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# Legal Issues for Condominiums Impacted by Recession

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*Special to the Legal*

The real estate boom, followed by the bursting of the bubble and the economic recession, have all contributed to the current "perfect storm" of legal issues for condominiums, unlike anything we have encountered in the 45-year history of this unique type of property ownership. (The first-generation condominium law in Pennsylvania was the Unit Property Act, adopted in 1963, which is still applicable to older condominiums).

Since we are now a nation of more than 300,000 common interest communities (condominiums, cooperatives and homeowner associations, but all referred to as condominiums in this article), with more than 60 million residents, many professionals, businesses and citizens associated with such communities, such as developers, lenders, contractors, residents and community association lawyers, are now being confronted and challenged by a unique set of new circumstances and legal problems.

Although this situation is headline news in the overbuilt resort and retirement areas of Florida, Arizona, Nevada and California, we are also experiencing it in a quieter and smaller way right here in the Delaware Valley, giving us a greater opportunity to develop workable solutions to these problems. Both new and established condominiums are being impacted, often in different ways.

Condominiums are structured and governed much like municipal governments, based on a democratic and representative process. The condominium association is comprised of all the owners, who own their individual homes and a proportionate share of the common property and elect a volunteer governing body to operate the community as fiduciaries for the benefit of the entire group, often with the assistance of a professional property manager.


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The association functions as a nonprofit organization and assesses the individual owners to generate the budgeted funds necessary to pay for the community's operating and capital expenses. These assessments, or condominium fees, are the lifeblood of the community, and any major shortages can result in a financial crisis.

The association is governed by its organizational documents and is subject to the Pennsylvania Uniform Condominium Act (and/or its related statutes), which provide for the respective rights and responsibilities of the association and the owners. Individual owners (including the developer) are legally bound to pay their fair share and obey the rules, whether they are occupants or investors; and the developer is legally bound to fulfill its warranties and operate the community until control is transferred to the owners.

Developers want to build out the project and make a profit, lenders and contractors want to be paid, and owners want to enjoy the community promised to them and preserve their property values — but we are now seeing that these objectives, which should be compatible, are often in conflict.

Due to decreasing property values, highly leveraged mortgages, increasing unemployment, increasing rental vacancies and the general slowdown in the real estate market, condominium developers and owners are having more difficulty meeting their financial obligations. Although they may not be able to afford to pay these obligations, they also may not be able to get out from under them because they cannot sell or rent the units — fewer buyers and renters are available, less mortgage money is available, and they may owe more than the unit is worth.

The current much stricter mortgage underwriting guidelines and standards imposed by lenders and secondary mortgage market makers, such as Fannie Mae, Freddie Mac, the FHA and the VA, make it much more difficult to finance or refinance condominium units. We are seeing a significant spike in mortgage foreclosures, tax sales, bankruptcy filings, uninsured property, deferred repairs, mechanics liens, utility shutoffs, and just late or delinquent payments affecting developers, investors and unit owners. Any and all of these events are dangerous and can be catastrophic for a condominium association and its owners.

Associations must be more aggressive in collecting delinquent assessments, utilizing the various legal remedies available such as charging late fees and attorney collection fees, requiring security deposits or accelerated payments, budgeting for bad debts, suspending certain rights and privileges usually relating to amenities, enforcing an assignment of rents on leased units, suing the owner, and ultimately foreclosing on the automatic statutory lien for assessments.

Although the law gives associations a super-priority lien in most cases, it is very limited in first mortgage foreclosures and difficult to enforce in bankruptcies. The collection of some or all unpaid assessments can be so frustrated and delayed by the legal process that a community's very survival may be at risk.

A new condominium association is now often another serious victim of the developer's financial problems, and the unit owners may find themselves in a very precarious position. The developer maintains control of the association usually until the earlier instance occurs: five years pass or 75 percent of the units are sold. After that threshold is reached, control is transferred to the unit owners.

The pre-transition, developer-controlled association governing board often does not adequately protect the interests of the unit owners when they conflict with the interests or financial realities of the developer. The developer may not be paying the condominium fees it owes on its unsold units, which usually accrue from the date the first unit is sold. The developer may run out of funding and therefore also not pay its other obligations.

With the credit squeeze and lack of sales and rentals, unit owners in a new association are facing lack of control, cash shortages, incomplete construction, mechanics liens, voided construction warranties, unpaid utilities, unpaid insurance, developer related financial discrepancies, missing records, missing plans, incorrect "low-ball" budgets, and lack of permits or approvals relating to zoning and real estate tax abatements.

Unit owners in a new, pre-transition association may need to be proactive and creative in protecting their property investment. Lacking control of the association, the owners cannot impose assessments to fund operations, enforce collections of unpaid assessments, access the funds of the association, maintain the common property, make any decisions about the project, or even communicate officially for and with the community. They may need to unite and organize themselves, at least initially on a de facto basis, and possibly raise funds independent of the official association to hire professional advisers and legal counsel to evaluate any construction and financial problems, advise them of their rights and take appropriate actions.

This organizational and fundraising effort could just prove to be impossible to achieve, and the assertive unit owners may have to go it alone or wait impatiently for the developer's lender to take some legal action. Ultimately, some interested party (organized unit owners, the developer's lender or other creditors, or even the developer) may have to seek a court's intervention to order the appointment of a receiver, the early or temporary or limited transfer of control of the association to the unit owners, or other necessary or appropriate relief to protect the conflicting interests of the various parties. However, there is little precedent for such a process, and it could be very expensive and lengthy.

While those unit owners that are suffering through this crisis are waiting for some legislative or judicial relief, it is incumbent on community association lawyers to craft better and quicker solutions. Necessity being the mother of invention, there is now a desperate need for practical and workable remedies to these unique legal problems and issues.

Educating the consumer unit owner about the legal and practical realities is clearly a necessary part of this goal. Unfortunately, they must understand that as an owner they are financially responsible to carry their burden and share whatever operating expenses are necessary to fund the community, even when their neighbors and the developer are unable or unwilling to do so — the lights and power need to stay on, the property needs to be insured, and necessary repairs have to be made. Although the developer may have legal liability, it is usually a single-purpose entity with highly leveraged financing and little if any equity or assets, and therefore may not be a viable source of funds or a viable defendant.

So far, the government's attempts to deal with these little understood and snowballing problems have justifiably focused on protecting homeowners from foreclosures forcing them out of their homes and more strictly regulating the credit market and mortgage lenders. This addresses some issues, but also ignores other problems.

With limited credit available, developers cannot pay their obligations and successfully complete their projects. With delayed or postponed foreclosures, homeowners who cannot pay their condominium fees are staying in their units and forcing their already financially strapped neighbors to try to carry an extra burden. With less of the assessed fees being paid to condominium associations, communities are not being maintained, property values are decreasing, and units cannot be sold or rented.

With stricter lender underwriting and secondary mortgage market guidelines, associations with many rentals, high delinquencies, low capital reserve budgets, leasing restrictions or lawsuits against their developers are not being approved; and without readily available mortgages their units cannot be sold. With certain leasing restrictions imposed by some associations, investor unit owners who have not been able to sell their units now cannot even rent them and do not have the cash flow to pay their condominium fees.

For cautious buyers of units in new planned condominium projects or partially constructed or sold projects, one approach to prevent such problems could be to attempt to secure the developer's obligation to pay future fees for its unsold units, perhaps by an escrow account, a third party's collateral guarantee or a fee reserve in the construction loan.

However, if such an approach is intended to protect the new association, the developer may still control the association if units are not selling, and such remedies may then prove to be illusory. It has become apparent that many of these issues are intertwined, and some remedies create or uncover other problems.

Clearly, these unique circumstances and problems will continue to challenge community association lawyers to think outside the box to address these issues and to protect and preserve a very important part of our national and local real estate market. Stay tuned for new developments and ideas. •



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