STATE OF NEW YORK **DEPARTMENT OF LAW**

REAL ESTATE FINANCE BUREAU

M E M O R A N D U M

Re: Guidance on Compliance With the NYC Reserve Fund Law[1] **Date: May 4, 2015**

I. Introduction

Landlords in New York City seeking to convert buildings with residential units to condominium ownership must comply with Local Law 70 of 1982 (Title 26, Chapter 8 of the New York City Administrative Code, 26-701 *et seq.*), commonly referred to as the Reserve Fund Law.[2] Additionally, sponsors are required to disclose compliance with Reserve Fund Law in the offering plan. Required disclosures are set forth in 13 N.Y.C.R.R. § 23.3(ac)(1) through (6) and the Reserve Fund Law. Violations of the Reserve Fund Law carry both civil and criminal sanctions. The Attorney General can and has sought injunctive and monetary relief against sponsors violating their offering plan representations regarding compliance with the Reserve Fund Law. This memo is a guidance document meant to assist sponsors in complying with the disclosure requirements of the Martin Act and governing regulations regarding the Reserve Fund Law.[3]

A reserve fund must be established pursuant to the Reserve Fund Law. A working capital fund, which may be established by a sponsor, is not a reserve fund.

[1] This memo has been reviewed by the City of New York Department of Housing Preservation and Development (HPD). HPD is the agency charged with oversight of the Reserve Fund Law. HPD approves the statements made in this memo regarding the Reserve Fund Law.

[2] Because most conversions involve condominiums, this memo will focus exclusively on condominium conversions. However, the same analysis governs cooperative conversions. The Reserve Fund Law and DOL regulations governing cooperative conversions also require certain disclosures regarding reserve funds.

[3] Buildings where construction was completed within three years prior to conversion may be exempt from the requirements of the Reserve Fund Law upon successful application made to the City of New York Department of Housing Preservation and Development. *See* N.Y.C Admin. Code § 26-703(d).

II. Reserve Fund Calculations

The Reserve Fund Law provides two methods of calculating mandatory contributions. The first option requires the entire contribution to be funded within thirty days of closing of the conversion (*i.e.*, within thirty days after the first residential unit closing has taken place). The second alternative permits the contribution to be paid out over five years. The sponsor may elect which of the two alternatives it prefers at the time of the initial contribution is made, and such decision must be disclosed in the post-closing amendment.

a. Reserve Fund is Funded Within 30 Days of the First Closing ("Option 1")

The first option requires an initial contribution of 3% of the "total price," which is the sum of the offering of all units in the offering at the last price that was offered to tenants in occupancy prior to the effective date of the plan.[4] This means that the total price is the sum of the tenant offering prices of all residential units that were offered for sale, whether occupied or not (*i.e.*, the amount on the Schedule A prior to the effective date, excluding commercial units). Funding of the initial contribution must be made within 30 days of the first residential unit closing, referred to in the Reserve Fund Law as "the closing of a conversion pursuant to an offering plan," and the Reserve Fund account must be transferred to the condominium board (*i.e.*, the reserve fund monies cannot be in an account owned by sponsor).

Sponsor must determine if any units should be deducted from Schedule A when calculating the total price. Based upon a plain reading of the Reserve Fund Law, the superintendent's unit, ancillary spaces (*e.g.*, wine cellars, storage spaces and other amenities such as parking that are separately deeded or licensed), and non-residential units (*e.g.*, commercial units, community facilities) may be excluded. The superintendent's unit would be excluded only if the unit is not offered for sale to the public. If this is not the case, and such unit is being offered to a bona fide purchaser, then it must be included in the calculation. All non-residential units are excluded because the Reserve Fund Law makes references to "bona fide purchasers," which are residential purchasers under the Martin Act. This section is subject to taking the credit as described in c below. In this case the entire payment is considered the mandatory initial contribution.

b. Reserve Fund is Paid Over Time ("Option 2")

Option 2 is more complex and has a number of steps, as follows:

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[4] Turtle Bay Towers Corp. v. Welco Associates, 228 A.D.2d 189, 190 (1st Dept. 1996) ("last price" for purposes of calculating the amount of the reserve fund is the last price prior to the plan being declared effective and not the last price following the 90-day exclusive period offered to tenants in occupancy following acceptance of the plan for filing by the DOL); Bd. of Managers of 184 Thompson St. Condo. v. 184 Thompson St. Owner LLC, 106 A.D.3d 542, 542 (1st Dept. 2013).

1. It is necessary to determine 1% of the total price, which is the amount of the "mandatory initial contribution" to the reserve fund.

2. The sponsor should determine the credit it will claim for capital replacements.

3. Next, the sponsor should calculate 3% of the actual price for the sale of those residential units in contract on the date the offering plan is declared effective and determine whether this is less or more than the mandatory initial contribution. If the aggregate amount of actual sales prices by that time is less than the mandatory initial contribution, the sponsor must contribute the mandatory initial contribution to the condominium. However, if the total Credit claimed is the maximum permitted under the law, the mandatory initial contribution will equal the amount of the Credit, so there will be no mandatory initial contribution. If the Credit is less than 1% of the total price, the difference should be paid to the condominium board within 30 days of consummation of the plan. Note that the full Credit is always applied to the initial contribution to the reserve fund (which is the mandatory initial contribution). There is no credit available thereafter. An example of how to calculate the reserve fund mandatory initial contribution under this option is as follows:

3% of total price:	$150,000
1% of total price:	$50,000
Actual sales for effectiveness:	$1,000,000
3% of actual sales:	$30,000
Mandatory initial contribution:	$50,000

BUT

Maximum Credit based on capital replacements:	$50,000

Accordingly,

Mandatory initial contribution:	$0

3% of actual sales is less than 1% of total sales, so the mandatory initial contribution would be $50,000. However, because sponsor has a Credit of $50,000 (see (c) below), there would be no mandatory initial contribution.

4. For each closing pursuant to purchase agreements that are executed after the date the plan is declared effective, and within five years of the first closing, the sponsor must contribute to the reserve fund account an amount equal to 3% of the actual sales price of the unit no later than 30 days after the closing of the sale. In the event of a bulk sale, the

contribution may be paid at the time of bulk sale or by the successor sponsor upon each sale. The intent of the parties should be disclosed in an amendment to the offering plan.

5. If, on the date that is five years and thirty days following the first closing, the total amount contributed to the condominium reserve fund is less than the amount that would have been payable under Option 1, the difference must be paid to the condominium board on that date. Otherwise, no payment is due.

Because prices can be expected to increase over time, the reserve fund payments under Option 2 may be more, and in some cases substantially more, than they would have been had a sponsor funded using Option 1; under that circumstance, sponsor will receive no refund or allowance at the conclusion of the five-year period.

Other than as set forth above, no contributions are due after five years from the date of the first closing .

c. Capital Replacements Credit (the "Credit")

The sponsor is permitted a credit against this mandatory initial contribution for qualifying work performed between the initial submission of the offering plan to the Department of Law (the "red herring") and the date the offering plan is declared effective. Courts have held that work for which a credit is claimed may not be utilized for MCI increases as they relate to rent regulated tenants. The work, which must be identified in the offering plan together with the actual or estimated cost thereof, is limited to "capital replacements." For purposes of the Reserve Fund Law, capital replacements must include only building-wide replacements of a major component of certain systems, specifically the elevator, heating, ventilation and air conditioning, plumbing, wiring, windows, as well as a major structural replacement to the building. Replacements made to cure code violations are not considered capital replacements and thus the sponsor may not use reserve funds to cure violations of record. The amount of the Credit is limited to the lesser of (i) the actual cost of the capital replacements, or (ii) 1% of the total price. This means that if the maximum credit is claimed (1%), the reserve fund contribution when funding in full within 30 days of the first closing shall be 2% of the total price. An example of how to calculate the reserve fund contribution and the maximum credit are as follows:

Total price of offering:	$5,000,000 (this is for residential units only)
3% of total price:	$150,000

Capital replacements made by sponsor between the date the red herring is submitted and the date the plan is declared effective:

Elevator:	$50,000
Plumbing:	$50,000
Windows:	$150,000

Total costs of capital replacements: $250,000

1% of total price: $50,000

Maximum credit = $50,000 (the lesser of the actual costs of capital replacements and 1% of the total price)

3% of total price ($150,000) minus the maximum credit of $50,000 means that the sponsor must establish a reserve fund to be delivered to the board in the amount of $100,000.

III. Mandatory Reserve Fund, Warranty and Useful Life Disclosures

At the time of plan submission to the Department of Law, the following disclosures must be made:

a. Front Cover: The front cover of the plan must provide an estimate of the reserve fund, which should be noted with an asterisk, and a disclaimer that states the estimate is the minimum amount required under the first alternative under the Reserve Fund Law, and that the actual amount of the reserve fund cannot be determined until the plan is declared effective. Refer readers to the section of the plan entitled "Reserve Fund" for additional information.

b. Reserve Fund Section/Special Risks:

1. Provide a summary of the anticipated amount to be placed in the reserve fund under the first alternative. Describe the second alternative. In either the Reserve Fund Section or in Part II, include a complete copy of the Reserve Fund Law.

2. Disclose as a special risk whether sponsor has knowledge of any known capital items that are necessary or likely to become necessary within 5 years from the date of first year of operation set forth in Schedule A and B.

3. Disclose the restrictions on the use of the funds pursuant to the Reserve Fund Law.

4. Identify when the funds may be used by the non-sponsor controlled board. If funds will be used when sponsor controls the board, so state. If this is intended, include special warning language on the front cover of the plan.

5. Identify which capital replacements are to be credited against sponsor's contribution. State the work commenced after the initial submission that is intended to be completed before the plan is declared effective.

6. If applicable, disclose the section of the by-laws that authorizes the establishment of the reserve fund.

7. Discuss whether the reserve fund will be sufficient to pay for the replacement of capital items likely to be needed as disclosed in the description of property and building condition report.

8. Identify the condominium's available means and options to finance needed capital expenditures such as renewal or replacement of building components or systems or to remedy major building defects.

9. Disclose that reserve funds pursuant to the Reserve Fund Law shall never been used to reduce common charges.

10. Disclose the useful life of the boiler and burner, as required by 13 N.Y.C.R.R. § 23.7(k) (3) and (4).

11. Identify any warranties for capital replacements and any limitations on the warranty, including time limitations and whether the warranty covers materials only.

10. State that neither the Department of Law nor any other governmental agency has passed upon the adequacy of the reserve fund, and that the obligations under the Reserve Fund Law shall not be waived under any circumstances.

11. Disclose the obligation of the board of the condominium to provide a semi-annual report with respect to all deposits into and withdrawals from the reserve fund as mandated by the Reserve Fund Law.

12. Disclose any other matter as required at 13 N.Y.C.R.R. § 23.3(ac)(1) through (6).