

RESERVE FUND STUDY UPDATES: Prudence and Diligence MUST Govern!

By John J. Molnar

The Province of Ontario became the acknowledged leader, both in Canada and the USA, in tightening up the provisions of the legislation with the Ontario Condominium Act, 1998 and its subsequent Regulations 48/01 and 49/01. Still there are some pretty big holes that have to be plugged, related to such issues as condominium conversions, enforcement, a central compliance tracking mechanism and reserve fund studies.

Most Ontario condominiums have already or should be having their Reserve Fund Study Updates done. Some have even had their second Update (the one with the Site Visit).

New condominiums must have a Comprehensive Reserve Fund Study (Type 1) done within the first year of registration. Every three years thereafter, they must have an Update – alternating between a Type 3 (Reserve Fund Study without a Site Visit) and a Type 2 (Reserve Fund Study with a Site Visit).

With “phased in” condominiums, each time a new phase is registered, a new Comprehensive Reserve Fund Study must be done. This, then, becomes more challenging to track for Updates because each of the phases has differing and staggered reserve component life cycles.

Such is the basic outline of Reserve Fund Study and Update types and cycles. This is pretty fundamental information that should be known by every board member, property manager, individual unit owner, realtor and lender in the condominium market. Due diligence and liability issues abound, particularly when things are not done correctly and on time or worse, not at all.

Storm Clouds on the Horizon

Despite the applause over the new requirements for Reserve Fund Studies and Updates, many are not turning out to be the cure-all for condominium reserve fund planning. Several problems are beginning to be discovered with Reserve Fund Studies and Updates, not the least of which is that quite a few are simply not being done according to schedule.

In some cases, the initial Comprehensive Reserve Fund Study with a Site Visit hasn't been done at all and is way overdue. This applies to both “standard” condominiums and conversions from existing rental buildings. A few smaller, self-managed condominium corporations that have been registered for years are just now getting their first ones done.

Reserve Fund Study Updates must be done in the proper sequence and with regularity. This is to ensure that the reserve funds are maintained at proper levels and with appropriate contribution adjustments.

Presently there is no government enforcement body or mechanism in place or even in the works to police any of it.

Law Suits Looming?

There haven't been any test cases yet on Reserve Fund matters yet, but I believe that they are sure to come, given the inherent lack of enforcement and monitoring of certain provisions of the Condominium Act and Regulations. The questions will go first to the amount of damages and next to who is really liable. Then the scramble will start with the legislation again.

Suppose, for instance, that you're trying to sell your unit and your condominium corporation hasn't had the prescribed Reserve Fund Study Update, or even its first Reserve Fund Study. Here, both you and your REALTOR® could be in a real pickle. In a tough and competitive market or even a falling or slow market, you might not be able to sell your unit at all. Why not?

Most diligent REALTORS bringing in Offers to Purchase advise the Buyer to include a clause in the Agreement, making it conditional upon a satisfactory review of a Status Certificate from the condominium corporation. What's in the Status Certificate? Amongst other things is a summary of the Reserve Fund information.

Far too many Agreements of Purchase and Sale are accepted and this condition is removed long before the Buyer's solicitor gets the paperwork. Real estate lawyers know this risk and must also be aware of some very important Reserve Fund issues in order to properly advise their Buyer clients about them.

If the deal for the sale your unit falls through because the condominium corporation hasn't had a proper Reserve Fund Study or Update, the next question will be "what recourse does the Seller have"? They could petition the condominium board to have the Reserve Fund Study or Update done or hope for an unsuspecting Buyer with bad advisors.

Even in petitioning to have the Reserve Fund Study or Update done, they can't be done right away – certainly not within the timeline of some Offers to Purchase. It could take weeks or even months before the exercise is completed, and the Seller and their REALTOR would have lost extremely valuable marketing time – and money!

The Quantum – How much for Damages?

A frustrated Seller or REALTOR, unable to sell because of no prescribed Reserve Fund Study or Update being on hand, would have a case for claiming damages. A judge would have to determine how much the damages are – a really tough question because there could be other related costs and side issues. The REALTOR might also join in the action for lost commissions and even the Lender of Mortgagee too, in the case of a Power of Sale proceeding if the unit couldn't be sold over a Reserve Fund fiasco like this.

Who's Responsible? – Kicking the Ant Hill

With Reserve Fund Studies and Updates, there are several groups or individuals who could be named in an action for damages by a frustrated Seller, REALTOR or other damaged party. Each should consult with their respective solicitors for certainty as to their exposure. As with a lot of legal actions where there are several named Defendants, with a conviction, judges often apportion the blame according to the Defendants' respective levels of responsibility. They then award damages according to what the judge decides are reasonable percentages, or splits.

Ultimately in this hypothetical situation, the frustrated Seller/REALTOR/Lender would sue the condominium corporation and their Board of Directors for not having the prescribed Reserve Fund Study or Update in place. Arguably, this canned the deal and money was lost. Here I'm not so sure that the Director and Officers liability insurance policy would afford total protection to the Board, especially if the board minutes showed that there was negligence or lack of good faith of some sort in not having the Reserve Fund Study or Update done. The property management company might even be brought into the action in a counter suit started by the Board if, for example, a relatively new Board could prove its total reliance on them for advice on all matters of compliance.

It gets both messy and a little spooky to consider. Just one well publicized case would set the entire condominium industry reeling, much like kicking over an ant hill.

Updates – The Numbers Shock with no Ground Fault Protection

With both Type 2 and 3 Reserve Fund Study Updates some corporations are shocked with the new numbers and schedules that are presented to them by their Reserve Fund analyst – often by a different person who did the previous study and one who could very well be using a different methodology.

Many Reserve Fund Updates are calling for steep increases in the required annual contributions, significant recalibration of reserve component life cycles, and large shifts in chunks of the Reserve Fund cash flow forecasts – both on the contribution and the expenditure sides. There are several reasons for this.

Component Costs Increases

One is that major repair and replacement costs, especially for certain reserve components, have risen dramatically in recent years. Consultants, for example, are costing out a new flat conventional built up roof at \$ 11.00 to \$ 12.00 per sq. ft. when, only a few years ago, they were citing them at \$ 6.00 to \$ 7.00 per sq. ft. Anything with a petroleum base, such as vinyl siding, asphalt paving and roof shingles, have skyrocketed in cost with the huge oil price increases.

Metal costs have gone up a great deal as well. Some components to be replaced are also obsolete and will require upgrades to keep up with newer electronic technologies, built-in redundancies and code requirements. This is one reason why Updates absolutely must be done in a timely manner. These Reserve Fund component costs are constantly increasing.

Most everyone agrees that a 30 year forecast is far too long to project with any reasonable degree of accuracy. Any forecast beyond 4 to 5 years begins to lose its credibility rapidly because of construction cost increases alone.

Inaccurate Forecasting

Another reason could very well be the result of inaccurate forecasting by the Reserve Fund analyst. Using inappropriate component costs and low or unjustified inflation factors will likely result in incorrect 30 Year Cash Flow Forecasts and recommended annual reserve contributions. With the Updates in particular, the problem can be compounded by the simple repetition of old assumptions by the Reserve Fund analyst, especially if they're wrong.

As with insurance for "full replacement cost", the process of "trending up", or simply adding increases based on the Consumer Price Index, is not prudent. The Construction Cost Index

is a great deal different and absolutely must be used. The analyst has to start from scratch with each item, particularly with a Reserve Fund Study with a Site Visit, examining the assumptions used in the original Reserve Fund Study analyst's model. Plus, the reserve components need to be visually inspected again at least every six years. Components age at different cycles for different reasons and there may even be discretionary replacements done ahead of schedule. (If this beginning to sound a bit academic, it really is; Reserve Fund analysts, schooled in how to properly do studies, should know this).

When the initial set of numbers is wrong or based on inaccurate information, this may very well lead to many corporations not having sufficient funds on hand for individual reserve components coming due for major repair and replacement. Financial hardship for condominium unit owners will be the certain result.

At a recent Canadian Condominium Institute (CCI) sponsored session, one Board member confided in me about their frustration with their Reserve Fund Study. Their high rise condominium is facing replacement costs for a major Reserve Fund component that is three times the cost of what their Reserve Fund Study and Update analyst forecast. They are now beginning to question all the analyst's other numbers, their underlying assumptions and the entire amount of their reserve fund amount in the bank. Thus, inaccurate Reserve Fund Study and Update forecasting almost defeats the purpose of having a Reserve Fund Study, Updates and even the reserve fund itself in the first place, at least for those victimized condominium corporations in similar circumstances.

In this particular instance, a bank loan, a special assessment, or combination thereof is likely to be necessary, unless the Reserve Fund analyst made some other mistaken assumptions in overestimating costs that would accidentally compensate or cancel this oversight. The only way to really know is to do a thorough Reserve Fund Study Update with a Site Visit over again, with a close eye on all of the previous assumptions and component costing.

Next, the Condominium Act of Ontario, Regulation 48/01 prescribes a list of categories of individuals who may or may not conduct a Reserve Fund Study and Update, and sets out a minimum of what must be contained in those studies and updates. However, both the quality of the studies and the experience of the Reserve Fund analysts are not scrutinized closely enough. The approaches, formats, rationalizations and details contained in Reserve Fund Studies and Updates vary a great deal. There is no uniform standard. One analyst is quoted as saying, "you can write whatever you want as long as you can defend it in court." Now, that's not comforting at all to hear. With that attitude, he may very well wind up in court explaining his methods to a judge who lives in a condominium facing a gigantic special assessment. Wouldn't that be a richly deserved irony?

There is no single body of Reserve Fund analysts in Canada to self-regulate the quality of their service, as there are in the USA. There, the Reserve Fund analysts are required to submit an actual Reserve Fund Study or Update for independent peer review EACH YEAR in order to keep their professional designation as either a PRA (Professional Reserve Analyst) or a RS (Reserve Specialist). We don't have that in Ontario or Canada at all. From much of the material I've seen, and with some unchecked unhappiness over the accuracy and quality of Reserve Fund Studies and Updates, this might be forced on the industry. It is long overdue, together with a central registry to keep track of each condominium's status on having had Reserve Fund Studies and Updates completed.

Other Bad News in the Making – Latent Construction Deficiencies

Generally, most of the older condominium corporations have already dealt with their construction deficiencies. The soil and foundations have settled, with leaky windows and walls repaired and defective mechanical equipment replaced. Still, there are design deficiencies that were missed by warranty coverage which are showing up as very unpleasant surprises.

One case in point is a townhouse project built in the early 90's with vinyl siding on most of its walls. Due to a construction design deficiency, small amounts rain water was allowed to get behind the siding and sit, with no way out. Over the space of 10 to 15 years, this water rotted the supporting walls which became a medium for mold growth and wet rot. Only after destructive testing by structural engineers was this discovered. Needless to say, the siding as a reserve fund component had to be replaced well ahead of its typical life cycle as it had to be removed to remediate the rotten exterior supporting walls. Their Reserve Fund Plan needed major surgery too.

Other much newer condominiums are experiencing similar latent design deficiencies well after Ontario's Tarion warranty period has expired. In many cases, they are small and inexpensive to fix. In others, they are extensive and expensive. The effect that this can have on the Reserve Fund can be enormous. It is incumbent on every Reserve Fund analyst to note any inkling of these to the condominium client as soon as they become known and to recalibrate the Reserve Fund Study Update accordingly.

This is why it is so important for the Reserve Fund analyst to conduct interviews and perhaps even obtain written statements from board members and/or property managers who know or strongly suspect that there are latent construction deficiencies in a condominium development. It is part of the Reserve Fund analyst's due diligence to ensure that as much reliable and pertinent information is obtained that could affect the various reserve fund components and hence, the annual contributions.

Wouldn't these problems have been possible to detect with the visual inspections by a Reserve Fund analyst? The answer is a resounding "no" – not unless the Reserve Fund analyst suspected something unusual in the reserve fund expenditure history and recommended further investigations and the corporation became involved destructive testing (such as dismantling, closer examination and reassembly of an outside wall). Unfortunately with some management company changes and even the loss of a condominium corporation's "in-house historian" much of the corporation's repair history gets lost or forgotten. Many management companies often take over a new condominium account and receive only the minimum of historical data (in some cases, none at all).

A thorough analysis of the condominium corporation's reserve fund expenditure history can offer clues as to problematic areas. This history should be outlined in a separate section in the Reserve Fund Study and Updates. Furthermore, the Reserve Fund analyst should make sure that they clearly spell out specific items in a Statement of Limiting Conditions in their reports. We've seen far too many Comprehensive Reserve Fund Studies and Updates where both of these components are missing.

Unfortunately, corporations with any common element component deficiencies that are not able to have rectified by the developer or through Tarion, will simply have to digest the major repair costs associated with the remedial work. A good Performance Audit with a controlled mandate for destructive testing as a secondary step in new developments should pick up any major construction deficiencies and suspected design deficiencies so that they

can be rectified before their warranty periods expire.

It is a different case altogether with condominium conversions. There is no Tarion home ownership protection afforded to them at all. In most cases, the local municipalities require a Technical Audit, but only limit it to structural, safety and code violations. This is another weak link with the present condominium legislation.

Remedies and Solutions

For latent construction deficiencies there is no quick fix. You simply just don't know that they're there until a problem becomes manifest. Even the most meticulous Performance Audit is likely to miss some of them. The engineer or architectural group that is hired can't dismantle your entire complex then reassemble it just to verify that things were built according to the specifications and codes. It would cost you a fortune! You simply have to deal with them as they occur and know that the reserve fund will likely be the piggy bank that is drained to deal with them.

When I was a kid growing up in the 50's I remember my mother keeping a couple of separate cookie jars. From each pay, she'd religiously deposit a small amount into each one for the baker, the department store, the car insurance, the milk man and the life insurance man (yes - the life insurance agents came around to pick up their payments in person in those days). If some emergency expense happened, like a visit to the dentist for one of us, then those cookie jars got raided and emptied. Mother then had to come up with a way of robbing from Peter to pay Paul, juggling things around, until the time when those visiting collectors came around and payments had to be made. You might be able to delay a week or so with a payment, but certainly no longer. Those were the days of lay-away plans, not credit cards. Your reserve fund is much like a series of those little cookie jars that Mother kept for each expense that she knew would have to be paid, in our case, sooner than later. I've used this analogy to condominium clients for years because it is so appropriate in explaining Reserve Fund Planning.

Latent construction deficiencies, depending on the urgency of dealing with them, could very well act like that emergency visit to the dentist for us and take large amounts of money out of the various "cookie jars". There are no two ways around it. They have to be replenished - and quickly in order to keep your "assumed" interest rate working for you.

I mentioned "phased in condominiums" earlier and the problem with tracking and updating their reserve fund studies. We've found that our "Consolidated Functional Reserve Fund Study Hybrid" is the only satisfactory method to tackle these assignments. But for those Reserve Fund analysts whose real expertise is in very narrow areas like structural engineering, mechanical engineering, or architecture, it means learning an entirely new set of skills involving advanced spreadsheet work with complicated links and formulae - hardly their bread and butter or something that they do every day. The number crunching is getting more and more complicated.

While sitting with a condominium board treasurer or property manager with a laptop and plugging in a couple of number changes in an Excel spreadsheet, might appear impressive, most fail to recognize that 98% of the work before that happens is done ahead of time. If the basic information is wrong to begin with, then so would all the "what if" scenarios. The Reserve Fund analyst must be accurate with this starting information, assumptions and methodology.

With the “professions”, if there were wholesale damages to the public by any one of them (physicians, accountants, lawyers, the clergy), there would certainly be an outcry for discipline, additional training and/or stricter peer review. For example, if a bunch of lawyers were giving their clients advice that resulted in the government successfully prosecuting their clients for tax evasion, you bet the Law Society would step in. Of if a doctor’s patient death rate were ten times that of the average of his colleagues, the College of Physicians and Surgeons would be all over him or her. Unfortunately, if you wind up in hell, you wouldn’t have any recourse against your clergyman, but you get the picture.

Some condominium corporations are on their way to Reserve Fund Hell in a hand basket, often relying dogmatically to the numbers presented in their Reserve Fund Studies and Updates. The Reserve Fund Plan is exactly that – a plan – not something fixed in stone.

Either a self governing body for Reserve Fund analysts or one imposed by the provincial government will solve the problem with inconsistency, fundamental inaccuracies and lack of training of analysts in Ontario. Peer review affords an opportunity to increase the standard of Reserve Fund Study and Updates being presented to condominium clients and it should definitely be on the list of refinements and enhancements to the regulations governing the provision of Reserve Fund Studies and Updates in Ontario.

A central registry for condominium corporations to file proof of their compliance with having their Reserve Fund Studies and Updates done would go a long way to avoiding the “frustrated Seller” scenario cited earlier. These are only two of the needed upgrades for the Ontario Condominium Act and they only deal with Reserve Fund Studies and Updates. Sadly though, we’ll probably have to wait until there are one or more court cases to get us really moving on it.

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