

When Homeowner Associations Borrow— What Attorneys and Lenders Should Know

by Ronald Garfield

As condominium projects age, substantial funds may be needed to repair or replace common elements that are beyond their useful life. Under such circumstances, many homeowner associations are turning to bank loans as a source for these funds. While such loan transactions on their face appear to be straightforward, banks and their attorneys need to be mindful of potential pitfalls. Attorneys who represent homeowner associations should be aware of how such loans are structured.

Condominium development in Colorado resort towns accelerated in the late 1960s.¹ The 1990s saw Colorado's population increase by more than 30%.² In the first decade of 2000 this trend continued, with the population increasing nearly 17%.³ With the influx of new residents came builders who were eager to profit from the increased demand for housing. The condominium form of ownership became popular for both part-time and full-time residents along the Front Range and in the mountains. Aside from temporary slowdowns due to national economic conditions, development of condominium projects has continued through the present. It should be noted that metropolitan areas like Denver are now seeing a wave of rentals instead of ownership regimes, but the reasons behind this dynamic are not relevant to this article.

Early condominium projects are now 30 to 50 years standing.⁴ Complete teardowns for obsolescence are rare. However, despite good maintenance practices, common elements like roofs, stairs, exterior walls, facades, balconies, elevators, retaining walls, and amenities, especially in older projects, need major renovations.⁵ Also, some amenities are simply outdated and must be upgraded to keep the condominium project competitive, especially where short-term rentals are an important source of income to owners.⁶ Lenders, such as commercial banks, have good reason to make loans to homeowner associations (HOAs). First, there is a low risk of any loss. Second, the loan typically comes with a covenant to maintain all accounts with the lender. If the HOA has the resources, it might choose to maintain certificates of deposits with the lender for the term of the loan as security for repayment. This kind of security is

rarely available. Third, if the HOA has a good experience with the lender, it might open the door for the lender to establish relationships with individual owners, whether to refinance their units or otherwise.

Cost of Renovations

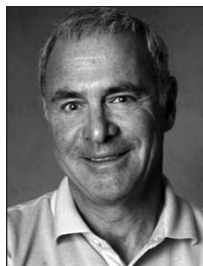
The costs involved today in renovating common elements, coupled with current building codes and the entitlement process, can sometimes exceed the original cost to build the entire project. So the question arises: How can condominium owners obtain funds for these renovations? While some high-net-worth owners may simply write a check for their *pro rata* share, many owners are interested in alternative methods of financing renovations. The alternative of choice for the HOA is to take on debt.⁷ The HOA is the borrower and individual owners have no personal liability. However, as indicated below, the individual owners' condominiums will indirectly serve as the lender's collateral.

Real Estate as Collateral

In cases where the HOA owns land that could, by a foreclosure, be severed from the project without materially impairing the condominiums, the lender may require such real estate as additional collateral or, if the value is sufficient, as the only collateral. HOAs with available real estate like this are rare. Suffice it to say that if the HOA's real estate is to serve as collateral, the condominium map, declaration, project entitlements, and applicable zoning should be

Coordinating Editors

Christopher D. Bryan—(970)
925-1936, cbryan@garfieldhecht.com;
Stefanie L. Sommers—
stefanie.sommers@gmail.com



About the Author

Garfield & Hecht, P.C. is a full-service law firm with offices in Aspen, Avon, Basalt, Glenwood Springs, and Rifle. Ronald Garfield is a founder and the firm's managing shareholder. He specializes in business, real estate, and loan transactions—garfield@garfieldhecht.com. The firm represents a number of commercial banks on the Western Slope that make loans to homeowner associations. He thanks Jason Buckley, an associate attorney in the firm's Avon office, and Chelsea R. Clark, a summer 2015 intern in the firm's Aspen office, for their valuable assistance in the completion of this article.

Real Estate Law articles are sponsored by the CBA Real Estate Law Section.

carefully reviewed to learn what restrictions there might be on the use of such real estate should the lender ever foreclose.⁸ If the real estate is a common element, then, absent language in its declaration to the contrary, allowing the HOA to encumber common elements will require the approval of at least 67% of the ownership interests.⁹ This type of collateral should be treated like any other real estate loan, including receipt of a title commitment and policy following closing.

Threshold Questions

Typically, lenders will not make unsecured loans to HOAs, especially the larger loans needed to finance renovation projects. Generally, even working capital loans require collateral. This article assumes the lender will require collateral for its loan and such lender's collateral will be a pledge of future income in the form of an assessment levied by the HOA to repay the loan. With regard to the pledge of an assessment lien, the threshold question is what authority, if any, the HOA has to borrow to finance a renovation. Perhaps just as important is the issue of what authority, if any, the HOA has to pledge future income (i.e., the proceeds of the assessment earmarked to repay the loan).

CCIOA Considerations

The Colorado Common Interest Ownership Act (CCIOA) became effective July 1, 1992.¹⁰ Condominium regimes in existence before the effective date of CCIOA, and assuming the HOA has not elected treatment as if were created after June 1, 1992,¹¹ are

often referred to as pre-CCIOA regimes.¹² CCIOA allows an HOA to pledge future income, including rights to assessments, "but only to the extent the declaration so provides."¹³ Thus, there are three possible outcomes as to an HOA's ability to pledge future income. First is a pre-CCIOA regime where the declaration is silent on a pledge of future income. This seems to be the most common scenario with renovations of older projects. Second is a CCIOA declaration or a pre-CCIOA declaration that allows a pledge of future income. Third is a CCIOA regime where the drafter of the declaration did not include, for whatever reason, the pledge of future income as one of the specific powers of the HOA.

Where the pre-CCIOA declaration is silent on a pledge of future income, authority to do this may be found in the Colorado Revised Nonprofit Corporation Act (Nonprofit Act), which, in pertinent part, provides:

Unless otherwise provided in the articles of incorporation, every nonprofit corporation has . . . the same powers as an individual to do all things necessary or convenient to carry out its affairs, including the power: (g) To make contracts and guarantees, incur liabilities, borrow money, issue notes, bonds, and other obligations, and secure any of its obligations by mortgage or pledge of any of its property, franchises, or income.¹⁴

A pre-CCIOA HOA could adopt bylaws allowing for a pledge of future income so long as the bylaws do not conflict with the declaration.¹⁵ While not necessary, a pre-CCIOA HOA could also amend its declaration to allow for a pledge of future income.¹⁶ The preferred choice would be to amend the bylaws, which typically can be done by the HOA board and is less cumbersome than amending the declaration.¹⁷ Attorneys representing HOAs in this situation may prefer to rely solely on the Nonprofit Act. HOA attorneys will likely be required to furnish an opinion letter to the lender that the Nonprofit Act is sufficient authority for the HOA to pledge future income.

More troublesome is the CCIOA regime where the declaration did not include a pledge of future income as one of the powers of the HOA.¹⁸ This exclusion creates a presumption that the declarant did not intend for the HOA to have the power to pledge future income, and the only method to overcome this presumption is a duly enacted amendment to the declaration.¹⁹

Hand in hand with the authority to pledge future income is the authority of the HOA to borrow.²⁰ Typically, this language appears in all declarations or bylaws.²¹ However, there may be limitations as to amounts and purposes of the borrowings.²² Often, a cap exists on the dollar amount that can be borrowed without the consent of the unit owners.

Due Diligence

In its underwriting process, a prudent lender will want to review the HOA's collection history on assessments. For example, the lender should not be concerned if the HOA has 50 condominium units and two or three owners are delinquent. However, in a 10-unit condominium, two or three delinquent owners could have a material adverse effect on the HOA's ability to service the debt. A Uniform Commercial Code (UCC) search should be performed to assure there will be no competing interests in the collateral (i.e. the payment intangible). Occasionally, the HOA may have failed to file annual reports with the Colorado Secretary of State, so a certificate of good standing is also advised. It is not unusual to find one or two housekeeping items like this that need attention. For

example, if the bylaws provided by the HOA are unsigned, they will need to be re-adopted. Never rely on a copy of the condominium declaration provided by the HOA. Rather, search the public records to ensure that the declaration is current and complete and includes any amendments or supplements.

In performing due diligence, the lender's attorney should review the HOA's collection policy to assure compliance with CRS § 38-33.3-209.5(5). A lender would be bound to follow this policy to the extent the HOA has not complied. If the collection policy is more lenient than the minimums required by statute, consideration should be given to having the HOA amend the policy to just satisfy the minimums. Noncompliance with the HOA's collection policy would be a bar to lender's foreclosure on any assessment liens. The language in the statute specifically applies to a "holder or assignee of the association's debt." This is recognition that HOAs may enter into commercial transactions (e.g., a loan). Lender's loan documents should require that the HOA must enforce without any delay its collection policy as soon as an individual unit owner is delinquent.

Governance Procedures

House Bill 13-1276 made certain governance procedures mandatory on all (CCIOA and pre-CCIOA) HOAs. The amendment made by this bill to CRS § 38-33.3-316(11)(a)(II) should be of concern to lenders and their attorneys because a lender cannot foreclose on its collateral until: (1) the amount due equals or exceeds six months of regular assessments and (2) the HOA board by recorded vote authorizes the filing of legal action.²³ The amendment goes on to say:

The board may not delegate its duty to act under this subparagraph (II) to any attorney, insurer, manager, or other person, and any legal action filed without evidence of the recorded vote authorizing the action must be dismissed.²⁴

The above-quoted language: (1) establishes a duty on the part of the HOA to take formal action to approve any foreclosure against a specific unit for non-payment of any assessment and (2)

prohibits the HOA from delegating that duty. One might argue that in light of HB 13-1276, a lender would have to wait until the HOA took formal action to foreclose and thus the lender's lien is inchoate and cannot be enforced absent such board cooperation. If an HOA goes into default on its loan, the lender cannot assume that the HOA will take the required formal action. Yet at the same time, HB 13-1276 intended that HOAs could enter into commercial transactions (e.g., loans) where the association lien could be assigned. This intent is evidenced by the amendment to the language requiring that the assessment lien can be foreclosed like a mortgage by "the holder or assignee of the association lien."²⁵

Commercially, it makes little sense for a statute to recognize the possibility of HOA loans but at the same time put up roadblocks to a lender enforcing its collateral. CRS § 38-33.3-316(11)(a)(II) is silent as to: (1) when this formal action has to be taken, or (2) whether the owner has to be delinquent in payment of the assessment at the time the formal action is taken. It is prudent for the lender to, at the time of loan closing, obtain as part of the HOA board resolution language authorizing legal action, including foreclosure upon default of payment of the assessment earmarked to repay the loan. This resolution language should identify each owner by name as well as the unit, apply to any subsequent owner, and be effective in the event of a current default or a default in the future. The information to identify each unit owner by name can usually be obtained from the HOA's records, but the resolution will likely be sufficient for the purposes intended even if the names of the owners are not included.

UCC Considerations

The lender's collateral consists of two parts: first, the assessment and the proceeds thereof;²⁶ and second, the lien right granted under the declaration to enforce.²⁷ In looking at the Colorado UCC, the assessment should be considered a payment intangible.²⁸ In theory, the lien right granted under the declaration to enforce should follow the assessment.²⁹ This lien right is a lien on real estate (i.e., the condominium) and would be considered an interest

in real estate.³⁰ However, this lien right will follow and cannot be separated from the payment intangible.³¹ Given the nature of this collateral, how will the lender perfect its security interest? As to the security interest in future income,³² a UCC-1 financing statement would need to be filed with the Colorado Secretary of State (assuming the debtor is “located” in Colorado).³³

Loan Documentation

Once the power to borrow the needed amount for the purposes intended and the right to pledge future income are established, the HOA must follow certain steps to satisfy the lender’s requirements for documentation.³⁴ The HOA must levy an assessment earmarked to repay the loan.³⁵ The earmarking is critical so that this particular assessment can be carved out from all other HOA assessments and become the lender’s collateral. The declaration may require a special assessment for this purpose.³⁶ The label is less important than the HOA’s following procedures established under its declaration to levy the assessment and to ensure that the assessment is earmarked solely to repay the loan. An assessment to repay over the term of the loan essentially constitutes future income that the HOA will receive for such purposes.³⁷ The lender will require an agreement that grants a security interest in the assessment along with the proceeds thereof and the lien rights of the HOA to collect thereon.³⁸ As to the lien right, the lender should require the HOA to record an assignment to lender of the lien right in the real estate records.³⁹ Without the assignment, an argument could be made that the lien right part of the collateral is inchoate and dependent on further action by the HOA. Neither the HOA nor individual condominium owners should find the assignment objectionable because the lien right already exists by the terms of the declaration and typically payment of the assessment occurs when the unit is sold.⁴⁰ Generally, (1) some HOAs prefer “due on sale” type language added to the lender’s loan documents rather than dealing with a new owner in regard to this assessment; and (2) the sale or refinancing of a condominium will not fail to close because of a recorded document that evidences the assignment of the assessment lien to the lender to secure borrowings for upgrades to common elements or for other proper HOA activities. Simply relying on the HOA’s promise to enforce the lien in the event of loan default is not enough, because it represents nothing more than an unsecured promise. The lender’s loan documents should allow the HOA to enforce the assessment lien as long as the loan remains current. However, any default by the HOA probably means that the HOA has not been vigilant in collecting assessments from delinquent owners, and the lender should have the right to step in and enforce the lien.

The lender’s attorney should inquire if there is a management contract where the manager’s duties include collection of assessments. In these circumstances, an agreement should be put in place where the manager subordinates its right to collect assessments to the rights of lender to collect assessments upon the occurrence of loan default. The lender’s attorney should review all minutes of the HOA meetings that approved the renovations and borrowings. Generally, these minutes approve the borrowings before the lender is selected and will need to be supplemented by a separate borrowing resolution adopted by the HOA that approves a specific lender, gives more detail about the loan terms and collateral, and agrees to maintain all accounts with the lender. Always insist that the resolution include language stating that it cannot be amended or re-

scinded without the consent of the lender. The lender’s attorney should always draft this resolution and provide the form of opinion letter. The security agreement that covers the payment intangible should provide that, in the event of a default, lender’s collateral has a first right to all proceeds of any assessments collected by the HOA, including but not limited to the “super-priority” portion of the assessment lien.⁴¹ This first right would automatically expire when the assessment against the unit earmarked to repay the loan has been satisfied. Finally, the security agreement should carve out an exception for owners who pay upfront or at some later date pre-pay in full their remaining share of the assessment earmarked for the loan. When owners have paid their share of the assessment early, their units should be released from the effect of the recorded assignment of the assessment lien.

Loan Default

It is important to remember that upon the occurrence of a loan default and assuming compliance with the HOA governance procedures more fully discussed below, the enforcement of lender’s lien right will be limited to units that are in default in payment of the assessment.⁴² It would be unwise for an HOA to ever agree to enforcement of the lender’s lien against units that are current in the payment of their assessment. The loan default occurred because some owners failed to pay their assessment, and it is only those owners who should be subjected to a foreclosure of the assessment lien. A loan default will trigger an acceleration of the entire loan amount and the lender can (without regard to any HOA governance procedures) immediately commence a collection lawsuit against the HOA. When governance procedures are complied with, the lender can also foreclose on units that are delinquent in payment of their assessments concurrently with the collection lawsuit against the HOA.⁴³

In theory, a lender following a loan default has an alternate path to realize on its collateral by conducting a UCC sale of the payment intangibles.⁴⁴ As mentioned above, the assessment lien would go with the successful bidder at the UCC sale.⁴⁵ Following such a path would likely be unproductive because there is no recognized market for this collateral, and anyone besides the lender would be reluctant to wade into the affairs of the HOA.

Conclusion

In summary, loans to HOAs can be very beneficial for all parties involved. The lender provides a ready source of needed funds to make renovations that will improve property values for individual unit owners. Because the loan is payable over time, owners avoid having to come out-of-pocket for large up-front amounts to fund their share of the renovation costs. However, the passage of HB 13-1276 has created some uncertainty about the ability of the lender to foreclose on its collateral absent formal action on the part of the HOA board. Assuming that such formal action can be taken when the loan closes and compliance with the HOA collection policies, on the occurrence of a loan default, a lender could proceed with a foreclosure free of any involvement or hindrance by the HOA.

Notes

1. Jensen and McNeill, “Colorado Common Interest Ownership Act—How It Is Doing,” 25 *The Colorado Lawyer* 17, 17 (Nov. 1996) (not-

ing that rising land costs in the 1960s and 1970s created an emerging market for condominiums).

2. See U.S. Census Bureau, “Ranking Tables for States: 1990 and 2000” (April 2001), www.census.gov/population/cen2000/phc-t2/tab01.txt.

3. See U.S. Census Bureau, “Population Distribution and Change: 2000 to 2010” (March 2010), www.census.gov/prod/cen2010/briefs/c2010-br-01.pdf.

4. See Svaldi, “Apartment dwellers in metro Denver getting priced out, pushed out,” *The Denver Post* (March 15, 2015), www.denverpost.com/business/ci_27709567/apartment-dwellers-metro-denver-getting-priced-out-pushed.

5. See *id.*

6. See Jensen and McNeill, *supra* note 1 at 17.

7. Polinsky, “HOA and Condo Association loans are cash-flow based,” CondoAssociation.com blog (May 26, 2010), www.condoassociation.com/condo-association-loans/tabid/81563/bid/8383/HOA-and-Condo-Association-loans-are-cash-flow-based.aspx.

8. Leder, “Maximizing Values and Minimizing Liabilities in a Failed Phased Community,” 38 *The Colorado Lawyer* 89 (July 2009) (“lenders often prefer to acquire title adversely through foreclosure rather than by a deed that may carry successor liability with it”).

9. CRS §§ 38-33.3-302 and -312 (outlining requirements to encumber common elements).

10. CRS §§ 38-33.3-101 *et seq.*

11. See CRS § 38-33.3-118.

12. CRS § 38-33.3-115; 2A *Colo. Practice, Methods of Practice* § 73:1 (6th ed.) (“Since 1992, condominium communities have been categorized as a subset of common interest communities under CCIOA and are either pre or post-CCIOA common interest communities.”).

13. CRS §§ 38-33.3-302(1)(n) (“The association may assign its right to future income, including the right to receive common expense assessments, but only to the extent the declaration expressly so provides.”) and -312(4) (regarding the form of agreement by which an association may encumber common elements).

14. CRS § 7-123-102(g).

15. CRS §§ 7-122-106(2) (stating that bylaws may contain any provision for managing affairs of corporation that are not inconsistent with articles of incorporation) and 7-123-102(c) (directors may amend the bylaws unless such power is reserved to the members).

16. See CRS §§ 38-33.3-117(1.5)(d) and -217(1)(a)(I).

17. CRS § 7-123-102(c); 2 *Colo. Corporate Forms* § 11:28 (2d ed.) (“The board of directors may amend the bylaws at any time to add, change, or delete a provision unless it would result in a change of the rights, privileges, preferences, restrictions, or conditions of a membership class as to voting, dissolution, redemption, or transfer by changing the rights, privileges, preferences, restrictions, or conditions of another class.”).

18. *Lion Square Phase II and III Condo. Ass’n, Inc. v. Hask*, 700 P.2d 932, 934 (Colo.App. 1985) (“A condominium association may exercise its powers only within the constraints of its condominium declaration and bylaws.”) (citing *Rytwalt v. Writer Corp.*, 526 P.2d 316 (Colo.App. 1974)).

19. *Id.*

20. CRS § 38-33.3-302(e) (authorizing HOAs to incur liabilities).

21. CRS §§ 38-33.3-205(1)(h) and -302(1)(n).

22. CRS §§ 38-33.3-302(1)(n) and -312(4).

23. CRS § 38-33.3-316(11)(a).

24. CRS § 38-33.3-316(11)(a)(II).

25. CRS § 38-33.3-316(11)(a).

26. CRS § 4-9-102(a)(64)(B) (collateral definition includes future proceeds). See also CRS § 4-9-102, cmt. 3.a.

27. CRS § 38-33.3-316.

28. CRS § 4-9-102(a)(61) (a payment intangible means a general intangible under which the account debtor’s principal obligation is a monetary obligation).

29. CRS §§ 38-33.3-315 and -316.

30. CRS § 4-9-109, cmt. 10 (generally, the UCC does not apply to interests in real property).

31. See CRS § 4-9-101, cmt. 4.a (noting that Article 9 of the UCC explicitly address payment intangibles and real property “that secures a right to payment or performance that is subject to an Article 9 security interest.”); CRS § 4-9-203, cmt. 9 (stating that CRS § 4-9-230(g) “codifies the common-law rule that a transfer of an obligation secured by a security interest or other lien on personal or real property also transfers the security interest or lien”); CRS § 4-9-308(e) (stating that perfection of a security interest in a right to payment perfects a security interest in a lien on real property that secures the right to payment).

32. CRS § 4-9-310(a) (indicating that a financing statement must be filed to perfect all security interests—the default rule for perfection is to file). *But see* CRS § 4-9-309(2) (allowing perfection of a security interest in payment intangibles in certain situations).

33. CRS §§ 4-9-502 and -504 (outlining contents of financing statement and description of collateral); CRS § 4-9-521 (mandating uniform form of written financing statement); CRS § 4-9-501 (requiring filing of a financing statement with the office of the secretary of state). A recommended collateral description in the UCC-1 filing should include:

All Accounts Receivable now owned or hereafter acquired; All Chattel Paper, Accounts and General Intangibles; whether any of the foregoing is owned nor or acquired later; all accessions, additions, replacements, and substitutions relating to the foregoing; all records of any kind relating to any of the foregoing; all proceeds relating to any of the foregoing (including insurance, general intangibles and other accounts proceeds), membership dues and assessments of the “X” Condominium Association.

34. See generally CRS § 38-33.3-312.

35. CRS §§ 38-33.3-306(3)(a)(I) to (III) (regarding the earmarking of association funds) and -302(b) and (e).

36. *Id.*

37. See “Lending to Community Associations,” FindLaw.com (March 26, 2008), corporate.findlaw.com/business-operations/lending-to-community-associations.html.

38. *Id.*

39. CRS § 38-35-109(1).

40. CRS §§ 38-33.3-316(1) (“The association . . . has a statutory lien on a unit for any assessment levied against that unit . . .”) and -316(4) (recording of the declaration constitutes record notice and perfection of the lien).

41. CRS § 38-33.3-316(2)(a).

42. See CRS §§ 38-33.3-316 and -316.3.

43. See *id.*

44. See CRS §§ 4-9-601 (outlining rights of a secured party after default by debtor), -604 (dictating procedures if security agreement covers real property or fixtures), and -607 (mandating secured party’s collection and enforcement rights).

45. See CRS § 4-9-617. ■