FINANCING OPTIONS FOR COMMUNITY SCHEMES

In *Alice in Wonderland* by Lewis Caroll, Alice asks the Cheshire Cat, "Would you tell me, please, which way I ought to go from here?". The smiling Cheshire Cat responds, "That depends a good deal on where you want to get to." This exchange between Alice and the Cheshire Cat captures the challenge, complexity and confusion of making decisions when the destination is unclear. Similarly, scheme executives and owners face a multitude of choices in the legislative matrix and market, each with significant consequences, and must clearly define their financial goals to navigate these options effectively.

Community schemes often require substantial funds for maintenance, repairs, or upgrades or to fund an accumulating arrear levy debt problem and the costs required to recover those arrear levies. To address these financial needs, there are several options available, each with its own set of advantages and disadvantages, that should be considered as they are relevant. Ignoring relevant considerations or taking irrelevant considerations into account can be problematic when making a decision.

This article tabulates a summary of the different financing options available to community schemes, including raising special levies, tapping into reserve funds, borrowing, selling arrear levies, and arrear levy insurance, and some of the pros and cons associated with each.

Funding Option	**PROS**	**CONS**
Raising Special Levies	• For sectional title schemes: ○ The trustees have the statutory authority to raise special levies by trustee resolution for unbudgeted expenses.[1] ○ A body corporate must prepare annual financial statements for presentation at the annual general meeting, which statements must include analyses of the amounts due to the body corporate in respect of contributions, special contributions and other charges, classified by member and the periods for which such amounts were owed.[2] • Directly raises some of the required funds without incurring debt, thereby saving on interest and other charges. • For sectional title unit owners, the successor in title becomes liable for the *pro rata* payment of such contributions from the date of change of ownership of the sectional title unit.[3]	• Raising special levies to fund a shortfall caused by an accumulating arrear levy debt problem, passes the burden of the community scheme's indebtedness, caused by arrear levy debtors, onto paying unit owners, which is grossly unfair, and can cause further financial hardship for paying owners. • Existing arrear levy debtors will most probably not pay the new special levy either, causing further financial hardship on paying unit owners, as the special levy will need to be increased against a smaller pool of paying owners compared to total owners, to try to raise the required level of funds. • Has the tendency to place a significant financial burden on owners, particularly those on fixed incomes. • May be met with resistance or disputes among owners. • Can lead to cash flow issues if owners are unable to pay the levy on time.

[1] Section 3(3) of the STSMA.
[2] PMR 26(1)(c)(i) of the STSM Regulations.
[3] Section 3(3) of the STSMA.

		• Not always a transparent process, so not all owners are aware of the purpose and amount upfront, until after the scheme executives have already passed the resolution raising the special levy.

Tapping into the Reserve Fund	• For sectional title schemes:
	  ○ Money may be paid out of the reserve fund at any time in accordance with trustee resolutions and the approved maintenance, repair and replacement plan ("MRRP").[4]
	  ○ A body corporate must prepare annual financial statements for presentation at the annual general meeting, which statements must include analyses of the amounts in the reserve fund showing the amount available for maintenance, repair and replacement of each major capital item as a percentage of the accrued estimated cost and the rand value of any shortfall.[5]
	• Immediate access to funds without needing to raise additional money.
	• No interest or fees, as it is the scheme's own money.
	• Can be a quicker process than borrowing or raising special levies.
		• For sectional title schemes:
		  ○ Accessing the reserve fund depends on the provisions contained in the MRRP, and trustees may be restricted from, or have conditions attached to, accessing the reserve fund.[6]
		  ○ The trustees must report to the members on any such expenditure from the reserve fund as soon as possible after it is made.[7]
		• Depleting the reserve fund can leave the community scheme vulnerable to future unforeseen expenses. The reserve fund will have to be topped up by raising additional levies at the next annual general meeting for the following financial year.
		• May not be sufficient for large projects or unexpected repairs to major capital items.
		• Reduces financial security and may impact the community scheme's financial stability.

Borrowing Funds	• For sectional title schemes:
	  ○ Bodies corporate are empowered by statute to borrow money, upon special resolution.[8]
	  ○ A body corporate must prepare annual financial statements for presentation at the annual general meeting, which statements must include analyses of the amounts advanced to the body corporate by way of levy finance, a loan, in terms of a guarantee insurance policy or
		• For community schemes, like homeowners associations (HOAs), whether a specific HOA is empowered to borrow money, and what resolution is required, depends on the provisions of their constitutional documentation[10] which is not always clear, and may require amendment.
		• Interest and fees (especially if the loan includes hidden raising fees and administration fees) can significantly increase the total repayment amount, and the effective cost of borrowing.

[4] PMR 24(5)(a) of the STSM Regulations.
[5] PMR 26(1)(c)(iv) of the STSM Regulations.
[6] PMR 22(3) and 24(5)(b) of the STSM Regulations.
[7] PMR 24(5)(b) of the STSM Regulations.
[8] Section 4(e) of the Sectional Titles Schemes Management Act 8 of 2011 ("the STSMA").
[10] Such as the constitution of a common law voluntary association or the memorandum of incorporation for registered non-profit companies (NPCs), as well as any adopted rules of the HOA.

	otherwise, setting out the actual or contingent liability of the body corporate and the amounts paid by the body corporate and by any member in terms of such arrangement.[9] • Immediate access to necessary funds for outstanding maintenance projects or payments to creditors and / or for the recovery of arrear levy debts. May allow for larger projects to be undertaken without delay. • Spreads the cost over a longer period, reducing the immediate financial burden on paying owners. • For arrear levy loans, repayments are usually linked to the recovery of the arrear levy debts, protecting the paying unit owners from financial hardship or from having to subsidise their non-paying neighbours – unless the scheme defaults on the arrear levy loan's payment obligations. • Transparent process, as all owners are aware of the purpose and amount upfront.	• For term / project loan funding, repayments are required monthly, which has the potential to strain future budgets if special levies raised fall short when due for collection. • Often requires collateral such as a security cession of and / or notarial bond over unpaid past, present, and future levy contributions, whether levied or not, and other forms of security from the community scheme. • For arrear levy loans, if there is a shortfall in the recovery of the underlying arrear levy debts, the community scheme is still liable for the balance owed on the loan. • There is a risk of a joinder application being obtained against owners if a judgment is taken against a body corporate which remains unsatisfied.[11] • Adoption process can be complex and time-consuming. • Legal fees required for arrear levy recovery is the responsibility of the community scheme.
Selling Arrear Levies	• Quicker influx of cash from selling arrear levy debts to a third party purchaser. • Shifts the burden of collecting arrears, and paying legal fees, to the third party purchaser. • Can improve the community scheme's cash flow and financial stability if arrear levies are sold for full value.	• For sectional title schemes, it is not clear where in the legislative matrix, a body corporate is empowered to sell levies and if so, what type of resolution is required from owners, and unlike the other funding options available, it is not clear what obligation a body corporate has to report on this transaction in its annual financial statements. • If arrear levies are sold at a discount, it results in the community scheme receiving less than the total amount owed, burdening paying unit owners. • Loss of control over the levy collection process and loss of entire upside from collection of full arrear levy amounts. • Potential reputational damage for the community scheme and scheme executives if the third party purchaser uses aggressive collection methods, or if some of the owners were not mad aware of the transaction.

[9] Prescribed Management Rule ("PMR") 26(1)(c)(iii) of Annexure 1 to the STSM Regulations, 2016 ("STSM Regulations").
[11] Section 15(1) of the STSMA.

SECTIONAL TITLE SOLUTIONS

Arrear Levy Insurance	• For sectional title schemes, a body corporate must prepare annual financial statements for presentation at the AGM, which statements must include analyses of the premiums and other amounts paid and payments received by the body corporate and any member in terms of the insurance policies of the body corporate and the expiry date of each policy.[12] • Provides a safety net against future non-payment of levies by covering shortfalls. • Can improve financial planning and stability. • Reduces the financial risk associated with defaulting owners. • Community schemes do not have to pay for legal fees for the recovery of arrear levies.	• Insurance does not cover historical arrear levies, only arrear levies falling due and remaining unpaid after adoption of the levy insurance. • Premiums add to the community scheme's regular expenses and must be budgeted for. • Adoption and claims process can be complex and time-consuming. • Usually subject to exclusions and limitations on claims (maximums) and franchise amounts, or excess amounts, or additional fees. • Does not provide direct cover for funding required for projects.

Just as Alice found herself in a bewildering world where choices were abundant and guidance was often cryptic, scheme executives and owners must navigate many complex financial options. The key to making sound decisions lies in understanding the specific needs and circumstances of the community scheme, and the costs of each option, much like Alice needed to understand her destination to choose the right path. By carefully evaluating each available option and considering all relevant factors, scheme executives (and owners) can make informed decisions that best support the long-term sustainability of their community schemes and members to whom they owe a fiduciary duty.
In the ever-changing wonderland of legislative and market possibilities, clear goals and thoughtful consideration are the compass that will guide community schemes to financial stability and success.

As the Cheshire Cat wisely implied to Alice, knowing where you want to go is the first step in choosing the right path.

FAUSTO DI PALMA
SECTIONAL TITLE SOLUTIONS (PTY) LTD
13 JUNE 2024
SANDTON

*****END OF ARTICLE*****

[12] PMR 26(1)(c)(v) of the STSM Regulations.