WSCAI Journal — June 2012 WACAI

Investment In Distressed Community Associations

Dan Zimberoff

The protracted economic recession has hit condominium and homeowner associations especially hard. Many associations are facing unprecedented levels of foreclosures, skyrocketing rental ratios and even developments stopped midcourse due to bankruptcy or dissolution of the developer/declarant entity. As a result, many community associations throughout the state are facing vast financial crises jeopardizing their very sustainability.

In some instances, associations have sought assistance from investors to purchase blocks of homes or entities to step in the shoes of the original declarant to complete a development abandoned by the original developer. It is premature to judge the success of investment into distressed community associations, yet there are several issues that can be identified to examine if “angel” investing may be plausible.

Is Investment a Viable Option?

Associations may look to investors as saviors, even in untenable situations. An investor may not be able to play the knight in shining armor if the castle is already burning. In other words, if an association is in such dire straits that a bank or the homeowners themselves cannot find a reasonable solution, the circumstances likely will not make financial sense for an investor, either.

However, if a bank or investor chooses not to invest, it does not necessarily mean demise of the association. Though drastic, there are alternatives that may save the association, including radical budget cutting or shifting services in-house (e.g., bookkeeping, landscaping, minor maintenance, etc.) performed temporarily by homeowners until a stable financial situation is restored. In some instances, appointment of a receiver may be required to prevent termination or dissolution of the association.

The bottom line is an angel investor does not always equate to a magic pill, and in many instances, is not viable. If all else has failed, it is doubtful an investor will swoop in and save the day. However, in some instances, as demonstrated below, it makes financial sense for an individual or group to invest in a distressed association.

The Upside

The upside to third-party investment in an association is obvious.What may not be so apparent is understanding exactly what the investor is investing in. Unlike a for-profit business, the individual or entity is not investing in the corporation itself, that is, is not exchanging capital for shares of stock. The investor is purchasing real property, and in some circumstances, declarant developmental rights. In a best case scenario, the investor completes the project and sells the remaining homes or units, or at a minimum, purchases units and pays the monthly assessments. In instances of acquisition by foreclosure of condominium units, the new owner should also have to pay up to six months of past due regular assessments from the previous owner under the

Washington Condominium Act's super lien priority codified by RCW 64.34.364(3).

The Downside

Even if an investor commits funds, investment in an association does not always translate to a seamlessly positive outcome for All parties. There have been cases where an investor, including a bank, purchases multiple units and then defaults on payments or assessments. In other situations, the investor buys a group of units or homes, rents them and runs them like apartments, leaving the Association to handle CC&R enforcement and other "grunt" work (e.g., tenant registration, move-in and move-out coordination and administration, lease review, etc.).

Some associations have reported difficulty achieving quorum when block investors are not actively participating in association affairs.In such circumstances, it is imperative that the board of directors establish a working relationship with the investor. If the investor refuses to cooperate, perhaps because it is a group or located out of area, then the association may have to seek a receivership or other court intervention in order to continue its corporate governance.

Another downside to a single individual or group owning multiple units in a condominium relates to FHA certification and Fannie Mae funding. Under FHA and Fannie Mae guidelines, a single investor cannot own greater than 10 percent of the total number of units in a condominium. The reason for this limitation is fear that in a pinch, the owner would fire sale the units, thus adversely affecting resale value of the remaining units.

There are also stories of investors who run roughshod over the other homeowners either through swaying votes at an annual meeting or more aggressive direct confrontation with board members or association members. From the investor's standpoint, they merely wish to protect their investment, possessing the single largest stake in the association, and believe they should have disproportionate power. Yet, under the common interest ownership scheme of a condominium or homeowner association, disproportionate power takes the form of voting rights, not in governance through board action. A community association, as a quasi-governmental organization, exercises representative government. An association board of directors is comprised of a number of homeowners who share equal votes and powers (unless explicitly stated otherwise in the bylaws or declaration). If one of the board members is an investor, he or she should not bully or intimidate the remaining board members. If they do act outside their legal rights, then the association board of directors may have no alternative other than seeking a receivership or other court intervention.

Conclusion

If feasible, investment in a distressed community association may prove effective. In order to have the highest chance of success, an association must ensure it maintains realistic expectations, works closely with the investor or group to ensure a compatible and reasonable framework of governance and operation is established, and should set forth a realistic exit strategy, unless the investor plans to be a long term owner of multiple units. If all parties work together cooperatively under a comprehensive plan, then a financially distressed community should survive.