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Deficient HOA Budgets and Assessment Delinquencies In Broken Condominium Projects

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Receivers and lenders taking control of "broken condominium projects" (i.e. completed projects where some, but not all of the units have been sold) must be aware of duties, responsibilities and potential pitfalls of stepping into the developer's shoes. Significant project management and budgeting responsibilities to the existing owners and the homeowners' association ("HOA") will become the obligation of receivers and lenders taking over such projects. If these fiduciary responsibilities are not properly understood or addressed, lenders and receivers should be prepared to deal with unpleasant surprises at best, and significant liabilities, at worst.

A foreclosing lender or court appointed receiver who takes control of a broken condominium project or master planned community is often so focused on the goals of completing construction and selling unsold units that it fails to appreciate the developing entity's (developer, receiver or successor lender) fiduciary obligations owed to existing homeowners and the HOA. More often than not, where a significant number of units remain unsold, the developer will still have control of the HOA's board of directors ("Board"), and the developer's agents and employees are the corporate officers at the time the lender or receiver assumes control of the project. The developer, through the control of the Board, owes a fiduciary obligation to both the HOA and its members to manage and operate the HOA and its finances for the benefit of its owner members, and not for the exclusive benefit of the developer. Those same fiduciary obligations become the lender's or receiver's when they take control of a project and they step into the developer's shoes as a member and/or controlling member of the HOA's Board.

The duties, obligations and responsibilities of the Board and officers of the HOA are spelled out in the project legal documents, CC&R's and Bylaws, and include among other responsibilities, the responsibility to assure that the HOA is adequately capitalized, that there are adequate funds necessary to properly operate, manage and maintain its property, to pay bills, that there is adequate insurance coverage, that the developer (or lender in control) performs all acts necessary to enforce the Use Restrictions, Architectural Guidelines, and Rules and Regulations of the HOA.

Adequate capitalization of an HOA is a common problem when units remain unsold and the developer lacks the funds to pay the assessments due on the unsold units. HOA assessments become due on all units on the first day of the month following of the close of escrow for the sale of the first unit within the project, or, in a phased project, the first of the month following the close of escrow for the first unit within a specific phase. Receivers and lenders should immediately determine: (i) whether or not assessments have been paid by the developer for its unsold units, (ii) whether or not the HOA is properly capitalized, (iii) the amount and status of any delinquent assessments, and (iv) the likelihood of collecting on delinquent assessments (both

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from homeowners and from the developer). If an HOA is undercapitalized, delinquent assessments may be a significant expense which receivers and lenders will need to factor into their analysis of a project's financial requirements. An early determination must be made regarding how to fund, who can and will fund the delinquent assessments, and how the Board will meet the on-going obligation to pay assessments pending resolution of issues.

If the lender forecloses, it takes title to the unsold units free of delinquent assessments owed by the developer. The developer will remain personally liable for the delinquencies caused by the non- payment of assessments on its unsold units. If a receiver is appointed and the lender does not foreclose, the developer, as owner of the unsold units, remains liable for the delinquent assessments during the receivership and will continue to amass unless addressed by the receiver.

Neither situation, foreclosure or the appointment of a receiver, will remedy the practical problems created by a shortfall in funds necessary to properly operate and manage a project. If the delinquency is not paid by the developer, the lender or receiver will have to consider its options on how to remedy the deficiencies in both the operating and reserve accounts as a matter of its fiduciary obligations as the controlling interest on the Board and, as a practical matter, how such deficiencies are going to be addressed in order to sell the unsold units. The Board may be forced to apportion the deficiencies in the HOA's accounts among all unit owners in the project that are subject to assessments, including those unsold units, which then become subject to a portion of the aggregate delinquencies. This action may require a vote by the other owner members of the HOA in addition to the Board. The net effect is potentially an untenable monthly assessment which may be problematic for future sales of the remaining unsold units.

Funding sources for remedying the delinquencies must be identified, since it is unlikely that the developer will be able to pay for either delinquent or on-going assessments. The lender may find it necessary to cure the deficit in both the operating and reserve accounts because no other source of funds is available. A determination should be made concerning the status of any security the developer may have posted to guaranty payment of its obligation to pay the monthly assessments on the unsold units (i.e. surety bond or letter of credit). As the controlling member of the Board of the HOA, the lender or receiver will be required to make a demand on any such security to help remedy the shortfall in HOA accounts.

Lenders and receivers will also need to evaluate the sufficiency of the HOA's reserve account. Reserve accounts are established and funded to set aside funds for the future replacement of capital improvements. If the developer has not been paying assessments on the unsold units, then it is almost a certainty that the reserve account will be deficient because required funds were not deposited into the account as required, and to the extent that reserve funds existed, in many instances the reserve funds collected were improperly used to fund operating expenses. There may be other reasons why a reserve account may be deemed deficient, including the fact that there has been a significant suspension in sales or where the units have been rented for a period of time and no reserves had been accumulated during that period of time.

In certain situations, the DRE has issued Orders to Desist and Refrain prohibiting the continued sale of units until a satisfactory solution has been agreed on to resolve the deficits. Lenders and receivers will be obligated to take some action to increase the monthly assessment, to attempt to pass a special assessment to cover the deficiencies, or to simply fund the deficit. Between the required disclosures to new buyers and the high monthly assessment requirement that would result from any such actions, sale of unsold units would be virtually impossible. The only viable conclusion for lenders and receivers is to collect unpaid assessments from the developer, if possible, and delinquent owners and then be prepared to fund the balance.

As part of the financial analysis of a project, receivers and lenders should also be familiar with the budget for the project approved by the California Department of Real Estate ("DRE"). Often, the initial budget approved by the DRE was created and approved prior to the actual completion of construction. Budgets should be reviewed to determine a variety of issues: (i) whether the assessments are still sufficient and realistic for the project as built and currently operated, (ii) whether allocations should be reduced or increased in light of incomplete common area improvements and or amenities, any changes in construction, design, or maintenance costs, or rephrasing of the project, (iii) whether all elements of the project are accounted for in the budget, (iv) whether assessments are reasonable or practical in the current market place, and (v) whether updates need to be made if there had been a suspension in sales activities.

If the project is a phased project, additional facts will have to be evaluated regarding the budget. For example, was the original development plan for the project unrealistic in light of the current much slower absorption rates. Do the original large phases need to be reduced in size in order to meet sales objectives and FHA, FNMA and Freddie Mac pre-sale requirements? Has the developer closed escrows in subsequent phases or annexed phases out of sequence? In any of the above situations, the developer, lender and/or receiver may face excessive assessments that are due and continue to accrue on the unsold units. A determination should be made as to whether the project can be re-phased.

Finally lenders and receivers have a fiduciary responsibility to evaluate whether common area improvements have been completed and delivered to the HOA. If not, a bond or letter of credit should be in place to secure the developer's obligation to complete construction of common area improvements. However, completion and delivery of common area improvements can itself pose serious issues and problems, especially if only a small number of units have been sold. Lenders and receivers must determine the effect of imposing the ongoing maintenance costs of the common area facilities and amenities, and the related amounts for accumulation of reserves, on the HOA, and whether or not it is feasible to increase the monthly assessments by the amounts necessary. It may be that the resulting assessment level would increase to a level that sale of the unsold units without some form of subsidy would be impossible and that existing owners may refuse or be unable to pay the higher assessments.

Many of the conclusions reached on the issues and matters raised in this article may require the lender or receiver to apply to the DRE for an Amended Final Subdivision Public Report and new

budget review. More importantly, failure to adequately assess and address the issues raised may expose the lender or receiver to potential litigation claims for breach of their fiduciary duty, give cause to the DRE to issue an Order to Desist and Refrain prohibiting further sale of units, or, at best significantly impair the ability to successfully achieve the goal of completing sales to members of the general public. Finally, take-out lenders have routinely taken the position that if there is no accepted plan to correct the deficiencies in an HOA's books, they will not fund the financing for new buyers.

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