

Options for reserve fund shortfalls



The adequacy of condominium corporation reserve funds has been the subject of frequent legal and engineering analysis. Is there or isn't there enough in the communal kitty?

BY RAY MIKKOLA

Reserve funds are one of the key features which differentiate condominium ownership from a non-condominium "fee simple" form of ownership. When a homeowner needs a new roof the owner is required, sometimes on very short notice, to find the necessary funds in order to pay for this significant expense usually in full and usually without any recourse to a former owner.

From the outset, the Ontario Legislature decided that condominiums would be different. The first version of the Condominium Act, enacted over 40 years ago, required boards of condominiums to set aside monies in a separate fund or funds for the purpose of ensuring that those funds would be available for major capital repairs and replacement of the common elements.

Initially, the minimum amount to be set aside was five per cent of the maintenance fee, which was later increased to ten per cent, prior to the enactment of the 1998 version of the Act on May 5, 2001.

Boards were always required to set aside a sufficient sum for reserve funds but,

for reasons having to do with satisfying owners' desires to keep common expenses at a minimum and the absence (prior to the current version of the Act) of mandated reserve fund studies, boards typically allocated an insufficient amount to the reserve fund. This resulted in the board having to scramble to find sufficient funds to pay for major capital repairs and replacement, in a manner similar to a homeowner of a freehold dwelling.

The new Act has made significant strides in remedying the state of the reserve funds across the province. But it is still, of course, possible for a reserve fund to be underfunded when the money is actually required. In this scenario, the board has two options.

Option one: special assessment

The board may levy a special assessment. Generally, this option is available to the Board where insufficient monies are on hand to pay for unexpected expenses which have been or are about to be incurred by the condominium corporation.

These expenses are generally unexpected. If they had been anticipated, the board would likely have included them in the budget for the year in which they

were or are to be incurred. In short, you don't know what you don't know.

The authority for the assessment comes from the Act under the general authority of the board to manage the financial affairs of the Corporation and is also generally included in the operating by-law of the condominium. The by-laws need to be carefully reviewed to ensure that notice provision, timeframes and other requirements are met to avoid a challenge as to the validity of the assessment. The funds are then used to pay for the expenses for which the reserve funds were insufficient.

A special assessment, properly made and administered, is a very effective way to raise large amounts of cash. Generally, no owner consent or even owners' meeting is required. The monies are usually payable within a very few number of days in full, or the board spreads the payments over a period of time sufficient none the less to ensure that the funds are available when required.

In my experience, boards hate special assessments almost as much as the owners who must pay them do. Owners who cannot pay them on time or at all are faced with dealing with expensive lien claims against them. Sometimes, the amount of the required special

assessment is not clearly known, as in the case of an expensive but unanticipated parking garage repair where the extent of the problem isn't always clear until the work has commenced.

Going back to the owners for a second round of special assessments is an unpalatable task for even the hardest board. A special assessment has the potential to divide a community and otherwise to affect deleteriously the spirit and cohesiveness of a community.

Option two: borrowing funds

The board may borrow the required funds. Sometimes, the borrowing option is adopted to avoid a special assessment. The borrowing of funds by a condominium corporation is unique.

There is no mortgage, as the corporation typically owns no real property or other assets of any value. The corporation covenants to repay the loan and financing institutions (including banks) require the execution by the board of various additional documents to evidence and better secure the loan.

However, the covenant of the condominium corporation, properly and validly obtained, given the ability of the board to access the equity of each owner's unit ultimately by a lien mechanism which all but guarantees payment in first position, is all that the lender really requires.

The loan ensures that the required monies are paid back over a longer timeframe and sometimes in circumstance where unit ownership has changed a number of times. The loan repayments are included in subsequent budgets along with all of the other common expenses.

But the corporation (and lenders) must be very careful in executing and extending monies on a loan to a condominium corporation.

In some cases, a loan specific by-law is required. This requires the approval of a majority of the unit owners in like manner as any other by-law. The provisions of the by-laws and the declaration must be carefully reviewed and a legal opinion is universally required.

In my experience, the documents ancillary to the loan as provided by lenders sometimes

contain provisions which are or may be contrary to the Act. Great care must be used in describing the purpose of the assessment. For example, monies placed in a reserve fund must be used only for capital repair and replacement, so if the borrowing is required for a number of purposes including non-reserve fund expenses, the loan proceeds need to be the subject of careful accounting.

The best way to avoid a shortfall in reserve funds is to undertake the mandated reserve fund studies in a timely and prudent manner. In doing so, the board will be complying with the Act. The failure to do so may result in the directors' and officers' errors and omissions insurance being cancelled and will eventually result in difficult questions being asked of current and former board members as to how they discharged their duties to current and future owners. **CB**

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