

IV Requirements for Replacement Reserves

Note: These rules were adopted before the Legislature approved the “cash flow” method of funding reserves. As a result, not all of the rules are fully consistent with the cash flow method of funding reserves. In addition, these rules are based on Chapter 514A, not Chapter 514B. As a result, additional inconsistencies may exist. Nevertheless, Section 34 of Act 273 (SLH 2006) confirmed that these rules continue in effect until changed by the Real Estate Commission.

§16-107-61 Objective. This subchapter implements the requirements of Section 514A-83.6, HRS, that all condominium associations must follow budgets and establish statutory replacement reserves. These rules try to ensure that each owner in a condominium project pays a fair share of the short-term and long-term costs of operating the project, based on the owner’s period of ownership. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83-6)

§16-107-62 Definitions. Unless the context clearly indicates otherwise, the definitions in chapter 514A, HRS, apply to this subchapter and the following definitions apply to chapter 514A and this subchapter:

“Asset” means any part of the association property.

Note: Initially, reserves must be calculated for each part of the association property because each part has a different life expectancy. An asset is a part of the association property which the association must maintain, repair, or replace. Note that the term asset may include a part of the exempt association property which ceases to be exempt.

“Association property” means those parts of a condominium project which an association is obligated to maintain, repair, or replace, including but not limited to:

- (1) All of the common elements of the project, as determined from the project’s declaration and the bylaws of the association and any master deeds, restrictive covenants, apartment deeds, apartment leases, or other documents affecting the project;
- (2) Any real property which is not part of the common elements but which the association either owns or leases for a term of

more than one year, such as a manager's apartment acquired by the association after the project was developed;

- (3) Any personal or movable property owned or leased by the association; and
- (4) Any fixtures owned or leased by the association.

“Association property” does not include any part of the project which is “exempt association property” or which fewer than all owners are obligated to maintain, such as apartments or certain limited common elements.

Example:

A condominium association's documents state that a deck is a limited common element assigned to less than all of the owners. The documents also state that the owners of the apartments to which the deck is appurtenant must pay for the cost of maintaining and repairing the deck. Therefore the association need not set aside funds for replacement reserves for the deck.

Note: One of the key elements of a reserve study is determining the property which the association is obligated to maintain, repair, or replace, and, therefore, for which the association must establish a reserve. Certain association property is exempt from the reserves process (see definition of “exempt association property”). Since reserves are primarily for large expenses, parts of the association property which have low value may be excluded. Since reserves are also for items with a limited life, parts of the association property which (theoretically) have an unlimited life, such as the concrete, plumbing, and wiring of a project, can be omitted from the reserve study, as long as they fit within the definition of “exempt association property.” Eventually, the passage of time may reduce the “unlimited” life of such property to the point where it ceases to be exempt and must be included in the reserve study,

Property which an association has leased is usually deemed association property for purposes of a reserve study. Including leased property is based on two assumptions: (i) the association has leased the property because it is required for the operation of the project; and (ii) the leased property must also be maintained, repaired, or replaced. Therefore, an association must include leased property in the association's calculations of a full replacement reserve, if the association is obligated to maintain, repair or replace that property.

“Budget year” means the association’s fiscal year for accounting and budgetary purposes.

“Contingency reserves” means all reserve funds, other than replacement reserves, in an association’s reserves accounts, including but not limited to reserves for:

- (1) Unexpected contingencies or emergencies which, in the reasonable judgment of the board, may occur;
- (2) The payment of insurance deductibles or other expenses relating to insurance;
- (3) Legal expenses and lease renegotiation or fee purchase expenses;
- (4) Exempt association property or additions and improvements to the association property, such as new construction; or
- (5) Late payment or non-payment of an assessment by any owner.

Note: Hawaii’s reserve law only requires “replacement reserves” - i.e. reserves for anticipated, not unanticipated expenses. In addition, these rules require reserves only for association property, not exempt association property. Nevertheless, many boards may wish to establish reserves for the unexpected, for exempt association property, for new construction, or for emergencies. Contingency reserves are for items for which no reserves are required but for which a board may establish reserves if it chooses.

“Emergency” means the same as “emergency situation,” defined in section 514A-83.6(j), HRS.

“Estimated age” means the estimated useful life of an asset minus its estimated remaining life.

“Estimated remaining life” means any period: (1) which is shorter than the estimated useful life of an asset; and (2) for which the asset will continue to serve its intended function without requiring capital expenditures or major maintenance.

“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.

“Estimated useful life” means the period of time a new asset, or an existing asset which has been newly restored or refurbished, will serve its

intended function without requiring capital expenditures or major maintenance.

“Exempt association property” means any asset which:

- (1) At the end of its estimated useful life will require capital expenditures or major maintenance of less than \$ 1,000 or less than 0. 1 per cent of the association’s annual operating budget, whichever is greater; or
- (2) Has an estimated remaining life of more than twenty years.

Any asset which because of the passage of time ceases to be exempt shall become association property and be subject to the transitional rules stated in Section 16-107-71.

Note: Since reserves are primarily for large expenses, parts of the property which have low value can be excluded from the reserve study. Since reserves are also for items with a limited life, parts of the property which (theoretically) have an unlimited life (here defined as more than 20 years) need not be included in the reserve study. (Examples of the latter may be concrete, plumbing, and wiring in a project.) Nevertheless, nothing in the law or these rules prohibits an association from establishing reserves for exempt association property. Note that these rules require the board to disclose which assets are exempt association property and the basis for the exemption (see Section 16-107- 71).

“Existing association” means an association which has held its first association meeting before January 1, 1993.

“Full replacement reserve” means reserve funds for an asset 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.

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 $\$100,000 \times [10/10 =] 1 = \$100,000$.

Note: A full replacement reserve is sufficient funds to maintain, repair, or replace an asset at the time the expense must be made (i.e., the end of the asset's estimated useful life). At any time before then, a full replacement reserve is a percentage of that amount, based on the estimated age of the asset and its estimated useful life.

“Funds” or “reserve funds” means cash or cash equivalents but excluding any funds which the association has borrowed. No borrowed funds shall be included when calculating whether an association has collected its statutory replacement reserves.

Note: The law is clear that reserves must be at least fifty percent funded in cash or cash equivalents. Therefore, the association must exclude any borrowed funds when calculating whether the association has fifty percent of a full replacement reserve.

“Managing agent” means, for purposes of the good faith exemption provided by section 514A-83.6(d), HRS, any person who prepares a replacement reserve study and who:

- (1) Is a managing agent as defined by chapter 514A, HRS, and commission rules and policies relating to managing agents;
- (2) Meets all legal requirements for managing agents; and
- (3) Is the managing agent for the association for which the reserve study is prepared.

Any employee of a managing agent who prepares the replacement reserve study shall be deemed a managing agent for purposes of this definition.

Note: Under this definition, even a person who meets the definition and legal requirements for a managing agent will not be entitled to the good faith exemption unless the person (or entity) also serves as managing agent for the association for which the reserve study is prepared.

“Minimum replacement reserve” means fifty per cent of a full replacement reserve.

Note: Act 189 (SLH 1992) reduced the amount of reserves an association must collect to 50% of a full replacement reserve. In these rules, the amount required by Act 189 is also referred to as the association's minimum replacement reserve. Note that under the “cash flow” method of calculating reserves, an association must by law collect 100% of its required reserves.

“New association” means an association which holds its first association meeting on or after January 1, 1993.

“Statutory replacement reserves” means fifty per cent of an association’s estimated replacement reserves.

“Substantially deplete” means any expense for an emergency which reduces the association’s replacement reserves and contingency reserves by more than seventy-five per cent. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

Note: The law allows associations which have substantially depleted their replacement reserves up to three years to rebuild them. This section defines when substantial depletion has occurred and ties in with Section §16-107-67. Since contingency reserves are primarily for emergencies, the definition includes contingency reserves in the calculation of substantially deplete.

§16-107-63 Effective date for establishing statutory replacement reserves. (a) The requirements of this section shall be subject to the transitional rules stated in section 16-107-64 and the emergency rules stated in section 16-107-67.

(b) Each budget year, beginning in the 1993 budget year, the board of an existing association shall prepare and adopt an annual operating budget for the following budget year. Each annual operating budget shall include assessments sufficient to fund the association’s statutory replacement reserves for the year to which the budget relates. Each budget year, beginning with the 1994 budget year, the association shall assess and collect at least its statutory replacement reserves for that budget year.

(c) Each budget year, beginning in the year of a new association’s first annual meeting, the board of the new association shall prepare and adopt an annual operating budget for the following budget year. Each annual operating budget shall include assessments sufficient to fund the association’s statutory replacement reserves for the year to which the budget relates. Each budget year, beginning in the first budget year after the new association’s first meeting, the association shall collect at least its statutory replacement reserves for that budget year.

(d) For those projects where the declaration has been recorded but the association has not held its first meeting by the later of either:

- (1) December 31, 1995; or
- (2) That date which is thirty-six months after the filing of the declaration, then at least once each calendar year, commencing with the calendar year immediately following such later date, the developer shall, unless the developer owns one hundred per cent of the apartments in the project,

notify in writing each apartment owner of the manner in which replacement reserves for future project maintenance and repairs are being addressed.

Such notice shall inform the owners in reasonable detail of at least the following:

- (1) The purpose for establishing replacement reserves;
- (2) A general summary of the replacement reserve requirements that would apply to associations under chapter 514A, HRS, and this subchapter, which held their first meetings before January 1, 1993, instead of after January 1, 1993, which general summary may be in such form as the commission may provide;
- (3) Whether any replacement reserve studies have been prepared for the project; and
- (4) The amount of replacement reserves, if any, being collected as part of the owners' maintenance fees, or otherwise being funded by the developer and the manner in which those reserves were established. [Eff.1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

Note: This section states the basic rule of the reserves law: every association must collect sufficient funds from its members to establish a minimum of fifty percent of the full replacement reserve for the association by the end of each budget year. The association must collect one hundred percent if the association funds its reserves under a cash flow plan. Nevertheless, the section recognizes that the law requires not just reserves but a budget process, which includes reserves. Therefore, the section requires that the budget process begin on the effective date of the law, but that the reserves be collected when the budget actually goes into effect, that is, the year after the budget is developed and adopted. In addition, the following section gives an existing association until January 1, 2000 to collect at least fifty percent of a full replacement reserve—its “statutory” replacement reserves.

§16-107-64 Transitional rules for full replacement reserves for existing associations prior to January 1, 2000. (a) Prior to January 1, 2000, an existing association shall collect at least fifty per cent of a full replacement reserve in its reserve account; and prior to the budget year beginning in 1997, an existing association shall collect at least twenty-five per cent of the amount which the association's replacement reserve study indicates will be a full replacement reserve for the association on January 1, 2000. Moreover,

in the 1994 operating budget and in each succeeding annual operating budget prior to January 1, 2000, an existing association shall clearly disclose:

- (1) The dollar amount which the association's reserve study indicates will be a full replacement reserve for the association on January 1, 2000; and
- (2) How much of that amount the association intends to collect each budget year prior to January 1, 2000.

(b) In calculating a full replacement reserve for an existing asset, an association may disregard the actual age of the existing asset on January 1, 1994. Instead, the association may assume the estimated age of the existing asset on January 1, 1994 is zero and that the asset's estimated useful life is the same as its estimated remaining life on that date.

(c) An existing association whose budget year begins after January 1, 1993 may have up to six additional months beyond the dates given in this section to budget and assess for replacement reserves, provided the association collects fifty per cent of its full replacement reserves by January 1, 2000.

Example:

An existing association's reserve study indicates that a full replacement reserve for the association on January 1, 2000, will be \$200,000, so the law requires the association to have at least fifty per cent of that amount, the minimum replacement reserve, or \$100,000, by that date. If the association has no replacement reserve on January 1, 1994, this section requires the association to fully disclose how much of the \$200,000 the association intends to collect each budget year prior to January 1, 2000. Moreover, the association must collect at least \$50,000 by January 1, 1997, and will have to collect sufficient funds thereafter to ensure the minimum replacement reserve is collected by January 1, 2000. The rule permits the association to collect \$50,000 during 1996 and \$50,000 during 1999, provided the association fully discloses its intent.

Example:

An existing asset which has an estimated useful life of thirty years, is already twenty years old on January 1, 1994, and has a replacement cost of \$100,000. Under the standard method of calculation, on December 31, 1994, a full replacement reserve for that asset would be \$70,000 ($\$100,000 \times 21/30$ - see the definition

of full replacement reserve). If an association had not already established a replacement reserve for that asset, the amount required to establish a full replacement reserve by December 31, 1994, would be \$70,000. (Note, however, that to establish the minimum replacement reserve -fifty per cent of a full replacement reserve - would require only \$35,000). The estimated replacement reserves for each of the next nine years would be \$3,333 (\$30,000 divided by 9) to collect a full replacement reserve by the end of the year 2003, or fifty per cent of that amount (\$1,666) each year for statutory replacement reserves.

If the association adopts the method of calculation permitted by subsection (b), the full replacement reserve amount required by December 31, 1994, for the same asset would be only \$10,000 (\$100,000 x 1/10), or \$5,000 for the minimum replacement reserve. Each subsequent year, however, the estimated replacement reserves will be \$10,000 (\$90,000 divided by 9)—higher than in the first example because the method of calculation permitted by subsection (b) requires annual contributions to be higher to meet funding requirements. The statutory replacement reserves for each of the same nine years will be \$5,000. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

Note: This section states the basic rules during the transitional period of Section 514A-83.6, i.e., from January 1, 1993 to January 1, 2000. First, an existing association need not establish 50% of a full replacement reserve— i.e., its statutory replacement reserves— until January 1, 2000. Starting in 1994, however, the association board must fully disclose the amount of reserves the association will need by January 1, 2000 to establish a full replacement reserve by that date. The association also must disclose how much of that amount it will collect each year prior to January 1, 2000. Rule 16-107-64 only requires an association to collect at least 50% of a full replacement reserve by that date; and 25% of that amount prior to the budget year beginning in 1997. Note that an association which funds its reserves under a cash flow plan must collect a full replacement reserve by January 1, 2000.

Second, regardless of the actual age and estimated useful life of an asset, the association's reserve study may calculate the asset's estimated age and useful life as of January 1, 1994, the date on which an association must normally begin collecting reserves. (Note, however, that the association may decide to defer actual collection of part of its minimum replacement reserves until as late

as the end of 1999, under the transitional rules stated in subsection “(a)” of this section).

Because of the way a full replacement reserve is defined, the rule stated in subsection “(b)” can reduce the initial reserve contribution required for an older asset, especially if an association has not previously established a reserve for the asset.

Third, subsection “(c)” recognizes that not all associations have a budget year which begins on the first of every year. For example, under subsection “(c),” an association whose budget year began on May 1, 1994 could begin collecting reserves as of that date. The association could also calculate asset age as of that date, not January 1, 1994. Nevertheless, the Association would still have to make its final contribution to establish fifty percent of a full replacement reserve by December 31, 1999.

§16-107-65 Calculation of estimated replacement reserves; reserve study; good faith. (a) A board of directors of an association shall calculate the association’s estimated replacement reserves based on a reserve study developed in compliance with this section.

(b) The board shall compile a list of the association’s assets. If the project’s declaration and association’s bylaws fail to clearly state whether a particular part of a condominium project is association property, the board may adopt a resolution allocating responsibility for that part to the association, an individual owner, or individual owners. The board’s resolution shall be based on chapter 514A, HRS, the project’s declaration and the association’s bylaws, and any other applicable legal requirements or documents. The resolution shall clearly indicate whether the part in question:

- (1) Is an asset of the association;
- (2) Is the responsibility of an individual owner or individual owners, but fewer than all owners; or
- (3) Is partly an asset of the association and partly the responsibility of fewer than all owners, such as plumbing or electrical system.

The resolution shall state the basis of the board’s decision and shall be effective to determine responsibility for replacement reserves for the part in question upon adoption and until changed by the board or by an amendment to the declaration or bylaws.

(c) The board shall determine the estimated useful life of each asset, based on at least one of the following:

- (1) The association's past experience with the asset;
- (2) Any publication, such as the commission's Condominium Reserve Reference Manual; "Life Cycle Cost Data" (McGraw-Hill, New York); or "Repair & Remodel Quarterly" (Marshall & Swift, Los Angeles), which provides statistics of the estimated useful lives of items similar or comparable to the asset;
- (3) The estimate of any Hawaii licensed contractor or an authorized supplier for the asset, any item similar or comparable to the asset, or any materials or services for the asset's upkeep, repair, or replacement;
- (4) Any warranty provided by the supplier, installer, manufacturer, or builder of the asset or any services relating to its installation, upkeep, repair, or replacement.

(d) The board shall calculate the estimated capital expenditure or major maintenance required for each asset, based on at least one of the following, adjusted for inflation:

- (1) The association's past experience with expenses relating to the asset;
- (2) Any publication, such as the commission's Condominium Reserve Reference Manual; "Life Cycle Cost Data" (McGraw-Hill, New York); or "Repair & Remodel Quarterly" (Marshall & Swift, Los Angeles), which provides statistics on the estimated capital expenditure or major maintenance, required for the asset or items similar or comparable to the asset; or
- (3) The estimate of any Hawaii licensed contractor or an authorized supplier of the asset, any item similar or comparable to the asset, or any materials or services for the asset's installation, upkeep, repair, or replacement.

(e) Each year, the board shall adjust the amount of the estimated replacement reserves for an asset based on reasonable projections for inflation and for interest which will be earned during the estimated useful life of the asset. Adjustments for inflation shall not assume an annual inflation rate less than that of the Honolulu Consumer Price Index for All Urban Consumers for the prior year. Adjustments for interest earned shall

not exceed the prior year's average interest rate for Seven-Year United States Treasury Bills.

(f) If a board plans to assess less than one hundred per cent of the association's estimated replacement reserves for a budget year, the association's operating budget for that year, the reserve study, and the association's other records shall clearly and prominently indicate:

- (1) The total amount the association's replacement reserve study indicates will be a full replacement reserve for the association at the end of the current budget year; and
- (2) The total amount the association will have collected at the end of the current budget year.

(g) Any association, or any apartment owner, director, officer, managing agent, or employee of an association who calculates the association's estimated replacement reserves as provided in subsections (b), (c), (d), and (e) shall be deemed to have acted in good faith if the calculations subsequently prove incorrect; provided that an association board, director, officer, or managing agent must also make the disclosures required by subsection (f) to be deemed to have acted in good faith. [Eff. 1/2/95 (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)]

Note: This section outlines the three basic steps for a reserve study: (i) identify the property for which the association must establish reserves, (ii) determine the estimated useful life of the property, and (iii) estimate how much it will cost to maintain, repair, or replace. Although determining the association's responsibility for various parts of the project is often thought to be the easiest part of a reserve study, poorly drafted documents can present serious problems. That is especially true for those associations in which owner apathy makes document amendments difficult or impossible. Therefore, subsection "(b)" permits the board to adopt a policy resolution to allocate responsibility for reserves purposes, if the association's declaration and bylaws fail to clearly state whether a particular part of a condominium project is association property. The resolution must be based on an interpretation of the law and the project documents. The owners may override the board's policy resolution by amending the documents.

The Legislature has indicated an intent that the reserves process should not be made so complex that only professionals can prepare a study. Therefore, Subsections (c) and (d) give an association a broad range of sources for determining useful lives and anticipated replacement costs.

Adjustments for inflation can be made: (i) long-term, as part of the initial calculation of replacement cost or maintenance cost; or (ii) short-

term, every year when the reserve is re-examined as part of the budget process. Many people will find (ii) a simpler procedure. Overly optimistic long-term projections of inflation or interest income may undermine a claim of good faith if they distort reserve projections. Therefore, a reserves study should be realistic in its long-term projections.

The reserve account records and reserve study must clearly disclose if an association has less than 100% of a full replacement reserve. Failure to disclose under funding may prevent the application of the good faith exemption. Anyone who follows the basic procedures of this section and fits within the class of persons allowed a good faith exemption should be entitled to the exemption.

§16-107-66 Fund accounting for each part of the association property; use of separate funds for other than stated purpose.

(a) An association shall establish at least one reserve account for its replacement reserves. Within the replacement reserve account, however, the association shall establish a separate designated fund or funds for each asset for which estimated capital expenditures or major maintenance will exceed \$10,000. Replacement reserves for all assets for which estimated capital expenditures or major maintenance will not exceed \$10,000 may be aggregated into a single designated fund in the replacement reserve account.

(b) For each of the separate, designated funds, the association's records for the replacement reserve account shall state:

- (1) The purpose of each fund or the asset for which it is established; and
- (2) The amount of the replacement reserves allocated to each fund; provided, the association need not comply with paragraph (1) for the single, aggregated fund. Instead, the replacement reserve account records may state the purpose of the fund as "miscellaneous," or a similar term, and indicate the amount in the aggregated fund. Regardless, elsewhere in its records the association shall list the assets for which the aggregated fund is established.

(c) The association board shall use replacement reserves allocated to a particular fund only for the stated purpose of that fund, except:

- (1) In an emergency or emergency situation the board may use the replacement reserves in any fund for any legitimate association purpose, provided the board passes a resolution containing written findings as to the necessity of using the replacement reserves for other than their designated

purpose, the necessity of the expense involved, and why the expense was not or could not have been reasonably foreseen in the budgeting process, and the resolution shall be distributed to all members of the association; and

- (2) The board may at any time use up to fifty per cent of the amount in any fund in the replacement reserves for the stated purpose of any other fund. In such a case, the association records, including but not limited to board meeting minutes, shall indicate the change in use of the fund and the dollar amount of the fund used for another fund, and the board need not comply with the procedures of section 514A-83.6(f), HRS, for notice to owners.

(d) If a board collects less than one hundred per cent of the association's estimated replacement reserves, the association's reserve account records shall clearly indicate how the board has allocated those reserves among each of the separate, designated funds. The board may fund each of the designated funds by an equal percentage, fund them by varying percentages, or fully fund some and not fund others at all. Regardless of the option chosen, the reserve account records must accurately indicate the allocation of funds adopted by the board. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

Note: This rule outlines another basic principle of the reserves law: an association need have only one reserve account but shall allocate the money within that account to separate funds for each major asset. The separate funds allow the association to keep track of its reserves for each major asset. Less costly assets may be aggregated into one fund. Except for the aggregated fund, the association reserve records must indicate the purpose of each reserve fund and the amount in it. Since the aggregated fund may be for a large number of purposes, those purposes need not be indicated in the reserve study but must be recorded somewhere in the association records. If the association does not fully fund its reserves, the records must also indicate the amount in each separate fund. Note that this rule may not apply if the association funds its reserves under a cash flow plan.

§16-107-67 Emergencies and Emergency Situations. (a) An association whose replacement reserves and contingency reserves have been substantially depleted by an emergency shall have three budget years to re-establish a minimum of fifty per cent of a full replacement reserve. The three years shall be calculated from the end of the budget year in which the association makes the payment which substantially depletes the association's replacement reserve.

(b) The board shall have the discretion to assess the owners in monthly, quarterly, or yearly installments to re-establish a minimum of fifty per cent of a full replacement reserve.

(c) In an emergency situation subject to section 514A-83.6(f), HRS, the board shall calculate the twenty per cent limit of that section based on the association's total annual operating budget for the budget year when the expense will occur. The board must notify the owners if an expense required because of an emergency situation will exceed the twenty per cent limit, but the board need not obtain owner approval for the expense. Prior to January 1, 2000, the board of an existing association shall not be subject to the twenty per cent limit.

(d) Section 514A-83.6(f), HRS, shall only limit a board's right to exceed its annual operating budget during the budget year to which the operating budget relates. The section shall not limit the board's right to increase an annual operating budget by more than twenty per cent over the annual operating budget of the previous year. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

Note: The three years to reestablish a substantially depleted reserve must be calculated from the end of the budget year in which the association makes the payment which substantially depletes its reserve (see definition of "substantially deplete," above).

The section also states that although the board must follow a procedure to inform the owners if the board will exceed its budget by more than 20% in an emergency situation, the board does not need the owners' permission to exceed its budget. The section clearly states that the 20% percent means 20% of the total annual operating budget, not 20% percent of the amount budgeted for the asset or item for which the emergency expense must be made.

§16-107-68 Contingency reserves. Nothing in this subchapter shall prohibit the establishment of a contingency reserve in compliance with this section. Unless a project's declaration or an association's bylaws provide otherwise, the board of directors may establish a contingency reserve in an amount the board considers appropriate, based on: the age of the project; its maintenance history; plans for additions or improvements to the project; or any other factors the board deems relevant. The contingency reserve shall be subject to all the requirements relating to reserves except the requirements of sections 16-107-63, 16-107-64, 16-107-65, 16-107-66(c) and (d), 16-107-67, and 16-107-69. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

Note: The note at the end of the definition of “contingency reserves” in Section 16-107-62 discusses the purpose of contingency reserves.

§16-107-69 Conflict of chapter 514A, HRS, and this subchapter with association declaration or bylaw requirements. (a) Chapter 514A, HRS, and this subchapter shall override any contrary provisions in a project’s declaration or an association’s bylaws, or any other applicable documents regarding: preparation of budgets, calculation of reserve requirements, and assessment and funding of reserves. Except as stated in subsection (b), limits on spending or assessments shall not restrict the board’s right to spend or assess for items required by the association’s reserve study.

(b) Chapter 514A, HRS, and this subchapter shall not override any contrary provisions in a project’s declaration, an association’s bylaws or other applicable documents:

- (1) Requiring the board to collect more than the association’s statutory replacement reserves;
- (2) Restricting a board’s right to assess or spend to upgrade the common elements for such things as additions, alterations, or improvements; or
- (3) Requiring a board to repair or maintain assets more frequently than the law, this subchapter, or the association’s replacement reserve study requires. [Eff 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

Note: This section states the basic rule: the law and rules will prevail over any more restrictive provisions to the contrary in the association’s declaration or bylaws. The legislative history of Act 189 (SLH 1992) indicates a clear intent to set a minimum standard of reserves and maintenance and repair. Therefore, the project documents may not further reduce that standard. Nevertheless, to the extent that the declaration or bylaws: (i) require more than fifty percent of a full replacement reserve, (ii) restrict a board’s right to spend for more than maintenance, repair, or replacement costs (i.e. restrict the board’s right to improve or add to the property), or (iii) require the board to maintain the project to a higher standard than the reserves study requires, those provision will apply. Note that the whole purpose of the reserves law is to set minimum standards and require the board to assess and spend to adequately maintain the property. Therefore, except as provided in subsection (b), the law and these rules appear to override assessment and spending limits to the extent they restrict the board’s authority to assess and spend in accordance with the association’s reserve study.

§16-107-70 Reserve funds non-transferable. Replacement reserve and contingency reserve funds which an association collects from apartment owners become the property of the association. An owner who sells an apartment shall have no right to reimbursement of the replacement reserve and contingency reserve funds from either the purchaser of the apartment or the association. The replacement reserve and contingency reserve funds shall not be conveyed or transferred separately from the apartment to which they relate. Instead, they shall be deemed conveyed or transferred with the apartment, even though they are not specifically mentioned in any conveyance, assignment, or transfer of the apartment. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

§16-107-71 Exempt association property; disclosure; transition to association property. (a) The association's reserve study shall clearly disclose all assets for which funds are not included in the replacement reserve study because they are exempt association property. The reserve study shall also contain a brief explanation of why those assets are determined to be exempt association property.

(b) An asset which is deemed to be exempt association property because its estimated remaining life is more than twenty years shall become association property on the date its estimated remaining life becomes less than twenty years, referred to in this subsection as the transition date. The asset shall be included in the association's reserve study for the first budget year after the transition date. In calculating a full replacement reserve for the asset after the transition date, the association may disregard the asset's actual age. Instead, the association may assume that at the beginning of the first budget year after the transition date, the asset's estimated age is zero and its estimated useful life is the same as its estimated remaining life.

Example:

An existing asset has an estimated useful life of fifty years, becomes thirty years old on January 1, 2010, has an estimated remaining life of twenty years, and an estimated replacement cost of \$100,000. Under the standard method of calculation, a full replacement reserve on December 31, 2010, for that asset would be \$62,000 ($\$100,000 \times 31/50$). If an association had not already established a replacement reserve for that asset, the full replacement reserve contribution by December 31, 2010, would be \$62,000 (or fifty per cent of that amount - \$31,000 - for the minimum replacement reserve). If the association adopts the method of calculation permitted by subsection (b), the full replacement reserve contribution required by December 31, 2010, for the same asset would be only \$5,000 ($\$100,000 \times 1/20$), or fifty percent of that amount—\$2,500—for the minimum replacement reserve, although subsequent annual contributions will be higher than in the first example. In

effect, the asset is deemed to be only one year old, not thirty-one years old on December 31, 2010. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: §514A-83.6)

Note: The association's reserve study must clearly disclose which parts of the association property are not included in the reserve study. The study must further disclose the reasons for exclusion, namely, that the asset is inexpensive or has an estimated remaining life of more than 20 years (see definition of exempt association property).

Eventually, certain exempt association property will become association property when the passage of time causes its estimated remaining life to drop below 20 years. At that point, the property is no longer exempt and must be included in the association's reserve study for the following budget year.

Nevertheless, regardless of the actual age and estimated useful life of an asset, the association's reserve study may calculate the reserve contribution for the asset as if it were new on the date it becomes part of the reserve study. That rule can reduce the initial reserve contribution required for an older asset, especially if an association has not previously established a reserve for the asset.

§16-107-72 Borrowing and special assessments to fund replacement reserves. Provided an association assesses and collects sufficient funds to comply with the law and these rules, the association board may:

- (1) Transfer funds between the separate, designated funds required by section 16-107-66, subject to the requirements of that section;
- (2) Borrow funds, subject to the requirements of section 514A-82.3, HRS; and
- (3) Specially assess the apartment owners; to pay the cost to maintain, repair, or replace assets of the association. This section shall apply if the board underestimates the reserve requirements for an asset, or if the cost to maintain, repair, or replace an asset will reduce the association's replacement reserve funds to less than fifty per cent of a full replacement reserve during any budget year.

Example:

An association's full replacement reserve requirement is \$500,000, but the association has only \$250,000 of that amount in cash, as the law permits. The association's replacement reserve account designates \$200,000 of the

\$250,000 to replace its roof in 2001 (i.e., after the transition period ends on January 1, 2000). In 2001, the association replaces its roof on schedule. If the association spends all of the \$200,000 designated in its replacement reserve account for the roof, large assessments will be necessary to re-establish fifty percent of a full replacement reserve in cash by the end of 2001.

Replacing the roof will reduce the association's replacement reserve requirements during 2001 by \$200,000, from \$500,000 to \$300,000 (to which must be added, however, the funds required during 2001 for the other association assets). Nevertheless, spending the \$200,000 will also reduce the association's replacement reserve funds by \$200,000, from \$250,000 to \$50,000 (plus whatever the association collects during 2001).

Thus, by the end of 2001, the association will have only \$50,000 in reserves, but need at least \$150,000 (i.e., fifty per cent of its full replacement reserve requirements of \$300,000). Therefore, the association must collect at least \$100,000 by the end of 2001 to reach the minimum replacement reserve of \$150,000 (plus whatever else the reserve study indicates is necessary for other assets).

To reduce the hardship, the board can fund the expenses for the roof by borrowing or by special assessments. Even if the association has designated a specific fund in its replacement reserve account for the asset, the board may also transfer the money in that fund to other designated funds. Essentially, the section permits the board to use cash on hand, special assessments, borrowing, or any combination of the three to replace the roof and reduce the hardship on the owners. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

Note: The 1992 amendments to Section 514A-83.6 require an association to collect only fifty percent of a full replacement reserve (i.e., "statutory replacement reserves"). Nevertheless, they are clear that the association must reach that level of funding at the end of each year, regardless of the association's expenses for reserves during a budget year. Therefore, each year, the board must collect sufficient funds to have at least fifty percent of a full replacement reserve in the association's reserve account. (Note that for this purpose, reserve funds cannot include borrowed funds but must be cash or cash equivalents.) If the association funds its reserves under a cash flow plan, its reserves must be one hundred percent funded.

On the other hand, the board has the option of relying on special assessments or borrowing for the remainder of the association's reserve requirements. The board has the same option if its calculations to establish an adequate reserve for an asset proved incorrect. Given the imprecise

nature of reserve calculations, a shortfall in funds may be common, despite good faith efforts by the board. The basic principle is that an association may borrow to put the money into the project but not to put the money into the bank.

§16-107-73 Leasing of association property. An association board may lease rather than buy property to repair or replace any association property. Property which meets the definition of association property shall be deemed an asset of the association and must be included in the association's reserve study, regardless of whether the association owns or leases the property. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

Note: *The board has the option of leasing property and this section specifically recognizes that right. Although not owned by the association, leased property, must often be maintained and repaired by the association. Eventually, leased personal property and fixtures must also be replaced. Therefore, leased property must be included in the association's reserve study.*

§16-107-74 Distribution of budgets and reserve studies. An association board shall distribute the annual operating budget required by section 514A-83.6(a), HRS, at least thirty days before the date of the association's annual meeting. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §514A-83.6)

§16-107-75 Enforcement. If an association board fails to prepare an annual operating budget or replacement reserve study in compliance with the requirements of section 514A-83.6, HRS, or this subchapter, an association member may enforce those requirements. The association member may collect the costs of enforcement in compliance with the procedures provided in section 514A-94, HRS, including fees and costs incurred by the owner. If an arbitrator or judge determines that a board or board member has breached a fiduciary duty by intentionally ignoring the requirements of section 514A-83.6, HRS, or this subchapter, the judge or arbitrator may award the owner's fees and costs of enforcement against the board or board members, rather than against the association. [Eff. 1/2/95] (Auth: HRS §§514A-83.6, 514A-99) (Imp: HRS §§514A-82.4, 514A-83.6)

Note: *Section 514A-83.6(h) puts the burden of enforcing the reserve requirements on the owners. The Real Estate Commission does not enforce those requirements, although it may request a copy of the association's annual operating budget (see Section 514A-83.6(e), HRS). Thus, owners may face a considerable burden if their board fails to follow the reserve requirements. This rule allows an arbitrator or judge to impose the costs of enforcement directly against the board or certain board members in a*

proper case, i.e., where the board has intentionally failed to follow the law or rules.

