

ASSESSMENT COLLECTION: GENERAL PRINCIPLES AND STRATEGIES©

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Introduction

This Article contains general advice and comment regarding the collection of past due Homeowner's Association assessments and Condominium Association assessments by lien and foreclosure.¹ It is **not** an exhaustive treatment of the subject. Many issues are omitted because of space and time constraints. The reader is encouraged to discuss the issues of a particular case with their attorney.

This information applies to both Homeowner's Associations and Condominium Associations unless noted otherwise. The word "unit" is intended to include a residential lot in a Homeowners Association as well as a condominium unit in a Condominium Association.

What is a Lien and how is it Foreclosed?

Liens are evidence of the Association's collateral interest in the unit. A lien is evidence of the secured principal assessment owed, plus interest, late fees, attorney fees and costs of collection, if any. Liens are recorded in the public record of the County in which the property is located. There is a recording fee charged by the clerk for recording.

Liens may be foreclosed by the Association by filing a complaint in the County or Circuit Court. The complaint asks the Court to determine the total amount owed by the unit owner (the "judgment amount"), and to set a date for the property to be sold to satisfy the debt. This results in the sale of the unit on the "courthouse steps" (the "judicial sale").

The property is sold to the highest bidder at the judicial sale. The Association bids at the sale, but does not have to pay cash "out of pocket" for its bid. It may bid up to its judgment amount without coming "out of pocket" with cash. The Association will be the high bidder, if no one else bids on the property. As the high bidder, the Association is given a Certificate of Title by the clerk. When the Certificate of Title is issued, the Association is the owner of the unit.

The Association's Lien is Junior to a First Mortgage

The judicial sale of the Association's lien does not extinguish priority secured interests like lenders who have provided financing for the purchase of the unit (the "first

¹ The Association may pursue a personal money judgment against an owner, but that remedy is beyond the scope of this article.

mortgagee”). Thus, the Certificate of Title that the Association receives remains subject to any first mortgage.

Association liens are “junior” to first mortgages. If a unit owner goes into default in the payments due his first mortgagee, the first mortgagee may foreclose the mortgage. Upon the sale of the unit at the first mortgagee’s judicial sale the Association’s lien interest in the property will be extinguished and the Association will receive nothing, except i) if the high bidder *is* the first mortgagee, it may pay a statutory set sum to the Association, or ii) if the high bidder is *not* the first mortgagee he may owe all past due assessments.² Moreover, if the high bidder bids more than the amount owed to the first mortgagee, the Association may be entitled to the “surplus.” The “surplus” is the amount bid in excess of the debt owed the first mortgagee and it is available to other secured interests like the Association.

Given the current debt environment in the United States it is unusual for a surplus to occur in a typical first mortgagee residential foreclosure. The value of the unit has declined relative to the outstanding indebtedness owed to the first mortgagee. Thus, there is not sufficient equity in the property (distress sale value that exceeds the debt owed to the first mortgagee) to draw bidders “off the street” to engage in competitive bidding for the unit. Thus, the first mortgagee ends up with title to the unit, the Association’s lien is extinguished, and the Association may be limited in its recovery to the statutory amount.

The Association’s Title is Subject to a First Mortgage

When an Association takes a Certificate of Title of a unit through lien foreclosure it takes title “subject to” the first mortgage. The unit continues to stand as collateral for the first mortgage debt. Although the Association now has title, the first mortgagee may foreclose its delinquent mortgage, and take title to the unit from the Association.

Although the unit continues to stand as collateral for the first mortgage debt, the Association will not be obligated on the indebtedness owed to the first mortgagee. The Association does not become an obligor or guarantor under the promissory note that is secured by the first mortgage. The Association merely has taken possession of collateral (it has title to a unit) that stands as collateral for another’s debt. It does not become obligated for that debt by mere possession of the collateral.

² When a first mortgagee takes title to a condominium unit through foreclosure it is obligated to pay the Condominium Association the lesser of twelve months of delinquent assessments or 1% of the principal mortgage debt. The first mortgagee may also be liable for accrued interest, late fees and other charges, but Association council ought to be consulted in that regard.

When a first mortgagee whose mortgage was recorded after July 1, 2008 takes title to a lot through foreclosure located in a mandatory membership Homeowners Association, it is obligated to pay to the Association the lesser of twelve months of delinquent assessments or 1% of the principal mortgage debt. If the first mortgage was recorded before that date, the declaration of covenants for the Homeowner’s Association should be consulted and analyzed to determine the amount owed, if any, to the Association from the first mortgagee.

Why Foreclose a Junior Lien?

The Association usually does not know if the unit owner is current on his first mortgage or, if he is delinquent, how far behind he is. A unit owner may be keeping his head above water by paying his first mortgage on a timely basis, but avoiding the payment of Association assessments. If those are the circumstances, when the Association files its foreclosure case the unit owner may aggressively pursue funds from other sources such as second mortgage lenders, cash advances on unsecured credit cards, money from relatives, and the like, to pay the debt owed to the Association.

Or, the unit owner, realizing that he cannot hope to keep his mortgage current and his assessments current at the same time, may decide to give up, move out and no longer make his mortgage payments. In that case the first mortgagee will foreclose its mortgage and eventually the title will be in the first mortgagee or some other high bidder at its foreclosure sale. Paradoxically, that is what the Association wants – the first mortgagee or some other person taking title. Unlike the unit owner who is not paying their assessments, the first mortgagee is solvent and will pay assessments after it takes title.

Sometimes it is merely a matter of giving a unit owner a little encouragement. The unit owner can't imagine that the Association will ever foreclose its lien. When they see that the Association is serious about its collections, and is willing to foreclose, the unit owner may be quick to pay.

After taking the Certificate of Title through its lien foreclosure case the Association may put the unit up for sale or rent it out. Some Associations have realized meaningful cash flows by renting out the unit prior to the first mortgagee foreclosing its mortgage. Before foreclosing its lien in hopes of renting out the unit, the Association should compare the burdens of being a landlord with the possible benefits from rental cash flows.³

Selling the unit to realize a gain to the Association is seldom a viable option these days. Its fair market value may be less than the payoff amount of the first mortgage, requiring that the first mortgagee agree to discount what it is owed in order to clear the title for a sale (also known as a "short sale"). Although short sales are becoming more common, the first mortgagee typically requires that the seller, in this case the Association, receives no cash at closing.

To understand all the benefits and risks associated with taking title to a unit, please consult with Association legal counsel.

³ Make sure any lease of a unit between the Association as owner of the unit and a tenant contains a clause informing the tenant that the term of the lease is subject to early termination if the first mortgagee forecloses its first mortgage during the lease term.

Devise a Strategy

Residential real estate is experiencing record mortgage default rates. Gone are the days when the Association could follow the classic steps for every delinquent owner – give him notice of the delinquency, then lien him, then file suit to foreclose the unit, and eventually, on the courthouse steps, the unit owner pays the debt. The Association must be more selective.

It is important that an Association consult its counsel to devise an effective collection and foreclosure strategy. The Association's particular receivable picture should be evaluated, and a plan should be developed that economically and effectively maximizes the Association's net cash flow from past due assessment collection efforts.

The following is a possible strategy. It may not apply in every case. Before implementing any collection strategy, an Association should consult with legal counsel.

Pick the Low Hanging Fruit

1) First, check the public record to determine which units are in first mortgagee foreclosure status. Put those aside for the time being.

2) Next, of those delinquent units remaining, divide them into three categories; owner occupied, renter occupied, vacant.

a) Owner occupied. Foreclose owner occupied units first. The unit owners are most likely to do what is necessary to avoid a foreclosure sale.

b) Renter occupied. Foreclose renter occupied units next. At least the owner is getting some cash flow from the unit, and may not want to lose that cash by having his unit foreclosed by the Association.

c) Vacant. Foreclose the vacant units next. Vacancy is a good indicator that the unit owner may already be in default of the first mortgage or soon will be. Don't be in a hurry to foreclose vacant units.

3) Lastly, go back to those units that are being foreclosed by first mortgagees. Be cautious and consult with counsel before expending resources to foreclose these units.