New York

Is N.Y.C.'s Reserve Fund Law antiquated?

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In the 1970s and 80s, conversions from residential rentals to cooperative ownership were common and sponsors normally did not make substantial upgrades to buildings as part of the conversion process. Virtually all tenants in buildings undergoing conversion were rent regulated with a right to continue in occupancy indefinitely. It was necessary to convince at least some tenants to buy, which required negotiating with their representatives in order to successfully meet the requirements to convert. The result would be low purchase prices for all tenants, as discrimination among tenants was, and is, prohibited.

Because of the low prices to tenants, there was little money available for improvements. Buildings were often converted as-is without money provided as a working capital or reserve fund for future needs. Moreover, advance payments made by sponsors for such items as insurance and taxes on the real estate often resulted in closing adjustments that could leave a cooperative in debt to the sponsor following the conversion.

With the poor financial position of some buildings following conversion, New York City needed a requirement to provide these newly launched cooperatives with some money for critical needs. That is the genesis of the statutory "Reserve Fund Law," Local Law 70 of 1982, now Title 26, Chapter 8 of the New York City Administrative Code. The motivation for the Reserve Fund Law was to make sure that money was available after closing for cooperatives to make "capital repairs and improvements necessary for the health and safety of the residents."

Much has changed. Condominium conversions have largely replaced cooperative conversions. Today some of the language in the statute seems antiquated and difficult to apply. Condominiums have no building-wide tax obligations that are adjusted with the building. Instead, adjustments with individual purchasers at closing are often far greater in the aggregate than building-wide adjustments. As a result, condominiums often have little or no debt.

New York City rent laws have evolved, and many tenants now pay market rents with no right to renew their leases. These tenants may be moved out when their leases expire early in the conversion process, so there is less incentive to give tenants significant discounts to purchase. To profit in the current market, developers make major upgrades to vacant apartments and the buildings themselves in order to sell at high prices. Whenever possible, they use an available credit against part of their reserve fund contribution. This makes it less likely that these buildings will be converted while needing repairs.

In this environment, the method of funding under the Reserve Fund Law hasn't changed. It is based upon the price of units. Because of the evolving market, unit prices have escalated which may result in a bloated fund for reserves that will not be needed for years. Luxury conversions may be receiving a larger reserve fund than needed, which helps push prices even higher. Other buildings more in need, however, might be receiving the least money.

Under the assumption that funds might be misused, the statute provides for major restrictions on the use of the funds. The reserve fund may be spent for "capital repairs, replacements and improvements necessary for the health and safety of the residents." Other than repairs and replacements, exactly what kind of improvement would be necessary for health and safety? It's hard to imagine too many possibilities, short of modernizing elevator machinery or a remedy for a new hazard that is not yet understood.

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