New York Law Journal
SERVING THE BENCH AND BAR SINCE 1888
WWW.NYLJ.COM
An ALM Publication
VOLUME 263—NO. 15
THURSDAY, JANUARY 23, 2020

Outside Counsel

The Reserve Fund Law and Its Many Unanswered Questions

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The process of converting a rental building in New York City to a condominium or co-op is a complicated one, involving many elaborate statutes. Local Law 70 of 1982, now Title 26, Chapter 8 of the New York City Administrative Code, colloquially known as the "Reserve Fund Law," is one of them. The Reserve Fund Law requires sponsors seeking to convert a New York City building with residential units to condominium or co-op ownership to establish a reserve fund in order to provide the building with adequate funding to make capital repairs, replacements, and improvements to the building for the health, safety, and welfare of the residents (the Reserve Fund). But, the Reserve Fund Law is a byzantine and hyper-technical law that has rarely been interpreted by the courts. Recently, in *Bd. of Managers of 150 E 72nd Street v. Vitruvius Estates* (*Vitruvius*), the court examined the particulars of calculating the Total Price under the Reserve Fund Law. 173 A.D.3d 589 (1st Dept. 2019), aff'd on different grounds, 2018 N.Y. Slip Op. 31213[U], 10-11 (Sup. Ct., NY Cty. 2018).

'Vitruvius' presented two issues related to the Total Price: (1) what was the "last price" offered to tenants in occupancy prior to the effective date of the plan; and (2) could commercial units be included in the calculation of the Total Price.

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Calculating the Total Price To Fund the Reserve Fund

The Reserve Fund Law requires the sponsor to stock the Reserve Fund in an amount equal to 3% of the "Total Price," which the law defines as the sum of all the units being offered for sale at the last price that was offered to tenants in occupancy prior to the effective date of the offering plan. See Reserve Fund Law 26-702(b) (2); 26-703 (a) and (b). *Vitruvius* presented two issues related to the Total Price: (1) what was the "last price" offered to tenants in occupancy prior to the effective date of the plan; and (2) could commercial units be included in the calculation of the Total Price.

With respect to the former issue, looking to the plain words of the statute, Judge Sherwood of the lower court found that the price "in effect *just prior* to the effective date of the plan" forms the basis of the Total Price calculation, and

thus held that the price offered in a plan amendment that was made contemporaneously with the plan being declared effective did not form the basis for the Total Price calculation. The First Department disagreed, finding that "although the discount price in [that amendment] was made effective simultaneously with the acceptance of the amendment for filing, the fact that the price was made available retroactively to any tenant who had purchased a unit under the original plan or any amendment preceding [that amendment] renders it the lowest price offered 'prior to the effective date of the plan.'" The First Department, quoting a 1991 New York County Supreme Court decision by Judge Schlesinger, further reasoned that this "discounted price promotes public policy by 'encouraging the sponsor to lower the insider price, which inures to the benefit of the tenancy in occupancy,' and 'gives the sponsor an incentive to fund the entire reserve fund at closing, which is beneficial to all shareholders.'"

Notably, the express purpose of the Reserve Fund Law set forth in the statute is to create a "reserve fund to be used exclusively for making capital repairs, replacements and improvements necessary for the health and safety of the residents of such buildings." Reserve Fund Law 26-703(a). But the First Department, latching onto a public policy argument that favors a lower Total Price, thereby lowering the reserve fund, rendered an otherwise clearly enunciated statutory purpose ambiguous. After *Vitruvius,* a sponsor can, at any point, in any amendment, even after the plan is declared effective, retroactively lower the prices offered to the tenants in occupancy, thus lowering its reserve fund funding obligations.

In reversing Justice Sherwood's opinion, the First Department seemed to balance this potential blow to the reserve fund, by also holding that commercial units should be included in the calculation of the Total Price.

Not only did the First Department reverse the Supreme Court, it also went against a May 4, 2015 memorandum prepared by the New York State Department of Law, which articulated a policy that "commercial units" are excluded when calculating the "Total Price." See State of New York, Department of Law, Real Estate Finance Bureau, Memorandum re: Guidance on Compliance with the NYC Reserve Fund Law (May 4, 2015). Both the Supreme Court and the Department of Law reasoned that a plain reading of the Reserve Fund Law meant that non-residential units should not be included in the Total Price. The First Department took exception with these views, holding that the word "all" in the definition of "Total Price" was unambiguous and did not distinguish between residential and commercial units and thus commercial units should be included in the calculation.

The Reserve Fund Credit

Under the Reserve Fund Law, the sponsor may take a credit with respect to the mandatory contribution for capital replacements it performs between the initial submission of the offering plan to the Department of Law and the date the offering plan is declared effective (the Reserve Fund Credit). Reserve Fund Law 26-703(c). The amount of the credit is limited to the lesser of (1) the actual costs of the capital replacements, and (2) 1% of the Total Price. The Reserve Fund Law defines the term "Capital Replacement" as follows:

> 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.

Reserve Fund Law 26-702(c). Courts have not interpreted the key terms of this definition. The lower court in *Vitruvius* only nominally addressed the issue of the Reserve Fund Credit, likely because the parties made no argument as to whether the capital replacements proposed by the sponsor qualified as "building wide."

The dearth of case law on the Reserve Fund Law leaves many questions for all condo/co-op stakeholders. For example, the following remain unanswered:

(1) Whether the required disclosure of the capital replacements must be made before the offering plan is declared effective;

(2) Whether the capital replacements need to be completed, not just started prior to the offering plan being declared effective; and if not, can the sponsor claim a credit for capital replacement work performed after the offering plan is declared effective;

(3) What type of work qualifies as a capital replacement;

(4) What sort of work exemplifies "building-wide," "major component," or "major structural replacement?"

How these questions are answered can have far-reaching consequences for both sponsors and residential boards because if a sponsor's disclosed capital replacements do not qualify as such, then the Court can mandate credit must be refunded to the residents.

Use of the Reserve Funds

Because the purpose of the Reserve Fund is to "mak[e] capital repairs, replacements and improvements necessary for the health and safety of the residents of such buildings," the lack of case law leaves many additional questions unanswered and open to critical interpretation:

(1) What is a "capital repair"?

(2) Who or what determines if the work is "necessary"?

(3) Whether the capital repair was for the "health and safety of the residents;" and

(4) Could "residents" include commercial tenants and its occupants?

These issues are usually magnified during the change-in-control period when the sponsor-led board of managers or directors hands-off control of the building to the first residential unit owner board which inherits the sponsor controlled board's actions and resolutions and which may also inherit property management and professional firms initially retained by the Sponsor. If the new residential board members are not well-versed in laws like the Reserve Fund Law and unwittingly accept the prior board actions concerning the kinds of issues that arose in *Vitruvius*, unintended financial consequences could result, costing the residents of the building thousands or even millions of dollars without them even knowing it—until it's too late.

During this period, serving as fiduciaries, residential boards taking over from sponsor boards would be prudent to seek assistance from new legal, accounting, and property management firms having no relationship to the sponsor at the outset of their terms to conduct a review of the sponsor's reserve fund computations. Similarly, sponsors and their professionals would be prudent to work transparently with the new residential boards and their professionals to avoid messy, hyper-technical, and document-intensive lawsuits like the one in *Vitruvius*.