly had Teflon skin and let some really incredible things roll off. These little old ladies understood that they'd end up with better value and that their unit's structure would be more stable. In the end, only about five owners refused the special assessment, and the community looks absolutely beautiful now."

Even White learned from the board's process. "It was a great learning experience for me," she says. "I've been through lots of specials, and I was very skeptical and wasn't sure they were going to pull it off. If you're on the board and looking at that type of major special assessment, talk to other communities that have done it successfully, find out what process they followed, make sure you over-communicate with owners, and do it in a credible way. Budget that extra money for the education of the members."

HOA Special Assessment Didn't Pass? 4 Tactics to Consider

Your HOA has an absolutely necessary project, and you thought your special assessment to pay for it was on track to be passed. But something went haywire, and the owners have rejected it. What's your next step? Here are four options.

1. Double-check whether owners are in good standing.

Some states allow HOAs to suspend some rights—including voting rights—of delinquent owners. Find out if your state allows it and whether that would help you.

"Look into the question of suspending voting rights of people who are more than 90 days delinquent, which Florida statute allows you to do," says Andrew Lewis of Eisinger, Brown, Lewis, Frankel & Chaiet PA in Hollywood, Fla., who specializes in representing community associations. "If you suspend voting rights, it might cut down on the number of people you need to approve your special assessment. That's something that's happening a lot today because those people then don't count toward the quorum or the vote. For instance, if you have 100 units and need 75 percent of owners to approve a special assessment, you need 75 votes to pass. But if 30 percent of owners are delinquent, you need only 53 votes. But remember that you should stay on top of suspending owners' rights to begin with, not just to get a vote through."

2. Pause, educate, and then hold another vote.

"In Florida, proxies survive beyond the meeting for which they were originally intended," explains Lewis. "In condos, they extend for 90 days; in HOAs, it's something like 11 months. If the vote isn't in support of the special assessment, you can lawfully adjourn the meeting you originally called, try to collect more proxies over the next 90 days, and then reconvene your meeting. Then you can add the proxies you originally obtained to the ones you've collected between the adjournment and the reconvening of the meeting."

If you didn't do it well enough the first time, go back and sell the need for the special assessment. "I am always encouraging boards to have town hall meetings to explain what's going on and to be as transparent as possible," says Kristen L. Rosenbeck, a partner at the Mulcahy Law Firm PC in Phoenix. "Owners are watching every dime, but they may not understand what's on the flip side if the HOA doesn't get these funds approved. You may have to explain, 'If we don't get the funds for this roof, our insurance won't cover us, and how will we pay to defend any lawsuits filed against the HOA?'

"Maybe you have someone from code enforcement or your insurance carrier come to a meeting and tell owners what can happen if they don't approve the special assessment," adds Rosenbeck. "Be very transparent with the membership about what the association's going through to explain why you need this money." (See page 11 for more on "selling" the need for a special assessment to owners.)

3. Do what it takes to get it passed.

Even if your members make bad decisions, you have a fiduciary obligation to make good decisions. "I've faced this situation and so have other attorneys at our firm," explains Lisa A. Magill, a shareholder and association attorney at Becker & Poliakoff PA in Fort Lauderdale, Fla. "In one case, there was a parking garage adjacent to a condominium that desperately needed repair. Structural problems and deterioration made use of the garage unsafe. The owners were primarily older, and many didn't have cars anymore, so they didn't care about use of the garage.

"But the board still had the fiduciary obligation to maintain the building and improvements," explains Magill. "The governing documents required 60 percent of the membership to approve either a special assessment or a budget increase over a certain amount. Those members voted against the special assessment to repair the garage a number of times. Finally, the municipality began code enforcement proceedings, and the board levied the assessment. When owners challenged the assessment since it never 'passed,' we successfully argued that the association had no choice but to comply with a governmental directive."

You're probably thinking: Did that board report its own HOA to the local authorities? Not that we know of—but even if it did, maybe that would have been a good thing. "As a board member, you have a fiduciary obligation," says Magill. "The will of the people is maybe the popular thing to do. But by agreeing to serve on the board, you've agreed to make the tough decisions. If you have to find other ways to reach your objectives, by all means, use those other ways. It's difficult to convince owners the elevator has to be fixed because there will always be differences of opinion. You have to use good business judgment and make decisions that aren't popular, sometimes against your own desire, for the good of the community."

True, says Lewis, but carefully consider every move you make. "I've heard of boards reporting their own HOA to government authorities," he says. "You get code enforcement in there, but that's not something you necessarily want to spread around too much to people because it can have more adverse consequences than you'd anticipated. You could call code enforcement in to look at one thing, and suddenly they're looking at something else, too."

4. Go to court.

"If the projects aren't done, your HOA could go into court and seek receivership by showing the liabilities of the association aren't being met," says Rosenbeck. "A receiver could be appointed and act as the board to do what's needed to be done—and the HOA will have to pay for the costs associated with receivership. Or the board could go to court and say, 'We need relief from the governing documents to do this.' You'd have to show the court extreme hardship to be able to prove that you shouldn't have to follow your own governing documents. Both of those options are very expensive."

Homeowners Association Funding Options: 7-Point Checklist When Considering Using Your HOA's Reserves

When you're looking to fund an HOA project, one option is pulling from your reserves. How can you determine whether you can—and, if so, whether you should—use reserves for HOA projects? Here, our experts reveal seven factors to consider.

1. Check laws and your governing documents.

Your state law and governing documents might restrict your use of your HOA's reserves. Read both to learn if they do.

"Reserves are calculated according to a formula based on the estimated remaining useful life of an item or building component and the cost to repair or replace that item or building component," explains Lisa A. Magill, a shareholder and association attorney at Becker & Poliakoff PA in Fort Lauderdale, Fla. "In Florida we have two reserve methods. The straight-line method allocates funds to individual reserve accounts that may be spent only for the purpose for which they were collected. For example, reserve funds in the roofing account must be used for roof repairs. Those in the painting account must be used for painting purposes. Florida statutes also require that all funds and accrued interest from one category of reserves may not be used for another category or for other general operation purposes without a specific vote of the community membership."

The second option? The cash-flow method. "The cash-flow method maintains a 'pool' of money in the reserve fund, which is available for costs affiliated with any item in the reserve pool," explains Magill. "Instead of each reserve item having its own fund balance, there's a pool of money to be used for all the reserve items."

Arizona doesn't have a scheme like Florida's. "We don't have any laws regarding community associations and reserve funds," says Kristen L. Rosenbeck, a partner at the Mulcahy Law Firm PC in Phoenix. "We have to use general accounting practices. But HOAs should make sure they're not commingling their general operating account, their reserve account, and any special, earmarked funds."

And with any luck, you're not in Minnesota, where the laws on reserves have gotten exceptionally complicated because of 2010 statutory updates. Figuring out what HOAs can and can't use reserves for is, literally, a work in progress. "I've done some presentations on what's happened with the update of the statute," explains Matthew A. Drewes, a partner at Thomsen & Nybeck PA in Edina, Minn., who represents associations. "But we're still in the process of sorting through this statute as a state."

The upshot? "We've gotten a little more particular in our statutory wording regarding associations' obligations to establish reserves for any component that's required to be replaced due to ordinary wear and tear or obsolescence," says Drewes. "Since 2010, we've been helping HOAs understand their documents better to know which components they're supposed to be reserving for."

2. Review your reserve study.

"Look to your reserve study," recommends Rosenbeck. "The number-one factor on whether to use your reserves is how much the HOA is funded in reserves and whether the project is something that's set on the HOA's maintenance list, is unscheduled, is an emergency maintenance item, or is just a goal the HOA wants to achieve. Maybe the HOA members want to build a clubhouse where they've never had one before. The question is: Should we not use reserves and instead set up a separate fund for that project?"

3. Beware gray areas.

Sometimes, it's incredibly difficult to tell whether you've reserved for a particular project. "There was an association in which its roads were aging too quickly because there wasn't proper soil preparation under the roads," explains Drewes. "The HOA had to take out all its roadways and put in new roads and new drain tiles. The question was whether they could pay for the drain tiles using the reserves because they weren't reserving for drain tiles but for roads. Initially, my colleague was going to tell them they couldn't use reserves. But ultimately he went with the reasoning that although the drain tiles were something that wasn't in the road structure before, they were a necessary aspect to doing what the association is required to do, which is replace the road with an adequate new road.

"So there may be projects like that where your HOA has to do some additional work, but it's still appropriate to use designated reserves because those are necessary expenses in doing the work that was reserved for," concludes Drewes. "The same would occur if the association had defective roof shingles that required replacement in 10 instead of 25 years. It's still an improvement that should be paid out of roof reserve funds. It just creates additional pressure on those funds because now the HOA has to incur that expense much earlier than it wanted. Those things are bound to happen, and the HOA has to evaluate what it means for future planning—where are we now, and what do we have to do to get back on track? They just need a feasible plan."

4. Determine whether you can allow owners to override your reserve rules.

"Using your reserves used to be recommended as a last resort," says Andrew Lewis of Eisinger, Brown, Lewis, Frankel & Chaiet PA in Hollywood, Fla., who specializes in representing community associations. "But given the economic times, when you're saving for a rainy day and the rainy day is here, it may be time to dip into the reserves. If you're replacing or repairing an item you've reserved for, it's time to use the reserves.

"But what if the project isn't something that's designated as a reserve item?" asks Lewis. "Let's say you have a reserve account for roof repair or replacement. Your HOA wants to build a playground and use the roof reserves. You can't just take those. In Florida, you need a vote of the majority of the membership present at a meeting with a proper quorum. But that would defeat the purpose of having a reserve account for those specific items."

Magill agrees. "Changing the designated use for reserves or using reserves for a non-reserve purpose requires a vote of the members in Florida," she says. "I often find that the members will vote in favor of transferring reserve funds if the other option is a special assessment or a budget increase."

That's sometimes very unwise, though. "I wish more associations had reserves available," adds Magill. "I wish they had an appropriate study done so they would know their costs going forward and could collect those reserves so they'd have the funds available when necessary. It's unfortunate when HOAs have reserves and use that money for things like a redecorating project while not attending to the structural components. There are things you don't see that can be more important than what you do see."

5. If you *can* change your rules to use reserves, don't do it blithely.

"The biggest issue nowadays is the overall financial health of the HOA's members," says Lewis. "You have to get a feel for whether owners can afford to pay a special assessment. If they can't, you have to start thinking about dipping into the reserves. However, if people can afford a special assessment but you don't want to do that for political reasons, think about what you're talking about doing instead. Maybe you're talking about repairing the clubhouse roof, and you've reserved for it. But perhaps when you look at the estimated remaining life of that roof as indicated in your last reserve study, you find you'll likely need to replace the entire roof two years from now. Do you really want to use reserves to repair the roof today when you'll have to replace the entire roof in two years?

“Florida statutes require associations to use a formula to determine reserve levels,” adds Lewis. “How much is in a reserve account to start with? What’s the estimated remaining useful life of that asset as of right now? And what’s the estimated replacement cost of that asset? When you plug that into a formula, it spits out a number for your reserve account. You always need to consider those factors before you dip into the reserves for any purpose, but in particular for something the money wasn’t reserved for in the first place.”

6. Think about resale value.

“If you reserved money for repainting the building and it’s time to do that, it’s natural to decide that’s what the money’s for,” says Lewis. “But there may be other factors the board may consider, such as how using reserves is this going to affect sales in the community.

“Buyers are a lot more shrewd than they used to be, and they’re asking a lot of questions,” adds Lewis. “They’ll look at a parking lot and ask whether your HOA has money reserved for pavement resurfacing. They want to know whether the roof needs to be replaced next month and whether you have enough for that or whether you’ll be asking them to pay for that at a meeting to determine a special assessment next Tuesday. You’ll want to consider whether using reserves will have adverse effect on resales in the community.”

7. Don’t feel bad if you chose to use appropriately reserved money.

“I see no reason not to use reserves that were collected for a specific purpose for that specific purpose,” says Magill. “If the association budgeted and collected enough reserve funds to renovate or repair the tennis courts, the board doesn't need to levy an assessment for that project.”

Lewis agrees. “Several years ago, I’d have told my associations to look for a loan, look to do a special assessment, or even try to put the cost in their budget before I’d tell them to use their reserves,” he says. “But if it’s a necessary project and it relates to their reserve funds, consider using the reserves.”

HOA Reserve Studies: What You Need to Know

Just what is a reserve study? What should it include, and how often should it be done? We've got answers.

Reserve Study Definition

"A reserve study is a study made of all the major capital systems in the association," explains Robert Galvin, a partner at Davis, Malm & D'Agostine PC in Boston who specializes in representing condos and co-ops. "It evaluates how much life they have left and how much they're likely to cost when they wear out. From that, you can calculate how much money the association has to set aside each year to have enough to replace those items when they do wear out."

How do you do that calculation? You take the estimated replacement cost and divide it by the number of years the item is estimated to last. That number is the amount you should reserve each year.

Some states require that associations have reserve studies, others don't. Here's a sampling:

- California requires associations to perform reserve studies. "You have to get it updated on an annual basis," says Duane McPherson, division president at RealManage, a San Rafael, Calif., association management firm that oversees properties in Arizona, California, Colorado, Florida, Louisiana, Nevada, and Texas. "And every third year, you have to arrange for an on-site visit by the reserve study people so they can really see what's there."
- "Reserve studies aren't required in Massachusetts," says Galvin. "Our law states that a condo has to have a reserve fund, but it doesn't state how much has to be in it or mention anything about reserve studies."
- Minnesota doesn't currently require associations to perform reserve studies, but that may change. "In Minnesota, a reserve study isn't required," says Matthew A. Drewes, a partner at Thomsen & Nybeck PA in Edina, Minn., who represents associations. "But I'm aware that there's a push for it in the legislature."

Why You Should Do a Reserve Study Even If Not Mandated

Even if your state doesn't mandate that your association do a formal reserve study every so often, it may indirectly—and strongly—suggest that you meet that standard.

"Under Minnesota law, the reserve requirement is that the annual budget shall provide from year to year for adequate reserve funds to provide for those things the association is required to replace," says Drewes. "If you're not bringing those funds in based on a calculation of when those things should be replaced, you're failing in your efforts to adhere to the statute."

Drewes also advocates doing a reserve study to protect board members from liability. "It's a recommended procedure if for no other reason than to cover the board to ensure that somewhere down the line they're not subject to potential liability," says Drewes. "The standard for nonprofit boards, especially those that aren't compensated, is set fairly low in terms of competence. They need to act in good faith. But it's not too far of a cry to argue that a board is failing even that standard if it isn't making some effort to make sure adequate reserves are maintained. Whether they have to do a reserve study to meet that standard is debatable." It, however, would certainly go a long way toward providing the board protection if its competence were ever challenged.

Hire the Right Reserve Expert

Reserve studies can be costly, but McPherson advocates that you pay the necessary fees to get as detailed a study as possible. "The reserve study should contain every single component the association has," he says, "and it should be as detailed as it can possibly get."

How much will a study cost? "The cost depends on how complex the association is," says McPherson. "I've seen them cost as little $500-$600 a year and then as high as $5,000-$10,000 a year. They can get complex when you get into condos, where the association owns some walls and you have to assess the roof. There are a ton of different components in condos that make a reserve study more complex. Or if you're in an association that's gated and has its own roads, or if you've got a golf course, it's going to cost much more. But the vast majority of associations don't have those amenities. They'll have a park, a basketball court, or things like that are relatively easily evaluated."

Reserve studies aren't perfect, either. "There are problems with reserve studies," says Galvin. "If you ask someone, 'How many years does my roof have left?' Or, 'How many years until I have to replace elevators or the swimming pool, and how much is it going to cost?' the answers are only estimates. But you have to start someplace."

That's why McPherson advocates that you hire an expert who knows exactly what to include in a study by searching for one who does association reserve studies for a living. "There are a number of people certified to do them," says McPherson. "They have software to calculate the useful life of every aspect of the structure, including roofs, siding, water heaters, and so on."

The bottom line may be that unless your board has expertise in building components, it's just not qualified to evaluate the useful life of each. "The average layperson doesn't typically have an understanding of the useful life of and the cost to replace building components," says Drewes. "So the board needs to understand that a reserve study may be an important aspect of their responsibilities, and not doing one could have pretty significant consequences down the road."

Four Tips for HOA Reserve Studies: When and How to Do a Reserve Study Right

If you've opted to draw on reserves to pay for an HOA project, you've got a duty to ensure those reserves are still adequate for the next project. Here, our experts offer four tips on when and how to do a reserve study.

1. Review your reserve study to ensure it's still current.

Have updated reserve studies, advises Kristen L. Rosenbeck, a partner at the Mulcahy Law Firm PC in Phoenix, because each time you recalculate reserves, you'll be doing it based on new bids and more-current materials costs, both of which will likely have increased.

How recent should your most recent reserve study be? States don't usually set rules. In fact, Florida once set a rule for condo reserve studies, but lawmakers changed their minds. "One of our clients asked us about how often you need to reserve study," explains Andrew Lewis of Eisinger, Brown, Lewis, Frankel & Chaiet PA in Hollywood, Fla., who specializes in representing community associations. "I thought there was something in Florida statutes and went back and checked. In the condo statute passed three to four years ago, there was a requirement for most condos that they needed to do a reserve study once every five years—but that provision was revoked a year later. So there's no specific requirement.

"But I'd always recommend doing it at least every couple of years," adds Lewis. "How else is a board going to determine the remaining life of an asset? Board members are typically lay people who don't have that expertise, and it can cost six figures to replace a roof or paint a building. That's why I recommend they go all out on a pretty consistent reserve study and set aside the funds required."

Lisa A. Magill, a shareholder and association attorney at Becker & Poliakoff PA in Fort Lauderdale, Fla., says it's sometimes painfully obvious when you're overdue for a reserve study. "If you've waited 10 years in between reserve studies, you've waited too long."

2. Determine how thorough you want your reserve study to be.

"There are different levels of specificity in reserve studies," says Magill. "You want to know when your major components will need to be replaced or repaired. Some HOAs take it further and have it broken down into more minute categories like a hotel would have, with very detailed and complete reserves for each category. But most HOAs just have the major components studied for reserves, and other items are done on a guesstimate basis."

3. Hire experts, and don't balk at the cost.

"Get an engineering company capable of assessing different things like the roof, the paint job on the building, and the parking lot pavement," advises Lewis.

Both Lewis and Magill say that the cost of a reserve study depends on the size of your property and how many reserve items are studied. The more items studied, the more expensive your study will be. "You should be able to get a reserve study for about $7,500," says Magill. "Even if you have a very large complex, if all the buildings have the same construction and were built at about the same time, you can achieve economies of scale."

4. Use the reserve study to help owners understand your finances.

Owners can get cantankerous when you bring up increasing costs, and that can lead to underfunded reserves. "In Florida, it's always been my experience that associations underfund reserves," says Magill. "Historically, we've had an aging population, and the saying is, 'We don't like to buy green bananas.' That's one reason people are loath to fund reserves. They won't be around when the work needs to be done, or they're afraid the board will use the funds for another purpose. They think they've been paying in to fund reserves for 20 years and have gotten none of it back. But that money belongs to the association, and you've gotten 20 years of use of the HOA's facilities. When you own your own home, you can ignore the roof that needs to be redone or other problems that need to be attended to. But when you're on the board of a community association, you don't have the flexibility to decide to live with these problems. You're a fiduciary for other people."

Since you're making the tough decisions, it's important to use the reserve study to your advantage. "You can tell owners, 'Oh, our dues are going up again this year because we're rebuilding our reserves in light of our recent significant project. That's really a small monthly amount we're setting aside to avoid those huge special assessments; it's much better planning,'" suggests Rosenbeck. "Also explain how the reserve study helps you protect property values, too. In Arizona, we have to disclose whether an HOA has a reserve, and not having one can be a major turnoff to potential buyers. If buyers are considering purchasing in an HOA with major amenities, they want to be sure those amenities are covered through reserves. People are much smarter on those issues these days."

HOA Finances: Tips for Handling Your Reserve Account

How's your reserve account?

What would you do if your clubhouse suffers damage that's not covered by insurance? Are you putting enough money aside to pay to replace or repair the tennis courts, the swimming pool, the club house, or other amenities?

On the flip side, is it possible you're putting too much aside for reserves?

And do you even know how reserve funds are supposed to be used?

Here we discuss possible uses for your reserve account so that you have guidance on how to spend these funds.

Know What Your Reserves Are For

Board members are often not clear on the true purpose of a reserve fund. "The proper use of a reserve fund is very confusing, especially for members new to the board who aren't familiar with the protocols and legal requirements," says Debra A. Warren, principal of Cinnabar Consulting in San Rafael, Calif., which provides training and employee development services to community association management firms and training and strategic planning sessions for association board members. "The proper use of reserves isn't to maintain the common elements but to repair and replace them. 'Repair' and 'maintain' are words that people use interchangeably until they're familiar with the difference. Also, reserves are clearly not intended to add something new to your association."

A reserve fund is also sometimes called a replacement fund, explains Harry Styron, an attorney at Styron & Shilling in Branson, Mo., who's drafted covenants for more than 100 subdivisions and more than 40 condominiums. "It's intended to avoid special assessments," he says, "which are very politically unpopular for board members."

The proper use and funding of reserves is becoming a more prominent issue for associations. "As Fannie Mae, Freddie Mac, and the Federal Housing Administration are tightening their underwriting guidelines for loans, they're very concerned about reserves," explains Styron. "They have a minimum requirement that an association's annual budget include something like a 10 percent reserve contribution. And in many instances, they'll require independent reserve studies."

While those federal agencies, which purchase or guarantee mortgage loans, have begun to demand more information about reserves, it's not clear the effect their efforts will have on lending for community association units. "We don't know if they'll enforce reserve guidelines yet," says Styron. "We're just now seeing questionnaires that cover reserve balances from lenders using Fannie Mae and Freddie Mac for insurance."

Underfunding is a Huge Problem

"I was a member of an association that had low reserves but owned a clubhouse, a boat landing, docks, and swimming pools," says Jeff Vinzani, an attorney at Nexsen Pruet LLC in Charleston, S.C., who represents associations. "It had $50,000 in reserves, and I said, 'You've got to be kidding!'"

Vinzani was able to convince board members that they needed to boost the association's reserves. "They ended up raising the dues and got the capital reserve fund over $300,000—and they were able to fix the clubhouse."

Vinzani has also seen associations that had bulging reserves and used the funds for new projects—which isn't what reserves are for. "Other associations have had a chunk of money in their reserves and started doing pet projects," he recalls, "in one case because the president wanted to build a fence."

The lesson? "You need to be looking at your association's actual capital and the buildings and amenities the association owns, have some idea of what it costs to repair those buildings, and then budget for that," says Vinzani. "If something happens and the pool pump goes out, you can make an exception on occasion and use the reserve fund. But a reserve fund shouldn't go to pet projects or something new and not contemplated before. And if you've budgeted with a specific project in mind for the reserve account and don't use all the funds, you should carry them forward. You shouldn't use the reserve fund for some pet project or a party."

Though it's possible for reserves to be misused for pet projects, it's much more common for them to be underfunded. "There can be a concern about assessing too much for reserves because of the impact that will have on the amount of the overall assessments and how that relates to the marketability of individual units," says Warren. "But I haven't seen too much reserves leading to unnecessary repairs. Very rarely have I seen a community that has too much in reserves."

Determining the Right Reserve Level

That's been Styron's experience, too. "I've never found a situation where there's too much in reserves," he says. "It's generally woefully short, and the challenge is how over time to build up the reserve to a point where it's properly funded. The arithmetic behind reserve calculations is fairly conventional—it's a discounted cash flow analysis."

First, evaluate how much life all the major capital systems in the association have left and how much they're likely to cost when they wear out. Then calculate how much money the association has to set aside each year to cover the replacement of those items when they do wear out by taking the estimated replacement cost and dividing it by the number of years it's estimated to last. That number is the amount you should reserve each year.

You may even need to perform a reserve study. "Unless you have a very small association with little common property, a reserve study shouldn't be done by amateurs," says Styron. "In addition, the board can't defend itself unless it's hired someone with credentials who's independent to do the reserve study."

There are national companies and reserve consultants that perform reserve studies, explains Styron. Some engineering firms can also handle reserve studies. "The cost varies tremendously with the size and complexity of the property," he adds. "It would be difficult to find someone to do a reserve study for a 20-unit building for less than $1,000, and it could even go up to $5,000 for a complicated property with hundreds of units. For associations that are small in size with not a lot of common property, some of the do-it-yourself software can be pretty good, too, and it's not very expensive. Once a reserve study is done, it shouldn't take a lot to update it every few years. Things like decks and railings don't have to be measured again."

Can you just ask your accountant how much of a reserve you need? "I don't know why accountants would feel like they had the expertise to evaluate the physical condition of structures," says Styron. "I'd be suspicious of an accountant who says he can do a reserve study unless he had additional training."

Once you know the proper amount for your reserves, create a plan to build it up. "With so much financial distress in condo and homeowners associations because of foreclosures and people being unemployed, it's very hard to do anything aggressive in most of the cases I've seen," says Styron. "So you may have to start small but increase over time. Maybe set a target of 5-10 years, at which point the reserve balance might be adequate. You don't have to do it all at once, but there's no better time to start than now."

HOA Reserve Funds: The Pros and Cons of Underfunding Reserves

"I have a board member right now who wants to get his board to roll back assessments by 50 percent and not fund reserves," says David C. Swedelson, principal at Swedelson & Gottlieb, a law firm that represents associations in the Los Angeles area. "He's in [financial] trouble. So he's getting a petition of homeowners to compel the board to vote to reduce assessments."

In this ever-scary economy, Swedelson is surely not the only attorney to field questions from boards about whether they can stop or reduce their funding for reserves as a way to ease the burden on homeowners. Some, but not all states, have laws governing associations' reserve practices, so investigate your state law before your board takes any action.

Here, attorneys offer a taste of how state laws work from their perspective at each end of the country—California and Florida.

Funding HOA Reserves in California

California law doesn't specifically require associations to fund reserves, but Swedelson says board members' fiduciary duties come into play. "In California, associations are required only to disclose annually the categories of major common area components they're reserving for, how many years of useful life each component has left, and how much money they've set aside for reserves for each. Associations could put zero," he explains. "But most people take the position that it would be a breach of the board's fiduciary duty not to have reserves. I think it's the board's fiduciary obligation to do what's in the best interest of the association, which is to have money set aside for improvements."

In fact, Swedelson says a lack of reserves can lead to bad decision-making. "I was at a meeting at which a board voted to put on a lesser roof because it didn't have the money for the more expensive option," he explains. "The contractor said the association could put on a flat roof that would last 10 years for $80,000 or one that would last 20 years for $100,000. The association could have spent $20,000 and doubled the life of the roof, but it didn't have the money."

Relying on special assessments to fund major repairs can also lead to a failure to maintain property and a loss in value for all units. "The pro of underfunding reserves is that boards can levy special assessments if they need to," says Swedelson. "But what happens if homeowners don't fund the special assessment? Other than helping out homeowners who are having financial difficulties, I don't think there are any pros to it.

"The con of underfunding reserves is that it devalues the association," Swedelson adds. "If I were going to buy and saw that one association had somewhat healthy reserves and the other didn't have much in reserves, I'd know the second association was likely to special assess as it went along."

What did Swedelson advise the association where the board member is politicking for lower assessments? "My argument is that homeowners don't get to vote on that issue. That's a board function," he says. "In addition, not everybody's having hard times. Fortunately, this board's not going to lower its assessments and not fund reserves."

Another Perspective from Florida

In Florida, condo associations must follow specific rules governing reserves—unless they decide not to. "Florida condo associations are required by law to promulgate full reserves in all proposed budgets," says Robert L. Tankel, principal at Robert L. Tankel P.A. in Dunedin, Fla., a law firm that advises associations. "Those reserves have to be kept from day one, dollar one and funded in full unless the members vote to waive or reduce them."

Tankel says the process for voting on waiving or reducing funding for reserves isn't crystal clear under Florida law. "The legislature may have meant that it requires a majority of all voting interests or a majority of the voting interest at a duly called meeting at which a quorum is present," he explains. "Either way, the vote must take place before the beginning of the fiscal year to waive or reduce reserves before they become due."

Florida homeowners associations have the option of following the law that governs condo associations. "In 2008, the legislature allowed homeowners associations to implement the keeping of statutory reserves similar to the condo act," says Tankel. "This is either implemented by a vote of the membership or by the developer in developer-controlled associations. That decision isn't a legal issue but a business judgment. But I think it unnecessarily complicates life for boards."

Funding Association Reserves in Florida

If a Florida association doesn't waive the reserve funding requirements, it must collect for reserves, and the law even specifies the amount associations must collect. "Reserves are mandated for any item that costs more than $10,000 to repair or replace, but the reserve amount isn't mandated, nor is the method of calculation," says Tankel. "However, the law contemplates that the reserve item will be fully funded at the end of its useful life. So associations need to take the estimated replacement cost, divide it by the estimated useful life, and that's the reserve amount for a particular year."

Here's how that would work for elevators. Assume an elevator's estimated useful life is 40 years, and it would cost $400,000 to replace it. "Divide 40 into $400,000 and you get $10,000 a year that the association should be reserving for the elevator," explains Tankel. "However, the law allows expenditure of reserve funds for repairs if the life of the asset will be extended by more than a year, so members almost universally vote to waive the reserve funding requirement because it's likely they'll have a major repair that will extend the elevator's useful life for 10 years."

In other words, few associations would religiously reserve for the $400,000 expense since each time they did a major repair, they could use reserve funds to pay for the repair because it would extend the useful life of the elevator. That process can go on longer than most owners will live in the property.

As for whether associations should stop funding reserves to benefit community members during hard times, Tankel defers to his clients' judgment. "My advice to clients is to make sure they follow the rules because it's a pocketbook decision, not a legal decision, on whether to fund or not fund reserves," he says.

But he stresses that they must follow the law regardless of the path they take. "Communities frequently adopt budgets after the beginning of their fiscal year. If they don't vote to waive reserves or keep full reserves as required by law, they face a technical violation of the law for not properly funding. If they forget to waive the requirement, some member's going to come after them."

HOA Funding Options: Should Your Homeowners Association Take Out a Loan? 6 Factors to Consider

Is it time to get a loan to fund an HOA project? Here are six factors to consider if you're contemplating a loan or a loan against reserves to fund HOA work.

1. Check the restrictions on HOA borrowing in your state.

In some states, HOAs have been prohibited from taking out certain types of loans.

"For fiscal year Jan. 1, 2012, Minnesota community associations are no longer permitted to borrow money from their reserves," explains Matthew A. Drewes, a partner at Thomsen & Nybeck PA in Edina, Minn., who represents associations "A project is either properly funded out of reserves or the HOA has to find another solution. However, HOAs can pledge their reserve funds to get an outside loan."

Florida law is a bit different. "Florida law prohibits an HOA board from pledging reserve funds as collateral for a loan without an advance vote of the membership," says Lisa A. Magill, a shareholder and association attorney at Becker & Poliakoff PA in Fort Lauderdale, Fla. "Instead, the right to assess the members or a line item in the annual budget usually serves as collateral for a loan."

2. See what your documents require when it comes to loans.

"You have to look at your HOA's ability to obtain a loan based on your governing documents," explains Kristen L. Rosenbeck, a partner at the Mulcahy Law Firm PC in Phoenix. "There may be restrictions on how much the board can borrow without member approval. I've seen some governing documents where the maximum amount that can be borrowed without member approval is $10,000 and some where it's $1 million. It's typically reflective of the amenities in the community. With a big master-planned community, $1 million might not be a big part of the budget."

3. Search for an experienced community association lender.

Andrew Lewis of Eisinger, Brown, Lewis, Frankel & Chaiet PA in Hollywood, Fla., who specializes in representing community associations, says some lenders may not know your state's law—or they may know full well their restrictions under the law but try to pull a fast one.

“We get this quite a bit when we’re doing HOA loans and lenders give us their form documents,” he says. “They want to include provisions stating that the reserves are going to act as collateral for the loan. We always take issue with that because under Florida statute, you can’t use reserve funds for something other than what they were created for without a membership vote. So HOAs can’t pledge that account without taking that vote. A lot of lenders understand this concept and know associations can’t do that without majority vote.”

4. Ask what lenders will require of you.

“You’re going to be giving something as collateral,” explains Rosenbeck, “whether it’s your HOA’s reserves or its future assessment collection ability.”

Beyond that, what hoops will lenders require your HOA to jump through? “Lenders will still require you to do one of two things,” says Lewis. “You’ll have to put a line item in your budget that covers the debt service of their loan. If it requires $30,000 a year to be paid over the course of the 12-month budget period, you need to increase your budget by that much, just like you have a line item for electricity or garbage pickup.

“The alternative is that they’ll require you to pass a special assessment at the time you take out the loan,” adds Lewis. “Why do you need that? The payback will coincide with the time that covers the debt service of the loan. That way, the bank knows the HOA has set itself up to be able to collect that amount over the period of the loan. If people don’t pay their assessments—if things don’t work the way the HOA and bank planned—they can rely on their foreclosure and lien rights. And if the HOA needs to pass another assessment on those who do pay to cover the bad debt, that’s what needs to be done.”

5. Consider interest rates on loans and your investments.

“If you’re looking at draining your reserve account,” suggests Rosenbeck, “maybe you want to do a loan instead because a lot of banks have great rates right now.”

That, however, works both ways. “It’s true that interest rates on loans are low right now, but so are interest rates on your funds,” she says. “Those reserve funds aren’t producing appreciable income, and there are closing costs associated with a loan. Ultimately, the decision on whether to use your reserves or get a loan comes down to a business decision: Do you, as directors, want to preserve a 'nest egg' in case of an emergency?”

6. Seriously evaluate your HOA’s ability to pay the debt.

“Even if you can get a loan, it’s a bad idea if you know you’re not going to have the ability to pay it back,” contends Lewis. “You shouldn’t put yourself in the position where the association can’t afford the debt service on the loan. If you have a sense of where your community is headed in terms of people not being able to pay their regular maintenance assessments, you don’t want to get in a position where you also have to pay back a lender on a loan.”

HOA Financial Matters: Lean Times May Call for Loans

If your homeowner association has maintenance or repairs it must do today, along with a limited budget, it may be time to consider a loan. Here are tips for making sure you get members' approval and good loan terms before you sign on the dotted line.

1. Find a lender who knows homeowners associations.

"You have to shop around," says Edward Taylor, the principal at the Law Office of Edward M. Taylor in Smithtown, N.Y., who's also president of the Community Association Institute's Long Island chapter. "You can't just go to the bank you do business with or the one where your association's president personally banks. Some banks don't know what they're doing and how to handle a loan to a common-interest association. Other banks have very specific and developed programs for associations, and those programs vary from one lender to another."

2. Check your reserves.

Make sure your associations financial records are updated and easy to understand because lenders will require that you turn over copies of those records. One factor lenders will look at closely is your reserves. "Lenders won't lend unless associations have adequate reserves and an assessment stream," says Deborah M. Casey, a partner at Vandeventer Black LLP in Norfolk, Va. The obvious question is: If you have reserves, why would you need a loan? Because reserves aren't required to be so big that they cover every expense, and sometimes associations run into unexpected maintenance projects that nobody could have anticipated. "You might have a $100,000 reserve but a half-million-dollar repair you never intended," says Casey. In those cases, it may be better to take out a loan rather than to drain your account *and* levy a big special assessment.

3. Beef up collections.

Another factor lenders consider is your collection rate. "Overall, banks are looking for you to have 10 percent or less in delinquencies," says Donna DiMaggio Berger, managing partner at Katzman Garfinkel in Ft. Lauderdale, Fla. "Some associations have already been placed on lenders' blacklists because of delinquencies, and their only option is to wait for the market to improve."

4. Don't accept the terms at face value.

"Sometimes banks will do a small business loan and only slightly modify the terms for an association," says Berger. "You'll have stuff in the loan documents about personal guarantees and inventory—things that aren't applicable to associations. I'm not a big fan of people signing contracts that aren't applicable to them." Be careful about what constitutes a default. For example, Berger has seen loan documents state that default occurs if associations fail to send the lender copies of bylaw amendments or records of a change in unit ownership. Two other terms that could be deal-breakers: a prepayment penalty and a provision allowing the lender a security interest in common elements. The association plainly can't deliver such a security interest because it doesn't own common elements—owners do. There are, however, terms you'll probably have to agree to with any lender. "The lender will likely put a lien on your common charges," says Taylor, "and require you to move your account to the bank."

5. Be transparent with members.

Most banks require the approval of a certain percentage of members—sometimes even 100 percent—for the loan to be approved. So as soon as you get detailed information from lenders, begin educating members on why you need a loan and what it will mean to their wallets. "You need to provide members with such information as, 'This it how much we're borrowing, the terms, and what you'll pay in assessments if we take a three-year loan, a five-year loan, or a 10-year loan,'" explains Taylor. "You have to be able to spell those options out to owners so they can intelligently vote on deciding which loan to take and approving that loan."

A final note: When you're determining the amount of loan your association will need, be sure to build in a cushion to cover delinquent assessments and overages that almost always occur when dealing with contractors.

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8. **Discussion Forum Follow-Up: What's a Common Area in My HOA?**

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While a campaign-issued two-foot by two-foot Barack Obama or John McCain sign might look just fine on owners' lawns, would you feel as comfortable with a 10-foot by 10-foot sign? What if the sign promoted a White supremacist running for local office? The answer may be a rule banning political signs in your homeowners association. Before you enact such a rule, however, make sure you know whether your state permits you to do so and understand the Pandora's box you may be opening.

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Though it's still rare in community associations, receivership has become more common in today's economy. With any luck, your HOA will never experience receivership. But some unlucky associations will. So here are some basics on receivership, along with information about how it's arising in condo and homeowner associations today.

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