Rainy Day Money – Condo Style

Reserve Fund Obligations

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Do you live in a condominium conversion? Are your reserves underfunded? Then read on. You may be able to recover millions of dollars from your sponsor.

Sponsors of newly constructed condominiums have extensive obligations concerning the physical construction of their condominium projects. But sponsors of condominium conversions really have only one material obligation: to provide sufficient funds for a reserve fund. If sponsors don't leave large enough reserves, condominiums may not have sufficient capital to perform necessary remedial construction work, leaving buyers with potentially uninhabitable homes. (So long as the offering plan discloses that the building is deteriorating, that condition stands as no barrier to the completion of the conversion process.)

Our law firm has recently been retained by a number of converted condominiums with underfunded reserves. Discovering and prosecuting the underfunding can result in the recovery of hundreds of thousands – if not millions – of dollars to unit-owners and boards. To recover these funds, certain questions must be asked and answered. First, how much money must a sponsor provide? Second, as a unit-owner, board member, or managing agent, how can you discover whether your reserve fund is underfunded? Third, what are your enforcement options?

The Reserve Fund Law

Sponsors who file offering plans for the conversion of rental buildings to condominium ownership in New York City under General Business Law 352-eeee must comply with Chapter 8, Title 26, of the Administrative Code of the City of New York, otherwise known as Local Law 70, the so-called Reserve Fund Law. This law mandates that sponsors of condominium conversion projects provide condominiums with reserve funds at least equal to statutorily calculated minimums.

Sponsors must provide a reserve fund in an amount no less than three percent of the total price of all the units offered for sale – specifically, the "sum of the cost of all units in the offering at the last price which was offered to tenants in occupancy prior to the effective date of the plan regardless of number of sales made."

In order to properly calculate the total price, a sponsor must (1) include the offering prices of all units for sale by an offering plan, and (2) use the offering prices according to the formula prescribed by the statute.

The first part is simple. The sponsor must include the offering prices of all units in its calculation. This includes residential units, commercial units, roof units, parking units, and storage units.

The second part of the calculation is more complicated, which makes it possible for a sponsor to use artificially lowered offering prices to reduce its reserve fund obligations, without the condominium board or unit-owners ever realizing that a deception is taking place. "Last price which was offered to tenants in occupancy prior to the effective date of the plan" means that the sponsor must use the price it offered to tenants in occupancy the day immediately before the sponsor declared the offering plan effective. There is no ambiguity in the statutory phrase – the words of the statute are clear and must be given their natural and plain meaning.

Rather than follow the literal and proper calculation of total price, sponsors may try to limit the amount of the reserve funds they deliver to condominiums by calculating total price based on the last *discount* price offered to tenants in occupancy instead of the actual last price. Because of threshold sale requirements necessary for offering plans to be declared effective, sponsors frequently offer tenants in occupancy discount rates during the mandatory 90-day exclusive sales period, during which only tenants in occupancy may sign purchase agreements for their units.

However, it is common for sponsors to fail to meet the threshold sales requirements during the exclusive sales period, so the discount prices expire before the date the offering plans are declared effective. In these situations, the last price offered to tenants in occupancy is not the discounted exclusive insider price but the usually substantially higher price offered to outsiders.

However, actually finding this discrepancy requires a bit of detective work. A typical condominium conversion goes through numerous amendments, sometimes as few as five, often more than 20. Any one of these amendments, not necessarily the last one, can reveal the very last set of prices immediately before the plan became effective. Although it is a criminal act to do so, sponsors looking to make their reserve fund obligations as small as possible sometimes base their calculations on the lower insider price tables, figures that are actually obsolete in most cases before the plan is effective. Thus, they are relying on board attorneys' and purchasers' attorneys' lack of thoroughness in checking *all* of the amendments to keep their low-balling calculations hidden in plain sight.

Therefore, illegally relying on the discount prices allows sponsors to calculate their way to substantial savings for them and improper expenses passed on to the board of the converted condominium.

Different Funding Methods and Sponsor Credits

The reserve fund law provides sponsors of conversion projects with two different methods of funding the reserve fund of a condominium: (1) funding the entire reserve fund within 30 days of the first closing, or (2) funding the reserve fund over the course of five years with a "mandatory initial contribution." The mandatory initial contribution must be established as a minimum of one percent of the total price.

However, sponsors who choose to use the second method can fund less than the minimum one percent mandatory initial contribution by taking credits against the mandatory initial contribution. Sponsors may take a credit for the cost of "capital replacements," which began after an offering plan was submitted for filing, but before it was declared effective, in an amount not to exceed the lesser of: (1) the actual cost of "capital replacements" during the applicable period, or (2) one percent of the total price. A "capital replacement" is a "building-wide replacement of a major component of any of the following systems: (1) elevator; (2) heating ventilation and air conditioning; (3) plumbing;

(4) wiring; (5) window; or a major structural replacement to the building; provided, however, that replacements made to cure code violations of record shall not be included."

In order for a sponsor to take a credit against the mandatory initial contribution, it must set forth in the offering plan or amendments thereto its intention to take such a credit, and what capital replacements it will make/have made together with the actual or estimated costs thereof.

To investigate a questionable credit disclosed in the offering plan or amendments, board attorneys should research the Department of Buildings job filings. These filings, easily accessible online, can indicate start dates, job descriptions, and estimated costs for the claimed work. The Department of Buildings website also lists violations against each property, thus enabling board attorneys to determine whether a credit was impermissibly taken to cure a violation. Board attorneys should also hire engineers and/or architects to inspect the capital replacements to (1) determine whether the work was actually completed, (2) determine if the work was actually a replacement, and (3) compare their findings with the inspection report commissioned by the tenants in occupancy before the offering plan's acceptance for filing.

It is relatively rare that a condominium conversion takes place without any report prepared by engineers or architects employed by the tenants in occupancy, but in those unusual cases, boards should avail themselves of whatever inspection reports were gathered by purchasers of particular units in the complex.

Enforcement

The reserve fund law provides for civil and criminal penalties for violations. Criminal penalties include criminal liability and fines – up to two times the amount required to be funded by the reserve fund law, which was not funded, and civil penalties – $1,000 per day for each day the reserve fund was not

fully funded, with a maximum civil penalty equal to the full amount of the statutorily calculated reserve fund.

Thus, a sponsor who short-funds the reserve faces potentially quadruple liability: the amount of the reserve, plus that same amount again as a civil penalty, plus double that as a criminal fine. The reserve fund law empowers the Department of Housing Preservation and Development to enforce it on behalf of the City of New York. Further, the New York State Office of the Attorney General, under the Martin Act, has the power to start litigation on behalf of the state against sponsors who fail to fulfill their reserve fund obligations.

In addition, the statute specifically provides that "nothing contained in this section shall impair any rights, remedies or causes of action accrued or accruing to purchasers of… condominium units," meaning that unit-owners and boards may privately begin ligation directly against sponsors. Therefore, individuals and/or boards may be able to make out causes of action for breach of contract, fraud, and/or negligent misrepresentation.

When choosing enforcement mechanisms, it is important to realize that governments at every level are currently facing serious funding problems, depriving them of the ability to meet needs at even the most basic levels. Since the governmental agencies have the discretion but not the requirement to act against conversion sponsors, in many scenarios governmental assistance may be a vain hope and the only real relief may be for boards that hire outside counsel to enforce the law through the courts.

In New York City condominium conversions, unit-owners and boards should scrutinize their reserve funds to ensure that the condominium's sponsor complied with the reserve fund law, because discovering and prosecuting underfunding can result in the recovery of substantial dollars to the condominium.