The Board's Duty to Fund Association Reserves

The primary responsibility of a common interest community is to preserve, protect and enhance the community as a whole. Each director is responsible to ensure the association fulfills its obligations. State statutes legally define the standard of conduct for directors in their duty to oversee the affairs of the association. While Declarants and their appointed directors hold a fiduciary responsibility, which demands the highest degree of care, *all* directors are legally obliged to execute their duties in a responsible manner, obtaining expert advice and counsel as necessary.

The 'Standard of Conduct' includes: *acting in good faith* (sincerity, fidelity, deference); ***prudence*** (common sense, caution, deliberation, circumspection); and ***loyalty*** (allegiance, best interest of the corporation). Board members must never put their personal interest, or the interest of another, ahead of the association's. Willful neglect and reckless misconduct creates personal liability risk!

A breach of duty occurs when the directors fail to perform an official duty or legal requirement. Note: non-management *is* mismanagement. The courts have found board *inaction* to be a breach of duty rendering the Business Judgment Rule inapplicable *[Agassiz v Solum, ND Sup Ct. Civil No. 940184]*. Some state statutes, and the governing documents of many associations, explicitly require the association establish and maintain a capital reserve fund to pay for the eventual replacement of the parts of the community for which the association is responsible. To meet this obligation the reserve savings rate must be sufficient to meet the projected major repair and replacement costs. To fulfill this duty to fund reserves it is essential that every association prepare a long range capital budget. The legal standard of conduct requires the board of directors perform their due diligence as they determine the reserve budget.

If you haven't got a plan, you haven't done your due diligence.

Due Diligence in preparing an adequate reserve fund budget requires discovery, planning, implementation and disclosure. Discovery begins by compiling a comprehensive list of all the components which the association is responsible to maintain, repair or replace and which costs are to be reserved. A physical and financial analysis is then conducted, commonly referred to as a Reserve Study. The National Reserve Study Standards outline the *minimum* criterion for conducting a reserve analysis. An inventory is prepared for each component, its replacement cost is calculated, its physical condition assessed and its remaining life is estimated. This data is used to calculate accrued depreciation in order to evaluate the Reserve Fund Status. The Fund Status is often stated as a percentage of the total accrued depreciation, summed for all reserve components. For example, if the association has $100,000.00 in accumulated reserve savings but $400,000.00 of depreciation its Fund Status is 25% funded. It also means that 75% of its accrued depreciation ($300,000.00) is *unfunded*! A projection of future reserve expenditures is also prepared. The board must select a funding goal, and an appropriate funding plan is then calculated. Typical goals are:
(1) Baseline Funding- Simply keep the reserve balance above zero or
(2) Full Funding- Fund to a level equal to the Fully Funded Balance (total accrued depreciation) for all components.

Disclosure regarding the association's reserve fund status and future projections may occur by several means, including: special notice, annual reports of the treasurer, annual & interim financial statements, auditor's report, declarant disclosure and resale disclosure. Cover all the bases.

Formal Reserve Policies help ensure conduct of good faith, loyalty, prudence and diligence. For continuity, safety and long term success associations should adopt formal reserve policies-- preferably embedded in the association's by-laws by means of an amendment. Policies created by simple board resolutions lack long-term effectiveness as they are too easily changed. Exercise extreme caution when constructing your reserve policies. Your attorney can ensure proper execution of the amendment process and help you avoid stipulations which may adversely affect the association in the future.

Reserve policies should address:
(1) The board's duty to budget sufficiently to meet the funding goal.
(2) Co-mingling reserve & operating funds, cash flow management parameters and borrowing.
(3) Separate accounting or reporting requirements.
(4) Investment stipulations-Safety, Liquidity & Yield.
(5) Authorized and prohibited uses of funds.
(6) Expenditure authorization requirements & account access.
(7) Fidelity insurance.
(8) Reserve Study Update intervals.

Greg Pettersen, PRA, RS
Reserve Data Analysis, Inc.
(612) 616-4817 (866) 780-7943

Member: Association of Professional Reserve Analysts