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To Foreclose or Not to Foreclose

How to Collect Assessments in the Face of the Sub-Prime Crisis

We get it. The sub-prime mortgage crisis of 2008 that resulted in thousands losing their homes in foreclosure evolved into a stock market crash that morphed into a recession that has resulted in the highest unemployment rates (over 11 percent in California) seen in more than 50 years. The problem seems to be growing as news reports indicate more owners defaulting on their home loans with a significant number of owners owing more for their homes than they are worth. This crisis is not just affecting lenders and the many homeowners who may have had questionable creditworthiness to borrow money to purchase their homes in the first place; it is also negatively impacting their homeowner associations.

As assessments are typically the sole source of an association's income, many homeowner 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. We know this because we are getting the calls. This situation should not have been a surprise, as we have recommended for at least two years that associations get ready for the increase in defaults and

factor the potential "bad debt" into their budgets. While for more than ten years we enjoyed a period of increased value in real estate that correlated with very few owners' losing their homes (and thus paying their assessments), those good times, at least for now, are gone.

With so many owners in default on their loans and not paying their assessments, many boards of directors are paralyzed and do not know what to do. To foreclose or not to foreclose seems to be the big question. Their anxiety is further compounded by government-ordered moratoriums on foreclosure by lenders (that does not impact association collection action), which only complicate the issues and delay the decisions that boards need to make.

The purpose of this article is to answer questions regarding assessment collection when it appears that owners are likely to let their homes go to foreclosure sale. Should associations use the non-judicial foreclosure process or judicial foreclosure? Should associations foreclose or not foreclose? These are all good questions. We offer some answers in this article.

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 or foreclosures) tells us that most homeowners do not want to lose their homes and are eventually paying their delinquencies. One big benefit of the non-judicial process is that associations find out much sooner if the homeowner is going to pay or not.

Utilizing judicial foreclosure, an association (or its legal counsel) must first find the homeowner, personally serve him or her 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 records a lien, and if the owner does not pay, then the association 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 frankly, what good is a judgment if the owner has no money to collect? Let's not forget that many owners who are considered "sub-prime" have questionable credit and likely have no other assets. In many cases they are unemployed and have no income or money. What if the homeowner refuses to communicate, indicates that they cannot pay the delinquent assessments they owe or tells the association's board that they are going to let their home go into foreclosure?

If the senior lien holder (their bank or lender) has started foreclosure, then the association can 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 at the sale if there is no equity. In that event, the association may end up with the property, which has no value, as it is subject to the first trust deed. And, in many cases, boards will decide that they just want to foreclose, especially if the senior lender is not doing anything, so that the delinquent owner is not living off of the remaining owners.

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 that will show the amounts of liens, mortgages and deeds of trust in the senior position or otherwise ahead of the 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 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 obtaining a personal judgment against the owner (considering

the possibility that the judgment may not be collectable in any event).

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 because they don't really want the foreclosed properties in their portfolios. In addition, there have been government-mandated moratoriums on foreclosure by lenders to allow owners the opportunity to renegotiate their loans. Many lenders have too many borrowers in default, and it is taking them time to deal with their backlog. Lenders may be willing to talk to the association about taking over the loan or allowing the association to sell the property.

If, however, the lender has recorded a default notice, it may only be a matter of time before they foreclose on the property. But, if there is no equity in the property, the association may not want to proceed with a non-judicial foreclosure sale, as it may end up with a unit that has more debt than value, or an "upside-down" unit. Because the owner may have no ability to pay the debt, as mentioned above, the best solution may be to obtain a judgment in small claims court. This will not cost the association attorneys' fees (that may not be easily collected from the owner), and a judgment obtained in small claims court can be easily and inexpensively recorded as 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 percent per annum.

If the association does foreclose and obtains the property through a non-judicial foreclosure sale, it is not automatically obligated to pay the lender on the underlying and senior encumbrance (the former owner's trust deed). If the association determines there is value in the property and wants to keep it, once the statutory 90-day redemption period ends, it has to begin to pay the underlying mortgage. Otherwise, the association can just let the unit go back to the lender.

In California, an association cannot both foreclose and then seek to obtain a personal judgment against an owner. This is what is called the "single action

rule." Associations only get one chance to collect the money. An association can proceed with the foreclosure process to compel the owner to pay, but it cannot proceed with the actual foreclosure sale and then determine there is no equity and decide to pursue the owner for money (and not the property). We recommend that the association proceed nonjudicially to the point of sale and then make the decision because, in our experience, many owners will pay rather than lose their home.

In most instances, non-judicial foreclosure is simply the right answer, when other methods are a waste of time and money. For example, in one association we recently assisted, an evaluation of the title report showed that there was no equity in the property and the homeowner had several judgment liens pending against him. The lender had not started foreclosure, but the association decided that it was not in the best interest of the association for the owner to remain living in the unit without paying assessments. The association proceeded with non-judicial foreclosure, eventually acquired title to the property and removed the owner from the unit.

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. They are going to have to keep a closer eye on the status of their 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! ^{EJ}

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