



Ask The Lawyer

A General Discussion of Various Legal Issues
Concerning Reserve Funding

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About Adam H. Clarkson, Esq.

Adam Clarkson is the owner of The Clarkson Law Group, P.C. He is currently licensed and admitted to practice law in Nevada, Florida, California, South Carolina, Utah, the United States District Court of Nevada, the United States Bankruptcy Court of Nevada, and the United States District Court of Utah.

Mr. Clarkson's practice of law is dedicated to representing homeowner associations in corporate matters. Mr. Clarkson regularly serves as a speaker for education seminars sponsored by Community Associations Institute (CAI), Community Association Management Executive Officers (CAMEO), and leading companies. Mr. Clarkson is a member of the CAI Nevada Chapter board of directors.



Disclaimer

The *generalized positions taken within this presentation* are for educational purposes and *are not intended* to serve as legal advice, as a substitute for legal advice, or *to be utilized by you to provide legal advice to others.*

In the event you, your colleagues, or someone you know is faced with a specific problem calling for the exercise of trained legal judgment you should consult with a properly licensed attorney to obtain a recommendation for an appropriate course of action.

Overview

This presentation generally addresses legal issues related to reserve funding, such as: fiduciary obligations, underfunding claims, changes in reserve items, scope limitations, and other matters.

Today's topics are organized as follows:

- 1) General Definitions
- 2) Fiduciary Duty
- 3) Reserve Underfunding
- 4) Use of Reserves for Items Not Specified in Study
- 5) Scope of Work Limitations
- 6) Reserves for Alternative Measures

General Definitions for Today's Discussion

Terms and association obligations vary from state to state. The following terms shall be utilized for today's discussion.

Reserve Funds: Funds set aside and held by an association for the repair, replacement, restoration, or other maintenance of real and personal property that an association is obligated to maintain.

General Definitions for Today's Discussion

Reserve Study: A study that analyzes the real and personal property that an association is obligated to repair, replace, restore, or otherwise maintain and establishes a funding plan the association may utilize to properly/adequately fund such reserve expenses for components that may arise within a 30 year period, which includes: identification of the reserve components, analysis of existing useful life, estimate of future component expenses, and an estimate of the amounts needed to fund such components.

Fiduciary Duty

Fiduciary Duty in General: “A fiduciary relationship is a relationship in which ‘there is special confidence in one who, in equity and good conscience, is bound to act in good faith with due regard to the interests of the other.’” *Davis v. Dyson*, 900 N.E.2d 698, 712 (Ill. 2008)(internal citations omitted).

Fiduciary Must Not Harm Corporation: A “fiduciary ‘may not hinder or defeat the ability of the corporation to continue the business for which it was developed.’” *Maercker Point Villas Condo. Ass'n v. Szymiski*, 655 N.E.2d 1192, 1194 (Ill. 1995)(Internal citations omitted).

Board Members are Fiduciaries: “Condominium board directors owe a fiduciary duty to members of their association.” *Davis* at 712.

Fiduciary Duty: Requires Funding Reserves

Duty to Properly Fund Reserves: It is a common law violation of fiduciary duty, and in many states a statutory violation, to fail to properly fund an association's reserves.

- “Defendant should have known that plaintiff's obligations could not be met without his contribution of reasonable reserve funds. Furthermore, as a fiduciary, defendant had the duty not to hinder ‘the ability of the corporation to continue the business for which it was developed.’ By leaving plaintiff underfunded, defendant violated his fiduciary duty to plaintiff. After careful review of the Notes, the case law, and ‘the relevant statutory provisions, we determine that the trial court did not err, as a matter of law, when it concluded that *defendant owed a duty to fund reserves* for plaintiff.” *Maercker Point Villas Condo. Ass'n v. Szymiski*, 655 N.E.2d 1192, 1194-95 (Ill. 1995)(citations omitted)(emphasis added).

Fiduciary Duty: Business Judgment Rule

Business Judgment Rule: *The legal protection for director's actions under the corporate structure.*

- “Under the business judgment rule, ‘[a]bsent evidence of bad faith, fraud, illegality or gross overreaching, courts are not at liberty to interfere with the exercise of business judgment by corporate directors.’” *Davis* at 714.

Purpose: *To protect against honest mistakes.*

- “The purpose of this rule is to protect directors who have been diligent and careful in performing their duties from being subjected to liability from honest mistakes of judgment.” *Id.*

Fiduciary Duty: Due Care

Due Care Required: *Due care must be exercised to obtain the protections of the Business Judgment Rule.*

- “[I]t is a prerequisite to the application of the business judgment rule that the directors exercise due care in carrying out their corporate duties. If directors fail to exercise due care, then they may not use the business judgment rule as a shield for their conduct.” *Id.*

Fiduciary Duty:

Due Care Requires Reserve Study

Due Care Requires Obtaining a Proper Reserve Study:

Directors must be informed of material facts necessary to properly exercise business judgment, which in the context of reserves would require a proper reserve study from a reserve study professional.

- “One component of due care is that directors must inform themselves of material facts necessary for them to properly exercise their business judgment. (directors “may not close their eyes to what is going on about them in corporate business, and must in appropriate circumstances make such reasonable inquiry as an ordinarily prudent person under similar circumstances”). Thus, the business judgment rule is defeated where directors act without “becoming sufficiently informed to make an independent business decision.” *Id.*

Reserve Underfunding: Potential Defendants

There are a number of persons against who may find themselves defending against an association underfunding claim:

Declarant/Developer – Common law and statutory obligations require an association's declarant/developer to fund an association's reserves and shortfalls in such funding may result in claims.

Common Causes – Negligent oversight of funding resulting in a shortfall at transition; intentional refusal to fund (fraud); negligent retention of unqualified reserve professional; negligent/intentional omission of reserve component items; gross miscalculation of useful life; etc.

Reserve Underfunding: Potential Defendants

Board Members – Common law and statutory obligations require an association’s board members to fund an association’s reserves and shortfalls in such funding may result in claims.

Common Causes – Intentional refusal to fund (“We won’t live that long, so we don’t care”); failure to retain reserve professional; intentional misstatements to reserve professional regarding reserve component items to render false appearance of proper funding; disregard of advice from reserve professional; etc.

Reserve Underfunding: Potential Defendants

Association Management – Common law and statutory obligations require association management to direct their associations to consult with reserve professionals and preclude managers from serving as reserve professionals.

Common Causes – Failure to recommend association consult with reserve professional; attempts to provide reserve advice and/or studies without proper training and/or licensing; misappropriation of client funds (theft); etc.

Reserve Underfunding: Potential Defendants

Reserve Professionals – Common law and statutory obligations require reserve professionals to render reserve studies and advice that complies with certain regulatory and/or industry standards.

Common Causes – Failure to render study compliant with regulatory and/or industry standards; manipulation of funding requirements to render false appearance of proper funding; etc.

Reserve Underfunding: Identifying Underfunding

The most common information utilized in identifying underfunding is as follows:

1) Failure to Fund to Recommendations: Where a declarant or board fails to follow the reserve funding plan it has adopted such a deviation is readily apparent, which is why evidence of such failure is the most common information utilized for underfunding claims. Further, such information is difficult for a declarant or board to contradict where such persons adopted the study at issue.

Reserve Underfunding: Identifying Underfunding

2) Omission of Components: The omission of a component requires examination of the underlying facts establishing funding requirements; however, where such an omission is substantive the difference demarks the association's damages.

3) Gross Misstatement of Useful Life: Reserve analysis is an art, not an actuarial science, so any expectation that the useful life of a component may be determined with exactitude is unreasonable. However, asserting that a 25 year old 30yr roof has a 20 year useful life is unreasonable. Non-negligent inaccuracies in estimates of useful life are more difficult to utilize in identifying underfunding, but gross misstatements of useful life are easily used to both identify underfunding and undermine credibility.

Reserve Underfunding: Identifying Underfunding

4) Omission of Regulatory Required Funding: Some states have special requirements for items that must be funded and/or the manner in which funding may be planned. Omission of such requirements may be utilized to identify both an underfunding claim and an independent statutory claim for failure to meet the regulation.

5) New Study: A new reserve study is often utilized to identify underfunding. Such a study may not only serve as evidence of a deficiency based upon the difference between the recommendations set forth therein, but may also be utilized to illustrate the other identifiers discussed above.

Reserve Underfunding: Initial Demand

Following identification of underfunding, an initial demand is generally served upon the defendant prior to formal legal action.

- 1) **Request for Damages:** The claimant's demand should set forth, at a minimum the underfunded amount claimed. Ideally, the claimant shall utilize a reserve professional to assist in the determination of this amount.
- 2) **Notice to Counsel & Insurer:** The demand recipient should promptly notify its insurer if it wishes to preserve coverage, which may be required even if litigation has not been filed. Of course, the first notice should be to the recipient's own legal counsel so that actions may commence to preserve their rights.

Reserve Underfunding: Alternative Dispute Resolution

There are three methods of alternative dispute resolution (ADR) that are commonly required by contract or law that may be utilized in the underfunding dispute:

1) **Negotiation:**

- Generally, an informal attempt at resolution between the parties without the assistance of any third party. (ex: We just called each other and worked it out).
- Negotiation may be desirable because the informality tends to help preserve business relationships.
- It should be kept in mind that communications occurring during negotiations are usually not confidential, which means they may be (and often are) used against either party at a later date.

Reserve Underfunding: Alternative Dispute Resolution

2) Mediation:

- A neutral third party (usually an attorney) meets with the parties, considers the facts and legal issues, and tries to assist the parties in agreeing upon a resolution.
- The mediator does not render a decision on the matter.
- More expensive and formal than negotiation.
- Communications within mediation are confidential/privileged and therefore may not be used against either party at a later date.

Reserve Underfunding: Alternative Dispute Resolution

3) Arbitration:

- A neutral third party (usually an attorney), hears and considers evidence and legal arguments set forth by both sides, and renders a decision upon the matter.
- The arbitrator's decision may be binding (precluding court action) upon the parties if binding arbitration was agreed upon in a contract between the parties.
- Arbitration was originally intended to be faster and less expensive than litigation, but if your matter is subject to complex arbitration rules (ex: AAA, JAMS, etc.) then there may be no cost savings whatsoever.

Reserve Underfunding: Discoverable Communications

Long before a matter is in litigation, it is important to have an understanding of discoverable communications that may be obtained by your adversary, or the adversary of your client, and used against you or your client:

- 1) **Discoverable** – Reserve professional’s communications with board, management, and declarant/developer.
- 2) **Discoverable** – Reserve professional’s communications with third parties.
- 3) **Discoverable** – Litigation claimant reserve professional’s communications with claimant’s attorney.
- 4) **Confidential/Privileged** – Confidential reserve professional’s communications with attorney and through attorney for client consult.
- 5) **Privileged** – Communications with your own attorney.

Reserve Underfunding: Basis for Funding Analysis

The factual basis utilized to establish a funding analysis is critical in supporting or undermining the credibility of a reserve funding plan as well as whether or not a professional met regulatory and/or professional standards in the rendering of such analysis.

- 1) **Site Visit** – As with any expert, the lack of a professional’s observation of the actual subject matter will liquidate the value of their opinion and, in some instances, may cause the opinion to be excluded from jury consideration. Therefore, a site visit by a professional involved in rendering the ultimate opinion is highly important.
- 2) **Reserve/Estimating Software** – Software commonly used by industry professionals will be useful in supporting a position. However, blind reliance upon software may compromise credibility and admissibility.
- 3) **Cost Estimating Manuals** – Widely accepted and established manuals may be useful in supporting a position. However, like software, professional judgment should still be involved in the analysis.
- 4) **Product Warranty Information** – Documentation on use and life expectancy from the manufacturer of the product itself is very useful in supporting analysis that has been rendered in conformance therewith.
- 5) **Confirmation from Licensed Contractors & General Cost Research** – Generalized communications with contractors or other vendors, while useful in original analysis, may be excluded from jury consideration as hearsay. If such methods are used it is important to obtain written verification of the opinions rendered and good notes as to the persons consulted so that such persons may be called as witnesses to support the opinions at issue if necessary.

Use of Reserves for Items Not Specified in Study

Common Law (No Outright Preclusion) – At common law, as discussed in the fiduciary obligations discussed earlier, there is an obligation to fund reserves. The common law reserve obligation *does not establish a prohibition against utilizing such funds for purposes not specified in the study.*

Statutory Law (Preclusion is State Specific) – Certain state statutes place specific limitations upon how an association may spend its reserve funds and/or set aside such funds (ex: NRS 116.3115(1) limits use of reserves to reserve obligations and requires funding to be based upon a reserve study). *Depending upon the nature of the proposed use, use for items not specified may be precluded.*

Use of Reserves for Items Not Specified in Study

Regardless of whether common law or statutory limitations apply, *associations should consult with their reserve professional prior to and/or in conjunction with substantive expenditures not specified in funding plans.* Such a deviation from planned expenditures effects the overall funding plan, which, as noted earlier, *implicates directors' fiduciary obligation of due care to obtain and review appropriate information.*

Use of Reserves for Items Not Specified in Study

Exercising appropriate due care, directors should seek and obtain the following from a reserve professional where use of reserves for items not specified in the reserve study is contemplated:

- 1) **Consultation Letter** – A letter from the professional indicating the effect of the use on the study, indicating the consistency of the use with the study, and that no substantive adjustments to the study/plan are necessary to accommodate such use.
- 2) **Updated Study** – Where the use may have a substantive effect on the plan (ex: an increase in reserve assessments will be necessary to continue to fund to plan requirements), an association should obtain an updated study from the professional to make sure the association's directors are making properly informed decisions.

Notably, in states like Nevada where use of reserve funds is highly regulated, obtaining the above referenced documents is critically important to make sure that the assessments the association levies are based upon the study of the reserves as required by law.

Scope of Work Limitations

Scope of Work Limitation – Absent regulatory preclusions on such limitations, it is possible to limit a professional's scope of work, and thereby the related liability, by express contractual limitations on the scope of work. *Cf. Hammond Park Place, L.L.C. v. Loitherstein Env'tl. Eng'g, Inc.*, 881 N.E.2d 828 (Mass. 2008)(unpublished).

Scope of Work Limitations

Scope of Work Limitations in the Context of Reserve Studies:

The importance of reserve professionals is rapidly becoming more apparent to associations. At the same, associations are beginning to expect reserve professionals to address nearly infinite concerns.

- Should the study include an association-wide re-pipe or similar plumbing issue for buildings where the life of plumbing systems may come to an end within 30 years?
- Should the study include expenses related to replacing structural components of the building?
- Should the study address the useful life of the building itself and therefore contemplate demolition and reconstruction?

Scope of Work Limitations

Add Limitations to Contract & Study:

- Scope of work limitations placed both in the reserve study contract and the study itself protect both associations and reserve professionals.
- Associations are provided with a better understanding of the extent to which they may rely upon the study.
- Professionals may reduce both liability and client dissatisfaction by clearly communicating the extent and limitations of the work being performed.

Reserves for Alternative Measures

Traditionally, reserves are contemplated for physical items that will be maintained (ex: roofs, painting, etc). However, many associations may benefit from establishing reserves for certain alternative measures, such as:

- **Insurance Deductibles** – Often, associations carry large deductibles, which may or may not be permissible depending on governing documents and state laws. Setting aside reserves to cover such deductibles protects the association and its members from financial strain and are arguably part of maintaining the association’s property.
- **Unclaimed Losses** – Due to insurance coverage concerns, associations often repair losses without submitting claims. Reserving for such losses may improve the financial welfare of the entire community.
- **Litigation Funding** – Litigation is on the rise in associations. Regulations in some states may not allow associations to establish reserves for such issues as they are not directly related to maintaining property; however, where such reserves are allowed they may better protect association members from large unanticipated litigation assessments.

Questions

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The End!

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