Dealing with the Realities of the Recession

Default Protection

BY LISA IANNUCCI 2009 JUNE LAW & LEGISLATION

Consider the (fictional) couple, Mr. and Mrs. Smith. They love their co-op apartment, and have lived in their comfortable and convenient New York City neighborhood for the last seven years, moving in when Mr. Smith took a job as editor of a prestigious magazine. He was making a great salary, and Mrs. Smith was enjoying her new career as an elementary school teacher. When the economy took a hit last year, Mr. Smith's magazine took a major hit— advertisers bailed and the magazine folded. Mr. Smith has had a hard time finding a job ever since, and Mrs. Smith's salary isn't enough to make ends meet. The couple has been struggling— and they've missed several maintenance payments.

Their cousins, the Jacksons, own a condo in New Jersey. Unfortunately, they are experiencing some of the same struggles as their Big Apple relatives. The Jacksons have also experienced layoffs from their jobs and, as a result, have fallen behind on their bills. They've exhausted every avenue of financial help and have defaulted on their mortgage—missing several payments as well as monthly dues payments to their homeowners' association. Both couples are now facing foreclosure on their homes.

All Too Common

Unfortunately, this is a common scenario these days, both in New York and around the country. More than 1.5 million foreclosure actions occurred last year and at the time of this printing, there was tax help for struggling homeowners, which could slow down the problem. Unfortunately, when a homeowner misses a payment, they aren't the only ones affected. The entire building and homeowners association feels the effects when one homeowner misses a payment. That effect multiplies when there are more delinquent residents.

"Foreclosures on co-ops and condos affect the buildings because in order for the buildings to run they need to receive a certain amount of rent or common charges from their tenants," says Joseph Colbert, a partner at Kagan Lubic Lepper Lewis Gold & Colbert, LLP in New York.

"The impact of a foreclosure in a condominium is often more severe than a foreclosure in a cooperative,"says attorney Eric Goidel, a partner with the New York-based law firm of Borah Goldstein Altschuler Nahins & Goidel, PC. "While the lien of a cooperative for unpaid maintenance is superior to the liens of all lenders, the lien of a condominium board of managers is subordinate to the lien of a first mortgage of record."

This presents a superior challenge for a condominium association in light of home values that have drastically depreciated well below initial purchasing prices. "Particularly in this depressed real estate environment, the amount of the outstanding balance of the first mortgage can often exceed the market value of the apartment; let alone the foreclosure sales price of a unit," says Goidel. "Accordingly, while a cooperative apartment corporation will ultimately either recover the arrears due it, or recover the unit, frequently, a condominium board of managers finds that some, or all of the arrears, are lost."

In reality, foreclosures really aren't the preferred way of doing business. Nobody wants to see a homeowner fail at making their mortgage payments and ultimately lose their home. Banks and associations want to work with a delinquent customer to bring them up to date and save what could be a financial loss. After all, foreclosures aren't just a mark on the homeowner's record, but also on the building as well, affecting how lenders view the co-op or condo, and impacting its ability to borrow.

The Process

That being said, sometimes there's simply no choice. No matter what the Smiths or Jacksons do, there may be no opportunity to save their homes from foreclosure. How these foreclosures are handled and the impact of any charges which remain in arrears will, however, differ.

When a unit owner defaults on their payments in a co-op building, Ronald L. Perl, a partner and head of the community association law practice group with the Hill Wallack law firm in Princeton, New Jersey, says that it's easier to foreclose because the shares are not real estate—they are shares of stock. Thankfully, co-op owners can get a little extra assistance in the process.

"The banks are more likely to bring the account current because the shares can be taken back by the association," he says. "Under the terms of the loan with the building—which is really a loan secured by shares of stock, as opposed to a real estate mortgage—the lender is entitled to make an advance to the delinquent unit owner's association. If the unit owner still can't pay after the advance, the lender is not going to pay forever."

Curing any arrears is also a time-consuming process, according to Goidel. "Although a board of directors can simultaneously maintain a nonpayment proceeding, in court, to recover possession of the unit," explains Goidel, [the process to collect any maintenance in arrears] requires that a notice to cure for the nonpayment of maintenance be served under the proprietary lease, followed by service of a notice of termination. A foreclosure lien search is ordered and a notice of a sale is given to all parties with interests subordinate to the cooperative as their liens can be extinguished by the foreclosure. An auctioneer is engaged by the apartment corporation, and a notice of sale is published in a local newspaper in accordance with Uniform Commercial Code

Rules. Where, however, a bank has loaned against the shares and proprietary lease, the lender will typically step forward, pay the arrears and conduct its own foreclosure."

The unit owner will then be declared delinquent and evicted and shares will then be sold. "While not the absolute rule, typically in a cooperative, where a lender takes a unit back in foreclosure, the lender is often afforded holder of unsold share status, and has the right to sell the apartment without board approval, or is accorded a modified status and has the right to sell the apartment with only managing agent approval with such consent not to be unreasonably withheld," says Goidel.

This doesn't go on indefinitely. If a unit owner declares bankruptcy, it can slow the process down, cautions Perl. The exact details of the process are written in the building's governing documents.

A condominium foreclosure is different. When someone buys a condo, they own the unit they are living in outright and pay a mortgage to the bank. In addition, a unit owner is required to pay association dues, which are used to maintain and upgrade the common areas of the property. If a unit owner fails to make either payment, they can lose their property. Unlike a co-op foreclosure, foreclosing a condominium offers less alternatives to collect outstanding association dues.

Goidel notes that "a condominium foreclosure is very similar to a mortgage foreclosure, with a foreclosure proceeding being maintained in the Supreme Court of the county in which the unit is located, to foreclose a lien for unpaid common charges, which has either been filed out with the city register or with the county clerk (if outside the City of New York). A summons and complaint is served, and dependent upon whether a unit owner appears or defaults an answer may or may not be served. Any parties with liens subordinate to the lien of the board of managers must also be served with process, as their interests in the unit may be wiped out in a foreclosure. Upon application by the board of managers, a referee is appointed by the court to compute the sums due and owing to the board of managers. A motion for a judgment of foreclosure and sale is thereafter filed and upon judgment, the court appoints a referee to conduct the foreclosure sale."

Perl agrees. “A condo foreclosure process is the same as what a bank would go through with a mortgage of any property,” says Perl. “A notice goes out, and a foreclosure needs to be filed. This means that the bank is terminating the owner’s interest in the real estate and the property will be sold at a sheriff’s sale to settle the debt.” And in a condo, says Goidel, the successful bidder is entitled to the deed for the unit without any interference from a board of managers.

A Last Resort

“I don’t prefer foreclosure in most association situations,” Perl continues, “although some lawyers are regularly doing foreclosures now instead of just suing people. Foreclosures are more time consuming and expensive than a lawsuit for a money judgement. They can get a wage execution or levy on bank accounts and exhaust all other assets. Unfortunately, if this isn’t enough it can still force the sale of the unit.”

Something to consider, however, is that a foreclosure lawsuit can take a long time. “When a condominium unit owner falls behind on his or her end loan, the lender must commence a foreclosure lawsuit in state Supreme Court,” says Stephen M. Lasser, a partner with the law firm of Stark & Stark in New York. “A foreclosure lawsuit can take several years to complete. When a condominium unit is finally sold at a foreclosure sale, the proceeds are first applied to the amounts owed to the lender, then to the amounts owed to the condominium—assuming the condominium recorded a lien against the unit and there is money left.”

There are examples of foreclosure that still may not work out to the benefit of the building or the association. “For example, says Perl, say a unit owner buys a home for $250,000. They mortgage $200,000 and put $50,000 down. Unfortunately, now the home is worth $180,000 and the unit owners don’t even have enough to pay that first mortgage. Where does the building’s board or association go?

The only steps that a board can take to assist a struggling resident is with some type of deferral of the maintenance or common charge obligation, says Goidel. “In either situation, this agreement should be memorialized in a court proceeding with some severe implications for the resident if the terms of agreement are not honored. Unfortunately, where a lender foreclosure is involved, there is little, if anything that a board can do to assist."

The bank will typically give a board or an association up to six months of delinquent assessments, but in some cases, you can make a deal with the owner. "Boards have fiduciary duties that all owners pay their pro-rata share of maintenance or common charges," says Lasser. And they can also help a struggling resident by setting up a repayment agreement, he says. The board also can offer to waive some late fees or interest on unpaid amounts at the end of the repayment term if all payments under the agreement are paid on time.

Lasser recommends that boards act quickly when condo owners fall into arrears and encourage them to utilize the small claims part of the city or town court if the amount owed is less than the court's jurisdictional threshold, which is typically $5,000.

"Once a lender commences its own foreclosure action against a condo owner, it rarely makes sense for a condo association to start or continue its own foreclosure action because the bank's loan that is being foreclosed will typically have priority over the condo's foreclosure action," he says.

It's also important for managers to keep good payment records, so if a problem arises, you have exact documentation of payments made. "If a unit owner fails to pay their dues, send a reminder notice, then another warning letter 35 to 60 days later and then, finally, turn it over to legal," says Colbert.

The Manager's Role

Managers may run into complications when dealing with a unit owner. For example, the unit owner may be falling behind financially, but might have a rental tenant occupying the unit. The owner—not the tenant—is responsible for the maintenance payments to the building. The tenant might be paying the unit owner, but the owner might not be paying the association. If that's the case, says Colbert, "file a common charge lien, and notify the tenant that they have to pay the board directly. You may have to make some difficult decisions."

In some cases, just initiating any kind of foreclosure, liens or legal paperwork is enough for an owner to pay the back payments. They may borrow from family or friends to get themselves caught up. However, this isn't always the case and the owner may choose to take the loss. "It gets them out and forces the sale of the unit," explains Perl. "This is good for the building because the next owner is more likely to be a performing owner when it comes to paying association fee."

Of course, most buildings are going to encounter a defaulting resident every once in awhile, and usually it's not the end of the world. And Goidel points out that while there should not be any long term implications for a cooperative's ability to borrow, "a significant number of foreclosures at any given point in time, may have a temporary impact, as lenders look at the available cash flow in determining whether to commit funds to a building, and if so, in what amount." Therefore, he adds, that it may be necessary in the short term to temporarily assess shareholders in good standing to make up a likely shortfall in maintenance income.

Conversely, a condominium is different. "A condominium," says Goidel, "by its nature does not have the ability to mortgage any common property, and only has the ability to borrow money from a bank, with the security being a pledge of the cash flow in the form of common charges and other payments due the condominium. Accordingly, a diminution in the cash flow to a condominium will have impact on the willingness of a lender to make a loan, as well as on the amount that a lender is willing to make available."

Too many defaults can actually affect the association's borrowing ability down the road. "Banks look at delinquency rates," says Perl, "and in most cases an association has a line of credit with a lender set in advance. However, they may need some kind of credit later and a bank may look at these delinquencies as a credit risk. If 50 percent of the units are in collections, who would allow that association to borrow money?"

Sometimes all the unit owner needs is time to get through a difficult period. It's important for the association to weigh the pros and cons of an arrangement with the unit owner versus the traditional methods of foreclosures. What steps can a board take to assist a struggling resident while still protecting the building's interests?

"Someone might just be in hard times, and we've had times when someone can't afford to live in the building, so we've agreed to a standstill while they put their home on the market for a range of prices. They try to get market price, but if they don't then they'll go to foreclosure and have it auctioned."

It's a unique time in this world which calls for unique solutions to unique problems. There are more Smiths and Jacksons out there, so be prepared as to how to handle them without jeopardizing the day-to-day operations of your building or association.

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COMMENTS

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