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Hawaii Condominium Bulletin

100% Funded Reserve Study vs. 50% Fully Funded Reserve Study

By Mike Price RS

Too many times in the past I have been contacted by an owner complaining that their association had to take out a loan or implement a special assessment to pay for a major replacement project. Their understanding was the recent reserve study (not one of mine) stated that the association was 100% funded. If they were 100% funded, why wasn't the cost of the major project covered by the money collected under the reserve study plan? This is an example of the lack of clarity and understanding of Hawaii reserve study terminology and how it is applied.

Hawaii State law allows for three (3) options for reserve funding plans. They are 100% Full Funded, 50% Full Funded and "Hawaii Cash Flow Method" funding plans. Some of the subtle differences significantly impact the strength of the plan and level of risk of cash problems in the future.

A reserve study funding plan 100% funded would seem to be a stronger plan than a 50% **Fully** Funded plan. Actually the 50% Fully Funded plan will be the stronger plan in most cases. Typically, a reserve study funding plan prepared using the "Hawaii Cash Flow Method" will state that the plan is 100% funded. The plan will fund 100% of the estimated replacement reserves projected for each fiscal year of the reserve study plan twenty-year term. A 50% Fully Funded plan, in comparison, must maintain a Reserve Fund equal to 50% of the Total Deteriorated Value (also stated as the Fully Funded Balance) of all reserve components for each fiscal year. If the Fully Funded Balance equals the reserve fund balance, then the plan is 100% Fully Funded. A "100% Fully Funded" plan is not the same as "100% funded" Hawaii Cash Flow Method Plan. The difference created by the words "Fully Funded" is significant as will be explained. First let's look at the various definitions of terms under Hawaii State Law.

Hawaii State Law, HRS § 514A-83.6 and HRS § 514B-148 for Condominiums define replacement reserve terms as follows:

"Replacement reserves" means funds for the upkeep, repair, or replacement of those parts of the property, including but not limited to roofs, walls, decks, paving, and equipment that the association is obligated to maintain."

"Cash flow plan" means a minimum twenty-year projection of an association's future income and expense requirements to fund fully its replacement reserves requirements each year during that twenty-year period, except in an emergency: provided that it shall not include a projection of special assessments or loans during that twenty-year period, except in an emergency." (Currently referred to as "Hawaii Cash Flow Method").

Now consider another current Hawaii rule that further clarifies calculation of reserves.

Message from the Chair



Welcome to September. The holidays will soon be upon us and with that a review of house rules may be in order. Many house rules indicate what is and isn't allowed when it comes to decorating, i.e. "no exterior lights, decorations, etc." Some rules do allow for decorating but only for a specified time frame. It may also be a time to remind residents of these rules before the hectic activities of the holidays fall upon us. There is a reason this is important. I recently was helping a student in one of my CE classes understand house rules and the issue of "selective enforcement" or "no enforcement" of house rules came up. If a board ignores a rule violation that is open and obvious for a significant amount of time, then the board may legally have "waived" the right to enforce the rule against that unit owner and, by extension, against anyone in the community. Even though it is not always the most pleasant task, it is a board's responsibility to enforce every rule against every violator every time, lest you risk waiving the right to enforce the rule. The same goes to a board selectively enforcing rules on one owner and not another for the same violation.

On another subject, many AOUO's are trying to deal with the issue of emotional support animals in their associations. Some AOUO's go way too far in requirements that end up violating state and federal laws, and others choose to ignore the issue and just let it happen.

As an example, in May of 2016 a federal fair housing case involving emotional support animals was decided in federal court. The U.S. Department of Housing and Urban Development announced that it won an important fair housing act victory in the United States Court of Appeals for the First Circuit. The decision upheld a final order of the Secretary of HUD following a trial before an administrative law judge that a condominium association discriminated against a resident with disabilities by refusing to allow him to keep an emotional support animal. In October 2014, HUD found that the Castillo Condominium Association, violated the rights of a homeowner with disabilities by refusing to allow him to keep an emotional support animal as a reasonable accommodation to the association's "no pets" policy. HUD ordered the association to pay \$20,000 in damages to the victim, who was forced to sell his condominium and find alternative housing as a result of the association's discriminatory conduct. HUD also ordered the association to pay a \$16,000 civil penalty. The association appealed the order to the First Circuit Court of Appeals. On May 2, 2016, the Court of Appeals ruled against the association, affirming HUD's finding that the association violated the Fair Housing Act and ordering the association to pay the damages and penalty.

In fiscal year 2015, disability was the most common basis of fair housing complaints filed with HUD and its partner agencies, being cited as a basis for 4,548 complaints, or nearly 55 percent of the overall total. This now sets a precedent for associations in future litigation. When faced with a request for a "reasonable accommodation" to a "no pets" policy, it is prudent to consult with an attorney familiar with state and federal laws.

Finally, in this issue of the Condominium Bulletin, you will find articles on the finer points of budgets and reserves and about the different types of board members.

Aloha,

Scott A Sherley, REALTOR® Condominium Review Committee Chair

100% Funded Reserve Study vs. 50% Fully Funded Reserve Study (cont. from page 1)

Hawaii Administrative Rules HAR § 16-107-62 states:

“Estimated replacement reserves” means funds which an association’s reserve study indicates must be assessed and collected during a budget year to establish a full replacement reserve for the association by the end of that budget year.”

“Full replacement reserve” means reserve funds for an asset (component) equal to: The projected capital expenditure or major maintenance required for the asset at the end of its estimated useful life, multiplied by a fraction which has as its numerator and denominator the asset’s estimated age and estimated useful life respectively. The total of the full replacement reserves for each asset shall be a full replacement reserve for the association.” (*Full replacement reserves for each component are summed and “pooled” into an association’s total full replacement reserve (Total Deteriorated Value also stated as Fully Funded Balance by National Reserve Study Standards).*)

(Current Cost \$ to replace X (Number of years in service / Useful Life) = current deteriorated value cost \$)

“Example: A roof with an estimated useful life of ten years will cost \$100,000 to replace. At the end of its seventh year of life, a full replacement reserve will be $\$100,000 \times 7/10 = \$70,000$. In the tenth year of its life, a full replacement reserve will be $\$100,000 \times [10/10 =] 1 = \$100,000$.

(This calculation of current deteriorated value is calculated for each and every reserve component, regardless if it is going to be replaced that year or in 35 years. Then the Total Deteriorated Value or in this definition “the association’s total full replacement reserve” is the sum of all the component deteriorated values for that year.)

“Minimum replacement reserve” means fifty percent of a full replacement reserve.

Statutory replacement reserves” means fifty percent of an association’s estimated replacement reserves.

Yes, very confusing as to what is actually required to be funded. These HAR § 16-107-62 definitions appear to require calculation of all the components deteriorated value for each year, not just the projected expenses for components scheduled to be replaced each year.

Some “Hawaii Cash Flow Method” reserve studies ignore the HAR terms above and fund for reserve replacement expenses projected only. The reports still claim “100% funding”, but if the total full replacement reserve (Fully Funded Balance) defined above is calculated, many years the plan is below 30% Fully Funded. Being less than 30% Funded is a situation that has high risk of cash problems if events do not occur exactly as projected in the plan. In addition, the reserve fund cash balance may go below \$0 after the 20th year. Many “Hawaii Cash Flow Method” plans only cover replacement expenses each year of the twenty-year period of the reserve study. Current deterioration of components being replaced in the future is not considered unless the component is replaced during the twenty-year period as a projected expense. **Obviously ignoring current deterioration of all the other components lowers the amount of money that needs to be collected from current owners.** As long as the plan does not run out of money during the twenty-year period, it is acceptable. Even running out of money is not a problem if an “emergency” is declared to cover for unexpected expenses or early failure of a component. A loan or special assessment will be required to restore the reserve fund cash balance, otherwise needed replacement and major repairs typically will be deferred out into the future in a revised reserve plan. Future owners will be burdened with paying for these deferred replacements or major repairs, not the past owners. **The lower amount of cash collected is balanced by a higher risk of future cash problems.**

Both Hawaii Cash Flow Method and 50% Fully Funded plans “pool” individual Replacement Reserve expenses and Full Replacement Reserves for components respectively into the association total replacement reserve. The total fund is adjusted to cover current replacement costs using cash collected previously and cash collected for future projects but not needed until sometime in the future.

100% Funded Reserve Study vs. 50% Fully Funded Reserve Study (cont. from page 3)

If the reserve plan is 100% Fully Funded this cash flow methodology is not needed. The 100% Fully Funded plan has 100% of the cash needed each year and a strong margin for covering unexpected early failure and increased costs. Therefore, a 100% Fully Funded plan has minimal risk of future cash problems.

The pool of cash in the reserve fund is replenished with annual collections. Ideally the result is an annual reserve contribution requirement that is stable. In the real world this stable contribution will be impacted over time by economic forces unknown in the future such as, inflation, increased regulatory costs, labor costs and increased manufacturing costs. Plans usually need only small annual adjustments for these types of impacts during the Board of Directors annual budget review.

Now you can see that a 50% Fully Funded plan is stronger than a 100% funded “Hawaii Cash Flow Method” plan where total association deterioration is not considered. Maintaining 50% Fully Funded (Reserve fund balance divided by Total Deterioration Value) is not required under “Hawaii Cash Flow Method”.

Components start deteriorating as soon as they are put into service. Components will eventually fail and not always when projected to fail. Reserve funding plans can not control when a component fails, or the actual cost at the time of replacing or repairing the component. **Whether the reserve plan is adequately funded or minimally funded the actual replacement or repair cost is the same.** Either cash is available, or a surprise loan or, special assessment is needed to make up for the “shortfall” in planning.

What is the solution to avoid inadequate reserve funding and avoid surprise loans and special assessments?

Now you should be asking yourself if your association is really “100% funded”. If in doubt check the reserve study report for listing of the “Fully Funded Balance” (Total Deteriorated Value), and Percent Fully Funded calculation each year (divide the Starting Reserve Fund Balance by Fully Funded Balance) as defined above. Another approach is to contact the reserve study report provider and ask for these calculations. The calculation of percent funded is a bench mark measure of fund strength under National Reserve Study Standards.

National Reserve Study Standards are to be followed by reserve providers with the “RS” designation. These standards are found at: www.caionline.org/LearningCenter/credentials/Pages/RS.aspx under RS Application and Code of Ethics for reserve providers.

Association owners deserve an adequate reserve funding plan that avoids cash problems while maintaining the safety, appearance and resulting property value of their home. Reserve studies provide a tool to manage timely replacement of major physical assets, referred to as “components”. **The reserve study recommends a budget plan to collect enough money to properly fund replacement of deteriorated components without the need for loans or large Special Assessments.** The Board of Directors is responsible for maintaining these components for the good of all owners. An adequate Reserve Fund to replace components at the end of their “useful life” is the goal.

Objectives of an adequate reserve fund plan are;

- **Sufficient cash on hand**
- **Stable contribution rate**
- **Spreading cost fairly and evenly over present and future owners**
- **Fiscally responsible plan meeting legal, industry and property declarations requirements**

100% Funded Reserve Study vs. 50% Fully Funded Reserve Study (cont. from page 4)

The National Reserve Study Standards provides a checklist of items required in the reserve report. Download and use the checklist and information available on the website to evaluate reports. Make sure the reserve study that the Board is currently using meets these standards. The strength of the reserve plan can be confirmed by the Percent Funded Calculation. Any reserve plan's level of risk of future cash problems resulting in surprise loans, special assessments or deferred maintenance should be clear and transparent to the owners.

Minimal funded plans using terms like "100% funded" may appear low risk and give a feeling of adequate funding with low reserve fund contributions. Understand the subtle difference between "100% funded" and "Fully Funded", make sure the plan used Fully Funded calculation methods described above. Otherwise deterioration cost is pushed out onto future owners. This is not "equally spreading cost over present and future owners". Remember the objective is not to lower and minimize reserve fund contributions for current owners, or defer adequate reserve collections unfairly to future owners.

About the Author: Mike Price – CAI Reserve Specialist #164, former President and chief operations officer of Association Reserves Hawaii LLC, and currently a project manager at Akamai Reserves provides independent third party comprehensive reserve studies for all Islands. Mr. Price has a bachelor degree from Eastern Washington University and over 30 years' experience in construction and project management. He held CMCA and AMS designations in the past as condominium Site Manager and General Manager. Mr. Price can be contacted at mprice@akamaireserves.com or 808 936-4789. This article was reprinted with permission from the CAI Hawaii August 2016 newsletter.

Ask the Condominium Specialist

- Q:** I live in a small condominium association with an elevator and outside stairs. Some people on the first and second floors of our building (we have four floors total) are refusing to pay maintenance fees for the elevator; they maintain that they use the stairs, never the elevator and therefore do not owe fees for maintenance of something they do not use.
- A:** Maintenance fees (or as they are called and defined in HRS Chapter 514B, common expenses) are charged in proportion to each apartment's common interest. Maintenance fees cover the day-to-day operating costs of running the condominium project, such as minor repairs and maintenance, insurance, salaries of employees, security, and the operation of swimming pools and tennis courts, etc. An apartment owner cannot exempt himself from payments for common expenses by waiving use of the common elements, or because they don't need the common element. Owners may also not place their money in escrow because they feel they do not owe the money or disagree with board policies. All owners **MUST** pay the assessments.

The information provided herein is informal and intended for general informational purposes only. Consult with an attorney familiar with the Hawaii condominium law for specific legal advice regarding a particular situation.

What Kind of Board Member Are You?

By Jim Merrell, PCAM, MBA

When you are born in the United States, you are a U.S. citizen. As a citizen, you have the right to choose and vote for leaders you feel will best represent the interest of the people. Similarly, when you purchase a unit in a community association, you automatically become a member of the Association and, as an owner, have a say in choosing and voting for leaders (AOUO Board of Directors). You decide to attend the annual association meeting and may be nominated by a fellow owner, or, decide to nominate yourself. For some the fame, recognition and power lure their interest, for others there could be the simple interest in having a voice in the management of their investment expenses. Let's jump forward and say "you are elected to the Board of Directors." Your initial commitment is attending a scheduled meeting once a month to review issues regarding your association. What kind of Board member will you be?

As there is one and only one qualification to become a member of your community association Board, that is to be an owner, the mix of personalities and qualifications on any Board can and usually are interestingly diversified. Each month this group of people (Board of Directors), assembles together, creates budgets, forecasts, and collect reserve funds, addresses complex maintenance issues, enforces the governing documents and of course deal with and sometimes remedy owner disputes.

Cohesive Boards work well together, throw out personal agendas, seek solutions and prioritize the best interest of the community. Dysfunctional Boards dispute amongst each other many times without resolution to the issue. The individual director focuses on ego driven personal issues. This causes the members to dispute amongst themselves. They focus on personalities of other members. They miss the real agenda, which is working together for the betterment of the community. They distract themselves from the real issues. One thing that both groups have in common is that they are comprised of people with different backgrounds, different education, different personalities.

Professional. The Professional is the experienced business person who is respected for his/her knowledge in their field of endeavor whether that be architect, engineer, lawyer, accountant, doctor, nurse, fashion coordinator, interior designer, or [add yours here]. While respected for their opinion, a judicious Board should get a professional opinion on the matter to protect the Board as a whole. A professional homemaker has a lot to offer, so don't just think in terms of formal degrees. Are you in touch with what it is you have to offer and are you prepared to share it?

Place holder. Do you have one of these on your Board or do you fit the profile of a place holder? Place holders sit and take up a chair. They do not commit to anything, and often offer an abstention to any vote. Are you participating in your Board's decisions, helping to set goals and keeping up with the issues?

Supporter. These directors may or may not agree with a decision but once it is made, they will jump in and do the work to make it happen. They will be the first to arrive and the last to leave the Association party because they sign up for set-up and take-down committees. The majority of Board members play supporter roles.

Thinker. This Board member is a visionary and sees things as they will be in the future. Of course, since it is in the future, others without vision are not certain they believe what this person sees. The others may end up blocking progress, adding to the uncertainty of the future to every decision. As a Director, be open to everyone's ideas and suggestions.

Always late. Some board members are habitually late for meetings. They are probably unaware of the time they are stealing when having to bring them up to speed, the delay of business they cause and the disrespect they convey to their fellow members. As a Board member, be respectful of the time each member contributes for this volunteer position and be in your chair when the President calls the meeting to order.

Never prepared. This person also steals your time. Unprepared members have not taken the time to review the information up for discussion. The unprepared member will use valuable 'meeting' time to catch up and, as a result, is not prepared to make decisions. Be prepared. Start by reading the minutes BEFORE the meeting starts and be prepared to amend or approve as is.

The ME Director. Are YOU a ME Director? This director asks when is my unit going to be fixed, when do I get my roof replaced? This person is clearly all about themselves. They got on the Board to serve their own purposes. The Me Directors have their own hidden agenda. Since Board

What Kind of Board Member Are You? (cont. from page 6)

members are fiduciaries to the Association and its members, the Me Director is already breaching the duty of care and good faith by being self serving. You could argue that several classes of directors above breach that duty. But that's another story.

To be a good Board member, become more than familiar with the Declaration, Bylaws and House Rules. If your Association has Architectural Guidelines, know them. Do not violate any of the rules in these documents. As a Board member, you are going to be held to a higher standard. If someone sees you do something, they will automatically assume it is okay. So make sure it is. Come to meetings prepared. Ask questions. Be on time.

About the author: James M. (Jim) Merrell is the President and Principal Broker of Touchstone Properties, Ltd., a Hawaii real estate corporation and member firm of Community Associations Institute (CAI). Jim has been a property manager for Touchstone Properties since 1993 and became President of the company in 2005. He received his Bachelor of Science in Electrical Engineering from Ohio University in 1969. He received a Masters in Business Administration from Pepperdine University in 1982. In 1998 he was awarded the prestigious Professional Community Association Manager designation from the Community Association Institute. Jim may be reached at 566-4100. This article was reprinted with permission from the CAI Hawaii August 2016 newsletter.

The Future of Self Governance and Reserve Obligations

On August 25, 2016, the Hawaii Council of Community Associations (“HCCA”) conducted a panel discussion on the future of self-governance for community associations in Hawaii. A panel consisting of a condominium unit owner (Richard Port), board member (Bob Smolek) and managing agent (Steve Farago) discussed issues such as losing the ability to self-govern condominium and community associations, mandatory professional reserve fund preparation, a condominium ombudsman and the regulation of directors. The panel was moderated by Richard Emery, Vice President of Government Affairs for Associa.

The seminar revolved around the theme that the condominium association industry must service condominium unit owners more positively to reduce the amount of complaints and issues presented to the legislators; this in turn would minimize the likelihood that legislators would introduce and enact “draconian” regulations. For example, proposed legislation for a condominium ombudsman or “czar” in the last legislative session prompted HCCA to take pre-emptive action with its members to avoid losing the basic self-governing foundation of the Hawaii condominium law and to keep government jurisdiction over owner disputes to a minimum. HCCAs current educational efforts emphasize the dangers of outside regulation on condominium boards and associations. Accordingly, the overall emphasis of this seminar was to encourage people to act in ways that enhance and upgrade the condo association industry so as to keep the legislature out of associations’ every day governing affairs.

The panel members emphasized the importance of open communication with all owners. For example, they recognized the importance of conducting “honest” reserve studies by including everything that must be paid for, including those items with long potential life spans. Hiding maintenance or repair costs discourages open communication with the owners who will eventually be faced with large maintenance or special assessment fees that have merely been deferred.

With regard to the lack of disclosure of condo documents, (which is one of the most prevalent complaints of owners), it was noted that HCCA is working closely with RICO to affirm appropriate areas of disclosure and to clear up any gray areas (anecdotally, employment contracts are a big source of dispute). RICO is the first line of defense against the failure to disclose documents to condo owners so it makes sense that HCCA work with RICO on this matter.

HCCA will continue to emphasize in its educational efforts that owners must take control and accountability in self-governing their associations responsibly or the government and legislature will take over this function for the owners.

Mediation Case Summaries

From June 2016 through August 2016, the following condominium mediations were conducted pursuant to Hawai`i Revised Statutes § 514B-161, and subsidized by the Real Estate Commission. The mediation providers also conducted additional condominium mediations in the District Courts and community outreach in their respective communities.

Mediation Center of the Pacific

Through Skype video conferencing capabilities, MCP can conduct mediations with condominium owners who live part-time in Hawaii and are currently residing out of the state; MCP also continues to mediate condominium disputes referred from the Honolulu District Court.

| | | |
|-----------------|--|---|
| Owner vs. Board | Dispute over reimbursement for damages to unit caused by repair of common element. | Mediated; no agreement. |
| Owner vs. Board | Dispute regarding annual meeting procedures. | Owner withdrew complaint. |
| Owner vs. Board | Dispute over late fees and attorneys fees. Owner alleges no notification re: change of management companies. | Owner did not respond to requests to mediate once all parties were contacted. |
| Board vs. Owner | Dispute over reimbursement to owner for repair cost to common element. | Mediated to agreement. |

Maui Mediation Services

| | | |
|------------------|--|---|
| Owner vs. Board | Alleged violation of house rules re: dogs in condo unit. | Board did not respond to request for mediation. |
| Owners vs. board | Owners disagreed with board decision to fumigate areas within the association. | Mediated; no agreement reached. |

Dispute Prevention and Resolution, Inc.

| | | |
|-----------------|---|-------------------------|
| Board vs. Owner | Alleged violation of house rules and regulations. | Mediated; no agreement. |
| Owner vs. Board | Dispute over payment for damages due to water leak. | Mediated to agreement. |
| Owner vs. Board | Dispute regarding alleged improper proxy forms. | Mediated; no agreement. |
| Owner vs. Board | Dispute over what information an owner is allowed to view pursuant to declaration and bylaws. | Mediated; no agreement. |

Ku`ikahi Mediation Center

Board vs. 4 different owners in a single condominium association in a dispute regarding summary possession of the each owner's unit. The parties in the first mediation were unable to meet to mediate; the second mediation was mediated to agreement; the third mediation was mediated with no agreement; and the fourth mediation was mediated to agreement.

2016 Real Estate Commission Meeting Schedule

Laws & Rules Review Committee – 9:00 a.m.

**Condominium Review Committee – Upon adjournment of
the Laws & Rules Review Committee Meeting**

**Education Review Committee – Upon adjournment of the
Condominium Review Committee Meeting**

Real Estate Commission – 9:00 a.m.

Wednesday, September 14, 2016

Friday, September 30, 2016

Wednesday, October 12, 2016

Friday, October 28, 2016

Wednesday, November 09, 2016

Wednesday, November 23, 2016

Wednesday, December 07, 2016

Friday, December 16, 2016

All meetings will be held in the Queen Liliuokalani Conference Room of the King Kalakaua Building, 335 Merchant Street, First Floor.

Meeting dates, locations and times are subject to change without notice. Please visit the Commission's website at www.hawaii.gov/hirec or call the Real Estate Commission Office at (808) 586-2643 to confirm the dates, times and locations of the meetings. This material can be made available to individuals with special needs. Please contact the Executive Officer at (808) 586-2643 to submit your request.

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