Replacement Reserves: Assessing the Alternatives

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Since 1994, associations that are subject to Minnesota Statutes § 515B.3-114 have been required to include in their annual budgets from year to year, on a cumulative basis, adequate reserve funds to cover certain replacement costs. However, in recent years, associations and unit owners have faced significant financial challenges, and many associations have failed to adequately fund their reserve accounts or have "borrowed" reserve funds to cover operating expenses. In response to these developments, the state legislature has amended the statute to clarify reserve requirements and to provide greater flexibility for fiscal years commencing on or after January 1, 2012.

Under the new framework, annual budgets must include replacement reserves projected by the board to be adequate (together with past and future contributions to the reserve account) to fund the replacement of those components of the common interest community which the association is obligated to replace by reason of ordinary wear and tear or obsolescence. The evaluation of "adequacy" must be based on the estimated remaining useful life of each component. The association must reevaluate the adequacy of replacement reserves at least every third year. Replacement reserves must be kept in an account separate from the association's operating funds and cannot be used or loaned to cover operating expenses; however, replacement reserves may be pledged as collateral for a loan to the association.

For fiscal years commencing on or after January 1, 2012, replacement reserves are not required for the following components, unless otherwise required by the declaration:

1. Components that have a remaining useful life of more than 30 years.

2. Limited Common Elements whose replacement will be funded by assessments against the units to which they are assigned.

3. Components whose replacement is planned to be paid for by special assessments authorized by the declaration or by assessments levied exclusively against the benefitted units, subject to the following conditions: (a) the period of declarant control must have terminated; (b) the funding plan must be approved by the board; (c) the funding plan must be approved by owners, other than a declarant or its affiliates, of units to which 51% of the votes are allocated; and (d) approval is effective for no more than the association's current and three following fiscal years, subject to modification or renewal by the same approval standards.

While associations may be able to reduce annual assessments by thousands of dollars by planning to fund replacement costs through future assessments rather than replacement reserves, this should not be considered cost savings. In fact, many additional costs (in time, money and effort) may be required to amend the declaration, prepare and approve a funding plan, periodically modify or renew the funding plan and, when it is no longer possible to delay funding, to levy and collect assessments or obtain alternative financing.

Inadequate replacement reserves may continue to affect eligibility for project approvals from the Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), Department of Housing and Urban Development (HUD) or Department of Veterans Affairs (VA), potentially affecting property values and the availability of mortgages. Even if an alternative funding plan does not disqualify a CIC from a particular program at this time, there is a risk that eligibility requirements for these programs or for conventional mortgages may be tightened in the future.

As a practical matter, it is very unlikely that every unit owner will be able to pay their share of the replacement costs as a special assessment or limited assessment. At minimum, the project may be delayed pending collection of delinquent accounts. Some owners may simply walk away, resulting in mortgage foreclosure wiping out the lien for the assessment and leaving the rest of the owners to share the replacement costs attributable to those units.

Facing this situation, associations may seek loans to cover replacement costs. However, it may not be possible to obtain financing on favorable terms, and the total project cost may increase significantly due to high interest rates, loan origination fees, title insurance premiums, escrow fees, appraisals and other transaction costs.

If an association is unable to obtain or afford traditional financing, the association may seek help from a government program. Currently, Minnesota Statutes Chapter 428A authorizes a city to establish a housing improvement area ("HIA") and to make advances or issue bonds to fund improvements that are necessary to maintain and preserve housing units and to cover the city's administrative costs. HIA funding is only available as a last resort; the statute requires a finding that without the HIA, the proposed improvements could not be made by the association or by the unit owners. However, HIA funding is not a government bailout; municipal assessments are levied against the CIC units for fees to reimburse the city for advances or to produce revenue to pay principal and interest on the bonds. Therefore, HIA funding can significantly increase the total cost of the project.

An association should not rely on the government to provide a safety net. HIA funding is discretionary, not mandatory; a city may reject a petition for HIA funding. Further, Minnesota Statutes § 428A.21 (2010) provides "The establishment of a new housing improvement area after June 30, 2013, requires enactment of a special law [by the State of Minnesota] authorizing the establishment of the area." Thus, it is unclear whether this program will be available in the future.

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