The Practical Guide to Homeowner Association Management
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How to Fund Litigation When Your Condo/HOA Didn't Budget for It

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An HOAleader.com reader asks: "We're a small (11 homes zoned residential estate) Colorado self-managed HOA. One of our owners decided to install a steel shipping container over the architectural review committee denial of their request. They now claim (wrongly) that the ARCC didn't act within the statutory 30-day required by the CCRs at the time.

They've also amassed five trailers and park a commercial truck not in a fully enclosed garage. They're trying to use a poorly worded CCR sentence to justify these items. The board's enforcement actions have resulted in their filing a lawsuit.

When we passed this year's budget, this litigation wasn't anticipated. We have reserve funds beyond what the reserve study requires, and this funding has been used to pay for this enforcement. Does the board have the authority to pursue this enforcement without owner approval or comment? Is there a limit on how far a volunteer board can deviate from a presented and approved budget element?"

Here, we ask our experts the funding question: Can a board use excess reserves to pursue litigation to budget?

Reserves as Funding Options

Funny thing: HOAleader.com just had an entire webinar on building and using reserves. Our experts' general advice was to avoid using reserves for things for which they're not earmarked.

That's also the practice recommended by Zulema Mendoza, LCAM, regional vice president at KW Property Management, who oversees about 20 condo and HOA communities in Southwest Florida and North Carolina. "Reserves are meant for the replacement of the capital assets," she says. "I'm not an attorney, but I'd venture to say no, the community shouldn't use reserves to fund litigation. But they could recast their budget and enter money to allow for that expense."

Ditto in Michigan, reports Jeff Vollmer, a partner at Makower Abbate Guerra Wegner Vollmer PLLC, whose firm advises nearly 2,000 association clients throughout Michigan. "In Michigan, that's not at all possible," he says. "State law mandates that they can be dedicated only toward the major repair and replacement of common elements. That's for condos; we don't have a separate statute for HOAs."

For Vollmer's clients, the solution would likely be a special assessment. "I think if we're in the middle of the fiscal year, and most documents are set up this way, the board has the right to levy an additional assessment in its discretion if the existing operating funds are insufficient for the administration of the association," he explains. "Litigation to enforce the community's restrictions fits in that definition. So this would be an opportunity to levy that additional assessment"

The law is more flexible in Missouri and Illinois. "In Missouri, unless it says something different in the governing documents, the budget and reserves are just a tool," notes Todd J. Billy, CCAL, an attorney at The Community Association Lawyers in St. Louis, who is licensed in Missouri and Illinois and has more than 1,000 active condo and HOA clients. "We always say we're one bad winter away from blowing our budget and our reserves.

"I tell my clients that first they should recognize that things like the budget are tools to help and educate us," he notes. "But they're not so iron clad and inflexible that they prevent us from doing what we have to do."

In Illinois, it's possible to use reserves to fund litigation—but Michael Kim, of counsel at Schoenberg Finkel Beederman Bell Glazer in Chicago, who represents about 500 associations, stresses the practice technically creates a loan that has to be paid back.

"That's somewhat common in situations where, at least for the near term, there's a need to come up with cash, and the operating side of everything is spoken for," he says. "There can be an arrangement where the board will essentially borrow from itself, meaning from the reserves as an advance to the operating fund. However, it wouldn't be necessary to treat it as an advance if the subject of the litigation is a capital item, such as a construction defect.

"But if it's a noncapital item at issue in the litigation, the board need to consider appropriate documentation to evidence borrowing or the obligation of one fund to the other so that, at some point, that situation can be rectified," notes Kim. "Sometimes that's an interim measure. But if it's going to be a long-haul situation, you have to remember that the reserve fund is there for a purpose.

"If you have capital needs, you have to watch that practice of borrowing" he advises. "Those funds are meant to take care of the infrastructure of the property. If you're very comfortable in what you have in reserves, then it's possible to do that short-term self-financing or borrowing between the two funds—but that has to be paid back. If you're trying to avoid a special

assessment for now, you have to give thought to increasing assessments to replenish those reserve funds or doing a special assessment later."

And don't underestimate how long the litigation might continue, Kim adds. "If the litigation is ongoing, cases can take 2-5, even 10 years, to be resolved, and you may have an appeal," he says. "You have to be thoughtful about the timing of the litigation; often, it won't just be a six-month situation but a six-year situation. You can't be cavalier about borrowing from the reserves because you'll ultimately need to repay those."

Aye, There's the Rub

Have you figured out the underlying problem here? It's the lack of budget for litigation in the first place. "The underlying issue for associations is that they don't budget for a lawsuit" laments Billy. "Most don't."

So for Billy, it would be acceptable to borrow from the reserves for now, but this association needs to improve some of its practices. "They should be overly transparent with the costs of the litigation to the owners," he says. "They shouldn't be discussing legal strategy, but they should be saying, 'Here's what we anticipate in terms of steps,' but not strategy.

"Boards in this situation should be overly transparent about the money," notes Billy. "They should also be more diligent in managing these types of risks. They do that by working with their attorney and insurance professionals."

Mendoza agrees. "Community associations are businesses, so there's always litigation," she says. "Several of our associations fund for general litigation matters, and then they fund for specific litigation matters. If they expect to spend the money on litigation, they'll consult with their attorney and say, 'How much should we fund?' Then they'll put that line item in their budget."

Is This Worth Fighting Over?

On a final note, we wonder whether thumbing your nose at an architectural committee denial, along with a smattering of trailers and a commercial truck on a property, are worth fighting over if you don't have a litigation budget.

Our experts generally think so. "The decision is based on the community and the community-wide standards," says Mendoza. "Allowing a situation like that sets a precedent, and the next homeowner could add five more trailers. Where does that stop?"

Vollmer leans that way, too. "In an 11-home community, probably," he muses. "It's one of those things where you have to make your stand on something. If it's becoming such a nuisance where it's destroying the fabric of the community, I think this the one to go after."

For Billy, the question is: If not now, then when? "Courts in Missouri say the governing documents should reflect what the community wants," he explains. "If the community wants to prohibit this type of activity, it has to step up. The hard part is deciding how much you care about this problem. If you don't care enough to litigate it, it probably shouldn't have been in the governing documents to begin with."