Community Collateral Damage: A Question of Priorities

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COMMUNITY COLLATERAL DAMAGE: A QUESTION OF PRIORITIES

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ABSTRACT

Today’s soaring mortgage default rate and the uncertainty and delay associated with mortgage foreclosure proceedings threatens to cause financial tragedies of the commons in condominiums and homeowner associations across the country. Assessment defaults in privately governed communities result in an inequitable allocation of upkeep costs, and current law provides no way to prevent this spillover effect. But the collateral damages caused by delayed foreclosures and insufficient recoveries can be minimized by gradually increasing the priority position of the association lien.

In a majority of states, association liens are completely subordinate to the first mortgage lien. At foreclosure of the mortgage lien, the junior priority assessment lien will be extinguished whether or not there are sufficient proceeds to reimburse for community charges. Assessment delinquencies grow over time, so the longer it takes to complete foreclosure, the greater the costs to the neighborhood. Although several states have adopted a limited lien priority for up to six months’ worth of unpaid assessments, foreclosures today take far longer than six months, and the amount ultimately owed to a community can be significant and far exceed that cap. Federal housing policy impacts the resolution of the issue because the FHA, Fannie Mae and Freddie Mac only permit qualifying mortgages to be subject to a six-month assessment lien priority. The decelerating pace of foreclosure further exacerbates the already unjustifiable financial impact borne by non-defaulting neighbors. The lien priority status quo fails to adequately protect communities in today’s context of widespread and delayed foreclosures and under-collateralized mortgage loans. Decreasing the first mortgage lien’s priority during a foreclosure delay would mitigate the harm.

Lien priority statutory changes can protect association finances in the future, and such provisions may be applied retroactively as well. In other contexts, states have held that changes to a lien priority regime can apply to existing associations and existing mortgages without unconstitutionally impairing contract or property rights. This is particularly true where the association’s lien is deemed to be created as of the date the organizational documents for the community were recorded (prior in time to any unit’s mortgage). Bank lobbyists have historically opposed any enhanced assessment lien priority, but supporting property upkeep and making assessments more predictable and collectible would actually benefit lenders by shoring up the value of their collateral. Better certainty with respect to homeowner payment obligations will also enable more responsible credit underwriting and contribute to economic recovery. Shoring up assessment lien priority not only ensures a fair allocation of community costs, but also helps to contain the current housing market decline.
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INTRODUCTION

Culpable parties in today’s housing crisis are legion,¹ but innocent bystanders are directly and tangibly harmed by the fallout. Nonpayment of upkeep charges by financially strapped owners force their guiltless neighbors to fund the community budget revenue gap. The problem is exacerbated by foreclosure delay, since a property conveyance would replace an insolvent owner with a solvent one. Whether a delay in foreclosure results from mortgage lenders’ strategic behavior² or from procedural missteps by servicers,³ the result is the same: Hard-working, financially responsible homeowners are forced to pay significant additional amounts of money merely because of their neighbors’ payment defaults, and in the many cases where foreclosure

¹ Mortgage brokers pushed unrealistic loans. Appraisers validated unrealistic prices. Homeowners borrowed money they could not repay and lenders lent funds while ignoring credit and market risks. Secondary market purchasers and investors over-relied on securitization, and regulators and credit rating agencies blessed the entire system in error or negligence or both.

² In a normal housing market, pushing foreclosures through quickly is in a lender’s best interest. But in a depressed market, lenders have discovered that foreclosure in the absence of the prospect of a quick resale actually causes them to lose money. In 2009, lenders canceled up to 50% of foreclosure sales in some parts of the country, and many of these delays were inspired by the desire to avoid upkeep costs (maintenance, community assessments and property taxes) while awaiting a market rebound. Todd Ruger, Lender’s Latest Foreclosure Strategy: Waiting, HERALD-TRIBUNE (July 12, 2009).

³ In early October 2010, three of the largest mortgage lenders in the United States, Bank of America, J.P. Morgan Chase and Ally Financial, announced moratoriums in the 23 states that require court ordered sales to foreclose on mortgages in reaction to increased judicial scrutiny to sloppy – or even fraudulent – servicer foreclosure procedures. See Ariana Eunjung Cha and Brady Dennis, Judges Revisiting Foreclosure Cases May Help Owners but Clog Market, WASH. POST, A9 (Oct. 5, 2010). Within a week of the initial announcements of these servicer-initiated moratoriums, Bank of America had expanded its freeze on foreclosures nationwide, and attorneys general in all fifty states had begun investigative probes into the extent of servicer misconduct in foreclosure procedures. See Ariana Eunjung Cha, Steven Mufson and Jia Lynn Yang, Momentum Builds for Full Moratorium on Foreclosures, WASH. POST, A1 (Oct. 9, 2010). National civil rights groups called for a government mandated national moratorium on foreclosures. Jia Lynn Yang and Ariana Eunjung Cha, Obama Vetoes Foreclosure Bill as Anger Grows, WASH. POST, A1 (Oct. 8, 2010). While moratoriums have now been lifted, the concern that prompted them hangs over foreclosure proceedings and the increased servicer scrutiny operates to lengthen the foreclosure timeline.
sale proceeds do not even cover the loan, such amounts may never be recovered. The additional burden on the non-defaulting neighbors possibly forces such homeowners into their own financial distress. Allocating the cost of a delinquent owner’s upkeep share to the paying neighbors is an inefficient and unfair. Furthermore, inequitable cost allocation will ultimately lead to additional owner defaults and further impairment of collateral value for every lender.

Today, millions of blameless homeowners around the country face such inequitable and unexpected financial burdens caused by their defaulting neighbors. Approximately 62 million people in the United States (20% of the country’s population) live in one of the 309,600 privately governed common interest communities. Nationally, home loan delinquency rates are now between 10% and 10%

4 As of the end of 2010, according to the Rassmussen Report, 31% of U.S. homeowners with a mortgage owed more on their homes than their homes were worth. See Peter Schroeder, Poll: Nearly One-Third of Homeowners Underwater on Mortgage, THE HILL (March 21, 2011). Deutsche Bank predicts that 48% of American homes could have negative equity by the end of 2011. Mortimer B. Zuckerman, Housing Crisis Represents the Greatest Threat to Recovery, U.S. NEWS & WORLD REPORT (Jan. 27, 2011).

5 The concept that an unfair enjoyment of benefits by parties not bearing associated costs (free-riding) is inequitable and “wrong” was articulated by H.L.A. Hart in 1955, termed the “principle of fairness.” H.L.A. Hart, Are There any natural Rights? 64 PHILOSOPHICAL REVIEW, 175, 185-86 (1955). ‘Are There any Natural Rights?’ Philosophical Review 64: 175-91This concept has been favorably cited by John Rawls. JOHN RAWLS, A THEORY OF JUSTICE, (Harvard University Press, 1971), 96. Fair allocation of cost demands that all beneficiaries of a cooperative enterprise bear pro rata responsibility for the costs of such enterprise. This formulation of fair allocation is well-suited to the case of upkeep expenses of a common interest community such as a homeowners association or condominium.


7 “Common interest community” is defined by the RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 6.2 (2000) to be a “development or neighborhood in which individually owned lots or units are burdened by a servitude” that cannot be avoided by nonuse or withdrawal. Common interest communities include condominiums and homeowner associations, also known as P.U.D.s (planned unit developments). Data regarding the number of U.S. common interest communities and their residents is tracked by the Community Associations Institute (CAI), at Cnty. Ass’ns Inst., Industry Data, http://www.caionline.org/info/research/Pages/default.aspx [hereinafter CAI INDUSTRY DATA]. CAI’s data indicates that the number of residents of common interest communities has increased from 2.1 million in 1970 to 62.0 million today. This figure represents 20.2% of the population of the U.S.A., estimated by the U.S. Census Bureau in 2009 to be 307 million. See U.S. CENSUS BUREAU, Population Division.
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13% of all mortgages.8 Mortgage defaults are concentrated in certain geographic areas however, so the mortgage delinquency rate in those areas is much higher.9 The states with recent growth booms are the ones dealing with the steepest rate of mortgage default.10 Notably, these states also have the highest percentage of citizens

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8 According to the Lender Processing Services figures, as reported at PR Newswire, LPS September ‘First Look’ Mortgage Report: August Month-End Data Shows More Delinquent Loans Entering Foreclosure Process, REUTERS (Sept. 15, 2010), at www.reuters.com/article/idUS224331+15-Sep-2010+PRN20100915. Another article reporting these figures calculates that this rate indicates more than 7.2 million mortgage loans are behind on their payments. Carrie Bay, Residential Mortgage Delinquency Rate Surpasses 10%: LPS, DSNEWS.COM (Feb. 4, 2010), at http://www.dsnews.com/articles/mortgage-delinquency-rate-surpasses-10-lps-2010-02-04. The foreclosure rate is ten times pre-crisis levels, and the aggregate number of foreclosure sales in one month (around 100,000 nationwide) is now similar to the number of pre-crisis foreclosure sales for an entire year. Alex Viega, Foreclosure Rate: Americans on Pace for 1 Million Foreclosures in 2010, HuffingtonPost.com (July 15, 2010).


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residing in privately governed, common interest communities (CICs). The precipitous rise in mortgage default rates therefore indicates an even steeper rise in assessment delinquencies. These delinquencies continue until solvent owners replace delinquent owners.

All types of CICs, from high-rise residential condominiums to multiple-zip-code single home developments, share the same essential service and payment structure: common upkeep is performed at the direction of directors elected by the homeowners, and all homeowners contribute their pro rata portion of the common costs. More and more new developments nationwide have adopted this private governance model. The CIC structure enables more community amenities and upkeep, permitting

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13 See infra notes 76-80 and accompanying text.

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neighborhoods to self-fund and allowing local governments to avoid raising taxes in
response to more housing developments.\(^{15}\)

Owners in condominiums and homeowner associations expect to be financially
independent of their neighbors.\(^{16}\) Architects of CIC enabling legislation did not intend
to create financial co-dependence nor cause significant financial entanglement, since
in a well-functioning market, default would lead expeditiously to foreclosure and title
transfer to a solvent successive homeowner. If a credit-worthy party quickly takes
over a defaulting owner’s share of upkeep obligations and begins to pay allocated
assessments, the community would suffer only limited financial loss due to a
member’s mortgage default. It often does not work that way in today’s market. Now,
contrary to original intent and expectations, foreclosure is slow coming and sometimes
deliberately or negligently delayed, and community assessments can accrue and
remain unpaid for months or even years.\(^{17}\) Furthermore, the sheer number of owners
who are currently in default on their payment obligations – some ten times higher than
pre-crisis – means that an association could be suffering from widespread assessment
delinquency, both increasing its budgetary shortfall and decreasing the number of
owners shouldering the burden of bridging that gap.\(^{18}\) Having to pay additional
upkeep costs harms homeowners and uncertainty in association funding threatens the
viability of the community itself.

\(^{15}\) See generally Clifford Treese, Robert Diamond and Katherine Rosenberry, Changing Perspectives on
Community Association Mortgage Underwriting and Credit Analysis, RESEARCH INSTITUTE FOR

\(^{16}\) See infra notes 92-95 and accompanying text.

\(^{17}\) Pace, R. Kelley and Zhu, Shuang, The Influence of Foreclosure Delays on Future Default, Loan
Losses, and Contract Rates, 46th Annual AREUEA Conference Paper (November 29, 2010), available
at SSRN: http://ssrn.com/abstract=1717127. See also Brent Ambrose, Richard Buttimer, Jr. and Charles
Capone, Pricing Mortgage Default and Foreclosure Delay, 29 J. OF MONEY, CREDIT & BANKING 314

\(^{18}\) RealtyTrac’s Year-End 2010 U.S. Foreclosure Market Report\(^{TM}\) showed a total of 3,825,637
foreclosure filings (including default notices, scheduled auctions and bank repossessions) reported on a
record 2,871,891 U.S. properties in 2010, an increase of nearly 2 percent from 2009 and an increase of
23 percent from 2008. RealtyTrac, Record 2.9 Million U.S. Properties Receive Foreclosure Filings in
also shows that 2.23 percent of all U.S. housing units (one in 45) received at least one foreclosure filing
during the year, up from 2.21 percent in 2009, 1.84 percent in 2008, 1.03 percent in 2007 and 0.58
percent in 2006. Id. Today, at least 8 million Americans are behind on their mortgage payments, and
threats of further housing price decline (the so-called “double dip”) has been called the “greatest
strategic threat to the recovery of the economy.” Zuckerman supra note 4.
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In today’s context of lengthy mortgage foreclosure timelines, neighbors in CICs have become truly financially interdependent, and the failure of some owners to pay their fair share of common costs requires a greater financial contribution by the others. During the months or years that mortgage foreclosure on a unit is threatened or pending, the association still must pay for upkeep, utilities and necessary repairs, and its only source of revenue is increased assessment payments by those owners who are still able to pay. Increased assessments triggered by chronic non-payments essentially result in a forced inter-neighbor loans. Because, eventually, foreclosure of the first mortgage wipes away the association’s junior lien for assessments, these forced loans typically end up being forced inter-neighbor permanent subsidies.

Requiring owners to pay their neighbors’ debts is wrong, inefficient, and destabilizing for the hundreds of thousands of common interest communities in the United States and the millions of homeowners who live there. The current system forces people who completely lacked the ability to foresee, control or avoid their neighbors’ defaults to bear increasing costs due to irresponsible mortgage lending. These same owners end up effectively subsidizing mortgage lenders whose collateral they pay to maintain, insure and protect through association expenditures. Current laws fail to protect innocent, non-defaulting owners from being forced to provide their own private mortgage lender and neighbor bailouts. If neighbors refuse to privately fund deficiencies, lack of association funding for maintenance, insurance and management of common property will eventually lead to a deterioration of the housing stock.

Several states have responded to the dual problem of under-funded associations and inequitable cost allocation by providing for a capped amount of assessment deficiency (typically six-months of unpaid assessments) to be repaid at or after foreclosure of the first mortgage on defaulting homes. This often is not enough. Such limited obligations fail to adequately protect associations and their paying members from the costs of neighbor delinquency, both in terms of short-term uncertainty and in terms of ultimate association recoveries. Changing the lien priority regime – to allow the first

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19 See infra notes 76-80 and accompanying text.
20 See infra notes 170-180 and accompanying text.
21 Hart, supra note 5. CAI Industry Data, supra note 7.
22 See infra Part II.A.1.a.
23 See infra Part II.A.1.d.
mortgagee’s priority to decrease as foreclosure is delayed – is a better solution. Freeing post-foreclosure assessment claims from a dollar-capped limit would permit ultimate recovery by an association of the lenders’ share of upkeep costs.

Decreasing a lender’s priority based on the interval between mortgage default and foreclosure will likely incentivize more expeditious foreclosure sales. At first glance, this seems to run against conventional wisdom and current politics. Although lenders could choose to delay foreclosure and pay collateral carrying costs, increased lender costs pre-foreclosure could lead to faster foreclosures and faster home loss for defaulting borrowers. Even so, making lenders bear the costs of maintaining their collateral and encouraging transfer of title to solvent owners is the only way to contain a community’s financial distress. Whether foreclosure delays are caused by default volume inadequate lender documentation, faulty procedure, predictions regarding resale, or the lender’s desire to retain the defaulted loans as performing on the balance sheet, equity demands that the procrastination costs be allocated to the mortgagee rather than to the community as a whole. Lender funding of the upkeep of their own collateral avoids unjust enrichment and places costs on the parties who could have reasonably foreseen and prevented the assessment delinquencies in the first place – the lenders who should have been underwriting their potential borrowers. Creating a legal means for ultimate recovery and reimbursement of neighbor-funded budget deficiencies will shore up the finances of communities and non-defaulting homeowners and help stabilize the housing market.

Part I of this article explains the negative externalities of foreclosures and defaults in the context of CICs and the limited remedies currently available to community associations under disparate state statutes. Part II.A details and critiques some attempted and proposed solutions to the problem of assessment nonpayment and foreclosure delay, including judicial attempts to resolve the issue through application of equity and legislative efforts to increase limited lien priority coverage. Finally, Part II.B of this article describes and advocates a more nuanced and targeted approach to

24 See infra Part II.B.2. Furthermore, foreclosure delays result in a “free ride” for mortgagors and their lenders during the time that assessment obligations are not paid on behalf of the defaulted property. See Hart supra note 5. While public policy might justify giving defaulting homeowners reasonable time to relocate, economically and philosophically there is no justification for substantial foreclosure delays that create “collateral damage” on the surrounding community due to upkeep costs being allocated inequitably. There is no equitable reason to give cost-free occupancy to borrowers or cost-free collateral preservation to their lenders. In fact, the very definition of “fair allocation” would demand otherwise. See Hart supra note 5 and Rawls supra note 5.

25 See infra notes 324-325 and accompanying text.
solving the problem: capping the community’s losses by allowing the first mortgage lien’s priority to gradually erode during the assessment default period.

While foreclosure procedure must be closely monitored and stringently followed to protect mortgage borrowers, promoting foreclosure sales within such procedural limits helps combat negative externalities of defaulting community members. Laws that incentivize prompt and procedurally perfect foreclosures and allow for open-ended assessment lien priority would ultimately benefit homeowners, communities and mortgage lenders. Systematic erosion of mortgage priority during foreclosure delay promotes equitable allocation of upkeep costs and efficient property transfers and keeps lenders from getting a free ride. Compared with other potential solutions, first mortgage lien priority erosion is the best way to remedy the inequitable and community de-stabilizing status quo.

I. THE PROBLEM OF PRIVATE GOVERNANCE AND MEMBER DEFAULTS

A. NEGATIVE EXTERNALITIES OF DEFAULT

A property owner’s failure to meet assessment payment obligations creates significant negative externalities. Widespread payment defaults destabilize communities, depress property values, lower local property tax revenue and impose additional costs on public agencies providing municipal services. Although the problem of contagious declines in property values and neighborhood upkeep is often couched in term of the spillover effect of foreclosures, the most significant external harm arises not from the foreclosure sale itself, but from the default in homeowner payment obligations that preceded it. Below-market foreclosure sales may temporarily reduce market pricing of real estate in the immediate vicinity of the foreclosed parcel. But the adverse neighborhood effect of a property in limbo (foreclosure is pending while


28 In a May 5, 2008 speech, for example, Chairman of the Federal Reserve Ben Bernanke warned that “high rates of foreclosure can have substantial spillover effects on the housing market, the financial market and the broader economy.”

29 See infra Part I.A.2.

30 See infra notes 34-36 and accompanying text.
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upkeep is lacking) is both more tangible and long-lasting. The true risk of
contagion, therefore, comes from default and delay rather than from the ultimate
property transfer.

1. LOWER COMPARABLE SALES VALUATION

In general, property sells at foreclosure for a significant amount below an arms-length
market transaction. Because the market traditionally prices homes based on
comparable sales within the same community, any below-market sale creates a drag on
neighboring values and sale prices. In addition, mortgage default and foreclosure
increases the supply of homes for sale in the given neighborhood, and increasing
supply with static demand lowers market prices as well. Research published by
Fannie Mae in 2006 focused on the effect of subprime foreclosures estimated that 41
million properties in the U.S. faced declining property values due to foreclosure of
nearby parcels, resulting in an aggregate loss of $200 billion in value. The study
found that homes within 1/8 of a mile of a foreclosed property experience a decline in
value by 0.9% after the foreclosure sale. More recent empirical studies by John
Harding at the University of Connecticut and Eric Rosenblatt and Vincent Yao at
Fannie Mae questioned this figure, particularly in terms of the geographic scope and
duration of the foreclosure effect, arguing that the depreciation is closer to 0.6%, can
quickly rebound, and that the further away a “good standing” home resides from a

31 See infra Part II.A.2.

32 See John Y. Campbell, Stefano Giglio and Parag Pathak, Forced Sales and House Prices, Harvard
foreclosure sales prices averaged 27% lower than the appraised value for the home. The depressed
purchase price at foreclosure, however, is almost never cause to avoid the sale. See, e.g., B.F.P. v.
Resolution Trust, 511 U.S. 531, 545 (1994) (“We deem, as the law has always deemed, that a fair and
proper price, or a ‘reasonably equivalent value,’ for foreclosed property, is the price in fact received at
the foreclosure sale, so long as all the requirements of the State’s foreclosure law have been complied
with.”).

33 See John Harding, Eric Rosenblatt, Vincent Yao, The Contagion Effect of Foreclosed Properties, 66
J. OF URBAN ECON. 164 (2009). For a description of comparative sales methodology, see

34 Dan Immergluck and Geoff Smith, The External Costs of Foreclosure: The Impact of Single Family

35 Id. See also Chart of the Day: Foreclosure Contagion, PORTFOLIO.COM (Jul. 18, 2008), available at
http://www.portfolio.com/views/blogs/odd-numbers/2008/07/18/chart-of-the-day-foreclosure-
contagion/#ixzz10l33 YahF.
foreclosed home, the smaller the psychological and market pricing impact of the foreclosure sale.  

Interestingly, while neighboring homeowners may decry falling property values, the downward price pressure of foreclosure sales may actually help rather than hurt the housing market as a whole. Housing prices in this country are likely still inflated above market “equilibrium” – meaning that the ratio of a home’s value based on rental income is well below the comparable sale value of a given home. Even though rents have gone up and prices have gone down, in many cases, rents still cannot cover purchase-money mortgage payments, suggesting that real property prices have not yet decreased sufficiently to reach a stable, rent-neutral level. There is therefore a systemic (market stability-based) upside to this particular aspect of foreclosure “contagion.”

2. CONSTRUCTIVE ABANDONMENT

Comparable sales values of homes are notoriously finicky and fragile, and the foreclosure-related value losses likely represent unsustainable prior gains due to housing speculation. Far more long-lasting and tangible costs arise from homeowners defaulting on their property upkeep obligations. Our system of homeownership involves both rights and responsibilities of homeowners, and when

36 Harding, et al. supra note 33.

37 Office of Federal Housing Enterprise Oversight (OFHEO) Figure 1 “Overpriced Housing” in Suzanne Stewart & Ike Brannon, A Collapsing Housing Bubble?, REGULATION, Spring 2006, 16. (“A reading well below or above 100 indicates a market that is out of equilibrium: if the reading is below 100, renting is a bargain.”). In 2006, the average rental value of homes was only 70% of the purchase price nationwide, and was the lowest on record (since OFHEO began the index in 1985), with the next-lowest annual ratio (1989) being 91%. Id. The rental-sale price disequilibrium was far more pronounced in certain areas of the country, such as California, Nevada, Arizona and Florida where home prices in the prior decade had increased by over 99%. See FDIC, 2009 ECONOMIC LANDSCAPE, THE SAND STATES: ANATOMY OF A PERFECT HOUSING-MARKET STORM, http://www.fdic.gov/bank/analytical/quarterly/2009_vo13_1/AnatomyPerfectHousing.html. See also Anthony Sanders, The Subprime Crisis and its Role in the Financial Crisis, 17 J. HOUSING ECON. 254 (2008).

38 See, e.g., Emma L. Carew, To Woo A Renter: Homeowners Who Punt on Selling Face Challenge as Tenants Get Choosier, WASH. POST, Aug. 15, 2009. See also Stewart & Brannon, supra note 37.


40 Owners of real property are obligated to pay property taxes, are required to protect against hazards and nuisance on their properties, and face liabilities related to environmental hazards thereon. Real property cannot be abandoned. See RESTATEMENT OF PROPERTY § 504 cmt. a (1944). See, e.g., Pocono
owners abandon their homes, either literally by ceasing to reside there or figuratively by ceasing to maintain the property, the community suffers tangible and permanent losses in value. A defaulting homeowner facing imminent or even eventual mortgage foreclosure has little incentive to invest anything in the home and thus will forego many socially desirable activities: painting shutters, cleaning gutters, mowing the lawn or fixing broken appliances or cabinets.

The mere drop in home value itself can start the trend toward owner constructive abandonment because once a property is “upside-down” or “underwater” (more is owed on a mortgage loan than the property is worth), any improvements or maintenance made on a home effectively becomes “sweat debt” (value created for the lender) rather than “sweat equity” (value created for the owner). Some commentators

Springs Civic Ass’n, Inc. v. MacKenzie, 667 A.ed 233 (Sup. Ct. of Penn. 1995). Property law requires that some entity always hold seisin, because the holder of seisin is the gatekeeper, or responsible party, with respect to that parcel of realty. See Thomas W. Merrill and Henry E. Smith, PROPERTY: PRINCIPLES AND POLICIES (Foundation Press 2007), 201.

41 See Ivana Kottasova, A House Dies and a Block Sinks, The Brooklyn Ink (Mar. 9, 2011), quoting Josiah Madar (“Vacant properties are often not maintained properly and show signs of physical distress… that in itself causes property values to go down – and then the area becomes less attractive for residents”). The negative externalities caused by failure of an owner to exercise adequate property oversight are among the many justifications for the doctrine of adverse possession. See John C. Sprankling, An Environmental Critique of Adverse Possession, 79 CORNELL L. REV. 816 (1994).


have suggested that a typical borrower will consider walking away from a mortgage when the home value falls below 75% of the amount owed on the mortgage, and more than 5 million homeowners in the U.S. reached this “tipping point” of underwater valuation by 2010.

As of the end of 2010, according to the Rassmussen Report, 31% of U.S. homeowners with a mortgage owed more on their homes than their homes were worth. Deutsche Bank predicts that 48% of American homes could have negative equity by the end of 2011. Along with the numerous defaults on home mortgages caused by the inability to pay, more and more borrowers who are financially able to pay are strategically defaulting on their mortgages. When the lender holds 100% (or more) of the current value of a home, many homeowners feel that there is no financial incentive for the owner to continue to pay the mortgage or, for that matter, the community association assessments.

3. GOVERNMENT RESCUE EFFORTS

The negative externalities of homeowner constructive abandonment have been cited to justify policies and programs aimed at helping homeowners facing foreclosure. Many of these programs create additional incentives for lenders to pursue loan

44 David Streitfeld, No Help in Sight, More Homeowners Walk Away, N.Y. TIMES (Feb. 2, 2010).


47 Zuckerman supra note 4.

48 Gail Marks-Jarvis, Ethics of Strategic Default are Really Hitting Home, CHICAGO TRIB., Oct. 7, 2010. (“Morgan Stanley recently estimated that about 18 percent of defaults will be strategic.”)

49 Underwater homeowners have no incentive to pay property taxes either, but counties are always first in line to collect unpaid tax amounts from foreclosure proceeds. There is no cap on the amount of unpaid property taxes that a county can collect from the purchase price at a foreclosure sale.

50 For a discussion of the HAMP program and its successes and failures over the first year, see CONGRESSIONAL OVERSIGHT PANEL, EVALUATING PROGRESS ON TARP FORECLOSURE MITIGATION PROGRAMS, APRIL OVERSIGHT REPORT, April 14, 2010 [hereinafter, APRIL OVERSIGHT REPORT]. See also David Streitfeld, Program Will Pay Homeowners to Sell at a Loss, N.Y. TIMES, Mar. 7, 2010.
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modifications or permit short sales in lieu of foreclosure.\textsuperscript{51} To the extent that loan modifications create true incentives for owners to remain invested in their property by reassuming the gatekeeper role and paying upkeep costs and the like, such modifications would help eliminate the property value losses discussed above and should be promoted as sound policy. To the extent that short sales would streamline the process of replacing insolvent owners with financially capable “gatekeepers,” short sale incentives would also benefit the community and deserve to be encouraged.\textsuperscript{52} Unfortunately, however, these government efforts for the most part have failed to create viable mortgages and ensure homes are held by owners able to meet their assessment obligations. Even with payment reductions and government assistance, more than three-quarters of the mortgage loans which were modified under HAMP remained underwater in April 2010.\textsuperscript{53} The initiative for expedited short sales likewise has been mostly unsuccessful.\textsuperscript{54}

One obstacle to greater success through loan modifications and/or short sales is the problem of junior liens.\textsuperscript{55} Not only do many financially imperiled homes today have subordinate liens from second mortgages and home equity lines, but the community association in any CIC will have a lien securing its rights to recover unpaid assessments.\textsuperscript{56} Junior lienors, including a community association, can stymie modification plans by withholding consent to proposed changes to the senior loan.\textsuperscript{57}

\textsuperscript{51} Short sales are tri-party agreements amongst a defaulting mortgage borrower, the mortgage lender, and a third-party purchaser, whereby the purchaser agrees to buy the property for less than the outstanding loan amount, and the lender agrees to accept payment of the buyer’s purchaser price in full satisfaction of the borrower’s mortgage loan.

\textsuperscript{52} Streitfeld, \textit{supra} note 44.

\textsuperscript{53} April Oversight Report, \textit{supra} note 50.


\textsuperscript{55} Loan modifications without junior lienor consent can result in a complete loss of priority for the senior lienholder. Short sales are made subject to all junior liens, if these are not paid off or voluntarily released as part of the sale. \textit{See} Grant S. Nelson and Dale A. Whitman, \textit{Real Estate Finance Law} (Thompson West, 5\textsuperscript{th} ed. 2001), 871-876. \textit{See also} Kratovil & Werner, \textit{Mortgage Extensions & Modification}, 8 CREIGHTON LAW REV. 595, 610 (1975)

\textsuperscript{56} Many properties in default have other junior lienors as well, including second purchase money mortgages or home equity lines of credit. In many, but not all, states, second mortgages are junior in priority to the association’s lien.

\textsuperscript{57} Loan modifications occurring without the consent of junior lienors are vulnerable to priority loss should a court determine that the modification adversely impacts the secured position of the junior lienor. Many loan modifications, however, have been upheld as non-prejudicial to a community
A community association’s board might lack the authority to engage in debt forgiveness with respect to delinquent assessments, since this effectively imposes more costs on the remainder of the community and violates the payment allocation provisions of the CIC’s governing documents. The argument that in a bad mortgage debt situation, both a borrower and a lender should compromise by giving up value (in terms of lost equity and lost loan proceeds) is compelling. But no similar logic supports a claim that non-party neighbors should be forced to bear losses due to other people’s poorly conceived loans. This is one reason the “Helping Families Save their Homes Act of 2009” was voted down in the U.S. Senate: the proposed law would have given bankruptcy judges the ability to mandate massive write-downs on unpaid assessment liens, essentially blocking the already limited ability of associations to collect delinquent assessments and continue to perform their essential functions. If the government truly wants to encourage short sales or modifications in privately governed communities, then the government must ensure that the workout (a) ultimately stabilizes the community and (b) is not forcibly financed by the non-delinquent neighbors.

Government programs that encourage property to be efficiently conveyed to solvent and responsible owners ameliorate the harm caused by owner payment defaults. But


60 H.R. 1106 was defeated in a Senate vote on April 30, 2009, 45 to 51.

61 Unlike HAMP and the initiative promoting short-sales, the Neighborhood Stabilization Program of the Department of Housing and Urban Development (HUD) has focused on infusing money into communities directly, buying abandoned homes, renovating them and contributing to the community’s upkeep and property values. This HUD program is effectively the antithesis of foreclosure
Community Collateral Damage

most government attempts to mitigate the damage caused by mortgage defaults have failed to adequately address the problems caused by upkeep reduction and, in fact, some have exacerbated the spillover effects of default. For example, although purporting to help homeowners, foreclosure moratoriums can perpetuate the constructive abandonment maintenance problem. Forced loan modifications – to the extent they merely postpone the inevitable and leave a borrower unable (or unwilling) to pay assessments – do the same. Any government interference which slows foreclosure may (at least in the short-run) help an individual defaulting mortgagor and might, in a temporarily “down” market, even help the mortgage holder ultimately recover more on its loan, but in CICs, these benefits are funded by the neighbors. Every nearly-dead or ultimately doomed but un-foreclosed mortgage loan increases the current and ultimate costs borne by neighboring owners. Owners who abandon their property maintenance responsibilities cause increased CIC assessment levels that drive down the entire community’s property values.

Foreclosure rescue efforts have mostly failed to create viable long-term mortgage loans, and the most worrisome contagious effects of homeowner defaults remain, since true losses arise not from foreclosure sales themselves but from a chronic reduction in neighborhood upkeep. This fact drives home the point of this article: delaying foreclosure and allowing property to deteriorate is a lose-lose scenario, avoidable only by having owners who can and will maintain the property and pay association assessments. This is particularly true in CICs where there are additional, direct and

moratoriums: it encourages sales of constructively abandoned properties to prevent communities from bearing the negative externalities such properties cause. HUD provided $6 billion in two rounds of Neighborhood Stabilization Program funding, some of which was supplemented by state funds to create successful and effective localized programs. For example, $5.6 million in federal funds combined with $30 million in resources from the Twin Cities Community Land Bank created an entity able to buy up 250 blighted and defaulting properties in targeted neighborhoods. These properties were rehabilitated (updated to green standards) and sold to “responsible homeowners.” Shaun Donovan, Fighting Foreclosures and Strengthening Neighborhoods, BLOG/U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, Sept. 3, 2010, available at http://portal.hud.gov/portal/page/portal/HUD/press/blog/. The Neighborhood Stabilization Program is an example of a fairer and more forward-looking approach to the contagion effects of mortgage defaults in communities.

Moratoria can perpetuate the tenure of owners who are unwilling or unable to bear the costs of ownership, including paying community assessments, property taxes and basic property upkeep costs, delaying the conveyance of property owning responsibilities to an owner willing to assume such responsibilities.

Harding, et al., supra note 33 at 4-5 and 17-20. See also supra Part I.A.2.
compelling cost externalities with respect to payment defaults, so the contagion effect is more pronounced.\textsuperscript{64}

\section*{B. \textbf{FINANCIAL ENTANGLEMENT}}

\subsection*{1. \textbf{THE CIC OWNERSHIP, ASSESSMENT AND SERVICES MODEL}}

The CIC structure is a privatized governance solution to the collective action and free-rider problems often termed the “tragedy of the commons.”\textsuperscript{65} Widespread private property ownership in the U.S. has minimized the number of publicly maintained “commons,”\textsuperscript{66} and until recently, federal, state or local governments maintained most of those areas that could not be divided and privatized.\textsuperscript{67} In the past century, courts began to routinely hold that community covenants creating payment obligations for common area upkeep were servitudes running with the land.\textsuperscript{68} This enabled the rise of private governance and assessment systems across the U.S. In privately governed neighborhoods, common space and amenities are maintained by an association which assesses each owner a share of the upkeep costs.\textsuperscript{69} The association provides sufficient

\begin{footnotesize}
\begin{itemize}
\item[\textsuperscript{64}] See infra notes 79-80 and accompanying text.
\item[\textsuperscript{66}] Throughout the country’s history, the government has aggressively sought to sell land to private owners. This was the impetus behind Thomas Jefferson’s Land Ordinance Act, for example. Land Ordinance of 1785. See Richard P. McCormick, \textit{The “Ordinance” of 1784?}, 50 WILLIAM & MARY QUARTERLY, 112 (1993).
\item[\textsuperscript{67}] See, e.g., 59 Am. Jur. 2d Parks, Squares, and Playgrounds § 23; 39 Am. Jur. 2d Highways, Streets, and Bridges § 212. See also Lemley, supra note 65.
\item[\textsuperscript{68}] Neponsit Property Owners Association, Inc. v. Emigrant Industrial Savings Bank, 15 N.E.2d 793 (NY Ct. of App. 1938). Prior to \textit{Neponsit}, covenants to pay money were not typically seen to run with the land. The \textit{Neponsit} characterization of this covenant as creating a real property servitude, however, spurred the growth of suburban communities across the country. See also, e.g., Regency Homes Ass’n v. Egermayer, 498 N.W.2d 783 (Neb. 1993) (covenant to pay dues to a community association to maintain recreational facilities is a real covenant which runs with the land).
\item[\textsuperscript{69}] Most associations’ governing documents explicitly provide for assessment funding of association obligations. See Hyatt \textit{supra} note 14. Even in situations where governing documents for community associations have failed to provide for assessments, courts find the power to assess implicit in the structure of a CIC. See, e.g., Wendover Road Property Owners Ass’n v. Kornicks, 28 Ohio App. 3d 101, 502 N.E. 2d 226 (1985); Board of Directors of Carriage Way Property Owners Ass’n v. Western
\end{itemize}
\end{footnotesize}
governance to solve the tragedy of the commons by controlling overuse and creating a mechanism for maintenance and shared costs. Because an association solves the tragedy of the commons, it permits communities to avoid the economic downside of public goods, meaning that a neighborhood can enjoy better amenities at lower prices. The association is essentially a mini-government, performing public functions: upkeep of common areas and amenities and rule-making and dispute resolution. Association assessments are therefore, to some extent, the equivalent of property taxes, a mechanism to fund common costs.

For condominiums, a private governance and assessment system is not only beneficial, it is essential. Once states passed statutes allowing fee simple ownership of a three-dimensional “box” of space, multiple individuals could become owners of distinct units within one building. But having many owners within one building mandates certain jointly-held property: the roof, lobby, elevators, hallways, laundry rooms and, in some buildings, water, sewer, trash, electricity, and gas as well as hazard insurance on the building itself. The mechanism of private community governance provides and pays for all such commons equitably and efficiently.

Typically, CIC governing documents explicitly vest the association with broad authority to assess members according to budgetary needs, and courts have found

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70 See Hyatt supra note 14.

71 CAI Industry Data supra note 7; Treese, et al. supra note 15. Common upkeep also allows a community to take advantage of cost savings from economies of scale.

72 Id.

73 In fact, in New Jersey, the correlation of community assessments and property taxes has been acknowledged by the legislature which now permits a portion of community assessment payments to offset local property tax assessments. N.J.S.A. 40:67-23.2 et seq. See also K. Kennedy and B. Lambert, New Developments in municipal Services Equalization. 3 JOURNAL OF COMMUNITY ASS’N LAW 1 (2000). On the other hand, many of the community-provided services supplement local governmental functions rather than replace them and instead operate to replace individual upkeep costs. The trend toward municipal services equalization legislation - refunding members of a CIC local government taxes for items paid for by the association – is discussed in Treese, et, al. supra note 15 at 3.

74 Under the common law, real property is owned in a column of space defined with respect to a two dimensional real property mapping description, indicating a closed figure on the face of the earth.


76 Associations meet their budget requirements through a combination of regular assessments, special assessments and transfer fees.
that even when an association’s documents lacked explicit authorization, power to assess is implied.77 As long as the assessments are authorized, it is clear that the obligation to pay assessments is both an in personam obligation of a homeowner and an in rem affirmative covenant that runs with the land and is binding on all successor owners of the property.78 The obligation to pay assessments is the most vital one in a privately governed community – assessments are a community’s “lifeblood” and its primary (and sometimes only) funding source.79 As Wayne Hyatt, author of the seminal treatise on CICs explains, “when one member of the community chooses not to pay the assessments, everyone in the community pays the price through increased assessments, decreased services, and declining community appearance and quality of living.”80

Important for purposes of this discussion are two aspects of association assessments: their collectability and their durability. This ability to collect delinquent assessments is of crucial importance in a context – such as today – where increasing mortgage defaults indicate even steeper increase in assessment delinquency.81 In addition to the ability to assess charges, associations have the power to place a lien on a member’s real property to secure the assessment payment obligation.82 In some states, such liens arise and are perfected as of the date the association’s documents were recorded in the land records.83 In other states, the lien arises and is perfected automatically at the time

77 Hyatt, supra note 14, at 105-108. See, e.g., Fogarty v. Hemlock Farms Community Ass’n, 685 A.2d 241 (Pa. Commw. 1996) (holding that an association had implicit power to make special assessments arising from the power to regulate use and maintain). Other cases, however, have refused to find implicit authority to make assessments when the declaration was deficient. See, e.g., Board of Directors of Carriage Way Property Owners Ass’n v. Western National Bank of Cicero, 139 Ill. App. 3d 542, 487 N.E.2d 974 (1985).
78 Hyatt supra note 14, at 105-117.
79 Id. at 105 and 121.
80 Id. at 121.
81 Association assessment defaults are usually well in advance of loan payment delinquencies. See supra note 12.
82 Hyatt, supra note 14.
83 For example, in Colorado, a perfected association lien exists as of the date of filing the declaration. COLO. REV. STAT. § 38-33.3-316. Although this perfected lien could be essentially an “empty bucket” securing no indebtedness, it has statutory priority relating back to the date the community was created. First mortgages on units in such states, however, enjoy a special statutory super-priority over the pre-existing association lien.
an assessment comes due. In still other states, perfection of an assessment lien requires filing a notice of the lien in the appropriate land records. Whether or not this lien has payment priority over a first mortgage can determine whether an association will be able to ultimately collect. Assessment liens are generally junior in priority to first mortgage liens on the units, however, and junior interests are extinguished upon the foreclosure of a senior priority lien.

CICs are contractually bound to maintain the property and to provide whatever other services are mandated by the documents creating the servitude regime. In addition to document-based requirements, state and local laws may mandate the provision of other services and/or a certain level of association reserves. The Federal Housing Administration (FHA) will only insure loans secured by units in communities with sufficient reserve funding. Although reserve requirements support an association’s future financial health, increasing the required reserves means that the association must collect additional funds today. This can exacerbate the problem of increasing assessments for paying members in an environment of widespread payment defaults. The upkeep and reserve funding obligations of the association are not contingent on the condition of the economy or the payment participation of all members, and assessments are the association’s sole source of income.

84 Under the Uniform Common Interest Ownership Act § 3-116, recording of the declaration creating a common interest community constitutes record notice and perfection of the lien for all future assessments. See also infra note 173 and accompanying text.

85 See, e.g., F.N. Realty Services, Inc. v. Oregon Shores Recreational Club, Inc., 891 P.2d 671 (Ore. 1995) (association lien arises only upon recordation of notice of lien). See also infra notes 171-72 and accompanying text.

86 See infra Part I.C.2.

87 Nelson & Whitman supra note 55.

88 Hyatt, supra note 14.

89 States require reserve studies by condominiums and homeowner associations to ensure adequate reserves are collected. See, e.g., VA CODE § 55-514.1 and § 55-79.83.1.

90 Reserve requirements are 60% of the annual budget for established condominiums and 100% of the budget for new projects. October 2009 guidelines, HUD’s Mortgagee Letter 2009-19 (published June 12, 2009).

91 Some associations charge user fees, but most association costs are covered exclusively by assessments paid by unit owners. See Hyatt, supra note 14; Hyatt & French, supra note 14 at 319.
COMMUNITY COLLATERAL DAMAGE

2. TRAGEDY OF THE FINANCIAL COMMONS

The CIC structure attempts to solve the tragedy of the commons by establishing a government to prohibit commons overuse and under-maintenance. Such a private consortium democracy with governance obligations and powers theoretically can create a better neighborhood for all. But leaving the funding responsibilities for essential upkeep with the homeowners means that the fiscal fortunes of the members of a community are intertwined. A change in the economic fortunes of one owner can therefore impact the other owners. Defaults of members on payment obligations cause a direct and devastating impact on the other members of the community who must fund the difference. Sam Chandan, chief economist at real estate research firm Reis, explained the connection between the upside of joint maintenance and the downside of economic entanglement: “What motivated people to go into the condo market in a way that led to overbuilding was the expectation that it would be easier than owning a home on a maintenance basis. The downside is that your fate is tied to 50 to 100 other people who may stop making their condo payments.”93

Before 2006, no one anticipated the huge strain that so many highly leveraged mortgages taking so long to foreclose would eventually put on community associations. But today’s delinquency rate for assessments has caused many of these associations to fail. Their failure leaves the community without its expected amenities and upkeep and leaves the commons to its natural economic “tragedy” because local municipalities need not provide public services which had previously been left to private associations to fund and provide.

Most courts have held that CIC associations cannot declare bankruptcy as long as they retain the power to assess for budgetary shortfalls. Thus, solvent owners must fund their delinquent neighbors’ deficiencies. Delinquency levels in some parts of the

93 Haughney, supra note 6 (quoting Chandan).
94 The closest precedent is New England in the late 1980s and early 1990s when many associations were left with debilitating budgetary shortfalls as many owners defaulted on their mortgages and other payment obligations. It was this regional crisis among CICs that led Massachusetts to adopt a six-month lien priority for CIC association liens. See infra note 203. The six-month super priority in UCIOA was meant to solve this same issue, but the authors of that model legislation did not foresee that in today’s climate of extensive and long-delayed foreclosure, six months would generally be inadequate.
95 See supra note 12.
96 See infra Part I.B.4.
COMMUNITY COLLATERAL DAMAGE

country have seen astronomical increases since 2005. One management firm in the Boston area reported a 150% increase in delinquent assessments from 2006 to 2007.\footnote{Sacha Pfeiffer, \textit{Delinquencies at Condos Can Cost Neighbors}, \textit{The Boston Globe}, Oct. 16, 2007.} Vulnerability to increased assessments to fund neighbor shortfalls and the inability of an association to perform contractually required maintenance in the face of member default causes a significant adverse impact on the value of properties within a CIC.\footnote{See, e.g., Board of Directors of the Colchester Towne Condominium Council \textit{v.} Wachovia Bank, N.A., 581 S.E.2d 201, 206 (Va. 2003) (J. Lacy dissenting) (nothing that “part of the value of a condominium unit comes from the ability of the condominium association to maintain the common areas of the development” and that “the ability to maintain these elements is directly relate to the association’s ability to secure payment of assessments from the individual unit owners.”).}

Where available, statistics regarding the problem of assessment delinquencies underscore the magnitude of the problem. According to a study cited by the \textit{The Miami Herald}, more than 60\% of Florida condominiums and homeowner associations reported in March 2010 that at least half of their units were at least two months behind in paying their assessments.\footnote{Rachael Lee Coleman, \textit{Desperate Condo, Homeowner Associations Thrown a Lifeline}, \textit{The Miami Herald}, Mar. 7, 2010.} Losing half of required revenue completely hamstrings the operation of these associations. For example, Parkview Point Condominium in Miami Beach suffered such a loss of assessment revenue that it was unable to pay water bills for the building and the unit owners nearly had their water cut off before solvent owners were able to raise funds to pay the arrearage, and the lobby ceiling repairs, however, were stopped mid-repair, leaving wiring and ducts exposed.\footnote{Haughney, \textit{supra} note 6.} On the nation’s other coast, Gas Lamp City Square in downtown San Diego awaits pending foreclosure sales on multiple units in the building while the association struggles with a $115,000 budgetary shortfall because of unpaid dues.\footnote{\textit{Id}.} In Union City, California, a special assessment for roof repairs in Alvarado Village ended up costing each paying owner $18,494.27.\footnote{\textit{Neighborhood Fees Go Through the Roof}, Contra Costa Times, available at http://www.calhomelaw.org/doc.asp?id=487. The Alvarado Village association also blames the large special assessment on the property developer who they claim failed to adequately fund reserves.} A couple in San Francisco reports that over the past three years, their special assessments have exceeded $100,000.\footnote{Lloyd, \textit{supra} note 11.}
Pervasive assessment default unfairly impacts the paying neighbors financially and psychologically, and anecdotal evidence underscores the reality behind the troubling statistics of unpaid community dues. Ana Martinez, for examples, reported that she no longer felt safe living in her own home – a unit within a south Florida condominium which was deteriorating in the face of the association’s inability to pay for maintenance.\(^{104}\) Some of Ana’s neighbors had literally abandoned their units, leaving behind not only unpaid and underwater mortgage loans, but months of unpaid condominium assessments.\(^ {105}\) Ana’s monthly assessment tripled in response to the condominium’s budget shortfall, and her property’s value fell and continues to plummet in the face of lower occupancy, higher crime and substandard common area maintenance.\(^ {106}\)

In a modest, low-income area of Providence, Rhode Island, Debra McGarry was forced to take out a $4,800 personal credit card loan to keep water, gas and electricity from being cut off in the eight-unit condominium building in which she lives.\(^ {107}\) Two of the owners in the building stopped paying dues and abandoned their homes, nearly bankrupting the small condominium.\(^ {108}\) Even doubling the condominium fees that the remaining six paying owners were assessed failed to generate enough capital to keep the building afloat.\(^ {109}\) The “affordable” unit Debra and her husband Bernard, a disabled veteran, bought in 2006 ended up being their financial “nightmare” since Debra and her solvent neighbors were left to personally pick up the tab left by lenders who failed to foreclose on strategically defaulted mortgages.\(^ {110}\)

The problem of assessment delinquencies is not confined to lower income owners. Ritz Manhattan condominiums that come with top-flight amenities (gym membership, butler and maid service, billiards room and library) can no longer afford the cost of such services because of a rash of unit owner assessment defaults.\(^ {111}\)

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\(^{105}\) *Id.*

\(^{106}\) *Id.*


\(^{108}\) *Id.*

\(^{109}\) *Id.*

\(^{110}\) *Id.*

past year, foreclosure filings for Manhattan condominiums doubled, and now one in every 13 units are in some stage of foreclosure.112 Even before the housing crisis, it took on average two years for property to be sold at a foreclosure sale under New York law. During the several years foreclosure is pending in the current market, the non-defaulting owners in these glamorous buildings will see their own assessments increase to close the association’s budgetary gap while the building services and amenities simultaneously disappear. In one Manhattan condominium, the nonpayment of just one investor – who holds title to a dozen units in the building – caused monthly charges to all the remaining members to jump by 15%.113

3. **Entanglement Endangers Market Recovery**

Letting prices settle at a sustainable level while quickly clearing bad mortgage debts and replacing insolvent owners with those able to meet their obligations is the way out of the current imploding housing market. Stabilizing the housing market and attracting new investors in failed mortgages requires predictable costs of credit and upkeep charges. Rising CIC assessments increases volatility and stymies such an economic recovery. Would-be buyers, faced with uncertain future assessment increases due to financial entanglement in a CIC, are unwilling and unable to manage such risks. Loan modifications for overburdened borrowers do not work when assessments rise so quickly that borrowers still cannot meet their reduced mortgage debt obligations while also paying association assessments. Lenders resist financing and refinancing in communities where assessment levels and the fiscal health of the association are both uncertain. The possibility (or reality) of steeply rising assessments make investors hesitant to purchase a unit when rents may not cover additional increases. As one example: the common charge for a 601 sq. ft. studio in one Manhattan CIC is now $1095 per month, and this substantial cost has discouraged investor purchasers or financiers, even when the purchase price for the unit is set at a tremendous discount.114 When rents will not cover assessments, ownership of a unit generates a monthly financial loss.

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113 *Id.* The situation is different for cooperative buildings, because assessment payments are characterized as rent. Thus, the cooperative can evict a defaulting owner and need not wait for the owner’s lender to foreclose. In condominiums, however, the association lien is subordinate to the first mortgage lien and typically the association’s assessment will not be paid upon foreclosure.

114 Ryley, *supra* note 6. (Ryley also gives the example of a Manhattan studio that rents for $3,000 a month costing $5,750 a month in mortgage payments, taxes and common charges).
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Lenders are as wary of the uncertain financial future of CIC properties as are would-be buyers. Mortgage financing or refinancing of a unit in a condominium or a house in a privately governed community has become vastly more difficult as banks seek information not only about the creditworthiness of their borrower, but the credit of the other members of the financially linked community.115 Lenders have started to scrutinize a community’s reserve amounts and assessment delinquency levels in an attempt to quantify the risk of assessments materially increasing.116 A buyer of a new condominium unit in New York reported that Bank of America denied her application to refinance because the condominium association’s reserve account is depleted and 17% of the owners in her building are delinquent in paying their assessments.117 Many lenders now require that reserves be sufficiently funded and that no more than 15% of homeowners be more than thirty days delinquent on homeowner assessments before they will agree to lend on any property located in the community.118

The two giants of the secondary residential mortgage market – the government sponsored enterprises (or GSEs) Fannie Mae and Freddie Mac – likewise demand certain thresholds of reserves and non-delinquencies for CICs in which their prospective mortgage loan purchases are located.119 For example, Freddie Mac’s Condominium Unit Mortgages Project Analysis requires a budget and certification of a working capital fund, appropriate assessments levied with a minimum of 10% of the


116 Ryley, supra note 6.

117 Id.


119 Fannie Mae (formerly the Federal National Mortgage Association) and the Federal Home Loan Mortgage Corporation (a.k.a. Freddie Mac) were chartered by Congress and regulated by federal agencies. Although technically still owned by private shareholders, in September 2008, the Treasury Department placed Fannie Mae and Freddie Mac into conservatorship, reorganizing the enterprises and infusing them with new capital. At the time, this was the largest state rescue in history; to the tune of $100 billion dollars. See James Lockhardt Statement, TESTIMONY OF JAMES B. LOCKHARDT, FINANCIAL CRISIS INQUIRY COMMISSION, April 9, 2010, available at http://fcic.gov/hearings/pdfs/2010-0409-Lockhart.pdf. See also FACT SHEET, QUESTIONS AND ANSWERS ON CONSERVATORSHIP at http://www.ustreas.gov/press/releases/reports/fhfa_consrv_faq_090708hp1128.pdf. See also TESTIMONY OF HERBERT M. ALLISON, JR., PRESIDENT AND CEO OF FANNIE MAE, HEARING BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES, Sept. 25, 2008, Opening Statement.
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budget designated for replacement reserves and deferred maintenance and a working capital fund in an amount consistent with the remaining life of the common elements and no more than 15% of assessments delinquent more than 30 days.\textsuperscript{120} Freddie Mac also mandates that common elements be consistent with the nature of project and competitive with the local market and the community be in good financial and physical condition.\textsuperscript{121}

The lack of financing alternatives and the threat of instability that would result if assessment delinquencies reach 15% has chilled investment in condominium properties.\textsuperscript{122} Some investors report that they will pay only cents on the dollar because of the possibility that neighboring owners will default in paying their pro rata share of maintenance costs.\textsuperscript{123} Before he would agree to buy, one investor from Italy reportedly demanded a “written guarantee” from the association that he won’t have to pay bigger fees in the future (although such a guaranty is likely not enforceable against the association).\textsuperscript{124} The fact that no one – neither banks nor buyers – willingly takes on this uncontrollable risk today is more evidence that the current system is broken.\textsuperscript{125}

Some associations have responded to their community’s budgetary crisis by insourcing all possible costs.\textsuperscript{126} For example, owners of homes may be required to take turns mowing common area lawns, caring for common area maintenance, or even staying up all night to serve as a doorman/security guard. While these efforts may

\textsuperscript{120} Freddie Mac Condominium Unit Mortgages – Project Analysis (Aug 2010), available at www.FreddieMac.com/learn/.

\textsuperscript{121} Id.

\textsuperscript{122} Some areas of the country – New England and Manhattan in particular – faced a breakdown in the early 1990s. There is anecdotal evidence of New Yorkers during that crisis “handing over their Fifth Avenue apartments for $1 because they could not afford the maintenance fees.” Haughney, supra note 6.

\textsuperscript{123} Id.

\textsuperscript{124} Id. Associations cannot guaranty limitations on future assessments unless the documents so permit because any limitation to one unit owner’s obligations necessarily burdens other owners with greater costs should the association’s revenue requirements increase.

\textsuperscript{125} Condominiums as a real estate product type have incurred the biggest losses in terms of market value and transactional volume.

reduce the dollar contributions needed by associations to function, in-sourced upkeep actually replicates the very same collective action and free-rider problems that community governance was designed to eliminate: some people will contribute more than others, and others will be unjustly enriched by their efforts. In-sourcing actually just replaces the problem of increased assessments of money with the problem of increased “assessments” made in kind. And it is equally inequitable. Either way, the non-defaulting homeowners pick up the costs of the mortgage lenders’s free ride.\textsuperscript{127}

As an alternative to increasing assessments, associations may reduce the level of services offered to members of the community by decreasing maintenance, closing amenities or starting to charge amenity user fees. In an informal poll in 2008, the Community Associations Institute found that nearly 40\% of the associations nationwide had delayed capital expenditures and nearly 35\% had raised assessments – in each case because of an increase in delinquent assessments.\textsuperscript{128} Two years later, these numbers are likely even higher. The end result of the efforts to cut services and impose more costs on owners is the same: significant decline in a community’s property values and a community government that ceases to function effectively.\textsuperscript{129}

4. **ASSOCIATION BANKRUPTCY UNFEASIBLE**

Community associations cannot seek relief from their financial obligations in bankruptcy, even if their obligations outpace their revenues. Condominium associations typically have no assets of their own,\textsuperscript{130} and homeowner associations are prohibited by their governing documents from selling their assets or otherwise seeking to raise revenues in ways not foreseen and explicitly authorized in their covenants.\textsuperscript{131} These entities perform primarily (or exclusively) governance and maintenance roles. Although it is nearly impossible to file bankruptcy as a pass-through entity, it is also practically impossible for an association to function if a significant amount of the units are in arrears. Once more than 15\% of unit owners are delinquent in their assessment

\textsuperscript{127} See infra Part II.B.1 (discussing how lenders benefit from upkeep pre-foreclosure). See also Hart supra note 5 and Lemley supra note 65.

\textsuperscript{128} Bayles, supra note 11.

\textsuperscript{129} See Hyatt, supra note 14, at 121. A similar fate befell Alaskan condominiums when workers abandoned their units and moved away after the completion of the Alaska pipeline. See Min Dixon, WHAT HAPPENED TO FAIRBANKS? THE EFFECTS OF THE TRANS-ALASKA OIL PIPELINE ON THE COMMUNITY OF FAIRBANKS, ALASKA (Westview Press, 1980).

\textsuperscript{130} Condominium ownership form has the unit owners holding title to all common areas as tenants in common. The association’s role is purely governance.

\textsuperscript{131} Hyatt, supra note 14.
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payments, FHA insurance and Fannie Mae loan qualification becomes unavailable for purchaser mortgages on units in that community. At that level of delinquency, neither associations nor their member owners can obtain financing.

Bankruptcy law currently offers no good solution. Courts generally disallow bankruptcy filings by community associations because the associations have assessment powers, and courts can force associations to levy assessments on unit owners to pay for association debt. Since associations can theoretically make special assessments to make up any budgetary shortfall, an association’s inability to pay its obligations is seen as a revenue problem rather than a debt or asset problem. Only if all the members of the association are themselves insolvent does the actual ability of an association to meets its debts become imperiled. There have been very few exceptions to this general rule, and each has presented an atypical case. For example, in the recent bankruptcy case filed in Florida by Maison Grande Condominium, the association had entered into a long-term recreation lease with an escalation clause and faced inability to meet this obligation when 25% of its units became delinquent while lease fees rose astronomically. The association filed a petition for Chapter 11 bankruptcy seeking to reject the lease, and the bankruptcy judge in that case permitted the lease rejection. The court noted that the board of directors had concluded that further increases of assessments would be unavailing because unit owners had advised the board that they lacked the ability or willingness to pay. This case, however, is an anomaly and upon closer reading seems to be

132 Professor Evan McKenzie calls association bankruptcy attempts “a disaster” that accomplishes nothing. Joseph Dobrian, Condominium Associations Hard Hit by Foreclosures Consider Bankruptcy, J. OF PROP. MGMT., May 1, 2010 (quoting McKenzie). Recently scholars have called for reformation of the Bankruptcy Code to offer some relief to beleaguered condominium associations, Pinkerton supra note 12 at 142-147 (citing the inescapable “Death Spiral” of association unpaid dues and debt).


134 Comment, Escaping the Death Spiral of Dues and Debt: Bankruptcy and Condominium Association Debtors, 26 EMORY BANKR. DEV. J. 125 (2009), 147-164.


136 Id. at 688 (“Some owners advised members of the Board that they lacked the financial resources to pay additional assessments. Others advised the Board that they would refuse to pay additional assessments that were only necessitated by other owners not paying their fair share. The Board also took into consideration the demographics of the unit owners, including the fact that many are elderly
predicated on a finding that the subject lease’s escalation clause was illegal in Florida as against public policy.\textsuperscript{137}

More typical is the approach of another Florida bankruptcy case, in which the court adamantly rejected the association’s proposed Chapter 7 bankruptcy.\textsuperscript{138} The association had sought to dissolve and be reformed in order to avoid payment obligations to a roofing vender that it could not meet without significant increases to assessments. The court rejected this plan, calling the association’s attempt to avail itself of bankruptcy protection bad faith.\textsuperscript{139} Carla Barrow, counsel to the roofing company, noted that at least eight other condominiums had also filed for some sort of bankruptcy protection in south Florida, attempting to avoid paying for roof repairs,\textsuperscript{140} but such attempts are unlikely to be successful. In 2010, Florida passed the Distressed Condominiums Relief Act which, among other things, specifically empowered associations to take stronger measures to recover revenues from non-paying owners and permits “bulk assignees” and “bulk buyers” to take over unsold developer condominium inventory, assuming assessment obligations but not other liabilities of the original developer.\textsuperscript{141}

Without bankruptcy as a potential escape from financial obligations in excess of collected funds, associations with assessment delinquencies are left with only one alternative: increase assessment amounts and hope the paying members will make up the shortfall. Charging paying members more to make up for neighbor defaults is not only unfair,\textsuperscript{142} but it is unlikely to actually save the community from \textit{de facto} insolvency. As the court in \textit{Maison Grande} noted, increased assessments will likely increase delinquencies.\textsuperscript{143} Increased delinquencies lead to increased assessments that can further increase delinquencies, requiring still greater increases of assessments (\textit{ad

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\textsuperscript{137} Id. at 702.

\textsuperscript{138} In re Boca Village Association, Inc., 422 B.R. 318 (2009).

\textsuperscript{139} Id. at 321-325

\textsuperscript{140} Dobrian, \textit{supra} note 132.

\textsuperscript{141} Florida SB 1196, creating new Sections 718.701 – 718.708 to the Florida Code.

\textsuperscript{142} See Hart \textit{supra} note 5.

\textsuperscript{143} In re Maison Grande, 425 B.R. 684, 688.
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infinitum). Barring some ability to actually recover from non-paying owners or properties, the only remaining solution is to have a public (state, local, federal) government step in and bail out communities which are unable to collect sufficient revenues from their members.\(^{144}\) Private government failure in such a case would be similar to local government failure when tax revenues are insufficient to maintain the community and state or federal bailout funds are sought, although local governments – unlike community associations – can, in fact, declare bankruptcy.\(^{145}\)

C. PAYMENT COLLECTION AND LIEN PRIORITY

1. ASSOCIATION COLLECTION EFFORTS

Because of the difficulty of enforcing payment obligations in privately governed communities, conventional wisdom holds that an association board should act quickly in response to nonpayment of assessments. An association with delinquent members has the ability to enforce its payment obligation in several ways. Associations may be able to use self-help by denying a delinquent owner the right to use common elements or by suspending the owner’s voting rights.\(^{146}\) For example, a nonpaying unit owner may be barred from using a community amenity such as a swimming pool or health club. The extent to which services may be denied depends on state law. For example,

\(^{144}\) See Dobrian, supra note 132.

\(^{145}\) Chapter 9 of the Bankruptcy Code providing for reorganization of municipalities (which includes cities, towns, villages, counties, taxing districts, municipal utilities, and school districts). It does not, however, cover common interest communities. Municipal bankruptcy legislation has a history of Constitutional fragility: the Supreme Court struck down as incompatible with the Tenth Amendment the initial attempt by Congress to craft bankruptcy protection for local governments. Ashton v. Cameron County Water Improvement Dist. No. 1, 298 U.S. 513, 532 (1936). In the more than 60 years since Congress established a Constitutionally viable municipal bankruptcy procedure, there have been less than 500 governmental bankruptcy petitions filed. Those filings which do occur, however, are typically extreme cases and – in case of large municipalities (e.g., Orange County, CA) – can involve many millions of dollars in municipal debt.

\(^{146}\) Hyatt, supra note 14, at 119. See How v. Mars, 513 N.W.2d 511 (Neb. 1994) (holding that both the association bylaws and Nebraska’s nonprofit corporations code permitted the association to deny delinquent owners the right to vote in the community). But see Mountain Home Properties v. Pine Mountain Lake Ass’n, 185 Cal. Rptr. 623 (Cal. Ct. App. 1982) (California law bars a community association from denying membership privileges to a new members because of the unpaid association debts of the new member’s predecessors in interest). In most cases, private governments are able to suspend voting rights of members due to non-payment of assessments even though public governments may not suspend the right to vote based on non-payment of taxes. A Florida law passed in July 2010, Florida SB 1196, clarifies the availability of this type of self-help in Florida, for example. For further discussion of how assessments in communities are similar to and yet distinct from taxes, see infra Part II.A.3.
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a Texas court permitted an association to turn off the utilities of a delinquent owner, but few states permit the discontinuance of essential services, such as heat, water or electricity.

If such efforts fail, an association can commence an action to collect a debt against the non-paying owner. Federal case law is split on the issue of whether association assessments are debts for the purposes of the 1966 Fair Debt Collection Practices Act, 15 U.S.C. § 1692, which would require certain explicit warnings and notices to be served prior to collection efforts. To the extent an association complies with any such applicable laws, it can thereafter bring lawsuits against delinquent owners personally, claiming breach of contract and seeking damages equal to the unpaid assessment amounts. Collection based on a judgment against the owner can proceed like any other debt collection (garnishing wages, seizing assets, enforcing a judgment lien, etc.). Bringing a lawsuit, however, can be costly to the association in terms of time and attorney fees, and the paying owners – those who are already bearing the costs of their neighbors’ delinquencies – will have to foot that bill unless the costs of collection can be obtained by the delinquent owner or ultimate responsible party. Nevertheless, these sorts of collection actions are how the bulk of unpaid assessments are eventually collected.

The lien on the defaulting owner’s property that association covenants create for delinquent assessments is another tool for delinquency recovery. The lien guaranties

147 San Antonio Villa Del Sol Homeowners Ass’n v. Miller, 761 S.W.2d 460, 464-465 (Tex. App. 1988) (“A condominium dweller who does not pay his share of the maintenance fee, admits that the other owners are in essence paying his way, and fails to respond to notice of disconnection is in violation of the meaning and intent of the by-laws. The Association took appropriate action to abate this condition.”).

148 Among property managers, the belief is that the most efficient way to collect unpaid assessments is to turn off community-provided cable or satellite television service.

149 Compare, e.g., Bryan v. Clayton, 698 So. 2d 1236 (Fla. Dist. Ct. App. 1997) (assessments are not covered by the Act) with Newnan v. Boehm, Pearlstein & Bright, Ltd., 119 F.3d 477 (7th Cir. 1997) (past due assessment is a “debt” under the Act).

150 See Hyatt, supra note 14, at 119.

151 The priority of any such judgment lien, however, will be subordinate to any mortgages or other obligations currently secured by the property, and thus perfecting the association’s assessment lien likely offers a better chance for ultimate recovery.

152 See Hyatt, supra note 14, at 121.

153 See Pinkerton, supra note 12 at 143 (“Functionally, condominium associations only possess one remedy to recover their expenses from unit owners. They can obtain a lien on the unit for the amount
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that the association will be paid out the proceeds of any resale, after all senior interests are satisfied. Furthermore, a lien for unpaid assessments clouds the owner’s title and can be used as leverage to convince an owner who is seeking clear title (for sale or financing) to pay up. A last resort for associations is to foreclose on the property lien securing the assessment obligation.154

How useful foreclosure is as an enforcement tool depends greatly on the perfection and priority regime of the applicable state.155 A first mortgage loan on a particular

owed to the association by that unit owner. The association can then foreclose on its lien if the debt remains unpaid. However, this remedy is not very useful in the face of many states’ laws concerning the relative priority of mortgages”). The practical utility of the association lien has always been as a way to induce voluntary compliance with assessment obligations rather than as a means to collect from the asset’s value directly via foreclosure (although the viable threat of foreclosure can motivate payment). The problem arises in situations where a homeowner already is facing foreclosure (under the mortgage) and when the owner’s equity is gone. The association in such cases loses its power to motivate compliance. At this point, the only other interest holder of the property who still has a stake in its value is the first mortgagee, which is why eroding that priority position may incentivize a lender to pay or cause a borrower to pay assessments. A lender would be motivated to pay to preserve its own collateral value if its claim on the property would diminish should assessments remain delinquent.

154 See, e.g., Societe Generale v. Charles & Co. Acquisition, Inc., 587 N.Y.W.2d 1004, 1009 (N.Y. App. Div. 1993) (“[A] condominium’s lien for unpaid common charges may be foreclosed in the same manner as a mortgage on real property.”); Unif. Common Interest Ownership Act §3-116; Unif. Condo. Act §3-116 (1977) (amended 1980). Some state laws limit recovery for debt repayment from foreclosure of a homestead. Homestead exemptions protect a certain amount of equity from sale to satisfy a debt. In Missouri, for example, the first $15,000 of debt is exempted as the owner’s homestead. Florida, Texas, Oklahoma and Colorado have virtually unlimited homestead exemptions. See, e.g., 17 TEX.PROP.CODE ANN. Sec. 52.001 (Vernon Supp.1994).2 Section 41.001 of the Texas Property Code that provides a homestead is “exempt from seizure for the claims of creditors.” Mortgage lenders typically require an explicit waiver of this statutory protection of borrower equity. Similarly, association declarations may purport to waive application of the homestead exemption for foreclosure of the association lien. Many states have passed statutes explicitly carving out CIC associations from the applicability of such limitations. The Colorado statute expressly authorizes an association to ignore the homestead exemption otherwise applicable in that state. BA Mortg., LLC v. Quail Creed Condominium Ass’n, Inc., 192 P.3d 447 (Colo. App. 2008). Texas, a state with a very broad homestead exemption, allows association foreclosure to circumvent this limitation. Inwood N. Homeowners’ Ass’n v. Harris, 736 S.W.3d 632 (Tex. 1987). In other states, the applicability of the homestead exemption to association lien foreclosure proceedings is less clear. See, e.g., Knolls Condominium Ass’n v. Harms, 202 Ill.3d 450, 781 N.E.2d 261 (III. 2002) (holding that the homestead exemption did not preclude the association suing for possession of a defaulting unit, but not reaching the question of whether it would preclude foreclosure of the association’s lien); Andres v. Indian Creek Phase II-B Homeowner’s Ass’n, 901 So.2d 182 (Fla.App. 4 Dist., 2005) (dicta expressing doubt that covenants purporting to waive the state’s homestead exception would be effective).

155 See Hyatt, supra note 14, at 120-121. In some states, perfection of the lien is automatic. In other states, a filing is required to perfect the lien. State law may require re-filing to maintain perfection, for
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unit in a CIC enjoys senior priority to the association’s assessment lien in all states (although the first mortgage priority is subject to a capped payment priority association lien in several states). In those states lacking a six-month super-priority for assessment liens, the association will only be able to recover from the sale if foreclosure proceeds exceed the senior loan amount.

Depending on the jurisdiction, lien foreclosures are effected either by a sale in a court action in equity or by private power of sale granted in the security instrument. Judicial foreclosure is the exclusive method of foreclosure in over one-third of the states, and it is available in every jurisdiction. Judicial foreclosures are complicated, costly and time consuming compared with non-judicial foreclosures pursuant to a power of sale. Some states that permit a mortgage containing an explicit power of sale to be non-judicial foreclosed will likewise permit non-judicial

example, in New Hampshire, a notice of an association’s lien must be re-filed every six months to retain perfection. States specifically prescribe the method of foreclosure and the process required in order to legally foreclose on real property. In addition, certain states have attempted to limit the power of associations to foreclose based on unpaid assessment liens. For example, in 2004, a bill in California that would have set a threshold of $2,500 of unpaid assessments before an association could pursue foreclosure was vetoed by Governor Schwarzenegger. See Jim Wasserman, Schwarzenegger Rejects Ban on Foreclosures, ASSOCIATED PRESS, available at http://www.calhomelaw.org/doc.asp?id=462.

See infra Part I.C.2.

See, e.g., Long Island Savings Bank, F.S.B. v. Gomez, 568 N.Y.S.2d 536 (Sup. Ct. NY 1991) (an association’s junior lien is extinguished by foreclosure of the senior priority mortgage); Board of Directors of Olde Salem Homeowners Ass’n v. Secretary of Veterans Affairs, 589 N.E. 2d 761 (App. Ct. Ill. 1992) (a buyer at mortgage foreclosure takes the property free of assessments accruing prior to recording of deed, which were extinguished by the foreclosure action).

Nelson & Whitman supra note 55, 600-601.

Id. Judicial foreclosure is the exclusive or generally used method in Arkansas, Delaware, Florida, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Montana, Nebraska, New Jersey, New Mexico, New York, North Dakota, Ohio, Pennsylvania, South Carolina and Wisconsin. In two other states, Connecticut and Vermont, foreclosure is judicial but is not a public sale, but rather is a transfer of ownership to the lienor (called strict foreclosure).

In some states, an explicit statutory right to foreclose through the court exists. In others, judicial foreclosure is available as an incident to the jurisdiction of courts of equity. See Lansig v. Goelet, 9 Cowen 346 (N.Y. 1827).

foreclosure of association liens. Such states have a separate foreclosure statutory provision dealing solely with association liens.  

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Foreclosure of an assessment lien is viewed by most associations (as well as owners and legislatures) as “a last resort.” First of all, foreclosure proceedings – even in states permitting nonjudicial foreclosure of association liens – involve significant upfront costs such as advertising, auction and legal fees. These costs would have to be borne by the neighborhood as a whole, unless they can be recovered from the delinquent owner. Second, a buyer who purchases at an association foreclosure would take the property subject to a first priority mortgage lien unless that loan amount is paid off. This vastly decreases the ability of the association to find a third-party


163 Benny Kass, Condo Board Can Foreclose for Delinquent Fees, WASH. POST (Feb 14, 2009). See also Baker v. Monga, 590 N.E.2d 1162 (Mass. App. Ct. 1992) (holding a unit valued $350,000 may be foreclosed for the owner’s nonpayment of assessments totaling less than $3,000). Recent unsuccessful bills in California have attempted to place a significant dollar amount threshold limit on when an association could pursue foreclosure to enforce its lien for unpaid assessments. California SB 1682/AB 2598 (2004).

164 Junior priority liens are wiped out by foreclosure, after paying amounts owed to the association, are distributed to such lienors in order of priority, but buyers at the foreclosure of a junior lien, however, take subject to senior liens. Most courts have held and scholars have opined that this “subject to” means that a junior lien foreclosure transfers the property with the senior liens intact but unpaid. Nelson & Whitman, supra note 55 at 611-614. See also, e.g., In Shaikh v. Burwell, 105 N.C. App. 291, 412 S.E. 2d 924 (1992) (“If the trustee is only foreclosing on the junior deed of trust, the senior lien continues with the property and the trustee must sell subject to the senior lien”). In a puzzling recent Virginia decision, however, foreclosure of an association’s junior lien was misinterpreted to mandate payment of the first mortgage, rather than a sale of property subject to a first mortgage lien. The Supreme Court of Virginia, in Board of Directors of the Colchester Towne Condominium Council v. Wachovia Bank, N.A., over a vigorous dissent, interpreted the statutory authority to foreclose the unit “subject to prior liens” to mean that proceeds of the association’s foreclosure sale must be used first to satisfy the lien of the first deed of trust before any delinquent assessments are reimbursed. 581 S.E.2d 201, 203 (2003). The doctrinal basis of the holding seems misconstrued. The majority cites principles of interpretation – that a statute should be read to be internally consistent – to support its conclusion. But the asserted inconsistency seems to arise from the court’s complete misunderstanding of secured transactions law. The court states that by granting first mortgage liens super priority in VA Code § 55-79.84(A), the Virginia Legislature implicitly required the judicial reformation of the statutory repayment “waterfall” in an association foreclosure, as contained in VA Code § 55-79.84(I)(5)(c). As the dissent noted, this interpretation “is inconsistent with that phrase’s well understood and long accepted meaning.” 581 S.E.3d at 205 (Lacy, J. dissenting). J. Lacy also notes that there is nothing ambiguous or inconsistent in the statute that requires judicial re-writing of the language to reach the majority’s result, chiding that “We generally do not engage in adding words to a statute.” Id. While this decision runs contrary to nearly every other interpretation of the term “subject to,” the Virginia General
buyer at such a sale. In fact, in today’s environment of underwater properties, finding an interested third-party buyer at a junior lien foreclosure would be unlikely at best.

In the absence of a third party buyer, the association in an assessment foreclosure would be forced to take title to the unit itself. While this strategy might allow an association to rent out a unit and pay rental proceeds toward association costs, this approach is risky. Once an association takes title to a unit, it becomes responsible for the assessments on that unit, which means that the unit’s assessment obligations will continue to be spread among the paying owners in the community – precisely the unsatisfactory result that collection efforts against the prior owner were trying to avoid in the first place. As the owner, the association also becomes liable for property taxes, meaning that yet another cost is passed on to the community. Although the association could theoretically mitigate these costs by renting out the unit, this would entail the association becoming a landlord, exposing the community to the various risks and liabilities of assuming that role. Even should an association be willing to serve as a landlord, rental properties which are subject to pending mortgage foreclosure – and therefore potentially terminable with little advance notice – would likely fetch rentals that are far below market. The depressed rental revenue may not be enough to pay property taxes and assessment charges on the unit.

Generally, senior lienholders cannot be joined in a foreclosure action involuntarily.\textsuperscript{165} Some dated case law supports the contention that a junior lienor may join a senior lienor in a combined foreclosure proceeding when the senior loan is also in default and is due and payable.\textsuperscript{166} In the unlikely event that this doctrine would gain new traction, it could permit foreclosing associations to join a lender and potentially safeguard its lien in a sufficient sale or, at least, speed the process of senior lien foreclosure, giving associations the legal ability to self-protect in an environment of lender foreclosure.

Assembly has thus far been unable to pass legislation correcting this judicial precedent. See most recently S.B. 411, 2010 Session (VA 2010) (stricken Jan. 27, 2010).

\textsuperscript{165} Nelson & Whitman, \textit{supra} note 55 at 611. See, \textit{e.g.}, Osage Oil & Refining Co. v. Mulber Oil Co., 43 F.2d 306, 308 (10th Cir. 1930).

\textsuperscript{166} See, \textit{e.g.}, Hagan v. Walker, 55 U.S. (14 How.) 29, 37 (1852); Masters v. Templeton, 92 Ind. 447 (1883); Hefner v. Northwestern Mutual Life Insurance Co., 123 U.S. 747, 754 (1887) and Peabody v. Roberts, 47 Barb. 91 (N.Y. 1866). Even as late as 1992, the court in \textit{In Shaikh v. Burwell}, 412 S.E. 2d 924 cited five possible “special circumstances” that would enable a junior lienor to join a senior lienor in a foreclosure action.
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delays. Most courts today, however, agree that a lienor has the right to choose the timing of foreclosure of its lien.167

2. PRIORITY BASELINE

As a general rule, liens on real property enjoy a priority based on the order in which they were perfected.168 This first-in-time basic presumption is usually subject to a handful of exceptions under state law, including municipal real property taxes, which always enjoy the highest lien priority.169 In addition, most states set the priority of a mechanics’ lien supporting payment obligations for work done to the real property itself as relating back to the date on which such work was commenced.170 In the absence of a statutory directive to the contrary, assessment liens follow the general first-in-time priority rule, and because mortgage loans typically are funded prior to assessment delinquencies, such first mortgage liens are senior to assessment liens.171 The California Condominium Act, for example, explicitly follows the first-in-time rule, setting lien priority according to the time a separate “notice of delinquent assessment” is filed in the land records.172

In some states, assessment liens are considered automatically perfected with the date of perfection relating back to the date on which the association was formed (when the declaration was filed in the land records).173 However, statutes defining priority in such states specifically make an exception for first mortgage liens on individual units within the community, permitting the first mortgage to always enjoy a priority senior to the association lien, even though the first-in-time rule would otherwise deem the

167 Nelson & Whitman, supra note 55. This creative approach is similar to the “mortgage terminator” approach that has recently been used on occasion in Florida. See infra Part II.A.2.
168 Nelson & Whitman, supra note 55.
171 An increasing number of states have statutorily created a limited priority for such liens. See discussion at infra Part II.A. Some states define the time of perfection for association liens as relating back to the date on which the association was collected. See infra note 173 and accompanying text.
172 West’s Ann.Cal.Civ.Code § 1367.1(b) and (d).
173 The Uniform Common Interest Ownership Act takes this approach. See UCIOA § 3-116. See also Tex. Prop. Code § 82.113 (1997); Fla. Stat. Ann. § 718.116(1)(b1. to 2. See also, e.g., American Holidays, Inc. v. Foxtail Owners Ass’n, 821 P.2d 577 (Wyo. 1991) (date declaration was recorded deemed the date of perfection for assessment lien).
related-back perfected association lien to be first.\textsuperscript{174} For example, the Virginia Condominium Act provides that the assessment lien is subordinate to “sums unpaid on any first mortgages or deeds of trust recorded prior to the perfection of said lien for assessments and securing institutional lenders.”\textsuperscript{175} Arizona’s Condominium Act protects first mortgage priority still further, providing that such liens are always superior to assessment liens regardless of when they arose.\textsuperscript{176} Maryland and North Carolina also deem an association lien completely subordinate to first mortgage liens on units within the community.\textsuperscript{177} In states where the statute is arguably vague as to the priority position of the first mortgage, courts have clarified that even an assertion of super priority in the declaration establishing the community will not create a priority superior to a first mortgage lien.\textsuperscript{178} Thus, regardless of jurisdiction, first mortgages on units within a community are senior in priority to association liens for unpaid assessments. Legislatures and courts cite a policy of promoting financing availability as the motivation for this priority scheme.\textsuperscript{179}

Holders of junior claims on the property (both liens and holders of equity) must be joined in a foreclosure proceeding in order to terminate their rights.\textsuperscript{180} Because the association is a junior lienor, a foreclosing first mortgage loan is required to name the association as a necessary party to the foreclosure proceeding, and any excess sale proceeds beyond the amount owed on the first mortgage will be applied to the association’s claim. However, where mortgages are under collateralized, foreclosure sales typically do not obtain sufficient proceeds to pay off the first mortgage, let alone junior liens. Whether or not paid off, junior liens are wiped out in foreclosure of the senior lien.

\textsuperscript{174} See, e.g., \textsc{Colo. Rev. Stat.} § 38-33.3-316. This way of conceptualizing the priority of association liens likely originated with the FHA Model Condominium Act of 1961. In some cases, the priority granted first mortgage liens is subject to a capped super-priority. \textit{See} Part II.A. below.

\textsuperscript{175} \textsc{Va. Code Ann.} § 55-79.84(A).

\textsuperscript{176} \textsc{A.R.S.} § 33-1256.B.

\textsuperscript{177} \textsc{Md. Code Ann., Real Property} § 11-110; \textsc{N.C. Gen Stat.} § 47C-3-116.


\textsuperscript{179} See, e.g., Board of Directors of Colchester Towne Condominium Council v. Wachovia Bank, N.A., 581 S.E.2d 201, 202 (Va. 2003) (explaining that “the realities of the marketplace require that such lenders be encouraged to provide the desired financing for individual condominium units by granting priority to the lien of their first mortgages or first deeds of trust”).

\textsuperscript{180} Nelson & Whitman, \textit{supra} note 55 at 570-573 and 602-608.
Courts and legislatures in some states have attempted to limit the extent of association losses and protect community members against non-payment of assessments, even lacking any priority protection with respect to first mortgages. In New York, for example, the statutory lien securing all unpaid condominium assessments is junior in priority to first mortgage liens, and case law in New York confirms that all sums related to a first mortgage lien (including collection costs, fees, etc.) on a unit within a community take priority over an association lien. If a unit is delinquent on assessments in New York, however, legislation provides that the association may obtain a court-appointed receiver which will pay regular assessments to the association prior to making any mortgage payments, or can collect rents directly from a tenant. Case law clarified that this provision does not apply to special assessments which are payable by a receiver only after mortgage loan payments are made.

Even without appointing a receiver or foreclosing its lien, associations in Florida, like New York, can collect rents directly from any tenants living in units owned by defaulting members. The 2010 amendment to the Florida common interest community act provides that associations can collect rent payments directly from tenants when the owner of a unit is delinquent, and further provides that if tenants will not pay rent to the association, the board can evict them. The revised law also

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181 A limited priority lien for assessment liens has been proposed multiple times to the New York legislature, but lenders have lobbied against the adoption of the measure. The first year it was proposed, the measure was allowed to die in committee. The next year, it was defeated on the floor. See Ronald A. Sher, Habitat Board Leadership Conference Seminar: Condo Collections, available at www.himmelfarb-sher.com/options/condo_collections.htm.

182 Real Property Law, Condominium Act, Sect. 339-z.


184 N.Y. RPAPL Sec. 1325(2).


186 See Florida SB 1196 which went into effect July 1, 2010, and Amended NYS Gen bus. L. Sec. 352-2(2-d).

187 SB 1196, codified at Fla. STAT. CH. 718.116. The newly amended Florida provision attempts to permit associations to walk the fine line between incurring landlord liability and having the authority to collect rents and evict tenants. Tenants in Florida and New York, however, raise a valid complaint that they have no contractual or property relationship with the association (except indirectly through their landlord), and that even though the statute in question purports to immunize tenants who pay rents to the association against eviction by the landlord, landlords can do much to lower a tenant’s quality of life while still acting within the strict “letter of the law” of a lease. See Kenric Ward, Condo Associations
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explicitly permits associations to suspend voting privileges for owners who are ninety days delinquent in their assessments and clarifies that associations can restrict delinquent owners’ use of common areas.\footnote{188}{Id.}

Bankruptcy of a delinquent owner may impact an association’s ability to be repaid delinquent assessments, particularly in Chapter 12 which permits junior liens to be “stripped” of their collateral claims when the collateral’s value is less than the amount owed on a senior debt.\footnote{189}{Bankruptcy Code § 506(d) provides that when prior liens against a creditor’s collateral exceed its value, then junior liens are void and can be “stripped off” of the property. See In re Cook, Case No. 10-10113-SSM (U.S. Bankruptcy Court, E.D.N.Y., Nov. 10, 2010). See also Bankruptcy Code § 523(a)(16). Although Congress has specified that post-petition assessments are non-dischargeable in Chapter 7 bankruptcies, this carve-out specifically does not apply to pre-petition debts including assessments. Id.}

In a November 2010 decision, the Bankruptcy Court ordered a community association stripped of its unpaid assessment lien in the amount of nearly $7,000 because the property was subject to a first mortgage debt that exceeded its current county-assessed value, which, the court opined, left no excess security to which the association’s lien could attach.\footnote{190}{In re Cook, Case No. 10-10113-SSM (U.S. Bankruptcy Court, E.D.N.Y., Nov. 10, 2010).} Although the association in that case argued that the cited real estate value for the property was “artificially low” because of a depressed housing market,\footnote{191}{The association cites the “economic crisis that was triggered by the sub-prime mortgage loan meltdown” as having caused the drop in property valuation. Id.} the court refused to preserve the lien “based solely on anticipated future increase in the value of a secured creditor’s collateral.”\footnote{192}{In re Cook, Case No. 10-10113-SSM (U.S. Bankruptcy Court, E.D.N.Y., Nov. 10, 2010).} The court held that while under-secured creditor’s liens are generally valid, in the case of a party whose secured claim has “inconsequential value,” a bankruptcy filing should cause the lien to disappear.\footnote{193}{Id.} The operation of the Bankruptcy Code in this


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case further bolsters the argument that a fully junior priority for association liens is inequitable, particularly in the case of homes securing under-collateralized mortgages.

II. ALTERNATIVES TO FAILED PRIVATE GOVERNANCE

Under current laws, owners in a CIC face financial uncertainty stemming from the ownership structure and assessment model of their community. Linked fiscal fortunes means that owners face the threat of ever-increasing assessments due to their neighbors’ delinquencies, and these unpaid assessments may never be recovered because of such neighbors’ mortgage defaults. The status quo in most states is not only destabilizing, it is inequitable, allowing a lender to be unjustly enriched by association maintenance while its share of the costs are paid by non-defaulting neighbors. Courts and legislatures have struggled to resolve such unfairness, particularly now that the current crisis has highlighted this deficiency in the CIC assessment system.

A. ATTEMPTED AND SUGGESTED SOLUTIONS

1. LIMITED PRIORITY LIENS

a. UCIOA and Six-Month Limited Priority Lien

The drafters of the Uniform Common Interest Ownership Act (UCIOA), recognizing that assessment liens would ordinarily be junior in priority to individual first mortgage liens, crafted an “innovative” solution to the problem of assessment non-payment during mortgage default: the six-month “limited priority lien.”

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194 See Hart supra note 5 and Rawls, supra note 5.

195 UNIF. COMMON INTEREST OWNERSHIP ACT (1994). In 1977, the National Conference of Commissioners on Uniform State Laws began drafting the Uniform Condominium Act based on the 1974 Virginia model. Subsequently, the Conference prepared three uniform laws governing condominiums, cooperatives and homeowners associations – the three forms of privately governed communities with different ownership structures. The Uniform Condominium Act (UNIF. CONDOMINIUM ACT (1980)), the Uniform Planned Community Act and the Model Real Estate Cooperative Act. The Conference then combined the three acts, resulting in the Uniform Common Interest Ownership Act. This Act contains provisions governing condominiums, planned unit development/homeowner associations, as well as cooperatives.

196 As discussed in a presentation by Carl Lisman, Chair of UCIOA’s drafting committee, at “The Uniform Common Interest Ownership Act,” American Homeowners Resource Center, Jun3 9, 2006, transcript available at http://www.ahrc.com/new/index.php/src/news/sub/article/action/ShowMedia/id/2929. Lisman seems to believe that the UCIOA limited priority lien solves the problem of non-payment of assessments, noting that “we are now convinced that we are more brilliant than we thought we were.”
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UCIOA model law, which has been adopted by eight states to date, provides that an assessment lien, which is normally subordinate in priority to first mortgages on units, is given limited priority upon foreclosure of the first priority mortgage lien “to the extent the common expense assessments based on the periodic budget adopted by the association… would have become due in the absence of acceleration during the six months immediately preceding institution of an action to enforce the lien.” Thus, an association under UCIOA would have a priority position arising at a mortgage foreclosure sale for unpaid assessments up to an amount equal to six months of regular assessment assessments.

The six-month capped “super priority” portion of the association lien does not have a true priority status under UCIOA since this six-month assessment lien cannot be foreclosed as senior to a mortgage lien. Rather, it either creates a payment priority for some portion of unpaid assessments, which would take the first position in the foreclosure repayment “waterfall,” or grants durability to some portion of unpaid assessments, allowing the security for such debt to survive foreclosure.

The UCIOA priority portion does not include a costs incurred by the association to collect delinquent assessments, such as attorney fees. Some states, however, have

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197 Nevada, Alaska, Colorado, West Virginia, Connecticut, Vermont, Minnesota and Delaware. Legislative proposals to adopt UCIOA are pending in six more states: Utah, Indiana, New Jersey, South Carolina, Kentucky and Ohio.

198 UNIF. COMMON INTEREST OWNERSHIP ACT § 3-116 (1994).

199 Under such a capped priority arrangement, the priority position of the association lien is split: a super-priority position is given to up to six months of unpaid assessment amounts, and the remainder of unpaid amounts is accorded the typical priority position of the association lien, namely subordinate to the first mortgage lien.

200 Under this interpretation, six months of unpaid assessments are paid out of foreclosure proceeds prior to repayment of the first mortgage. See, e.g., Minnesota Code Chapters 500 - 515B Property Interests and Liens, Chapter 515A Uniform Condominium Act, Section 515A.3-115 Lien for Assessments.

201 Under this interpretation, a lien securing six months of unpaid assessments would survive the first mortgage foreclosure. One problem with this second interpretation of the super-priority provision is that post-foreclosure, an association often still has to bring a lawsuit against the buyer or lender to recover the six months of allowable unpaid assessments. This can be onerous for the association. For example, in Georgia, an association cannot recover the costs of bringing an action to recover the six months’ worth of assessments against the lender. First Federal Savings Bank of Georgia v. Eaglewood Court Condominium Ass’n, 367 S.E.2d 876 (Ct. App. GA 1988) (the statutory language limits recovery from the lender at six months of assessments and does not include costs of collection of such assessments).

202 The effect depends on a state’s interpretation of the provision.
enacted statutory variations that include such costs. According to D.C. lawyer Catherine Park, the failure of strict UCIOA states to include attorney costs can be exploited by mortgage lenders, who gamble that an association will not hire an attorney to recover “a mere six months” of unpaid assessments.

The lien priority concept contained in UCIOA has gained traction even in states that have not otherwise enacted these uniform acts. Today, in the eight UCIOA states (Alaska, Colorado, Connecticut, Delaware, Minnesota, Nevada, Vermont and West Virginia) and in nine more states (Alabama, Florida, Illinois, Massachusetts, New Jersey, Pennsylvania, Rhode Island and Washington) and in the District of Columbia, community association liens enjoy

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203 See, e.g., MASS. GEN. LAWS 183A § 6 and CONN. G.S.A. § 47-87.
204 Catherine Park, “Super Lien” Legislation: How Super is it Really? And Why isn’t the Mortgage Industry Complying with the Legislation?, Condominium Law Blog (July 10, 2010), available at http://cparklaw.com/condolaw/category/condo-fees/. See also supra note 152 and accompanying text. According to Park, the only way for would-be homeowners to protect themselves in such jurisdictions is to “avoid buying in a small community” and thereby hope to minimize the budgetary impact of assessment defaults. Id.
205 ALASKA STATUTES § 34.08.470.
206 COLO. REV. STAT. § 38-33.3-316; see infra notes 223-29 and accompanying text.
207 C.G.S.A. § 47-258.
208 25 DEL.C. § 81-316.
209 MN. STATUTES SECTIONS 515B.3-115(a), (e)(1)-(3), (f) and (i).
211 VERMONT CODE, TITLE 27 – PROPERTY, CHAPTER 15 § 1323
212 WEST VIRGINIA CODE CHAPTER 36B, §36B-3-116
213 ALA.CODE 1975 § 35-8A-316.
214 WEST’S F.S.A. § 718.116. See infra notes 257-63 and accompanying text.
215 765 ILCS 605/9. Illinois Condominium Property Act sec. 9(g) requires the association board to have “taken action” to trigger requirement that subsequent purchasers of a foreclosed unit pay six months of unpaid assessments.
216 MASS. GEN. LAWS 183A § 6. The Massachusetts statute includes a provision for attorneys fees together with a dollar-amount cap.
218 PENNSYLVANIA CODE TITLE 68, SECTION 3314.
219 H7512 Sub A.
220 WASHINGTON CODE TITLE 64 SECTION 64.34.364.
a limited priority, typically capped at six months. Legislatures in five more states (Indiana, Kentucky, Ohio, South Carolina and Utah) have been considering adopting a UCIOA-based statute which would include a six-month lien priority for unpaid assessments.\(^\text{222}\) Even with these progressive statutory developments in many states, more than 30 states still lack any lien priority for association assessments.

To illustrate the typical UCIOA lien priority approach, consider the Colorado Common Interest Ownership Act (CCIOA).\(^\text{223}\) Under this statute, association liens (which includes assessments and all collection costs) are considered automatically perfected as of the date the association was created.\(^\text{224}\) This lien is subordinate to property tax liens and to a first deed of trust on the property, but it is superior to all other encumbrances of record regardless of when such other lien is filed.\(^\text{225}\) At foreclosure of a first deed of trust on a property,\(^\text{226}\) the association lien will be paid according to a limited priority position to the extent of six months of budgeted assessment amounts.\(^\text{227}\) Colorado courts have held that that lien may be more than assessments alone and includes “attorney fees, interest & other allowable items.”\(^\text{228}\)

\(^{221}\) D.C. Stat. § 42-1903.13.

\(^{222}\) See discussion MALLACH supra note 26.

\(^{223}\) COLO. REV. STAT. § 38-33.3-316. The 1992 version of CCIOA automatically applies to associations created after 1992, but any pre-1992 association can elect to avail itself of the protections and provisions of the Act. By electing to come under the 1992 CCIOA, an association can effectively change the provisions in its own governing documents, without filing an amendment, since application of the law is deemed to change inconsistent declaration language to conform to the Act.

\(^{224}\) Id. This automatically perfected lien applies “any assessment levied against that unit or fines imposed against its owner,” which includes fees, late charges, attorneys’ fees and interest. There is no limit on late fees and interest, but it is arguably unclear whether the statutory language includes attorney fees.

\(^{225}\) This is because the priority timing for the association lien relates back to the recordation of the declaration. Id. This applies only to liens for deeds of trust recorded after 1992 when CCIOA was created. For all such provisions, the super-priority six-month lien applies, regardless of language in the community documents or the deed of trust to the contrary.

\(^{226}\) A deed of trust is essentially a mortgage. Non-judicial foreclosure through power of sale in a deed of trust is the common foreclosure method for mortgage liens in Colorado, however the only way to foreclose an association lien is through a judicial proceeding.

\(^{227}\) The super-priority amount is “based on a periodic budget adopted … which would have become due, in the absence of any acceleration, during the six months immediately preceding institution … of an action or non-judicial foreclosure either to enforce or extinguish the lien.” Id.

\(^{228}\) First Atlantic Mortgage, LLC v. Sunstone North Homeowners Ass’n, 2005 WL 427700 ( Colo. App.).
Colorado, the lien is not payable out of foreclosure proceeds, but rather survives the foreclosure of the first deed of trust (a durability interpretation of the UCIOA lien priority provision). 229

Some lien priority statutory provisions in non-UCIOA states originated in response to past housing crises imperiling community associations in that jurisdiction. For example, Massachusetts’ lien priority law grew out of the state’s real estate boom and bust of the late 1980s and early 1990s. 230 Two decades ago, Massachusetts associations struggled with massive budget shortfalls when homeowners abandoned units they could no longer afford, and the communities had to increase assessments on the remaining owners to keep the association afloat. The remaining owners often could not afford to make up extra payments to bridge the budgetary gap, which led to a domino effect of assessment and mortgage delinquencies. Today, CIC liens in Massachusetts have a capped super-priority because of judicial and legislative efforts to protect communities during the 1990s. 231

Rhode Island’s lien priority law is one of the newest in the nation: passed unanimously in the state’s House and Senate in June 2008. 232 In 2008, legislation increased the capped foreclosure and collections cost amount to $5,000 and $7,500 respectively (inclusive of legal fees) and provided for a six-month lien priority for assessment liens upon foreclosure of the first mortgage. 233 Before the measure came to a vote and when seeking the governor’s veto thereafter, the Rhode Island Mortgage Bankers

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229 This follows logically from the limitation on non-judicial foreclosure of association liens. See supra notes 201-202.


231 In 1992, a Massachusetts appellate court ruled that owners had absolute obligation to pay assessments with no right to withhold them. Baker v. Monga, 413 Mass. 1101, 597 N.E.2d 444 (Mass. 1992). The holding was reiterated in Trustees of Prince Condominium Trust v. Prosser when the Massachusetts Supreme Judicial Court explained: “For the same reason that tax payers may not lawfully decline to pay lawfully assessed taxes because of some grievance or the claim against the taxing governmental unit, a condominium owner may not decline to pay lawful assessments.” 412 Mass. 723, 592 N.E.2d 1301 (Mass. 1992). The legislature further attempted to mitigate the harm felt by associations losing their entire assessment lien by passing Ch. 400 of Mass. General Laws 183A, providing for a six-month lien priority arising at closing.

232 The previous law not only failed to provide any lien priority for assessments liens, but capped an association’s reimbursement for foreclosure costs at $2,500, with any additional costs having to be paid by the community as a whole.

233 H7512 Sub A.
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Association strenuously objected to the new law’s lien priority provisions, claiming that it would spell the end of residential mortgage finance for community association housing in Rhode Island.\footnote{Dunn, supra note 107. “A bank is not going to take second place…in the chain of liens against the property. They want to be first,” asserted Terrance Martiesian, lawyer for the Rhode Island Mortgage Bankers Association. Id. (quoting Martiesian).} Legislative Counsel to the Bankers Association bemoaned the measure, claiming that “It’s basically picking the lenders’ pockets, at the end of the day.”\footnote{Id. (quoting James Hahn).} Rhode Island disagreed and passed the measure.

By crafting legislation that creates a six-month limited lien priority for assessments, state legislatures hope to motivate first mortgage lenders to help pressure non-paying owners to pay their delinquent obligations. If their borrowers make all their association payments, lenders can avoid paying six-months’ worth of assessments out of their foreclosure proceeds. If the property is under-collateralized and mortgage foreclosures takes vastly longer than six months, however, the six month priority cap actually may (perversely) induce a lender to delay foreclosure still further, until there is a ready third-party purchaser on hand. This is because a lender purchasing at foreclosure will be liable for all subsequent assessments and the foreclosure will also trigger the six-month payment obligation, increasing the prospective lender costs of foreclosing. Also, a lender will still likely recover more in an upside-down loan if a borrower makes payments on the mortgage rather than association deficiencies because the lender will only have to reimburse a six-month capped amount of association deficiencies at some future time.

b. Federal Housing Impacts on Association Fiscal Recovery

Federal agencies and government sponsored enterprises (Fannie Mae and Freddie Mac) insure or guaranty more than nine out of every ten mortgages that have been originated since the meltdown in credit markets in 2008.\footnote{U.S. Department of the Treasury and U.S. Department of Housing and Urban Development, REFORMING AMERICA’S HOUSING FINANCE MARKET: A REPORT TO CONGRESS, 12, (February 2011) [hereinafter TREASURY/HUD REPORT].} The FHA now insures nearly 50% of all residential mortgages, up from 1.7% of the market in 2006.\footnote{Id.; National Association of Realtors, November 2010. See also Rick Newman, Kill Fannie & Freddie? Not Likely! US NEWS & WORLD REPORT, FEB. 21, 2011.} As the buyer or insurer of nearly every currently originated mortgage loan, these federal policies regarding lending risk have an enormous impact in terms of capital
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availability. The policies of the FHA and the GSEs impact the resolution of the community assessment issue in two ways: first, by requiring any super-priority of assessment liens to be limited at six months worth of assessments, and second, by prohibiting loans secured by units located in condominiums with high rates of neighborhood mortgage defaults.

The GSE secondary market purchasers and the FHA insurers specifically define qualifying mortgages as a mortgage subject to no greater than a six-month capped assessment lien priority. This effectively prevents association recovery beyond that threshold. These definitions of qualifying mortgages make it impossible for a state to increase the priority of a community assessment. Such funding or insuring requirements therefore indirectly – but effectively – limit a community’s ability to fully recover delinquent assessments at foreclosure of an underwater unit. These federal guidelines drive the bulk of all mortgage lending and unless the six-month limitation is changed, will prevent state legislatures from acting to solve the community assessment delinquency problem.

In addition to their priority requirements for qualifying mortgages, policies of these entities significantly limit finance capital availability for condominium units. The Department of Housing and Urban Development (HUD) maintains a list of “Approved Condominium Projects” and FHA, Fannie and Freddie will not insure or purchase mortgages to units in condominiums not on the approved list. The new approval process implemented in the wake of the Housing and Economic Recovery Act of 2008 now disallows “spot loan” approvals – approvals based on applications for individual unit mortgages rather than the condominium as a whole. Condominium projects will not be approved unless, inter alia, no more than 15% of the total units are in

238 Fannie Mae’s Warranty of Condominium Project Legal Documents specifies that in order for a loan to be qualifying, “Any first mortgagor who obtains title to a condominium unit pursuant to the remedies in the mortgage or through foreclosure will not be liable for more than six months of the unit’s unpaid regularly budgeted dues or charges accrued before acquisition of the title to the unit by the mortgagor.” Fannie Mae Form 1054 (1208). Section entitled “Unpaid Dues.” Freddie Mac’s Condominium Unit Mortgages Project Analysis requires that the first mortgagee obtaining title to the unit be liable “for no more than six months of unpaid, regularly budgeted assessments or charges (for late fees and collection costs) accrued before acquisition.” Freddie Mac Condominium Unit Mortgages – Project Analysis (Aug 2010), available at www.FreddieMac.com/learn/.


240 Id. Previously individual loans in a community could earn HUD approval even if the community as a whole did not get blanket approval from HUD. Such per-unit approval is no longer an option.
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arrears (more than 30 days past due) of their association assessments. An association with more than 15% delinquent owners can go after those owners personally for the unpaid amounts, and would be wise to do so. But if the owners are unable to pay, not only must the paying members make up the budgetary shortfall by over-paying, but they will be unable to obtain finance capital because of the default of their neighbors. Even if a community earns a coveted spot on HUD’s Approved list, that approval expires in two years unless all requirements are re-certified to the satisfaction of HUD.

Other requirements for condominium project approval also impact the resolution of the assessment delinquency issue and have contributed to a slowdown in condominium unit sales in an already-sluggish market. HUD requires that “no more than 10 percent of the units” be owned by one entity, and states that “at least 50 percent of the units of a project must be owner-occupied.” Such limitations may practically limit the ability of a condominium association to foreclose on liens for unpaid assessments and rent out units in the community in order to attempt to recover some amounts towards the delinquency and also prohibits troubled owners from generating income from property rental to meet obligations. Furthermore, such restrictions make it more difficult for a unit to be sold, since once a community passes the 15% delinquency tipping point (or the 50% rental tipping point), financing for

241 Id.
242 See supra notes 146-63 and accompanying text.
244 See, e.g., http://forum.brokeroutpost.com/loans/forum/2/283263.htm (advising realtors to “motivate sellers to slash the price [of condominium units offered for sale] NOW on their listings before the market does it for them….This is going to be the nail in the condo market. Values are going to plummet around here due to the number of projects that are at 51% concentration [of investor owners] and above”).
245 HUD Mortgagee Letter 2009-19 (June 12, 2009).
246 Although David Stevens, Assistant Secretary of HUD, explained in May 2010 that HUD had modified this “50% owner occupancy requirement to allow the exclusion of vacant and tenant-occupied REOs from the calculation,” such exclusions do not apply to real estate owned by associations rather than lending banks. See http://portal.hud.gov/hudportal/documents/hud_regpdf?id=MAY2010.pdf.
would-be purchasers essentially is no longer available. And most ironically, if a condominium restricts a unit owner’s freedom to rent a unit in its documents, which it must do to ensure compliance with HUD’s 50% rental limitation, then the FHA has deemed the documents as violating the “free transferability” provisions of 24 CFR 203.41. The result is: it is impossible for a condominium to be adequately approved for FHA insurance, either because it allows rentals or because it does not. Fannie Mae and Freddie Mac require similar owner-occupancy percentages, and thus a condominium today cannot simultaneously satisfy the criteria of the GSEs and the FHA.247

Because nearly half of all mortgage loans are now insured by the FHA and almost the entire remainder is sold on the secondary market to either Fannie Mae or Freddie Mac, the policies of the FHA, Fannie Mae and Freddie Mac therefore hugely impact resolution of the issue of assessment recovery.248 The current requirements for loans work at cross-purposes however: while delinquency rate is used as a proxy for community fiscal health, the priority limits on association assessments remove from a community one potentially crucial tool for ensuring the association’s financial well-being. In recognition of the community and lender harm that can result from a community with excessive delinquencies, it seems that the FHA, Fannie and Freddie should use their market power and definitions of qualifying mortgages to support community health rather than place roadblocks to recovery.

c. State Efforts to Add or Enhance Lien Priority

Because capped lien priority typically only protects six months worth of assessments, the longer it takes to get a paying owner to take title to the unit, the less protection the law provides. In early 2010, Lender Processing Services, Inc. estimated that on average, it took 15 months for a home loan to go from being 30-days late to the property being sold in foreclosure.249 The lengthy foreclosure timeline in part is caused by the sheer magnitude of the increase in foreclosure volume over the past few

247 Letter from Loura Sanchez of Hindman Sanchez to Community Associations Institute, Nov. 23, 2010.


249 Viega, supra note 8.
years: in 2010, there were more foreclosures commenced each month than were
typically commenced in an entire year prior to 2005.250 The recent foreclosure
moratoriums and government investigations into bank procedures introduced in all 50
states in October 2010 significantly lengthened the time needed to complete
foreclosure,251 as lenders have (appropriately) responded to increased procedural
scrutiny by slowing the process to ensure validity of the foreclosure.252

Some states have responded to this longer foreclosure timeline and the financial dire
straits of associations by increasing the capped amount of their lien priority statutes.
Nevada increased the six-month period to nine months,253 and Florida increased its cap
to the lesser of twelve months’ worth of assessments or one percent of the outstanding
mortgage loan amount.254 Although both of these enhanced lien priority measures
increased ultimate recovery by an association, they failed to solve the underlying
problem that still plagues the six-month capped priority laws: once the designated
period has elapsed (be it six or nine or twelve months), there is no further incentive for
the lender to contribute to the upkeep of the property or expeditiously foreclosure so
someone can take title who will.

The housing crash prompted the Nevada Legislature to swiftly pass legislation beefing
up lien priority protection for assessment liens, increasing the six-month lien priority
to a nine-month priority, effective October 1, 2009, but the state legislators were
mindful of the FHA and GSE guidelines, so the Nevada statute has an automatic carve
out for mortgages purchased by the GSEs, limiting the lien priority to the maximum
allowed by such entities’ guidelines (namely, six months).255 This undercuts the

250 See supra notes 17-18 and accompanying text.
251 Ariana Eunjung Cha and Dina Elboghdady, 50 States Attorneys General Announce Foreclosure
252 Ensuring compliance with foreclosure procedure is crucial to protecting borrower rights and equity.
Because the sale price at a foreclosure is not subject to substantive review, strict adherence to
procedural safeguards is the only way that the system can make sure the price obtained is fair and that
Borrower is given all notice and right to redeem that statutory law and equity require. E.g., the Supreme
Court has refused to review the adequacy of a foreclosure sale price, focusing exclusively on the
foreclosure process instead. B.F.P. v. Resolution Trust, 511 U.S. 531, 545 (1994) (“We deem, as the
law has always deemed, that a fair and proper price, or a ‘reasonably equivalent value,’ for foreclosed
property, is the price in fact received at the foreclosure sale, so long as all the requirements of the
State’s foreclosure law have been complied with.”).
253 NEV. REV. STAT. 116.3116(2)(c).
254 WEST’S F.S.A. § 718.116.
255 NEV. REV. STAT. 116.3116(2)(c).
statute’s effectiveness most dramatically, as the vast majority of residential mortgage loans are originated for resale on the secondary market, primarily through Fannie Mae and Freddie Mac. In addition, increasing the cap to nine months (even when applicable) rapidly became insufficient recovery as the post-default/pre-foreclosure duration of mortgages in the state increased.

Florida was the next state to increase assessment lien priority cap amount. The Florida Distressed Condominium Relief Act of 2010, effective July 1, 2010, provides that a first mortgagee taking title to property through foreclosure is liable for the twelve months of unpaid common expenses and regular periodic assessments which came due during the immediately preceding year. The total potential exposure of lenders under this statute, however, is capped at one percent of the outstanding mortgage debt. While the previous change in the law implementing a six-month cap inspired widespread adherence among lenders who have not contested its retroactive application, Florida courts have not yet stated definitively that the Florida amendment creating a twelve-month cap can be applied retroactively. In addition, although states like Colorado have specified that their statutory lien priority provisions trump association documents providing the contrary, it is unclear whether this is true in Florida, or whether Florida associations must amend their documents to take advantage of the enhanced lien priority if the documents reference the prior (six-

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256 See supra notes 236-37 and accompanying text.
257 SB 1196, codified at FLA. STAT. CH. 718.116. Previous modifications in the law had increased the cap to twelve months for single family homes in CICs, but had left the cap at six months for condominium units. The 2010 amendment equalized recovery in both types of CICs.
258 FLA. STAT. CH. 718.116. According to some Florida lawyers, the new law permits unlimited recovery of unpaid assessments from third-party buyers at mortgage foreclosure (unlimited durability of the association lien) and caps recovery only from lenders. October 2010 interview with Ben Solomon by author, notes on file with author [hereinafter SOLOMON INTERVIEW]. Other Florida attorneys dispute this reading of the law, noting that the twelve-month cap applies to all foreclosure sales, regardless of the identity of the buyer, and expressing doubt that the new twelve-month limit will apply to foreclosures of mortgages originated before 2010. February 2011 interview with Chuck Edgar by author, notes on file with author [hereinafter EDGAR INTERVIEW]. Edgar agrees that the statutory language is ambiguous on this point, but notes that there is nothing in the legislative history to suggest that Florida legislators intended to create a different rule for lender and third-party foreclosure buyers. Id.
259 Edgar notes that “Everyone is collecting the six-months of assessments, and lenders aren’t fighting it.” But opines that the twelve-month cap may not apply to mortgages originated prior to July 2010 (Edgar believes that the legislature in Florida cannot retroactively impose the cap, and only the federal government, not a state government, could pass a law that effects such an “impairment of contract”). Edgar Interview, supra note 258.
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month) capped level. The flaws of SB 1196 are already apparent, and less than a year later, new legislation has been introduced to “refund and expand upon those amendments and to clarify other condo association issues.”

Florida has been coping with perhaps the worst volume and quality of foreclosures in the nation during the past few years, and the large quantity of foreclosures and the many, many lender missteps have so far discouraged lenders at foreclosure from challenging the law or its application. Even if unchallenged, the long delay between commencing and completing foreclosure proceedings in Florida makes the twelve-month capped priority still inadequate in many cases anyway. In Florida, as in other states, the best way to ensure repayment of assessment amounts is to immediately start legal proceedings when a homeowner has not paid his dues to get a personal money judgment against the owner in order to compel collection. Pursuing a money judgment is often the cheaper and easier route for an association to take to recover unpaid assessments.

The Florida law is so new that the state’s mortgage market has not yet reacted to the change. Interestingly, Florida’s twelve-month limit does not have a GSE limit carveout like the Nevada provision. It is unclear how this limitation will play out in Florida with respect to availability of mortgage capital since Fannie Mae and Freddie Mac specifically exclude debts for which a lender could be liable for more than six months of assessment charges from pools of qualifying mortgages. Mortgage originators today almost never originate non-FHA loans that they cannot sell on the secondary mortgage market, and the only truly active secondary residential mortgage market purchasers are the GSEs. It remains to be seen if SB 1196 adversely impacts

260 See Edgar Interview supra note 258 and Solomon Interview supra note 258 (both agreeing that the statute is unclear on this point).

261 Joshua Krut, After Sweeping Legal Changes, Expect New Revisions, DAILY BUSINESS REVIEW (Feb. 23, 2011), A4 (calling this pending legislation the “glitch bill” because it is designed to clarify unanswered questions relating to the amendments of the prior year).

262 See Edgar Interview supra note 258.

263 See, e.g., supra notes 104-06 and accompanying text.

264 Although it does have a dollar-based cap of one percent of the mortgage loan amount. See supra note 258 and accompanying text.

265 Section B4-2.1-06 of Fannie Mae’s lending guidelines explicitly states that Fannie Mae will not purchase debt if the holder of the mortgage could be liable for more than six months of regular common expenses charged by a community association.

266 See supra note 236-37 and accompanying text.
the availability of mortgage financing in CIC homes in Florida, or if the GSEs will not
enforce these guidelines there or will change their mandates.

Bills specifically aimed at creating six-month limited priority for association
assessment liens are currently pending in Ohio, Maryland and Missouri – in each case
strongly supported by individuals who reside in CICs and community association
lobbies, and in each case strongly opposed by lobbies for banks. In Ohio, efforts to
pass a UCIOA-based lien priority for assessments (House Bill 408) failed to achieve
legislative action in the legislature’s 2010 session.\textsuperscript{267} The efforts are still alive, and
proponents of the measure hope that 2011 will see passage of a law creating a
providing for six months of assessments plus attorney fees, costs and expenses to
enjoy lien priority superior to all liens but those for property taxes. National and state
lenders in Ohio have strongly opposed the bill, contending that it will increase lending
costs and complexity and will chill mortgage lending in an already semi-frozen
housing capital market. Banks are also concerned with potential retroactive application
of the priority law with respect to loans that have already been funded.\textsuperscript{268} While active
debates on limited priority statutes remain in Ohio, Maryland and Missouri, in other
states, efforts to create a limited lien priority for association assessments have never
gained any traction.\textsuperscript{269}

d. Inadequacy of Limited Priority Liens

The priority law for community assessment liens varies among the states, but this
problem has been insufficiently addressed in all of them. When unpaid upkeep costs
are potentially unlimited, capped losses for the lender necessarily results in unlimited
losses allocated to the members of the community. Thus, even a “super-priority”
piece allocated to assessment liens becomes inadequate once that period has expired.

When foreclosure takes longer than six months and when foreclosure proceeds are
inadequate to pay off a first mortgage – and both of these factors are more and more
common today – only a fraction of unpaid assessments are paid, requiring paying
members of the association to fund the remainder.\textsuperscript{270} Furthermore, even in some
jurisdictions with a limited association lien priority, proceeds at foreclosure do not

\textsuperscript{267} See supra note 26.


\textsuperscript{270} Coleman, supra note 99.
automatically apply to unpaid assessments (the capped portion being deemed a durability rather than payment priority provision), and thus the association has to bring a lawsuit – and incur more community costs – just to recover the amounts that are legally theirs. Miami Beach Commissioner Jerry Libbin calls this problem an “outrageous loophole” in the law.271

The general problem of unpaid assessments is dramatically exacerbated in the current market context where lenders (sometimes deliberately) delay foreclosure on defaulting properties.272 Lenders can – and today often do – delay foreclosure. It is true that foreclosure can take a long time for other reasons: mortgage loan servicers are currently overwhelmed with the number of defaulting borrowers, and lenders look hopefully to future market price rebounds to recover under-collateralized loan amounts. In addition, mortgage servicers’ faulty record-keeping and failure to follow legally mandated procedures operate to stretch out the foreclosure timeline as well.273

But lenders also sometimes strategically delay based on their calculation that they will be unable to sell the property at foreclosure or resell the property afterwards because of the sluggish housing market. Procrastination can help lenders avoid incurring the obligations of home ownership, including property taxes and community association assessments. This is particularly true in cases where there is a very real risk that the ultimate sale price for the property will not reimburse such costs. Once the lender owns the real estate (real estate owned, or REO properties), the lender itself is responsible for assessment charges and, unlike insolvent mortgage borrowers, lenders can typically be sued successfully for assessment payments they neglect to make. Because this obligation is assumed upon taking title, lenders in many cases prefer to

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271 Ruling May Help Homeowner Associations, Historic City News, Feb. 5, 2010 at www.historiccity.com. Libben heralded the reverse foreclosure tactic (see infra Part II.A.2.) as an important step toward protecting owners in condominiums. Florida’s legislature considered a bill that would have required banks to complete foreclosure after a year of filing or pay all unpaid assessments, but this proposal never came to a vote. Rob Samouce, Laws Needed to Get Delinquent Properties Back on Market, Naples Daily News, Jan. 2. See also 2010http://titlesearchblog.com/2010/03/01/hoas-forcing-reverse-foreclosures/ and.

272 See, e.g., Marshall L. Jones, Condo Associations Battle Deadbeat Owners, Balky Banks in Collecting Fees, REAL ESTATE LAW & INDUSTRY REPORT (Apr. 6, 2010).

273 See supra note 3 and accompanying text. In addition to servicer and bank moratoriums on foreclosures, several states, including Connecticut and Texas, froze all foreclosures in October 2010 pending inquiry into faulty and fraudulent loan servicing procedures. Several other states stopped foreclosures by J.P. Morgan Chase, GMAC and Ally Financial, the institutions tainted with the “robo-signing” scandal. See supra note 3 and 251. The moratoriums have now been lifted, but the pace of foreclosure remains slow.
postpone foreclosure, hoping that the market will improve and property resale will be more quickly forthcoming. As Florida attorney Ben Solomon explains, “The bottom line is the banks don’t want to assume the liability associated with the unit, including the obligation to pay maintenance assessments to the association.” In the meantime, collateral values are shored up by assessments that others pay and lenders lack the legal obligation to reimburse.

The delay between initial mortgage default and actual foreclosure sale today is longer than ever before. Since bank liability for previously unpaid assessments is capped — or, in many places, non-existent — mortgage lenders receive an unjust enrichment of collateral upkeep at the cost of other members of the community. There is nothing in the law currently to prevent such an outcome.

Not only do foreclosure delays increase the ultimate charges borne by the non-defaulting neighbors, but neighboring owners suffer in other ways from the delays. As unpaid assessments increase, dues increase, units fall into disrepair, and abandonment increases the likelihood of vandalism and squatters. When foreclosure finally happens, both property values and quality of life for the community have declined.

Focusing on the complete lack of even a capped assessment priority in a majority of states, Washington, DC lawyer Benny Kass has publicly called for nationwide campaigns to create UCIOA-like provisions in those states which have not yet passed such a law. But even if the 33 states with no limited priority passed UCIOA-based six-month (or larger) caps, the underlying problem would persist: lenders can offload a theoretically unlimited amount of upkeep costs of their collateral onto innocent members of the community with no adequate recourse at law for the community and its paying members. And since the limited priority of assessment liens under UCIOA and similar statutes only takes effect upon a first mortgage foreclosure, the limited priority lien fails to force the bank’s hand and achieve a more expeditious resolution through conveying the unit to an owner willing and able to contribute to community costs.

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274 Sutta, supra note 104.
275 Benny Kass, Foreclosures are Impacting Condominium Projects, Syndicated Columnist in WASH. POST, available at www.kmklawyers.com/article-040307.htm. Kass says that such monthly-based limited priority lien systems “must be enacted all over the country as soon as possible.”
276 Note that some creative litigators have attempted to do just that, with some limited success in Florida. See infra Part II.A.2. and accompanying text.
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State legislatures could close this “loophole” by mandating true priority for community assessment liens (at least with respect to dues that are unpaid during a period of mortgage default) or by making CIC assessment liens non-extinguishable in foreclosure. Capping community losses rather than lender losses would eliminate the distortion that the current potential “free ride” creates for lenders weighing the costs of foreclosure. This will encourage lenders to pay community assessments during borrower defaults, whether or not it also encourages the pace of foreclosure to increase. Either way, the community’s losses and contagion effects of the distressed properties is contained: at some defined point in time, a solvent interest holder in a unit will be encouraged to pay the unit’s equitable allocation of costs. This type of limited priority would be vastly more equitable than the UCIOA-type of total-amount capped lien, both in terms of allocating upkeep costs and in terms of efficiently motivating housing rollover and market stability.

2. CREATIVE LITIGATION STRATEGIES

Florida is perhaps the epicenter of the CIC assessment crisis. Florida was the site of one of the largest housing booms over the past few decades. Condominium development and financing, in particular, flourished in Florida through 2007. Condominiums in Florida attracted many real estate investor-buyers, and the demographics of the state – in particular, the high percentage of retired persons – made low-maintenance/high amenity housing particularly appealing. But this same demographic makes the population more vulnerable to escalating monthly housing costs. Because of these factors, Florida today presents the most extreme case of foreclosure delay spillovers and community governance insolvency. And foreclosure delay is rampant: there are ample news reports of lender strategic postponement of public auctions, and the average foreclosure now takes longer than a year and a half. Although the amended Florida law permits a capped recovery after mortgage foreclosure of an amount equal to the lesser of twelve months’ worth of unpaid association assessments or 1% of the outstanding mortgage loan amount, this limited amount will not cover all of an association’s unpaid assessments in most cases.

Florida attorneys representing community associations have become very creative in seeking recovery for their clients. One particularly interesting tactic has been termed a

277 See, e.g., Coleman supra note 99.
278 October 2010 telephone interview with Kevin Miller by author, notes on file with author [hereinafter MILLER INTERVIEW].
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“reverse foreclosure.” To achieve a reverse foreclosure, the association must first foreclose on its assessment lien and take title to a delinquent unit subject to the first mortgage lien. The association, as now-owner of the property, files a motion for summary judgment in the mortgage lender’s own foreclosure action, seeking judgment in favor of the lender. The association waives all claim for notice and sale of the property under Florida’s foreclosure laws and moves that the court immediately order title be transferred to the lender.

Keys Gate Community Association successfully employed the reverse foreclosure approach on a home they had taken title to in 2007 after the owners stopped paying assessments. The first mortgage lender on the unit, HSBC Bank USA, filed its own notice to foreclose two months after the association took title, but the foreclosure sale never happened. Finding itself stuck with an empty house and 2½ years’ worth of unpaid dues (over $5,000), the association attempted the new strategy of moving for summary judgment in favor of the mortgage lender.

In January 2010, Miami-Dade Circuit Judge Jerald Bagley accepted the association’s argument and ordered title immediately transferred to HSBC, making it liable for all future community assessments. The court also ordered HSBC pay the association’s legal fees and court costs in connection with the reverse foreclosure action as well as the capped lien priority amount which trumped the first mortgage lien. Because this amount was capped, the association had to write off $3,820 of unpaid fees, but the at least the long delay in finding a financially responsible unit owner was finally over.

As Keys Gate attorney Ben Solomon put it, “The quicker we can move these distressed properties thorough the process and into the hands of somebody who will pay a mortgage and pay taxes and pay their dues, the quicker we can get the economy back on track.”

In the wake of the Keys Gate success, the reverse foreclosure strategy gained popularity during early 2010. Ben Solomon’s firm, Association Law Group, filed

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280 HSBC Bank USA, et al. v. Keys Gate Community Ass’n, Inc. (Fla. 2010).
281 Coleman supra note 99.
283 Id. See also Coleman supra note 99.
83 foreclosures around the state, with varying success.\textsuperscript{286} The reverse foreclosure concept is novel, and both judges and lenders were confused by the summary judgment motion.\textsuperscript{287} Some courts did not realize that the association in such cases was arguing for judgment for the lender. Some lenders did not realize this either. While the Miami/Dade judges have been receptive to the idea of a reverse foreclosure, no district court has yet considered and approved the tactic.\textsuperscript{288}

In some cases, the exotic nature of the reverse foreclosure claim caused lenders to just walk away. For example, Citibank responded to a reverse foreclosure motion by just writing off the entire mortgage debt, leaving the association owners owning the unit. But just as the association had hoped to win by losing the foreclosure case, winning the case by having the lender write off the debt left the association holding title to the unit, continuing (at least for the short term) association shared responsibility for its allocated assessments.\textsuperscript{289}

The reverse foreclosure strategy is interesting, but is legally cumbersome and unpredictable. In addition, this judicial tactic is limited to situations where (a) the association has previously foreclosed on its lien, subject to a first mortgage lien, and (b) the first mortgagee has already filed a foreclosure action. If a lender has not yet commenced a court action for foreclosure, no summary judgment motion can be filed. In addition, the reverse foreclosure requires the un-reimbursed costs of the association’s own foreclosure action. Furthermore, the entire recovery by the association in Florida is capped at the 1% of the outstanding mortgage loan or 12 months of assessment limit. If the unit in default already has a tenant, there is an even better option available to the association. Under the 2010 amendment, the association can collect rents from a defaulting unit without having to foreclose or file a motion in a lender’s proceeding, which may permit a more immediate and greater recovery for the community.

Association lawyers in Florida have made other attempts to find an avenue for recourse within the existing legal framework. In another case where the lender strategically delayed foreclosure, the condominium association sued to force the lender to act. The trial court, in \textit{U.S. Bank Nat’l Ass’n v. Tadmore}, found the association’s arguments compelling and ordered the lender to “diligently proceed with

\textsuperscript{286} Solomon Interview, \textit{supra} note 258.
\textsuperscript{287} \textit{Id.}
\textsuperscript{288} Miller Interview, \textit{supra} note 278.
\textsuperscript{289} Sutta, \textit{supra} note 104.
the pending foreclosure action…or pay monthly maintenance fees on the condominium unit in foreclosure.”^290 The court based its holding on its general equitable powers, holding that the association was unreasonably prejudiced by the lender’s deliberate delay in pursuing foreclosure. Thus, reasoned the court, it was fair and equitable to order the lender to pay monthly assessments even prior to foreclosure.

The trial court decision in *Tadmore* at first sparked a flurry of interest in the concept of using equity to force an expeditious foreclosure, but the holding was short-lived. The appellate district court in *Tadmore* reversed, holding that the lender cannot be obliged to pay condominium assessments on a unit it did not (yet) own.^291 There was no contractual obligation to pay those fees, and no obligation would arise until the lender acquired title. Although the association’s claim was made in equity, the court of appeals held that equity could only follow the law, not divert from it.^292

Other associations pin their hopes on provisions in the Florida foreclosure statute that mandate a foreclosure sale to be scheduled no sooner than 20 and no later than 35 days after court filing.^293 Although Florida attorney Kevin Miller opines that an association might be able to claim violation of this provision when foreclosure is unduly delayed, lenders uniformly have maintained that the provision creates remedies for the mortgagee alone.^294 In addition, an association, as a junior lienholder, could ask the court for a management conference for the foreclosure case according to a procedural rule designed to move cases along.^295

The Florida statute leaves unanswered the question of how far association documents can go to enhance the scope and priority of the assessment lien.^296 Citing the statutory

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^291 *Id.* at 823.

^292 *Id.* The court noted that “equity follows the law” and reasoned that therefore equity “cannot be utilized to impose this obligation without limitation before title is passed.” While the *Tadmore* approach was creative, it is unsurprising that the trial decision was reversed. There is a long-standing view that each lienholder can determine its own foreclosure timing. See Nelson & Whitman, *supra* note 55 at 611-615.

^293 Fla. Stat. § 45.031.

^294 Miller Interview, *supra* note 278. Even if courts agreed with the associations arguments with respect to this provision, however, there would be no way to use the statute to force lenders to commence a foreclosure proceeding.

^295 *Id.*

^296 A fifteen-year-old Florida case suggests that total super priority of an association lien could be created by the association declaration. Holly Lake Ass’n v. Federal Nat. Mortg. Ass’n, 660 So.2d 266 (Fla. 1995). The hope that such precedent held out has been chilled by a more recent Florida decision
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provision giving mortgage lenders priority over association liens, the court in Coral Lakes Community Ass’n, Inc. v. Busey Bank, N.A., for example, refused to hold a foreclosing lender jointly and severally liable with its borrower for unpaid assessments in spite of language in the declaration to that effect. But in an earlier case with similar declaration language, a Florida district court held that a wholly owned subsidiary of the mortgage lender who acquired title at foreclosure would be deemed a third party, not entitled to protection by the assessment priority cap, and thus could be sued personally for the entire unpaid assessment amount. The details of which entities could and could not be sued personally for unpaid assessments based on language in the association’s declaration could end up being quite complicated as the disputes regarding transfer of mortgages muddy the question of which entity holds what interest in the property. The Florida statute is unclear, and Florida laws are inconsistent on this point.

3. TRUE LIEN PRIORITY: AN ANALOGY TO PROPERTY TAXES

Community associations function like governments: they perform public functions and are funded by assessments paid by their citizenry. In fact, the trend over the past few decades has been for public governments to assign to private communities more and more responsibility for services that a municipality would otherwise provide. Community governance and upkeep costs incurred by municipalities are funded through property taxes, and unpaid property taxes are secured by a lien on the subject property that enjoys true super-priority status. Unpaid taxes are therefore paid first (or remain burdening the property) at the foreclosure sale. The simplest solution to the CIC tragedy of the commons posed by unpaid and uncollectable assessments would simply be to grant true priority to liens securing such amounts, analogizing the

where the association documents had provided that any subsequent parcel owner “regardless of how his or her title has been acquired, including by purchase at a foreclosure sale” is personally, jointly and severally liable for all unpaid assessments, along with the prior delinquent owner. Coral Lakes Community Ass’n, Inc. v. Busey Bank, N.A., 30 So.3d 579 (2010).

297 FLA. STAT. § 720.3085.
298 30 So.3d 579 (2010).
299 FLA. STAT. CH. 718.116.
300 Strangely, the court held that the statutory limitation on post-foreclosure recovery of assessments applied only to limit a lender-purchaser at foreclosure, leaving a third-party foreclosure purchaser fully responsible for unpaid assessments. Bay Holdings, Inc. v. 2000 Island Blvd. Condo. Ass’n, 895 So.2d 1197 (Fla. 2005).
assessments to property taxes. If association liens were granted complete and true priority over mortgage liens, then the association foreclosure would necessarily bring mortgage lenders “to the table” to pay for their collateral upkeep charges or to participate in a joint foreclosure proceeding.

On the one hand, an analogy between community assessments and property taxes is compelling: both governments offer public upkeep to a community, such as, in some cases, paving, snow removal and open space maintenance. In these ways, the community functions like a municipality proxy in providing services to the public.\(^{302}\) In fact, taxpayers who live in CICs in New Jersey have successfully claimed the right to offset from property taxes a portion of their community assessments, based on a double taxation complaint.\(^{303}\) However, this analogy can only be taken so far. Many community-provided amenities are actually a supplement to municipal services rather than their replacement, and in the vast majority of states, assessments are not legally considered local “taxes.”\(^{304}\) To the extent that community services provide private community benefits (such as amenity upkeep), they represent individual property carrying costs rather than funding a benefit to the broader public akin to property taxes.

Lenders would likely strongly object to the idea that community assessments should be granted true priority by virtue of their tax-like function and likely will predict the specter of complete absence of home mortgage credit should such a rule be adopted. Nevertheless, having property taxes prime the mortgage lien has not dissuaded lenders from making mortgage loans. Lenders routinely protect themselves against any superior priority payment obligation of their borrowers through establishing property tax escrow accounts. Lenders could demand similar escrow accounts for community

\(^{302}\) The town of Reston, Virginia was the first common interest community and provides many municipal government services. See website for the association at http://www.reston.org/default.aspx?qenc=HzT9ACzZbNs%3d&fqenc=HzT9ACzZbNs%3d

\(^{303}\) See supra note 73.

\(^{304}\) Assessments are not deductible from federal and state tax impositions, for example, even when the community association services are a proxy for services normally provided by local municipalities. See Hyatt supra note 14 at 106.
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assessments.\textsuperscript{305} In fact, current Fannie Mae and Freddie Mac forms already specifically anticipate escrow account mandates for such amounts.\textsuperscript{306}

4. CONSENT AND CONTROL BY COMMUNITY MEMBERS

Unlike a mortgage lender, who has the ability to perform credit inquiry and refuse to lend money to a financially risky borrower, homeowners in condominiums and homeowner associations have no ability to force their neighbors to disclose the details about their finances. Even if this information were available, owners currently have little ability to control who buys properties in their community. One potential solution to the problem of financial interdependence in privately governed communities, however, would be to permit communities to perform credit diligence regarding prospective new members and control entry into the association. Washington lawyer Benny Kass has suggested this type of solution: enable community boards of directors to approve or disapprove all potential purchasers of units.\textsuperscript{307}

Cooperatives have long had such ability to control the identity of their members. New York cases have repeatedly upheld pre-approval provisions in cooperative documents and even individual denials of approval for cooperative membership based on criteria as indirectly relevant as an applicant’s fame or legal training. The justification for legally permitting such practices in cooperatives is typically its disparate ownership structure: owners are co-investors in an entity which holds title to the building in addition to being tenants of their particular unit. Financing of the building occurs at two levels: through the entity title-holder and at the individual unit owner level. Because of this increased financial interconnectedness, courts have opined that cooperatives should be able to self-select their members.\textsuperscript{308} In the context of condominiums and homeowner associations, however, power to disapprove would-be unit purchasers would be more problematic, opening a Pandora’s Box of

\textsuperscript{305} Such escrow accounts might be more administratively expensive than those for insurance and taxes, however, because many CICs assess monthly rather than yearly or bi-yearly.

\textsuperscript{306} Fannie Mae Mortgage Form, available at FNMA website. Associations, on the other hand, are vastly more limited in their ability to create property-specific escrow accounts upon, say, resale. Unless community documentation so provides, any efforts would be struck down as \textit{ultra vires}.

\textsuperscript{307} Benny Kass, \textit{Foreclosures are Impacting Condominium Projects}, WASH. POST, available at www.kmklawyers.com/article-040307.htm. Kass reasons that “if lenders will not screen their borrowers, why should a community association have to suffer by having a new owner who will not be able to meet his/her financial obligations to the association.”

\textsuperscript{308} Subject to anti-discriminatory limitations imposed by the Fair Housing and the Civil Rights Acts.
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discrimination. The possible danger posed by such a solution underscores the importance of finding and enacting a viable solution through the priority law instead.

Property law is hostile to restraints on alienation, and restrictive covenants limiting the ability of an owner to sell his or her property are suspiciously scrutinized by courts. Economic theory in general argues for free alienation of property so that property may achieve its highest and best use and maximize its value. Although in the context of the entangled finances of a common interest community, free alienation increases individual member risks, courts typically strike down consent requirements as incompatible with fee simple absolute ownership rights. Even explicit contract regimes restricting free-transferability in the name of community harmony and joint objectives have been struck down as a restraint on alienation that is repugnant to the fee.

Retaining the right to approve purchasers through a covenant regime impermissibly recalls feudal controls; courts have consistently refused to enforce such restrictions.

An association’s right of first refusal to purchase a unit has been upheld, however, since an owner can be made economically whole by selling to the association in lieu of an objectionable buyer. However, such a provision will inadequately protect the financial interests of the community because it requires the community to itself fund the purchase and upkeep of a unit as the only way to block a prospective buyer. This is even more financially burdensome than permitting a prospective buyer to take title and then incur the costs of enforcing assessment obligations.

Although it is difficult to force bare approval requirements limiting an owners’ ability to sell his unit in a condominium or homeowner association, it is very common in a common interest community to control an owners’ ability to rent a unit. Absolute prohibitions on renting are sometimes claimed an unreasonable restriction of fee title, but initial limits on renting (an owner must occupy the unit for the first year, for example), limits on short-term leasing (for example, no leases with a term less than six months, for example), and even limits on the number of units in a community that can be rental-occupied at any time are typically enforced by the courts. Such leasing limitations are typically upheld even when they are created in non-unanimous

309 See, e.g., Northwest Real Estate Co. v. Serio, 156 Md. 229, 144 A. 245 (1929).
312 Woodside Village Condominium Ass’n v. Jahnren, 806 So. 2d 452 (Fla. 2002), held leasing restriction reasonable.
amendments to the governing documents.\textsuperscript{313} Also, not only do courts enforce aggregate limitations on the percentage of units in a CIC that can be rented at any one time, but Fannie Mae and Freddie Mac and the FHA have issued guidelines that limit the percentage of a community that can be rented out, likely as a proxy for financial health of the community.\textsuperscript{314}

Although permitting association boards to exercise approval rights over sales might be judicially justified as an extension of the broad enforcement of leasing restrictions boards already can exercise in any case, it would be bad policy to rely on board diligence and approval as a way to protect the community’s financial health, and this approach should be avoided. From a legal standpoint, requiring prior approval of purchasers would create a hardship for owners who are trying to sell and indeed the approval right is repugnant to the fee. Such a requirement would mean a would-be seller not only has to find a willing buyer, but has to prove that the candidate is a credible financial risk. In a tight market, the hardship and delay this requirement would cause would further freeze out-sales of units and would increase the possibility that an owner will default instead of re-selling.

In addition, the power to approve buyers is fraught with the potential for abuse by other members of the association, and it makes no sense to solve one problem (uncollectable assessments) by creating others (too much board power limiting freedom to transfer property and the potential for insidious discrimination). These problems are already rampant and difficult to resolve in coops. Plus, using the CIC structure to create legal limits on a seller’s right to transfer to certain types of borrowers hearkens back to the days of racial discrimination, since the perpetuation of racial segregation was what motivated the formation of many early suburban CICs to begin with.\textsuperscript{315}


\textsuperscript{314} Fannie Mae and Freddie Mac will not buy loans secured by properties in common interest communities where more than 49\% of the units are occupied by tenants rather than owners. See http://www.freddiemac.com/learn/pdfs/uw/condo.pdf and https://www.efanniemae.com/sf/refmaterials/approvedprojects/pdf/condoprojectreview.pdf

\textsuperscript{315} In fact, many community association documents still on the land records still contain racial occupancy clauses. Even though such clauses have no legal force today, their continuing existence in the chain of title as an unfortunate reminder of one of the initial motives of community ownership structures. It is well nigh impossible to strike such language from the record. See Stephen Magagnini, Reminders of Racism, Old Covenants Linger on Records, THE SACRAMENTO BEE, (Jan. 17, 2005).
The unsavory history of homeowner associations – still obvious from many first-generation restrictive covenants in the land records – reveals a dark side of private governments: racially segregated neighborhoods where restrictive covenants contractually barred would-be sellers from selling to certain would-be buyers based on pernicious discriminatory criteria. After the Supreme Court in Shelley v. Kramer, in tortured legal reasoning, held that racial occupancy restrictive covenants were unenforceable under the 14th Amendment because the enforcement of a contract to discriminate would amount to government action, Congress passed the Fair Housing Act that made discriminatory sale restrictions illegal and invalid. Today, because of that Act, housing decisions may not lawfully be based on the basis of race, religion, gender, etc.

On the one hand, it is perhaps too soon in our history to give blanket membership approval power to community associations, since the original raison d’etre of homeowner associations was to keep certain people out of them. If such power was given, courts would necessarily need to exercise some sort of oversight scrutiny to assess the reasonableness of any approval denial to make sure it did not violate the provisions of the Fair Housing Act or otherwise impermissibly bar alienability of property. The benefits of any self-protecting membership approval empowerment of community associations must be balanced against the costs of potential discrimination and the cost of judicial efforts needed to police appropriate disapprovals of neighbor sales.

Mortgage lenders (theoretically) already do credit diligence on would-be buyers in communities as part of their underwriting. It would be costly and difficult to force


318 See supra note 315 and accompanying text.

319 From 2000-2007, many mortgage originators neglected to do any credit diligence or at least did a terrible job. See Yulia Demyanyk & Otto Van Hemert, Understanding the Subprime Mortgage Crisis, 22 Rev. Fin. Stud. (2009). In August 2006, Steven Krystofiak, president of the Mortgage Brokers Association for Responsible Lending, in a statement at a Federal Reserve hearing on mortgage regulation, reported that his organization had compared a sample of 100 stated income mortgage applications to IRS records, and found almost 60% of the sampled loans had overstated their income by more than 50 percent. Steven Krystofiak, Statement at a Federal Reserve, Aug. 1, 2006, at
an association to inquire as to credit scores and employment and salary, and perhaps it would be unnecessary as well in cases when another entity is already assessing these exact same criteria for a would-be buyer – namely, his or her mortgage lender. It would be wasteful and inefficient to require the non-expert volunteer directors to try to replicate this effort.

Since neighbors do not (and probably should not) have the ability to do financial investigations of would-be buyers in their community, association members cannot manage their own risks in this regard. Mortgage lenders, on the other hand, are best able to do such investigations at the least cost since they specifically assess the financial health of their borrowers and can set the terms or limit the availability of mortgage loans accordingly.320

**B. ERODING MORTGAGE PRIORITY**

1. **EQUITABLE REALLOCATION OF PAYMENT DEFAULT COSTS**

Capped recoveries and limited priority liens are ineffective in a climate of underwater loans and long foreclosure timelines. Reverse foreclosures and other creative litigation strategies may obtain relief in certain situations, but are inadequate to generally protect communities from the fallout from foreclosure freezes. Although there is some appeal to analogizing assessments to property taxes and granting a true priority status to assessment liens, it would be almost impossible for such a proposal to garner sufficient political support to pass. Allowing community members more extensive approval rights over property transfers within their community raises property and liberty rights concerns which vastly outweigh the benefits of permitting self-policing due diligence in sales. The best party to perform credit diligence of new (or refinancing) members in a CIC is the party already performing this role: the mortgage lender.321 The party best able to control for unrealistic loans, sloppy foreclosure proceedings and unwarranted delays is also the mortgage lender. The mortgage lender should bear costs occasioned by its failure to diligently protect against the foreseeable externalities of its lending activities. In a situation where the

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320 Mortgage lenders also perform collateral due diligence (property appraisals) and are therefore well-situated to prevent a property from being so over-burdened with debt that a foreclosure sale will not net sufficient proceeds to cover obligations secured by the property.

321 Id.
property is “underwater” (more is owed on the mortgage than the property is worth), the only party with a valuable interest in the property is the mortgage lender. The lender, as the sole property interest holder in this case should bear the upkeep costs that protect and enhance the value of its security pending foreclosure.

Statutes should be passed in each state to create proper incentives for lenders to monitor or pay assessment delinquencies. Rather than relying on limited priority liens, this proposal – an eroding first priority for first mortgage liens – would treat the priority position of a lender’s first lien as conditional upon foreclosure within a certain amount of time after mortgage default (say six months). Thereafter, every month of unpaid assessments would become secured by a lien superior in payment priority to the first mortgage. Importantly, such a lien would have no upside cap, meaning recovery by the association would theoretically be unlimited, while the maximum paid by the neighbors would be limited. Such an eroding mortgage approach would cap the loss to the association rather than the loss to the lender, which is appropriate since it is the lender who controls the timing of the foreclosure sale.

Under this proposal, the priority of the assessment lien would effectively erode the first priority of the mortgagee. This would likely incentivize lenders to pay assessments on behalf of their borrowers who are delinquent and add such costs to the debt. Most mortgage instruments already permit lenders to do this. Increased lender responsibility for its share of community upkeep might also motivate more expeditious foreclosure proceedings. Either way, the costs borne by an association would be minimized. This better cost allocation regime would make sure that lenders are no longer distorted in their foreclosure timing analyses, which would ensure that delays in foreclosure result from relevant loan and market factors, not from a lender’s mere desire to free-ride by avoiding collateral upkeep costs.

Lenders would reasonably respond to such a law by making a better credit evaluation prior to advancing funds regarding a borrower’s ability to pay not only the mortgage loan but the applicable assessments. Lenders would also have even more reason to ensure an accurate appraisal of collateral value. Any change in the legal framework of home lending that achieves this outcome is likely beneficial to individuals and the economy as a whole. Also, such an evaluation cannot currently be done by the

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322 See supra note 306 and accompanying text.
323 Reasonable collection costs should be included in the priority lien amount, however this proposal does raise the important question of collection cost and late fee abuses, discussed infra at Part II.B.4.
324 See generally, Boyack, supra note 39.
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association itself, although such an evaluation can be easily and cheaply achieved by lenders.\textsuperscript{325} Lenders might respond to such a law by establishing an escrow account for association assessments, similar to accounts lenders already require for property tax and insurance amounts (and as already anticipated by form Fannie Mae and Freddie Mac instruments).\textsuperscript{326} Finally, this law would motivate lenders during foreclosure to pay outstanding assessments to avoid incurring additional costs and fees. This would benefit all property values in the community and keep other owners from being penalized for having delinquent neighbors. This also avoids the situation of unjust enrichment that currently exists when neighbors end up paying for the upkeep on mortgaged properties for which they hold no interest.

Allowing a first mortgage lender’s priority to erode over time as foreclosure is delayed is therefore both equitable and efficient. Un-capping lender liability for assessments will lead to assessment obligations being met more frequently by someone. This approach will also disincentivize irresponsible delays in foreclosure and, unlike the six-month limited priority regime, will continue to be effective even if foreclosure does take a long time to complete. A system of eroding mortgage priority could allocate some limited portion of unpaid assessments to a community or could allocate all unpaid amounts to the lender, depending on when the lien erosion “clock” would start.\textsuperscript{327}

Unlike the limited lien priority system, an eroding first priority system will not merely reduce association losses – it will tangibly improve community stability. Because responsible neighbors will be insulated from default spillover, recovery can occur: investors can purchase units secure in the knowledge that their investment is not subject to the unforeseeable and uncontrollable default rates of neighboring property loans. Lenders can lend on units in CICs knowing that the community will continue to be maintained, property values will be preserved, all at a cost allocation that is fair and equitable.

\textsuperscript{325} Lenders today are evaluating not only at its borrower’s ability to pay its assessment obligations but also the ability of all other owners in the community to pay their assessments.

\textsuperscript{326} See supra note 306 and accompanying text.

\textsuperscript{327} In lieu of having a front-end delay before erosion of a lien begins, a state could choose a shared-liability approach to assessments, mandating that a certain percentage of all unpaid assessments at foreclosure enjoy a payment priority. Under this system, the cost to a neighborhood would continue to grow as foreclosure is delayed, but so will the cost to a lender. At least this approach would somewhat curtail the lender’s collateral upkeep free ride.
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This system ultimately even benefits the first mortgage lenders who bear priority erosion losses as well, because the value of their collateral will be preserved. This should lead to a better recovery in foreclosure sales, which should offset the priority losses the system entails. For this reason, the GSEs should revise their policies and permit uncapped lender responsibility for collateral upkeep. Although a six-month limit is easier for a lender to prospectively quantify (since the maximum amount of foreclosure proceeds paid to an association pre-determined), this approach depresses the property’s value and limits capital availability to the entire community. Allowing a fairer allocation of community costs justifiably supports values and stability in the community – an outcome beneficial for the community’s lenders as well as its owners.

2. PROMOTING FORECLOSURE AS POLICY

One effect of the eroding mortgage priority solution is that lenders will be discouraged from delaying foreclosure just to avoid payment of community assessments. This means that foreclosures of community association properties may start to happen more expeditiously, which is arguably hard for defaulting homeowners who face losing their homes more quickly. Although it is politically difficult for governments to push for quicker foreclosures (which is seen as making the poor owners lose vis-à-vis the banks), providing an incentive for banks to foreclose promptly is actually good in terms of the neighbors and the community as a whole.\(^\text{328}\)

In some ways, both defaulting borrowers and mortgage lenders benefit from foreclosure delays, all at the expense of the community.\(^\text{329}\) Delinquent owners can stay in their homes, cost free. Lenders can wait out a bad market while avoiding the carrying costs on a property. The people who really lose from this delay are those least able to control for it: the innocent neighbors who fund the unpaid assessment bills.

Undue delays in foreclosure also cause adverse impacts on the wider market as well. Without lower priced sales to pull down comparable sale values of homes, housing prices remain propped up at unsustainable levels. Delaying foreclosure sales therefore

\(^{328}\) Politicians frequently balk at this approach of “getting it over with” and economists disagree about whether it is better to allow borrowers rent-free possession during a general market downturn or not.

\(^{329}\) At least to the extent that there isn’t a third party buyer for the property available to purchase at foreclosure or soon thereafter from the lender.
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delays the housing market from reaching equilibrium. Only when prices reflect fundamental values will the market start recovering in earnest.

Undue delays in foreclosure also discourage home buyers and investors who face uncertain timing and title. Lenders avoid financing because of the uncertainty posed by community properties left in limbo. In addition, delaying foreclosures also keeps the capital markets from establishing accurate pricing for mortgage-backed securities products, slowing the recovery in that market as well.

During the limbo of threatened foreclosure, properties are generally not maintained at the optimal level, and this threat to quality of our housing stock is nowhere greater than in CICs where a few delinquent properties can actually cause a decrease in upkeep for the entire community. Our housing stock is at risk of deterioration if responsible “gatekeepers” are not funding its upkeep. The longer the limbo is drawn out, the more extreme upkeep problems will be.

It sounds draconian, but actually the best thing for the community in the case of a nonpaying unit owner facing foreclosure is to have the foreclosure sale take place as swiftly as possible. Unnecessary delay costs the entire community money and increases uncertainty. Any benefits accruing to the lender (or borrower) from such delay are purchased with other peoples’ money. Plus, perceived lender benefits may be illusory since decline in collateral upkeep and increase in community assessment deficiencies will significantly drive down the value of the property and the lender’s ultimate recovery at foreclosure.

3. LENDER DISORGANIZATION AND MISBEHAVIOR

Blame for the financial troubles of associations – like blame for the housing crisis – targets the mortgage lenders, but the eroding lien proposal is not punitive. Rather,

330 In 2006, the Office of Federal Housing Enterprise Oversight (OFHEO) calculated the ratio of equivalent rents to home prices (comparing the amount for which a given home would rent to the home’s purchase price) and found that nationwide, the average rental value of homes was only 70% of the purchase price. OFHEO Figure 1 “Overpriced Housing” in Stewart & Brannon, supra note 37.

331 See supra Part I.A.2.

332 Miami Beach Commissioner Libbin, for example, blames “greedy banks” who “refuse to take financial responsibility for their reckless lending” for causing the mass of association delinquencies which end up saddling the remaining owners of condominium units with “huge special assessments.” Libbin has been spearheading a state-wide campaign to protect condominium unit owners from unfair assessments levied on them because of the housing meltdown, claiming that “loopholes in laws have allowed banks to escape from paying their fair share – forcing tens of thousands of Florida condo unit
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proper upkeep allocation is prerequisite to market recovery. Thus far, mortgage lenders have strongly objected to being forced to pay assessments on behalf of properties they are unable to sell quickly, although their own self-interest leads banks to take on maintenance obligations for collateral not located in privately governed communities. Governments and consumer protection groups have begged lenders to cut homeowners a break, yet they face being sued by Florida associations for not foreclosing quickly enough. The volume of defaulted properties is itself a barrier to expeditious foreclosure. Servicers are overwhelmed with as many new mortgage defaults each month as previously occurred in an entire year.

In the case of homes not located in CICs, lenders cannot avoid maintenance of constructively (or literally) abandoned properties prior to foreclosure. To prevent the ravages of permissive waste, lenders hire a manager to maintain such properties, lenders buy insurance on the properties, and even pay to have necessary repairs done. Such collateral preservation steps are merely prudent business decisions, and do not necessarily force lenders to foreclose at a time other than their choosing. Alternately, lenders can decide to modify loan obligations to free up borrower capital to meet needed upkeep costs. Lenders outside of CICs regularly act upon the clear understanding that maintenance of collateral value is in their own best interest. The only reason that lenders do not incur such costs in CIC properties is that someone else is already doing the maintenance and picking up the tab.

Foreclosures cannot proceed when it is unclear who owns what loans. Because a mortgage follows the note, only ownership (and, typically, possession) of the note evidencing the debt can permit an entity to foreclose on the mortgage. Before the owners in good standing to pick up the tab.” Ruling May Help Homeowner Associations, Historic City News, Feb. 5, 2010 at www.historiccity.com.

Alex Sanchez, president and CEO of the Florida Bankers Association, explains the lender perspective: “We get hit from every side. Some people say we’re foreclosing too fast; others say we’re foreclosing too slow [sic]. Bankers want to keep Florida families in their homes. Foreclosure is a last remedy.” Coleman, supra note 99.

On October 13, 2010, all 50 states began a joint investigation into mortgage foreclosures. This investigation was sparked by the “robo-signing” scandal. See supra notes 3 and 251. Robo-signing refers to the practice of having employees sign off on thousands of foreclosure affidavits stating that they had reviewed the underlying paperwork when, in fact, they had not. See Brady Dennis and Arian Eunjung Cha, Pelosi Calls for Federal Inquiry on Mortgage Lenders, WASH. POST, A1, (Oct 6, 2010). The robo-signing scandal and associated moratoriums slowed down the foreclosure process significantly and left millions of homes “in limbo”. Id. Although the moratoriums have now been lifted, the pace of foreclosure has significantly slowed in the wake of the scandal and a renewed focus on foreclosure procedure and mortgage ownership.
advent of the secondary mortgage market and securitization, note ownership was easy to track because in most cases loan originators remained holders of the instrument. But with the growth of the secondary market and the innovation of mortgage-backed securitization and its related products, ownership of mortgage debt was passed on post-closing and became segmented through pools of loans. By the mid-1990s, most mortgage banks no longer intended to originate mortgages for their own portfolios but rather acted as intermediaries – originating mortgages in order to sell them on the secondary market in turn.

Loan ownership changes, through secondary market sales of mortgage loans, pooling, tranching and securitization sales of pieces of those loans, were supposedly all tracked through an electronic system called MERS. Although MERS records of loans often do permit ownership to be tracked, the individual notes have in many cases become lost along the way. Because the lien (the mortgage) follows the payment obligation (the note), production of the note or a court-allowed substitute is a prerequisite to commencing a foreclosure proceeding.

335 The securitization concept basically holds that by splitting a group (pool) of mortgage loans into multiple classes (tranches) with a hierarchy of repayment rights (the top tranche has the least risky position in terms of credit and prepayment risk), the mere grouping and tranching of the pool will dramatically reduce risks for investors holding the top tier position because the lower positioned investors provide a buffer by bearing the first loss. Theoretically, this is true even if the entire pool is made up of risky mortgage loans: the lower tranches act as a risk shock absorber. Wall Street opined that pooling and tranching can be done several times, supposedly reducing risk of top-tiered securities with each re-tranching. This theory, widely accepted in the dawn of the 21st Century, seems to work less well under real market stress – witness the meltdown of the subprime market. The structure of securitization in the abstract was not the problem, it was rather the valuation model for securitized products that was inadequate. For an overview comparison of securitization and traditional bank lending, see Gerald Hanweck, Anthony Sanders & Robert Van Order, Securitization versus Traditional Banks: An Agnostic View of the Future of Fannie Mae, Freddie Mac and Banks, FINREG21, Sept. 28, 2009, http://www.finreg21.com/ lombard-street/securitization-versus-traditional-banks-an-agnostic-view-future-fannie-mae-freddie-ma. A concise description of the development of mortgage-backed securitization can be found at Kurt Eggert, Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine, 35 CREIGHTON L. REV. 501, 535-550 (2002).


338 Id.

339 Id.
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The delay is unfortunate but unavoidable: foreclosure as a process requires strict adherence in order to assure the fairness of the result.\textsuperscript{340} If foreclosures must slow down to ensure procedural due process, then a slower timeline is essential.\textsuperscript{341} However, the costs of these foreclosure delays should be borne by the entities who could have avoided the problems causing the delays – namely, the lenders or servicers. Hopefully, foreclosures will not be delayed more than necessary as a result of political posturing, since foreclosure delay causes far more problems than it solves.\textsuperscript{342}

Many of the problems plaguing the housing market today – from the robo-signing scandal to the poorly-underwritten loans in the first place – are products of lender sloppiness, disorganization and (sometimes) misbehavior. The structure of the market itself encouraged risk-taking at the originating lender level. Since borrower credit risk was assumed by the secondary market purchaser and securitizer of the loans, often with insurance companies providing credit enhancement to the mortgage pool,\textsuperscript{343} and was then passed on (in whole or in part) to investors in the pool who provided the actual funds through purchasing mortgage-backed securities,\textsuperscript{344} there was very little incentive for mortgage lenders to perform sufficient due diligence before advancing funds. The New York Times decries sloppy lending, property appraisals and securities ratings, pointing out that “Since we trust, why verify?” seems to have been the industry motto.\textsuperscript{345}

Again, there were many guilty parties in sloppy lending and loan transfers. But as between the mortgage lenders and the borrower’s neighbors, clearly the lenders emerge as more culpable. Thus, between these two categories of parties, the choice for cost allocation is likewise clear. The only party who can avoid similar problems in the future is also the mortgage lender. As the least cost avoider, economic theory supports the equitable judgment here: lenders should bear costs caused by their failure

\textsuperscript{340} Much like election law procedures assure fair election results and trial procedure assures viable findings of fact.

\textsuperscript{341} It is paramount to ensure that foreclosure sales are valid because flawed foreclosures raise three problems that threaten housing markets and the broader economy: the foreclosure itself may not be warranted or conducted correctly (with proper parties); buyers at foreclosure are not assured of good title; and lack of confidence in titles to land slows housing market recovery.

\textsuperscript{342} See supra Part I.A.2.

\textsuperscript{343} Id.

\textsuperscript{344} See supra note 355.

\textsuperscript{345} Floyd Norris, \textit{Banks Stuck with Bill for Bad Loans}, \textsc{The N.Y. Times}, Aug. 19, 2010.
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to carefully underwrite their lending, properly document their mortgage sales and securitizations and foreclose promptly and correctly.\textsuperscript{346}

Lenders uniformly lobby to keep the system as-is, particularly in states with no limited lien priority for assessments. But in reality, bankers’ associations which decry a viable solution to private governance failure are acting against their own long-term interest. Although lenders may see themselves as paying the price of revisions in the lien priority scheme, they very well could also be lenders on non-defaulting units currently being burdened with increasing assessments or, at the very least, facing the uncertainty of assessment increases in the future. A lender may desire to make a loan on a unit in a community where a large percentage of owners could stop paying assessments at any time. This uncertainty hurts owners and their lenders.\textsuperscript{347}

Alternatively, if the community could ensure the expected revenue stream, the risk to all lenders decreases even though their exposure in terms of their non-paying borrowers goes up. The downside, however, should not pose a problem; lenders can manage this risk much more easily than the uncertainty risk related to potentially unrecoverable assessments. Lenders already take measures to protect themselves against property tax amounts which can accrue and are payable prior to their mortgage loan out of foreclosure proceeds. Lenders need only set up reserve accounts and affirmatively require payment of association assessments to control for borrower misbehavior and their own loss exposure from the loss of lien priority.

Lenders also benefit from legislation empowering associations to ultimately recover their upkeep costs because by keeping the community association solvent and active, lenders reap the benefits of supported property values and well-maintained communities. Even when lenders “save” money by delaying foreclosure to avoid paying assessments, they drive down the property value of their own collateral by causing community assessments to increase while services decline. In essence, lenders commit their own waste when they fail to ensure payment of association assessments.

\textsuperscript{346} This is not to say that uncertain foreclosures should be permitted. Strict procedural protections and requirements must be maintained. But any additional community costs incurred by lender missteps must be borne by lenders alone – not by the neighborhoods in which their collateral is located.

\textsuperscript{347} This is why Fannie Mae, Freddie Mac, FHA and other lenders impose a limit on the percentage of delinquencies before they will purchase or insure (or originate) loans in a community association. It also is why the GSEs want to approve community reserves levels. See supra Part II.A.1.b.
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4. ASSOCIATION ASSESSMENT ABUSES

Some commentators target association expenditures in general as wasteful spending, but statutory oversight of association budgeting and amenities is not a good idea. Rather than pass laws requiring communities to tighten their belts, this is best left to the governance system in place. There is nothing preventing members from voting to cut back services and save community funds. Furthermore, if a lender begins paying assessments after foreclosure, the lender will be able to assert the unit’s voting rights and have some input into community costs and fees.

Associations are typically empowered to charge late fees and collection costs in addition to delinquent assessments.\(^{348}\) Clearly, associations must be able to recoup the costs of collecting delinquent assessments. Some assert, however, that late fees and collection costs are out of control. Allegations abound that community associations hire lawyers who abuse the system by charging outrageous fees.\(^{349}\) Some California lawmakers, for example, have highlighted the danger of so-called “foreclosure factories” – law firms and collection agencies that charge an association $1,500 to $2,000 for taking over a foreclosure proceeding against a delinquent owner.\(^{350}\) The associations tack the amount paid to assessment collectors onto the delinquent charges, and the collection cost amounts can be “shockingly high.”

Current government oversight of collection cost charges is minimal at best. But there are compelling reasons to have statutory limits on late fees and charges that an association can charge, particularly if such charges are all ultimately recoverable against a first mortgage lender in its foreclosure sale.

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\(^{348}\) Hyatt, supra note 14, at 121-122 (describing two methods of imposing late fees in CIC associations: flat rate and monthly fees).


\(^{350}\) Id. See also Wasserman, supra note 11.

\(^{351}\) Ngai Pindell, Tensions Between the HOA Super Liens and Purchasers at Foreclosure, LAND USE PROF BLOG (Jan. 29, 2010), at http://lawprofessors.typepad.com/land_use/2010/01/tensions-between-hoa-super-liens-and-purchasers-at-foreclosure. Collection costs charged by associations are much maligned. Professor Pindell opines that “the only entities capable of engendering more ill will than over-zealous lenders are HOAs” and notes that “many see these perceived, excessive HOA charges as yet another manifestation of unchecked and intrusive power over homes and communities.”
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CONCLUSION

The unprecedented delay in foreclosure the U.S. is now experiencing is harming non-defaulting owners in privately governed communities. The financial “commons” of entangled fiscal fortunes in such neighborhoods illustrates a fundamental flaw in the common interest community system of ownership that must be remedied to prevent the potential failure of such governance forms during periods of great economic stress. The adverse external impact of community assessment delinquencies is an important but often overlooked problem which under the current housing crisis is reaching critical levels. Certain government and market actions, including current foreclosure moratoriums and delays, exacerbate the problem, spreading financial distress to innocent homeowners and bringing property values down in a tangible and significant way. Leaving community association effectively bankrupt is a lose-lose scenario, and we need prompt legislative action to prevent this result.

Current laws regarding lien priority fail to protect the interests of such communities and their paying members. Even in the handful of states that have enacted protective limited lien priority provisions with respect to community association assessments, assessment lien priority is almost always capped at six months worth of delinquent assessments. Because foreclosures take months or years longer than the time period representing the recoverable assessment amounts, such laws provide no real incentive for lender responsibility or expeditious foreclosure sales. As foreclosure is delayed, costs continue to mount while neighbors pay the costs left unpaid by delinquent owners.

To effectively preserve property values and protect blameless homeowners in planned communities, states across the nation must adopt measures to enable private governments to perform their roles. Allowing delayed foreclosures to erode the lien priority of a first mortgage achieves the needed result with the most contained and best allocated costs. Although creating incentives for prompt foreclosures may at first glance seem perverse policy in a difficult economy, it is actually the best and only answer to the insolvency contagion threatened by assessment delinquencies and foreclosure delays. Finding solvent owners to replace those who hold title to houses they can ill afford – both in terms of financing and in terms of upkeep costs – is paramount. To mandate that the paying members of a community association provide private financial support to the defaulting homeowners is unfair, inefficient and poor policy indeed.