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A LAY PERSON'S GUIDE TO THE COLLECTION AND FORECLOSURE PROCESS

The process by which communities go through the collection of assessments is more important than ever. The recent mortgage meltdown, coupled with massive speculation in real estate, has caused a crisis in the world banking system, and, on matters closer to home, community associations are currently more heavily impacted than at any time since the passage of the Condominium Act in 1963. While homeowner associations have been in existence for a long time, likewise, there is no precedent for the massive rounds of foreclosures or collections that community associations face. Unlike the federal government, community associations cannot run deficits and are often limited to some arbitrary increase in assessments, without a membership vote prior to approving increases for those who do pay, to make up for the shortfall of those against whom unpaid assessments become uncollectible.

What follows is an outline concerning the rights and remedies of the associations in Florida. This presentation is limited to entities governed by Chapter 720, *Florida Statutes,* and will be referred to as "HOAs."

MYTHS & FACTS ABOUT THE COLLECTIONS PROCESS:

There are a number of fundamental misunderstandings that I want to clear up before we discuss the matter in detail, along with a time line. The most fundamental of them is as follows: "We don't want to foreclose, because if we take title, we don't want to have to pay the first mortgage!"

GUESS WHAT? IF THE ASSOCIATION FORECLOSES AND TAKES TITLE, IT DOES NOT HAVE TO "PAY" THE MORTGAGE!

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In order to understand anything about the collections process, we need to understand the nature of the obligation to pay assessments and, for that matter, to pay a lender when property is purchased.

When an owner purchases property, the owner signs a note, which is a contract between the lender and the buyer. The contract sets forth, among other things, the amount borrowed, the interest rate, the payment schedule, and a provision that if the note is not paid, the lender may sue the owner and obtain a money judgment against the owner if the note is not paid. That is a contract solely between the owner and the lender. The **Association is not a party to that contract**, and therefore, there is no promise to pay the lender a nickel.

When an owner borrows money to buy the property, that owner is almost always required to sign a mortgage. That mortgage is a security interest in the property. It is not a promise to pay, it does not involve the Association, or any other party. It simply puts the World on notice that somebody borrowed money, because usually the note is referred to in the mortgage, and states that in the event that the note is unpaid, a remedy of the lender is to foreclose the mortgage.

Similarly, when someone buys property in an HOA, the Declaration is a contract between the Association and the owner. That Declaration provides that if an owner does not pay assessments, the Association may sue the owner and obtain a money judgment against the owner, or file a lien and foreclose against the owner. The law and just about every Declaration provides that the mortgage of a first mortgage holder is superior to any claim of lien against the property that may be filed by the HOA. Why is that? Because no lender would lend, and real estate commerce would come to a halt, if lenders knew that their security interests could be affected by the foreclosure of a lien for unpaid assessments.

So, to dispel that notion, the Association is <u>not</u> obligated to pay anybody anything if it forecloses and takes title!

<u>WHAT ARE THE STEPS TAKEN IN THE COLLECTION PROCESS</u>?
<u>WHAT IS THE TIME LINE AND WHAT ARE THE RIGHTS OF THE PARTIES</u>?

At the beginning, it is vital to note that every association needs to make sure that it follows its own budgeting requirements. Strict compliance with the budget provisions set forth in the Governing Documents and notice requirements of law must be followed to the letter. If there is a mistake made in the adoption of an increase in the budget or a special assessment, that mistake could be fatal to the ability of the Association to collect payment. Courts do not look kindly on associations that do not “dot their i’s and cross their t’s” because it is a violation of the contract between the owner and the Association. In the collection process, enforcement of unpaid assessments is enforcement of a contract, and the contract must be followed to the letter or significant issues, including denial of the ability to collect and the award of prevailing party’s attorney fees, can be encountered. What is the moral of the story? Make sure that your

assessments, budgets and special assessments are properly noticed, levied, and that proper minutes, notices and records exist to substantiate that.

Since the beginning of the real estate crisis (I believe that we're only about, at most, one-half of the way through, so batten down the hatches), I have developed a much more aggressive approach in the recommended steps that clients take. They are, in no particular order of importance, as follows:

1. Adopt a uniform collection policy. Make it crystal clear that assessments are due on a certain date, that notification of unpaid assessments will be sent by regular mail, within a certain relatively short time period (10 or 15 days) after the due date as a "friendly reminder" and start the formal collection process as soon as allowed under your Documents. I understand that times are hard; however, it is vital that owners in your community are aware that this is one bill they should not ignore. First of all, no HOA that I am familiar with has more assets than Visa or MasterCard, or any other creditor. Moreover, if you don't pay a credit card bill, just about the worst that can happen is that you can get sued and have a money judgment against you. Under Florida law, the holder of a money judgment cannot sell homestead property to satisfy that judgment. On the other hand, a condominium association or HOA can sell homestead property for unpaid assessments. Many people don't realize that the remedy of the Association can lead to sale of their home on the courthouse steps.

2. In 2007, the legislature modified the steps that an HOA must follow in order to properly collect unpaid assessments. Essentially, the legislature added about 120 days to the collection process if a matter goes to foreclosure. I don't understand why the legislature has such sympathy for people who do not pay their obligations, but that is something to take up with your own legislator. What that means is that it requires you to take formal legal action as soon as possible.

3. The burden on management companies in tracking all of these delinquent owners is severe. They are forced to hire personnel, invest in new computers, software programs, and incur a number of costs in order to keep up with the crushing number of delinquent owners. Perhaps in recognition of this, in 2007, the legislature changed the law so that, as part of the initial letter, "actual costs" incurred by the Association can be recovered as part of the initial demand. I strongly suggest to all of my clients that they discuss this with management in order to authorize imposition of a cost recovery system, so that management can offset its internal costs in providing these additional delinquent tracking services to the associations. Managers are caught between a rock and a hard place; they must either pass on these increased costs in the form of higher "per door" fees, which means that people who pay their assessments on time will be forced to pay for the costs of keeping track of delinquents, or delinquent owners can pay for the costs that they impose on the management company, allowing it to hold down the "per door" costs to all owners. I believe this is a "no brainer," and I have suggested that every client authorize imposition of this cost.

EXPLANATION OF STEPS IN THE COLLECTION PROCESS:

1. The first formal action taken is commonly referred to as the "45-day letter" for an HOA and a "30-day letter" for a condominium association. While this is not required to be sent by a lawyer, the law does provide that, in connection with this letter, the Association may recover legal fees, interest, late fees, and actual costs in an HOA incurred in the preparation and sending of the letter. Given the fact that this might be the practice of law, and given the fact that most managers and management companies are not set up to handle this type of payment, the vast majority of my clients have authorized management to send the "friendly letter" referred to above, but to have my firm send the initial letter and authorize, as part of the collection policy, management to work with my firm from the inception of the matter to its conclusion. A practical reason for this is that managers who send their own letters out must then be able to account for the monies collected; the actual costs need to be deducted and distributed to the management company, while the assessment, late fees and interest are disbursed to the Association. That money is placed in my trust account which, by law, I cannot touch until it clears. At such time as it clears, I disburse the funds. Part of the problem for managers is that they are commingling the Association's money with their own, and can find themselves in a real legal predicament is a person pays, the company disburses, and then the check bounces. All in all, this is a business decision of the HOA to make, but I recommend that the initial letter be sent by counsel.

Traditionally, about one-third to two-thirds of the delinquent owners pay, in full, upon receipt of this initial demand letter, or the lien, discussed below.

2. Preparation of the lien, recording, and follow-up demand: If the account remains unpaid, the next step is to prepare a Claim of Lien, along with another 45-day demand letter, and include additional interests, costs, late fees, and attorney fees. That letter must be sent by certified mail, return receipt requested, as well as by regular mail. A Claim of Lien is simply a notice to the World that the Association claims a property interest in the lot subject to the Declaration, and the demand letter warns that if the amounts due are not paid, the HOA may either foreclose the Claim of Lien or seek a money judgment against the delinquent owner (more about that later).

The Supreme Court of Florida has ruled that lien preparation is the practice of law. When I started practicing law in Tampa Bay 22 years ago, a number of management companies were actually preparing "mechanic's liens" or some other type of document as an additional service to their clients. At that time, I could not understand why they were doing it. It's the same reason why I do not understand why management companies want to send out the 45-day or 30-day letter. It simply didn't make sense to me from an economic viewpoint. Regardless of whether or not it is the practice of law, preparation of a Claim of Lien has certain liabilities that run with it. If the lien is defective, for example, and a complete title search is not prepared and the lien does not name the owner, or there is a mistake in the legal description, or it is recorded in the wrong county, or a number of any other matters, the manager has just opened himself up to liability because the process starts over and no additional monies can be charged or reimbursed for that effort under either the Documents or the statute. That action never made economic sense to me, and as

a result, I have always recommended that lawyers who have malpractice insurance and are held to a certain standard of care when dealing with their clients, take both the liability for the preparation of the collection documents, including the lien, and can charge and collect a fee for that.

As noted above, our historical average for collections being cleared at this point are about two-thirds of the delinquent owners. Given that the two-step process of the initial letter and follow-up Claim of Lien over a 90-day period is somewhat new, I have not broken out the statistics as to what amounts are collected at what point. If anything, the percentage of people paying in full by the end of the deadline outlined in the Claim of Lien and demand letter is down to perhaps 55%. I do not know if this is because people just don't understand that their property can be taken away from them, and they think that the lien will just sit there and rot until they sell or refinance, or if they indeed have no money. I tend to think that it is the former and not the latter. Homeowner association dues are relatively small amounts to pay, and there is a misperception on the part of the general public as to what the rights of the Association are.

ENFORCEMENT OF THE LIEN AND THE OBLIGATION TO PAY THROUGH THE COURTS:

When a delinquent owner has not paid in full after the expiration of the lien demand period, then legal action is required. Several steps must first be taken before a legal action can be filed in court.

First, a complete title search is obtained. An analysis must be done on the title report, because the Association must sue everyone with an inferior interest in the unit, such as second mortgage holders and judgment holders; otherwise, it will not obtain "clean" title with respect to inferior encumbrances on the property. Additionally, the proper persons need to be named in the suit. Frequently, owners will take title in the name of a trust or a corporation and the Association never gets a copy of the deed. In a legal action, everyone must be named, and their proper name must appear in the body of the lawsuit.

When a Complaint is prepared, the Association seeks two remedies: The first remedy is the foreclosure of the lien. This is the remedy that we almost universally seek. This remedy results in the sale of the property on the courthouse steps if the owner (or someone else) does not pay before the lawsuit concludes. Foreclosure is what is known as an action in equity.

The second count of a lawsuit is an action at law, for money damages. We hardly ever ask for money damages, for several reasons. First, a money judgment is not cash in the pocket of the Association. A money judgment must be executed, and substantial additional legal work needs to be done with regard to determining what assets might be available to satisfy the judgment (remember, the lien right is superior to homestead, so a foreclosure can divest the owner of title, even to a homestead property, while enforcement of a money judgment cannot be used to sell homestead property). Additionally, Florida law gives debtors a number of other exemptions, such as head of household wages, and so forth. Because of this, and because the Association generally must elect its remedies, we choose foreclosure. The property is not going to move to Alabama and the property does not go bankrupt. A judgment which results in sale of the property provides finality to the process.

When a tenant resides in a unit in foreclosure, we have the ability to seek a receiver to be appointed to collect the rent, and forward it to the association and pay all legal fees and costs until paid in full. Naturally, we love well behaved tenants, as they are the source of payment. Recently a Miami association was successful in getting one receiver appointed for all foreclosures in the building and we have made arrangements with that receiver to try and get this accomplished here. If successful, that will save time and money and get the rented delinquent cash flowing within about 100 days for the time we start our procedure.

What Is the Culmination of the Foreclosure Process?

I recommend that clients exercise the foreclosure option over 99% of the time. A foreclosure ends up with the Association taking title (Unless someone outbids it on the courthouse steps at the publicly open and advertised sale) and it can then exercise a number of options, as follows. First, if the former owner is in possession, the sheriff can eject the owners from the property in a writ of possession action. This action alone has chased a number of people into my office to make payment as prior to that time, the owners thought they could ignore the lawsuit. If the unit is vacant, or after the former occupants are dispossessed, it can be rented pending foreclosure of the first mortgage. Some clients have taken this option, but ownership of a home or condo unit and being a landlord is never easy. The Association can sell the property to a private party subject to the first mortgage to someone who will rent it, pay assessments, and otherwise deal with the hassle of owning it and operating it. Done properly, this can result in a profit for the owner, as I recommend that the Association sell it for only what is due; the new owner then pays off the old debt, all interest costs and legal fees are paid, and the problem is solved. There a number of entrepreneurs who have formed companies to do this and they are sensitive to the needs of my clients regarding compliance with occupancy and use restrictions. **By the way, there is no reason why the Association could not immediately list the unit for a "short sale" if it is going to retain title, but why do so if you can recover your money in full by selling the property for what you have in it and providing a Quit-Claim deed to the buyer?**

FORECLOSURES - OFFENSE AND DEFENSE:

Prior to about four months ago, my office routinely stopped prosecuting the Association's action to collect when there was a first mortgage foreclosure. This is because the foreclosure of a first mortgage will wipe out the claim of lien the Association has in the property. My theory was "why throw good money after bad?"

However, things have changed in this economy. Mortgage foreclosures that formerly took six months are now taking anywhere up to two years. Plaintiffs who file foreclosures frequently take months just to move ahead one step in the process, and I have seen many lawyers take them all the way to sale, and stop. They set a sale and then cancel it waiting six months, nine months or more, because lenders already have over a trillion dollars in property. In this market, no mortgage holder wants more property to have to pay

assessments on, insure, maintain, repair, and so forth. (That is why I have always said that the collections process is a "race to the courthouse steps" because we try to beat the mortgage holder to the foreclosure, take title, and deal with it, by either selling it or renting it.)

Because of the delay involved with foreclosures, I changed my policy somewhat. Prior to April 2009, I was willing to write off all fees and costs in an association lien collection and foreclosure as a good will gesture. Now that the bottom has fallen out of the market and shows no sign of letting up, I was forced to institute a maximum charge of $1,500 on out-of-pocket costs and fees for clients who take a collection matter to foreclosure and end up taking title or are wiped out by the mortgage foreclosure. Because the Association's foreclosure has costs of approximately $800 from start to finish, my legal fees are capped at about $700. Given the delay in foreclosures by first mortgage holders, we recommend that the Association move as quickly as possible to foreclose its own mortgage, take title, and either rent the unit or try to sell it.

One benefit of working with the Firm is that we work with qualified investors willing to take title from our clients who do not want to hassle with renting or selling property acquired by foreclosure. Those investors pay some, most or all of ther past due fees, and pay all attorney fees and costs in exchange for a quit-claim deed. That buyer has the obligation to pay assessments going forward and fully comply with the Governing Documents of the community. The investors generally try to rent the property and purchase the mortgage for a discount allowing the property to become a "productive" part of the community and an asset instead of a foreclosure house with an uncertain future.

BAD FAITH FORECLOSURES - WHAT TO DO?

Under Florida law, when a plaintiff brings a lawsuit based on breach of contract, the plaintiff must attach a copy of the contract between the plaintiff and the defendant. A mortgage foreclosure action is a breach of contract action. We are being served with thirty(!) foreclosures a day where homeowners are being sued and the Association is named because it has some interest in the property by virtue of the lien rights in the recorded documents. (This is why an association is never responsible to pay a mortgage; it is only a security interest in the property, not the obligation to pay.) An amazing **sixty percent (60%) of those lawsuits attach a mortgage that was neither assigned to the plaintiff, nor was there an endorsement or assignment of the note which was the promise to pay, in favor of the plaintiff**.

This is because the selling and reselling of first mortgages, which helped blow a $14 trillion hole in our economy, was so fast and furious that people who sold the paperwork never got formal assignments of the mortgages when they were bundled up into packages of billions of dollars and then sold as a security.

What does this mean to you? This means that when a plaintiff files to foreclose a mortgage and the mortgage and note attached to the complaint do not show any evidence of ever being assigned to the plaintiff, Section 57.105, *Florida Statutes*, allows a defendant who has been sued to demand that the lawsuit either be dismissed, or if not dismissed, seek relief from the court to have it dismissed by the court and

attorney's fees awarded. We are working with several dozen clients to go on the offense against these bad faith foreclosures, and demand that they either be dismissed or ask the court to dismiss them. The benefit of this type of action is that it will either result in the dismissal of the mortgage foreclosure, leaving the Association in a position to move ahead with its foreclosure, take title and rent or dispose of the property, or require the plaintiff to move more quickly (unlikely) in its action. **There is no exposure to the Association when taking this action, as to attorney's fees or costs. My firm does this at no charge, but we do ask for specific authority to do so.** Case law has held that the remedy for a bad faith foreclosure is a dismissal of the lawsuit with prejudice, without leave to amend the suit. This means that even if the plaintiff obtains a later assignment, it cannot bring the action again, and someone else must start the lawsuit all over again. This buys the Association several months to take the actions it needs to move forward.

THE CORAL LAKES CASE AND "REVERSE FORECLOSURES"

On February 19, 2010, the Second District Court of Appeal ruled, in the Coral Lakes v. Busey Bank case that Section 720.3085 Florida Statutes, which was effective in July of 2008, and requires that a first mortgage holder who forecloses must pay one year or one percent of the mortgage is unconstitutional as a retroactive impairment of contract prohibited by the Florida Constitution. As a result of this case, most Homeowner Associations will receive no past-due assessments when a first mortgage forecloses. The law only applies to foreclosure of mortgages that were entered into after July of 2008. Based on this case, it is more important than ever that HOA's move, as quickly as possible, to collect assessments from delinquent owners, because if they do not, the bank will drag out the foreclosure process, take perhaps as long as two or three years before it finishes the foreclosure (after all, even though it doesn't have to pay past-due assessments, it would still have to pay ongoing assessments, property taxes, insurance and maintenance) and then finally finish when and if it has a buyer for the property. This case was probably a misapplication of the law but suffice it to say that it is the law and it means that HOA's can no longer count on receiving a year of assessments upon foreclosure.

Recently, newspaper wire services picked up a story about "reverse foreclosures" describing how condominium and homeowner associations are "turning the tables" on mortgage foreclosures. The story got the facts and the law kind of backwards, but it bears a better understanding here. When a mortgage foreclosure, or any lawsuit commences, it is generally the plaintiff who pushes the action. For example, when we file a lien foreclosure, we press ahead with the action is fast as possible in order to move to final judgment and either get paid or obtain title. Well over 90% of the time, we and the case by filing what is known as a Summary Judgment. This is a motion, filed with the court which alleges that there are no material facts at issue, only issues of law. Questions of fact tend to make lawsuits expensive and time-consuming; you need to take testimony, ask questions both orally and in writing, require production of

documents and other procedural matters that can drag out a case. If Summary Judgment can be applied to a case, it tends to end the case rather quickly in favor of the party who moves for it.

As a general rule, it is the plaintiff who seeks Summary Judgment. In the vast majority of cases, people who are sued want to drag on the suit as long as possible and make it as expensive as possible for the plaintiff to succeed. In the “Reverse Foreclosure” referred to in the newspaper, it’s very simple; the Association files a motion for Summary Judgment against itself(!) The motion asks for judgment be entered against the Association, and it is supported by an affidavit by the client who agrees to waive a public sale and the right of redemption. The court is asked to enter an order which conveys title to the plaintiff as soon as the motion is granted, and the order entered. If the court can be convinced to enter the order, the plaintiff, for purposes of the litigation, owns the property, and is required to pay ongoing assessments and, in the case of a condominium association, pay the statutory six months of assessments or one percent of the mortgage, whichever is less (this law has been in effect since 1992, so it is not in danger of being overturned like the similar law dealing with HOA foreclosures was. Depending on the circumstances involved, this may be a cost-effective way to try and foreclosure lawsuit. Every case is different and coordination with counsel on the matter is vital.