



To Foreclose or Not Foreclose; That Seems to be the Question

How To Collect Assessments During the Sub-Prime Crisis

*By: David C. Swedelson, Esq., Swedelson & Gottlieb
Tracy Neal, Esq., Association Lien Services*

What a difference a year makes. The sub-prime mortgage crisis seems to be growing as news reports indicate an increasing number of owners defaulting on their home loans with many owing their lenders more than their homes are worth. This crisis is not just affecting lenders and the many homeowners who may have had questionable ability to borrow money in the first place; it is also negatively impacting their homeowners' associations. As assessments (monthly fees) are typically the sole source of an associations' income, many associations are now finding that they are having trouble collecting thousands of dollars in delinquent assessments from owners who in some cases have no equity.

This situation should not have been too much of a surprise as we have recommended for the last two years that associations get ready for the increase in defaults and factor the potential "bad debt" in their budgets. While for more than ten years we have enjoyed a period of increasing value in real estate that correlated with very few owners losing their homes through foreclosure (and thus paying their assessments), those good times, at least for now, are gone.

The purpose of this article is to answer the questions you will likely have regarding assessment collection when delinquent owners appear likely to let their homes go to foreclosure sale. Should you use the non-judicial foreclosure process or judicial foreclosure? Should you foreclose or not foreclose? These are all good questions. We have some answers.

First, non-judicial foreclosure still remains the fastest and least expensive method for collecting delinquent assessments. Experience (we have been collecting delinquent assessments for more than 20 years and have weathered prior real estate market downturns and increased defaults/foreclosures) tells us that most homeowners do not want to lose their homes and are eventually paying their delinquencies. While we have seen an increase in the number of homes being lost in foreclosure, as expected, most are being foreclosed on by senior lenders. And while assessment lien foreclosures are also up, two thirds of those homes we have foreclosed on have been

redeemed by the owners (yes, owners now have 90 days after the sale to redeem or buy their property following the foreclosure sale). One big benefit of the non-judicial process is that associations find out fairly quickly if the homeowner is going to pay or not. The hard reality is that some of them cannot.

Utilizing judicial foreclosure, an association's legal counsel must first find the homeowner, personally serve them with a lawsuit, wait for them to respond, and if they do not respond, take their default. Upon default, the association will have to apply to the court for a default judgment, which may include an order to foreclose. Then the association can try to find an asset like a bank account to execute on or start the foreclosure process.

With the non-judicial foreclosure process, the association's collection service sends out the required pre-lien notice, records a lien, and if the owner does not pay, records a notice of default, starting the foreclosure process. Using the non-judicial foreclosure method of assessment collection, the association does not receive a personal judgment, as there is no court action. But what good is a judgment if the owner has no money to collect? Let's not forget many owners who were considered "sub-prime" had questionable credit and likely have no other assets.

What if the homeowner refuses to communicate and/or indicates that they cannot pay the delinquent assessments they owe and tells the association's board that they are going to let their home go into foreclosure? If the senior lien holders (their bank/lenders) have started foreclosure, then the association can record a lien and then wait to see if the owner loses the home. If the association is at a point in the process where the owner has not paid, and the next step is the actual foreclosure sale, the board needs to decide if it wants to proceed. Why is this a big decision? Because there is a possibility that a third party will not buy the property if there is no equity (meaning that the amount of the underlying "senior" liens exceed the value of the property). In that event, the association may end up with the property, which likely has no value as it is subject to the first trust deed. Boards will sometimes decide that they just want to foreclose, especially if the senior lender is not doing anything to eliminate a delinquent owner that is trying to get a free ride. And no, in California we do not have "super" liens, and the banks are not obligated to pay the amount owed to the association prior to their foreclosure .

At this point in the process, the board should evaluate the owner's equity in the property. Through the non-judicial foreclosure process, a title report is obtained which will show the amounts of liens, mortgages and/or deeds of trust in the senior position or otherwise ahead of a association's lien and other encumbrances on the property. The board should have a good idea of the current value of the homes or condominiums at their association and should be able to determine if there is any equity at all in the property. If there is no equity, and the lender is foreclosing, it is

likely that the association's lien will be extinguished or “wiped out” (as the association’s lien is junior to the lender). The association can then decide to proceed through small claims court as the fastest and least expensive method of getting a personal judgment against the owner (considering the fact that the judgment may not be collectable in any event). This will not cost the association attorney’s fees (that may not be easily collected from the owner) and a judgment obtained in small claims court can be easily and inexpensively secured by recording a judgment lien. If over the next ten years the owner sells any real property, the owner will have to satisfy the judgment lien plus interest at the rate of 10% per annum.

Although it has been many years since we have seen such a significant number of lender foreclosures, from our prior experience we believe that lenders generally take their time in foreclosing, as they don’t really want the foreclosed properties in their portfolios. They may even be willing to talk to the association about taking over the loan (perhaps at a reduced amount) or allowing the association to sell the property.

If the association does foreclose and obtains the property through a non-judicial foreclosure sale, it is not automatically obligated to pay the lender. If the association determines there is value in the property and wants to try to sell it to recoup its losses, once the statutory 90 days redemption period ends, it can take possession and negotiate with the lender and pay the underlying mortgage. Otherwise, the association can just let the property go back to the lender. It may also be able to collect rent from a tenant residing in the property.

You may be asking why the association does not foreclose and if it does not recover any money, then sue the former owner for the unpaid assessments. In California, we have what is called the “single action rule” and an association cannot both foreclose and then seek to obtain a personal judgment against an owner for the deficiency. Associations only get one chance to collect the money. An association can proceed with the foreclosure process to compel the owner to pay, but cannot proceed with the actual foreclosure sale and then determine there is no equity and thereafter pursue the (former) owner for a money judgment (and not the property). We recommend that the association proceed non-judicially at least to the point of sale and then make the decision (based on the factors described above), as in our experience, many owners will pay rather than lose their home. Even an owner with no equity will often want to keep the home as they may realize that with their credit tarnished by a foreclosure, they may not get another chance to buy a home, and eventually their property will increase in value. In most instances, non-judicial foreclosure is simply the right answer, when other methods are a waste of time and money.

In conclusion, the current “sub-prime crisis” and resulting increase in defaults by owners is going to require that associations and their boards realize that they may have some bad debt. It is also going to require that boards of directors and managing

agents for community associations be more diligent about assessment collection. You are going to have to keep a closer eye on the status of delinquencies, and be prepared to make the evaluations and decisions that we described above. More importantly, it is likely that associations will encounter situations where they are just not going to be able to collect an owner's delinquent assessments. Be prepared!

For more information regarding the matters addressed in this article and/or assessment collection in general, you may either contact David Swedelson dcs@sghoalaw.com or Tracy Neal trn@sghoalaw.com or you may visit hoalawblog.com for articles and information relating to California community associations.