Why Community Associations are Failing the Price of Survival and a Glimpse into the Future

By Tyler P. Berding, J.D., PhD.

Predictions of the Future in an Uncertain Present

BERDING | WEIL

Predictions of the Future in an Uncertain Present

By Tyler P. Berding, J.D., PhD.

Berding & Weil, LLP
3240 Stone Valley Rd West
Alamo, California 94507
925-838-2090
www.berding-weil.com
www.condoissues.com

Printed in the United States
April 2009

Predictions of the Future in an Uncertain Present

Why Community Associations are Failing the Price of Survival and a Glimpse into the Future

By Tyler P. Berding, J.D., Ph.D.

Common interest developments are reliant on member assessments to provide long-term maintenance and repair. Since the association's governing documents and state statutes give directors and members control over the amounts raised, funding decisions tend to be more political than practical with the result being that critical funding is often deferred to future residents and boards who are unable or unwilling to handle this unexpected obligation. If the problem isn't solved, many communities will be unable to discharge their responsibilities and will become obsolete in the coming decades. With that in mind, just what does the future hold for common interest communities? What do prospective buyers need to know about the state of the association's funding? What options are available to attorneys, association leaders and legislators?

Co-operative, private maintenance of commonly owned land and structures in small villages and towns has been around for hundreds, probably thousands, of years. But in California and many other states, "common area," and the community associations that maintain it, have only been regulated by statute for a few decades. The California Condominium Act was enacted in 1963. The Davis-Stirling Act, in use today, was enacted in 1985.[1] We began seeing condominiums mass-produced for California consumers in the early Sixties when the McKeon Corporation started building their ubiquitous four-plex buildings throughout California.[2]

Consequently, California's experience with this form of housing, and the experience of many other states, dates back perhaps no more than 50 years, and with so little history, predicting the future requires a lot of speculation. We do have some data however, and from those sources we can piece together a picture of how community associations, and the attached housing projects they maintain, might evolve over the next half-century. Some of this comes from other writer's accounts, and some from our own experience. We have tried to make practical predictions, based on recognized trends. From

1. California Civil Code Section 1350, et seq.

2. The McKeon four-plex condominium has a single story unit in the front, a two-story, townhouse-style unit on each side, and a single-story unit over the garage in the rear of the building.

The Fatal Flaw 1

Funding Based on Political Rather than Economic Decisions

this effort we can draw two conclusions: the short term prognosis—that is say, the next 20 years—looks bleak with the likelihood of widespread failures, but the longer term looks better—if we re-align our thinking.

Community association projects are aging. The oldest are now more than 40 years old. Twenty and thirty-year-old condo buildings are quite common, and consider all of the old apartment buildings that have been converted to condos—many of those are thirty to forty years old, and can be sixty years old or older. Regardless of the converter's enticing sales presentations, these older buildings are wearing out and a big challenge for the future will be how to fund their restoration. Funding is the over-riding problem. The future survival of existing condominium associations is anything but assured. Many community associations are in danger of becoming obsolete. We don't mean because the housing is out of date or that its design is unsuitable for the purpose for which it was built—we mean that the funding model upon which it relies for its survival cannot sustain the project.

Whether failure will occur in the short or long run depends upon the age of the buildings, whether they are attached or single family housing, and how seriously deficient are the association's reserves, but failure is inevitable in all but the most intrinsically valuable projects—those with historical value or in exceptional locations that justify a large and continued investment by their owners. A concept that has not been apparent—although its symptoms are usually visible—is that community associations fail because their funding model is completely reliant upon the will of individual owners who, by the nature of their circumstances, have no long-term interest in the project. This situation puts long-term decision-making into the hands of individuals who have only a short-term interest in the property, and that is the single most significant cause of an association's eventual collapse. Let's explore the problem in more detail.

The Law is not the Problem

Did you know that California has a mandatory full-funding statute? Civil Code Section 1366 says: "Except as provided in this section, the association *shall* levy regular and special assessments sufficient to perform its obligations under the governing documents and this title."[3] *(Emphasis added)* It doesn't say, "may" or give a community association board any other options. It says, "shall" and that means assessments adequate to do the job are mandatory up to the limits of the board's authority. In California, the board has the authority to increase regular assessments up to 20% over the prior year and can impose a special assessment of up to 5% of the gross budget, all without a vote of the members[4]—so why is there a funding problem?

The problem is not the law. The problem is that board members are also owners and neighbors and any increase in assessments affects them perhaps more than any other owner since they will have to take the political heat that an assessment increase inevitably brings. The board of directors of a community association has a statutory duty to impose adequate assessments and, unlike a lot of other states, in California it also has the authority to raise assessments without a vote of the members to the statutory limits. But boards rarely exercise that authority.

A recent survey done with 600 California community associations revealed that the average association had only 50% of the cash in reserves that its reserve study called for. That's not 50% of the funds that they will *eventually* need, that's 50% of the cash that the reserve study requires be on hand *now*. And if that's the case, where is the other 50% going to come from when it's needed? And when it *is* needed, raising 50% more than you have on hand by relying on the members to approve a large special assessment is usually a doomed scenario.

We've also reviewed board authority to raise assessments in 35 other states, and most are not as generous as California—most require a vote of the members to approve *any* assessment increase, with Hawaii

3. California Civil Code Section 1366(a).

4. California Civil Code Section 1366(b).

being one exception. The problem with Hawaii, which has one of the few mandatory funding statutes in the nation, is that it mandates that associations maintain a reserve of at least 50% of what the reserve study requires, so in practice, it is no better than California's experience as seen from the survey above. In virtually every state that we have looked at, the will of the owners dictates the success or failure of whatever funding effort the board of directors puts forth.

Taking Value and Leaving Liability Behind

I recently ran across the following quote in a memo from the Hawaii Department of Real Estate:

"All condominium associations face the problem of high and ever increasing costs to maintain a condominium project, including reserves. To compound the problem, a number of condominium boards cannot, or will not, make 'hard and unpopular' decisions of raising maintenance fees to meet this problem and facing any criticism.

The law requires condominium association boards to study the project's particular maintenance and replacement needs of the common elements and to collect and establish reserves so that funds will be on hand when repairs and replacements are needed as well as emergencies. The law was enacted to provide relief for the vast majority of condominium associations, although a good number of well-managed condominium associations were already providing for reserves. If the reserves are properly calculated, each owner's share should only be what the owner ought to be putting aside each month for the true cost for repairs and replacements. The law tries to prevent owners from taking value out of a condominium property by underfunding reserves, selling out, and leaving subsequent purchasers to pay for the underfunding…

Any delay in confronting and controlling reserve situations will not change the condominium association's need for repair or replacement or the common elements nor the need for funds. The Commission's research reflects that those condominium associations deciding on 50% funding of reserves and/or are substantially underfunded, especially if they face major common area repairs and replacements in the near future, will have to dramatically increase maintenance fees, make special assessments and/or take out a loan."

Timely? No. The Hawaii Real Estate Commission wrote that memo in 1995. The problem has obviously been around for a long time. Two statements from that memo stand out. Those associations that have decided to only fund their reserves at 50% or less had better start looking for alternate funding. It cannot be put off forever, and merely increasing monthly assessments alone cannot usually make up for years of underfunding. It's too late for that when you are ten years behind. Special assessments coupled with bank loans are usually necessary, making the financial hit on the then owners that much greater and make units harder to sell.

But the statement that really had an impact on me was this one: "The law tries to prevent owners from taking value out of a condominium property by underfunding reserves, selling out, and leaving subsequent purchasers to pay for the underfunding…" That's exactly what happens when an association bends to political pressure and tolerates an assessment level that is less than what is necessary for predictable maintenance and repair. The board allows current owners to take value out the back door by passing on the liability to future owners. The seller has *taken value* by failing to pay his or her share of the maintenance and repair costs.

So how do associations deal with significant shortfalls in funding for future repairs? They either extend the time for repairs beyond their consultant's recommendations and the useful life of the component, or they borrow the money from a lender. The former option simply delays the inevitable to a time when the cost of the repair will have increased. The latter option brings with it additional payments that have to come from somewhere and that usually means an assessment increase or a special assessment to meet the re-payment schedule. Had modest, periodic raises been acceptable to the board of directors and to the members in the past, the funds to do the work would already have accumulated and borrowing wouldn't be necessary, nor would a crisis have arisen that required borrowing the funds and paying interest on a loan.

Isolation Breeds Indifference

But we're getting ahead of ourselves. The real question here is *why*? Why do the owners of condominiums fail to see the impact of not investing sufficient funds to properly maintain the project—to stay ahead of normal deterioration so that it does not cause a crisis? The answer is because *they are insulated from the downside*. The fragmentation of ownership that is true in every attached common interest development effectively insulates individual owners from the consequences of underfunding. At some level, they simply do not see a connection between their individual

interests and the long-term interests of the community association.

This happens for several reasons. First, the turnover rate in a multi-family development is more frequent than with single-family homes. Various sources report that turnover for condos averages about 3–4 years, while the rate for single-family homes is closer to 8–12 years. This differing rate of ownership turnover is significant. People who do not see themselves owning a property for more than say, another 5 years couldn't care less about a reserve for a roof to be replaced in 20 years. Elderly people are in that category. Young couples with expanding families are in that category. A lot of residents in condominiums are basically transient and hence are psychologically detached from the objectives of the long-term reserves. In other words, they don't care because they see no benefit accruing to them. What they do care about is keeping their monthly outlay within the confines of their income, and the future, if not immediately upon them, can take care of itself. Any connection between an adequately funded reserve and the market value of the units is obscure at best, even with the disclosure requirements required by California law and the law of other states.

Second, the buyer of a unit in a condominium is confronted with a financial structure that lacks clarity. As we discuss further below, a budget, a reserve study, perhaps reports of various experts, all can appear to an outsider to be detailed and professional and hence, credible in most cases. It is difficult for a potential condo buyer to obtain an independent physical inspection or to understand the nuances of the reserve program. A severely underfunded condominium project can appear to the untrained observer to be not only properly maintained, but adequately funded as well. For these reasons, budget or reserve underfunding is not adequately reflected in the market value of a condominium.

Third, a subset of the problem above, only the board of directors of a community association is kept reasonably up to date on the condition of the budget and the buildings. I say "reasonably up to date" meaning that first; management has to understand the impact of failing to budget properly and the condition of the buildings to be able to explain it to the board of directors. The manager's information is only as good as the consultants who provide it, if there are consultants. In California, that's most likely to be the company that prepares the reserve study and their obligation is limited to a "visual" study of the "accessible" areas of the project.[5] Further, even if management understands the impact of underfunding, there may be very little it can do if the board is resistant to raising assessments. Owners are usually isolated from these issues and this level of detail and this isolation from the realities of caring for the project brings indifference, and with indifference comes a readiness to reject any request for additional funding that might come from management or the board.

Cause and Effect

The owner of a single-family home is not isolated from the realities of funding repairs. There is a direct connection between the money he or she spends and the value of their interest. The obligation is not shared with others or delegated to management. It is not organized or paid for by anyone but him or her. If they choose to allow the house to deteriorate, they solely suffer the detriment. If they keep it well maintained, they are the only people rewarded. There is a direct cause and effect relationship at play. The single-family homeowner bears 100% of the risk and gets 100% of the reward from the success of that investment. Keep it well maintained and the value goes up. Let the maintenance slip and the value goes down. It's simple to assess the condition of a single family home and it's effect on market value.

With condominiums there is no similar cause and effect relationship because a condominium project is complex, its condition is not easily inspected or understood, and even if it is inspected, any evaluation cannot be limited to just the physical condition of a single unit. The value of a condominium unit depends upon factors that are usually beyond even a seasoned home inspector looking at one unit, and definitely beyond the capabilities of the buyer, and that's just the physical condition visible and otherwise. The true value of a condominium unit depends more often upon its *financial condition*, and that is a factor that is very hard for the average buyer, or even a lot of professionals, to understand or determine.

Financial statements or other disclosures are available to prospective buyers. But consider, how many people that you know would understand how the typical financial reports reflect on the value of a single unit? Unless the buyer were able to read and understand a reserve study, accrual accounting, and also evaluate the physical condition of the entire project's roofs, siding, plumbing, paint, and a myriad other components in relation to the foregoing, they will be unable to intuit the financial condition of that project, and without that understanding, there is no realistic way that a prospective buyer can determine value. To put it bluntly, if the financial condition is unknowable, it doesn't reflect in the purchase price.

Ownership of a condominium is akin to ownership of mutual funds, or perhaps ironically, mortgage-backed securities. The individual investor owns only a small piece of a much larger whole and unless he or she is very astute about the composition and past performance of the investment they will fail to appreciate the risk attendant to decisions made by the fund managers. With condominium owners, this naïveté is the seed of the project's eventual destruction. The ever more attenuated owner relationship with immediate problems and their isolation from the long-term effects foster the lack of understanding and consequent indifference that we spoke of earlier. The owners' individual slice is so small and their residency there so short-term, that it is natural for them to feel detached from the financial realities of maintaining the property.

With indifference comes an unwillingness to participate financially, and without owner financial participation, it will be impossible for management to stay even with the physical deterioration of the project. With indifference also comes resistance to paying ever-higher assessments. The statistics bear this out. More and more common interest developments are underfunded when the bids for the work come in.

5. California Civil Code Section 1365.5(e).

As a direct and predictable consequence of owner isolation and indifference, many community associations, in California and elsewhere, will have insufficient reserves to deal with predictable maintenance, let alone those unpredictable issues that arise in older buildings. And, as consequences are masked, sellers are able to walk away from what amounts to a deferred yet pending obligation, transferring that obligation to the unwitting buyer, or leaving it in the hands of his neighbors, or both. In the meanwhile, the project continues to deteriorate and begins to approach obsolescence with the buildings eventually becoming uninhabitable. What happens next depends upon the unique circumstances of each association, but possible legal scenarios can involve bankruptcy or other dissolution of the corporate association and then condemnation of the property, or the sale of the entire parcel through an action in Partition.

The Path to Obsolescence. As the association's funding falls farther and farther behind, it becomes less able to meet its ongoing *routine* maintenance obligations. As we said above, this problem is insidious, and contains the seeds of the property's eventual obsolescence—the failure of the project to operate as intended.

How do we know this will happen? We have real-world examples. We wrote about two obsolete projects in our essay, "The Uncertain Future of Common Interest Developments."[6] Two former McKeon condominium developments, most likely built in the sixties in Sacramento, California, had become obsolete. They could no longer raise the necessary funding to continue operation, became uninhabitable and had to be condemned by the City of Sacramento. The city removed the remaining owners. The projects were then rebuilt, using public funds, and turned into affordable housing. Many similar projects will meet the same fate, yet public funding will not always be so readily available.

More recently the reality of this problem has been accelerated by the failing economy and the wave of condominium conversions that have hit the market. For the most part, these are older apartment buildings with a great deal of deferred maintenance, in many cases more than you would find in a condominium project of the same age. Further, they have had no time to accumulate reserves and the sellers are notorious for failing to correct the deferred maintenance conditions. Little reserve funding for these deferred conditions was provided, and they often extend to problems

6. Berding, T., *The Uncertain Future of Common Interest Developments*, 1999, 2005, 2008.

that are neither visible nor accessible—dry rot, pipe corrosion, and similar issues. These conversions are real-life examples of what older condominiums can expect a few years from now. Unless the converters gave the new association a sizeable cash infusion, many conversion projects are already close to obsolescence. The association cannot maintain the property, and soon may not be able to carry out its obligation to provide other essential services. We had a discussion with a board of directors very recently where we had to assign a priority to the limited funds they had. We were down to what happens if they can't pay the water bill, not to mention repair leaks, or mow the grass. This is a real crisis.

The future of many common interest developments resembles the present-day reality of these conversions. Once they cannot pay for essential maintenance, their value will drop, similar to the recession-caused loss of value today, but they will fail to sell nonetheless and the owners will stop paying their assessments. In one conversion today, the developer still owns 50% of the units that it was unable to sell. They stopped paying their assessments, but the bank refuses to foreclose. The converter is in arrears about $400,000—a not inconsequential sum and critical to the future of the entire association. When they get to that point when they can no longer pay for essential services or do critical maintenance, then, like the two Sacramento examples above, the local municipality will have to decide if they are habitable. If not, condemnation is the next step.

Court Intervention?

Condemnation, or Eminent Domain, is initiated by the local government agency—a city or county—when its inspectors realize that the project can no longer support its residents. There is, however, another possible avenue leading to condemnation—a judgment awarded against an association by a court in an amount that is impossible for the association or its members to pay. A case decided in California found that a board of directors of a community association not only has the responsibility to pay the debts of the association, it also has a *duty* to specially assess the members sufficiently to pay those debts, and not only that, that a court may put a receiver in place to insure that the obligations are carried out.[7] In that case, a vendor obtained a judgment against the association and asked the court to appoint a receiver to collect assess-

7. *James F. O'Toole vs. Los Angeles Kingsbury Court Owners Association*, (2005) 126 Cal App 4th 549, 23 Cal Rptr. 3d 894.

ments from owners to pay the judgment. The association argued that California Civil Code Section 1366 (c) prevents such an action. It states:

"Regular assessments imposed or collected to perform the obligations of an association under the governing documents or this title shall be exempt from execution…to the extent necessary for the association to perform essential services…"[8]

The court rejected the association's claim of exemption, holding that Section 1366 (c) applies only to regular assessments, and therefore nothing precluded the board of directors from the levy of a special assessment under the "emergency" provisions of the California Civil Code Section 1366(b) (1), (2), or (3). The appellate court not only upheld the lower court's judgment against the association, it agreed that the appointment of a receiver to collect the special assessments was proper.

But the court also stated:

"The imposition of a special emergency assessment will not transform the homeowners into judgment debtors or otherwise make them personally liable for the debts of the Association."[9]

This is simply not a true statement. If a receiver steps into the shoes of an association it can then enforce whatever collection rights the association might otherwise enjoy, and this includes the right to place a lien upon the individual owner's separate interest in the amount of any unpaid assessment.[10] Whether this is a debt "personal" to an owner or simply against the owners "separate interest" is a distinction without a difference—the owner has to pay or risk losing his or her property. So if the court believed it was not passing judgment on to the individual owners, it was ignorant of the pass-through provisions of an association's governing documents. And it doesn't necessarily stop with obligations to vendors.

What if, for example, an owner grew tired of waiting for an association to repair the roof and sued the association to force it to make the repairs, and prevailed, obtaining a judgment that the association must repair the roof? Could the *O'Toole* case be used as authority to require that the association assess its members for the funds necessary to make the repair? We see no logical distinction between the obligation to pay a creditor and the association's obligation to its members to make repairs to the common area. In fact, two of the emergency assessment provisions of

8. California Civil Code Section 1366(c).

9. *James F. O'Toole*, supra, at pp. 575–576.

10. California Civil Code Section 1367 et. seq. (Recent amendments have placed a limitation on the right of an association to seek non-judicial foreclosure to amounts exceeding $1,800.)

Civil Code Section 1366 (b) relate directly to the obligation to perform repairs and the third to satisfy an order of a court.[11] Therefore, in the proper case, we believe *O'Toole* could, and perhaps will be cited in support of just such a claim by an owner or group of owners who are dissatisfied with the association's performance. The only defenses that would likely be available to an association would be whether the association is responsible for the repairs; whether the repairs are necessary; and the scope of such repairs.

So what if the owners cannot *afford* the special assessment levied to pay the judgment requiring that the association complete the roof repairs? That would not be surprising since the most likely reason that the association delayed repairing roofs in the first place is that it had insufficient funds available to do the repairs. Now we come full circle. If a court can order the owners to pay a judgment against the association that they cannot afford, the next logical step would be for the court-appointed receiver to initiate foreclosure of the *individual* properties to collect that assessment. The court in *O'Toole* ignored an essential truth—that ultimately it is the individual owners' obligation to pay for maintenance and repairs, and if the existing owners lack the cash to do that, the project will likely default to lender ownership or condemnation.

Partition?

In California, there is a statutory remedy for a failed common interest development—it's called *Partition*. It allows an entire project to be ordered sold in one of three instances: (1) Material damage or destruction occurring more than three years prior to the partition request and repairs have not been made; (2) At least three-quarters of the project has been damaged or destroyed, and 50% or more of the separate interest owners oppose re-construction; and (3) The project is 50 or more years old, is obsolete and uneconomic, and more than 50% of the owners oppose restoration.[12]

Many associations are approaching the 50-year mark. But even before that, can a seriously deteriorated infrastructure qualify as "material damage" to the point where it would qualify under the statute above?

11. "(1) An extraordinary expense required by an order of a court. (2) An extraordinary expense necessary to repair or maintain the common interest development or any part of it for which the association is responsible where a threat to personal safety on the property is discovered. (3) An extraordinary expense necessary to repair or maintain the common interest development or any part of it for which the association is responsible that could not have been reasonably foreseen by the board in preparing and distributing the pro forma operating budget under Section 1365."

12. California Civil Code Section 1359.

Would a court, looking at a project that has deteriorated to the point of becoming uninhabitable and unable to raise the funding necessary to perform emergency repairs order it sold under this or similar statutes? In that instance, could a majority of owners force the project to be sold in its entirety, and if they did would they realize more value than trying to sell just their individual unit in this badly deteriorated project?

In the right circumstance with the right facts, the answer is “yes.” What are those facts? If the special assessment necessary to achieve basic habitability exceeds the ability of the present owners to pay, and its passage is defeated in a referendum, a court could find that the failure of a majority of owners to pass the emergency assessment was tantamount to a “no” vote on reconstruction under the provisions of the statute. In that case, a sale of the entire project is a distinct possibility and perhaps a viable remedy for the paralysis imposed by inadequate funding.

Does the Recession Raise the Possibility of a State Takeover?

The economy has wreaked havoc on the budgets of even adequately funded associations and this problem, when added to those above, leaves little doubt as to the chance for survival of many associations. Other states’ experiences are instructive as well. In Florida, the problem is epidemic. In a recent article, Jim Loney, writing for *Reuters.com*, tells the story like this:

"Florida's condominium and homeowners' associations are facing what experts call a trickle-down disaster from the property crisis. Dozens and perhaps hundreds of condo buildings have budget shortfalls as thousands of owners, under water on their mortgages or in foreclosure, stop paying monthly fees.

"I call it a death spiral," Miami Beach city commissioner Jerry Libbin said. "It's a catastrophe in the making."[13]

Community associations everywhere rely on the monthly cash flow from assessments to pay virtually all of their expenses. In most cases, they have no other source of income. When that income is seriously curtailed, the ability of the board of directors to protect and maintain the project is in jeopardy. Borrowing from reserves works for a while, assuming there are reserves in the first place. But that lasts only as long as does the available cash, and then what? We've written about this situation recently, and it leaves boards in the position of making some very tough decisions.[14] Landscape or pool maintenance? Painting or insurance premiums? Management or the water bill? When we get down to life-safety issues, like paying for electricity, security guards or the sewer bill, its time to re-evaluate the very survival of the association. Loney shows us that the problems in Florida are similar: "Rust pokes through the peeling paint on the railings, pest control has been curtailed and the palm trees are no longer being fertilized at the 1940s-era Miami Modern condominium building in Miami Beach."

But it's not just the owners who have lost their homes or who have lost their jobs and can no longer pay their assessments who are impacted. As we said above, the remaining owners are hit hard too:

"When a unit owner stops paying monthly fees, which can range from $150 in a small building to over $1,000 in a luxury tower, a condo board must collect money from other owners to make up the shortfall. Rising fees or special assessments, or levies, can drive other vulnerable owners into insolvency."[15]

How Did Things Get So Bad So Fast?

The same way it happened in California—a super-heated housing boom that allowed anyone with a pulse to become a homeowner. When the bubble burst, all of those people

13. Loney, Jim, "U.S. property bust threatens condo 'death spiral;'" *Reuters.com*, April 3, 2009.

14. Berding, "Your Association is Broke—Who do you pay when the cash runs out?" *CondoIssues.com*, December 3, 2008.

15. Loney, *Ibid*.

who could never have kept their loans current even while employed abandon those properties when the debt catches up or their income is cut off. The Florida problem sounds very much like many California projects:

"The apartments were converted to condos at the height of a boom that saw prices—inflated by speculation and fraud—double within four years, then tumble in the last three. A one-bedroom, 560-square-foot (52-square-meter) unit that topped out near $200,000 might now get $70,000, leaving owners drowning in debt. Still… it could be worse. The board president pointed to a nearby tower where she said more than 200 of the 244 units have liens or lawsuits pending. She said an upscale building not far away—where units that once sold for over $1 million and are now priced below $500,000—has 16 troubled apartments of 44 in the building. The crisis could mean serious pain for Miami Beach, a resort town with 88,000 residents and 42,000 condos. If debtors walk away from their units, buildings could become derelict. "I haven't seen it yet, but I think we're going to see it…"[16]

Foreclosures by lenders could actually be a blessing in disguise—if they were to actually occur. Banks and other lenders would foreclose and then pick up the assessments. The only problem is that in many cases banks have refused to do that and the properties are languishing. Whether it's the payments themselves that the banks don't want to make, or whether the act of foreclosing would force them to re-value these assets to the detriment of their balance sheets—the cause of this inaction varies from lender to lender—its effect can be devastating as well as unjust to the remaining owners in the project. The Florida examples are similar to what we have seen in California:

Condo advocates say banks are partly responsible for hobbling condo boards by being slow to foreclose on owners who have fallen behind… Lenders don't become responsible for an apartment's costs until they foreclose and under current law, a bank is liable to pay only six months worth of fees in arrears, or one percent of the mortgage value, when it takes back a property… Condo advocates say banks are deliberately stalling… "There's no doubt in my mind it's done so they don't have to pay the fees," Rosa de la Camara, a lawyer with Becker & Poliakoff, a Florida firm that does condo legal work.[17]

Many states are looking to their legislatures to fashion a way out. Bills aimed at forcing lenders to pay past assessments are being introduced.

16. *Ibid.*

"Proposed legislation would make banks pay up to 12 months of fees. Advocates also want the Florida legislature to allow associations to collect rent directly from tenants when owners are taking in rent but not paying condo fees, and said other states are considering similar legislation."

But even that might not be enough to save Florida projects in the most financial distress. There, the Miami Beach city commissioner is looking at a state takeover as a real possibility, stating "... the state might end up taking over bankrupt condo associations. "Imagine what it will be like if you have to call the governor's office to get a plumber…"[18]

Actually, a state takeover has certain symmetry to it. As a condition of approval, many community associations were required by cities and counties to maintain the very same infrastructure—streets, utilities, open space—that in other neighborhoods are maintained by the local public entity using property and sales tax dollars—income denied to community associations. So if the state or local government were to take over a community association and its various maintenance responsibilities, perhaps public instead of private revenues might finally finance some of that responsibility. Nothing like that would come without a price, however, and if the project were to remain in private hands, the price would probably be a re-payment lien placed by the government as a condition to taking over, but at least help would arrive. The future of common interest developments may lie in the hands of local or state government before we know it.

So the future for many associations appears to be a gradual slide into obsolescence, bankruptcy, and eventual sale or dissolution. We can save some of the present-day associations by radically altering their financial model so that they begin to accumulate adequate funding for their operations. Those associations that can raise assessments appreciably; have not already accumulated an insurmountable deficit; and possess the political will to put a sound financial plan to work to restore the physical condition of the project now and in the future may yet survive. For those associations and for those yet to be built, we offer the following glimpse into a new and interesting future for community associations.

17. *Ibid.*

18. *Ibid.*

The discussion above applies to many of those attached community associations built in the last 50 years. Many can be saved if the owners have the political and economic will and the means to rebuild them. Many will fail. But new projects can be built with an understanding of where we went wrong and changes can be made. The future of community associations is and should be of concern to every professional, owner, and politician. For one thing, a professional's livelihood depends on their ability to predict the direction an industry is going. For another, owners must be able to adequately plan their association's financial future and governments will need to solve the many housing problems that arise from an increasing population and serious energy concerns. With these thoughts in mind, let's take a look at the next 50 years.

The Next 50 Years

Neighborhoods and whole cities are changing character, and will change a lot more in the next 50 years. Many low-rise, low-density projects that were appropriate 30 and 40 years ago are space and energy inefficient, as well as functionally obsolete and re-development of these projects will be necessary. All of this will give rise to new ways of utilizing land, constructing buildings, organizing common elements, funding repairs, and managing community associations.

The Forecast

During the next half-century we will see density increase appreciably in present urban cores and former suburban locations in concert with expansions of rapid and mass transit options. This will be a response to European-style gasoline prices and environmental concerns that will make commuting from present-day suburban neighborhoods prohibitively expensive if not socially unacceptable.

Architectural Changes

The low-rise condo structures built during the last 50 years were constructed primarily of wood. Wood was used in framing, roofing, siding, decks, and staircases. Wood rots and eventually the funding will be unavailable to replace it because the owners will chronically underfund reserve budgets. As one consequence, construction materials will evolve from wood to synthetics, steel, glass, and masonry—many of them recycled and all of which will last longer and require less maintenance than wood. Components previously made of wood will be replaced with building components manufactured of synthetics to look and function like wood. Vinyl or metal windows, concrete tile roofs, fiber cement siding, and steel or composite decking and framing are all products that we have now. Acceptance of these and other synthetic materials will be dictated not only by the obvious economic longevity they provide but also by environmental and energy concerns as well.

Vertical steel, glass, and concrete cities will replace horizontal wooden suburbs. These will include mixed-use structures with not only private common areas, but also public common areas and public services mixed in with private services as well. Residences, commercial spaces, and government facilities will co-exist in the same shell. This multi-use mix will require carefully drafted governing documents to accommodate the needs of these diverse constituencies.

Structures will be taller, but also larger overall as economies of scale begin to pay off. Developers will build more units on the same parcel of land than they do now because growing population center density will dictate more volume to preserve the few remaining open spaces. This will further drive the move to re-develop the former low-rise, low-density wood-frame condominium projects that presently are the dominant form of attached housing in California.

Re-development

Older projects will re-develop as the urban core extends outward and upward to accommodate larger populations in and around existing cities. Urban density will reach 50–60 stories in San Francisco, San Jose, and Oakland. Walnut Creek will see high-rise construction reach 20–30 stories, as will Pleasanton and San Mateo. Other emerging urban areas will see similar development. Environmental and energy concerns as well as commodities prices and natural boundaries will prevent further development of outlying or agricultural lands. People will not be able to commute 50 miles to their jobs. Agricultural lands will be needed to grow food and bio-fuels.

So where will we get the land to build these higher density projects in what are now low-density suburbs? Ask yourself this question: What is the service life of an entire condominium project? 50 years? 100 years? It's not just the life of its physical components. As we have stated, it's also the life of the funding plan that maintains it and the neighborhood in which it exists. All three must remain viable for the project to survive. But what are the chances that the buildings, the financing, and the neighborhood will be viable and valuable indefinitely? Most neighborhoods underwent significant economic change during the last century. Some improved, some deteriorated. We've written reams about the failure of funding plans and to think that a community association will always be able to look to its members for funding is naïve. It's not happening now. For one reason or another, given enough time, all community associations will become obsolete.

But there's a conflict. Because the law as written in many states perpetuates the idea of an "unlimited" service life for community associa-

tions there is no notion of an end strategy in the law or in the governing documents. In California we must include repair or replacement of every component that has a service life of 30 years or less in a reserve budget, but how do we replace entire buildings or neighborhoods when they become obsolete and uninhabitable? A reserve fund cannot deal with buildings in such poor condition that they cannot be economically made habitable, and certainly not an entire neighborhood. When these communities are at the end of their service life, what is the end strategy going to be?

One answer will be to re-cycle and re-develop all or a portion of the common area. Owners can approve a partition (sale) of the property by an appropriate vote either under the governing documents or by statute, as discussed above, so re-development will be largely market-driven. Owners, who perceive that the common area is worth more sold for redevelopment than continuing as a community association will begin to search for ways to market the project. Those largely suburban, low-rise low-density projects will be re-developed to make better (at least, more efficient) use of the land. The old suburbs will become part of new urban cores. If you trace the development of cities like Oakland, San Francisco, and San Jose from the beginning of the last century, the trend to higher densities is obvious as is the gradual expansion of the urban core. The difference today is that a great deal of the developed property that lies in the path of these changes is now commonly owned by thousands of individual condominium owners and it will be a legal challenge to unwind that to create marketable parcels suitable for re-development.

New Methods of Funding

New larger, more expensive buildings will need reliable sources of funding to support them. Today's condos require consensus among a majority of the owners to properly fund critical building maintenance. Lack of that consensus has and will financially cripple those condo associations that do not have the ability to assess without restrictions. There will have to be changes in the law if large, multi-family, multi-use structures are to survive in the future.

There are several ways that community associations, with a little help from government, could correct the flaw and sustain their continued existence. These include new statutes requiring reporting and disclosures that give prospective buyers a better idea of what they are buying so they can better assess value. The prospective buyer and existing owners cannot tell, by looking at the project, or the budget, if a condominium project is adequately funded for repair, maintenance, or restoration. The association should provide disclosures based upon a proper investigation of all common areas, visible and accessible or not. To do this we should amend Section 1365.5 (e) of the California Civil Code to remove the limiting words "visual" and the phrase "of the accessible areas" from the requirements for reserve studies and require all components, including those that might require some intrusive investigation, be part of the study.

Mandatory reserve funding has already been implemented in Hawaii, as well as California, but we have no mechanism to enforce these requirements. The law should be amended to add appropriate state oversight and enforcement mechanisms such as are available to cities and counties when collecting property taxes—and legislating that unpaid assessments survive a foreclosure.

New methods of collecting assessments will evolve from the regular monthly assessment we see today. Deferred assessments collected from escrow at the time of sale will encourage greater funding of reserves since that portion of assessments intended to fund reserves could be paid from equity instead of income. Developers will couple these deferred reserve assessments with a reserve contribution when the project is new to limit monthly assessment payments to operating expenses only, qualifying more potential buyers. With some help from the Legislature, quasi-governmental special districts could also be used to maintain a consortium of large projects that would be funded by a tax rather than a voluntary assessment. This treatment could lead to assessments that are largely tax-deductible and more in keeping with the semi-public nature of these large projects.

Less Litigation

To avoid litigation over construction or budget issues and to encourage investment in these large projects, developers will create "hybrid" or dual-ownership buildings by separating common areas and the separate interests into several, separate legal entities. Investors or the developer will maintain the building and own the common area "shell". The community association will enforce the governing documents and deal with all other non-construction issues.

In essence, the investors will be landlords who "lease" the common area to the individual separate-interest owners or to residential or commercial associations. All infrastructure issues will be the responsibility of the "landlord" as they are in commercial buildings today. This arrangement will eliminate the problem of underfunded reserve accounts since necessary maintenance will be performed as needed and funded by the investors. These payments will be controlled, to some extent, by an independent panel that will judge the quality of the maintenance and condition of the building.

Investor equity appreciation will therefore depend in part upon the quality of care given the building by the "landlord" and the "lease" payments that the owners pay. Investors will also receive a percentage of the appreciation of the individual units at time of sale. This participation in the success of the building will provide the necessary incentive to investors. Since the association will have no maintenance or repair obligations, it will lack the incentive to sue the landlord over construction issues. Disputes over lease payments, building maintenance or services will be referred to an outside mediator/arbitrator for resolution. The governing documents will combine common interest and leasehold language.

Member Discipline

The residential association will enforce behavioral and social issues. Community associations, now much larger and with many more owners, will create private ombudsman-judge positions in-house or by contract, to resolve issues among neighbors and to enforce the rules. These positions will derive their authority from contractual arbitration provisions written into all sales and governing documents and their rulings will be enforced by a simple application to local courts.

Management

Governing documents will be maintained on the Internet with online legal and accounting advice in widespread use along with other management services, especially for smaller associations without in-house management staffs. College majors in community association management will be required of managers of these large complexes. The curriculum will include Engineering, Information Technology, Accounting, Psychology, and Law. Online management and training "packages" will be widely available which include Financial, Legal, and Maintenance services from consortiums of professionals.

Conclusion

We have to begin to change our thinking about the basic community association financial model for maintaining attached housing. Mandatory funding and oversight will be necessary to keep the product alive and functioning. Short of that, widespread economic failures are likely to occur with projects already weakened by the economic downturn and many years of deferred maintenance. An evolution of the condominium model, if we adopt a new financial structure, use better building methods and materials, and find less litigious ways of enforcing the rights of the association could finally lead us to what was promised so many years ago: a care-free lifestyle in an exciting urban setting.

Berding & Weil, LLP
3240 Stone Valley Rd West
Alamo, California 94507
925-838-2090
www.berding-weil.com
www.condoissues.com

BERDING | WEIL