The bankruptcy of a real estate developer can create myriad legal issues for a homeowners’ association left with a partially complete development. Consider, for example, the following hypothetical:

A developer of 90 fee simple townhomes files for chapter 11 bankruptcy protection. Thirty of the townhomes are sold and occupied by unit owners; 30 are under contract and in varying stages of construction; and 30 are not under contract and are not built. The development was to include a pool, clubhouse, and security gate, none of which are complete. Under each sales contract the developer paid funds into an escrow account at closing, with the developer as escrowee, to secure the developer’s obligation to build the pool and clubhouse. The initial layers of the streets and most curbs and sidewalks are in place, but the final layer of the streets has not been poured and the streets have not been accepted by the village for dedication. The developer entered into a development agreement with the village and an easement agreement with adjacent parcel owners to provide certain drainage and sewer improvements to tie into the village’s system. As part of the development agreement with the village, the developer provided a letter of credit in favor of the village to complete the promised improvements. The developer has not paid assessments on the unsold townhomes for many months and the undivided property tax bill is outstanding. As of the bankruptcy filing, per the terms of the development’s governing declaration of covenants, conditions, and restrictions, the developer still owns the common areas and the association has not been turned over to the homeowners.

This hypothetical is a common scenario in which many homeowners’ associations (HOAs) can find themselves in a retreating market. The developer’s bankruptcy presents the association with multiple complex issues that have few straightforward answers. In the end, the HOA and the homeowners currently residing in the development are those that must remedy the problems the developer’s bankruptcy creates. This article provides an overview of the issues facing the homeowners’ association and

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Representing a Homeowners’ Association Facing the Developer’s Bankruptcy

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its residents as they navigate through the processes and ramifications of the developer’s bankruptcy. It is no substitute, however, for sage advice from bankruptcy counsel.

**Lax Regulation of Community Associations**

The body of law regulating noncondominium HOAs is not nearly as developed as that of pure condominium law. The level of governance of a noncondominium residential homeowners’ association—be it a townhome association, a planned unit development, a common interest community, or any other name given to a residential development governed by a recorded declaration when an association owns or operates separate common property that benefits the homeowners—varies from state to state. The National Conference of Commissioners on Uniform State Laws has promulgated the Uniform Common Interest Ownership Act (UCIOA), some variation of which has been adopted by nine states as of the writing of this article. See, e.g., Del. Code Ann. tit. 25, § 81-101 et seq. UCIOA provides detailed regulations for noncondominium associations. Other than the enactment of UCIOA, however, most states scarcely address noncondominium HOAs. As a result, with only limited regulation developers are free to structure association declarations and bylaws in lieu of the financially Parsons on Uniform State Laws has promulgated the Uniform Common Interest Ownership Act (UCIOA), some variation of which has been adopted by nine states as of the writing of this article. See, e.g., Del. Code Ann. tit. 25, § 81-101 et seq. UCIOA provides detailed regulations for noncondominium associations. Other than the enactment of UCIOA, however, most states scarcely address noncondominium HOAs. As a result, with only limited regulation developers are free to structure association declarations and bylaws in lieu of the financially matters relating to the common areas. Thus, as an initial option, any action on behalf of the homeowners must be through a derivative action on behalf of the association. Cigal v. Leader Dev. Corp., 557 N.E.2d 1119, 1122–23 (Mass. 1990); Davis v. Dyson, 900 N.E.2d 698, 704–08 (Ill. App. Ct. 2008). Most HOAs are either required to be incorporated as not-for-profit corporations or are treated as such, making a derivative action appropriate. For states that have lenient standards for allowing third-party beneficiary actions, associations have been permitted to enforce the purchase contracts between their members and the developer. Terre Du Lac Ass’n, Inc. v. Terre Du Lac, Inc., 737 S.W.2d 206 (Mo. Ct. App. 1987). But the ability of the homeowners to enforce the purchase contracts as third-party beneficiaries would not resolve all of the issues facing the homeowners in the hypothetical. Enforcement of the purchase contract does not confer on the homeowners enforcement of the HOA’s declaration and bylaws in lieu of the financially paralyzed developer.

Statutory enactments addressing procedures on the bankruptcy of the developer are sparse. A recent amendment to the Florida Condominium Act mandates that on the filing of bankruptcy by a developer, a condominium association is turned over to the unit owners. Fla. Stat. § 718.301(e). Although this new law affects only condominium associations and not other types of HOAs, it shows that state legislatures are starting to notice the need of an association to take control of its affairs with a bankrupt developer. Other state statutes and the UCIOA address developer bankruptcy, but not to the extent of necessitating a turnover of the association to the homeowners on a developer bankruptcy. UCIOA § 3-104(d) disallows the “special declarant rights” afforded to the developer under UCIOA, but only on a sale of the development through bankruptcy and not on the filing of the bankruptcy petition.

If no statutory authority justifies the homeowners’ takeover of the association on bankruptcy, a more proactive approach to gain control of the association is to seek a judicial declaration that the developer’s bankruptcy is a de facto turnover of the association to the homeowners. Thus far, the only case serving to justify the de facto turnover theory is the New Jersey case of Poblette v. Town of Historic Smithville Community Ass’n, Inc., 809 A.2d 178 (N.J. Super. Ct. App. Div. 2002). In Poblette, the homeowners sued the HOA, the developer, and the developer’s management entity for damage from a flood in a detention basin owned by the developer and controlled by the association. The court found that the developer’s intent, under the association’s declaration, was to transfer the detention basin to the association on association turnover. On the point of the turnover, the court expressly rejected the contention that control over the common elements of the development was in “legal limbo”; the court held that when the developer went bankrupt, there was a de facto transfer to the association of the developer’s rights and obligations under the declaration. Id. at 185. If the Poblette holding proliferates to other states, the homeowners that do not control the association must take affirmative steps to gain control or risk inheriting the association’s unintended liability when the turnover eventually takes place. Even without the impetus.
of the Poblette holding, the homeowners should make all attempts to gain control of the association, either under a de facto turnover argument, through a derivative action, or under a third-party beneficiary theory.

Depending on individual state laws, the homeowners could marshal support and petition to have a receiver appointed to oversee the operation of the association. To marshal the support for a receivership, the homeowners could unite with the project’s lender to bolster the argument for the receiver. The receivership would not impart control of the association to the homeowners, but the interests of the association would be protected in the receivership. Regardless of the receivership, if sales to homeowners have not closed for a large percentage of the homes before the developer’s bankruptcy, the homeowners must somehow gain control of the association both to have standing to address any issues relating to the common areas and to enforce the declaration on behalf of the association.

**Developer’s Right to Reject Contracts**

One of the more powerful weapons within the Bankruptcy Code, 11 U.S.C. § 101 et seq., is the debtor’s ability to assume or reject executory contracts the debtor has undertaken before filing bankruptcy. More specifically, under Bankruptcy Code § 365(a), the bankruptcy trustee can assume or reject any executory contract or unexpired lease of the debtor.

As a general rule, a debtor may assume or reject a contract in total, without the ability to pick components or parts of a contract to reject. One of the litmus tests for rejection of executory contracts is whether there are requirements for continuing performance, benefits, and burdens by both parties to the contract. If there are substantial bilateral performance requirements, benefits, and burdens yet to be performed, the contract is executory and can be rejected. This general rule, however, has been diluted by contrary legal opinions. If an agreement contains a severability clause, courts have gone so far as to hold that a single written instrument may contain more than one executory contract that may be rejected by the debtor. *In re Holly’s, Inc.*, 140 B.R. 643 (Bankr. W.D. Mich. 1992). Another purported exception occurs if the contract contains affirmative covenants on the part of the debtor. Courts have held that the mutual contractual obligations within a document are severable from other affirmative covenants of a debtor—with the rationale that the covenants are not continuing mutual obligations and therefore not executory. *In re Noco, Inc.*, 76 B.R. 839, 843 (Bankr. N.D. Fla. 1987).

Once the developer files bankruptcy, the individual homeowners must take an active role to protect both their individual interests and the interests of the association that they will eventually inherit.

**Right to Reject the Declaration**

The complexity of Bankruptcy Code § 365 manifests itself when considering whether the developer can reject the declaration governing the association. In general, covenants running with the land are deemed to be property rights and are not contractual obligations that can be rejected under Bankruptcy Code § 365. *Gouweia v. Tabir*, 37 F.3d 295 (7th Cir. 1994). Most cases that address rejection of the obligation of a recorded declaration do so in the context of a unit owner debtor’s attempt to reject the duty to pay assessments under a condominium declaration. In that situation, the ability to reject the assessments might depend on whether the assessments are pre- or post-petition obligations and whether the debtor still retains ownership of the condominium unit. See, e.g., *In re Raymond*, 129 B.R. 354 (Bankr. S.D.N.Y. 1991) (refusing to allow rejection of post-petition assessments when debtor retained possession of the unit, but noting case in which debtors were allowed to avoid pre-petition assessments).

Many of the cases speaking to a debtor’s rejection of a condominium declaration highlight the notion that the declaration gives a unit owner undivided ownership in the common elements. If the declaration could be rejected, the very ownership rights enjoyed by the unit owner integral to the notion of the condominium form of ownership would be severed. This reasoning does not follow for HOAs. Unlike condominiums, HOAs are structured so that the common areas can be separately conveyed, encumbered, or even sold. If for some reason the HOA’s common areas were severed from the HOA, each homeowner’s fee title in her individual lot or townhouse would not be disturbed. In a condominium, however, the common elements are not subject to partition and one cannot convey or encumber a condominium’s undivided common element interest without conveying or encumbering the corresponding condominium unit. Id.

If an association’s declaration could be categorized solely as an easement agreement or restrictive covenant, the debtor clearly could not reject the declaration. There are many examples, however, of single-document contracts, such as operating covenants in a lease or noncompete covenants in franchise agreements, in which a debtor could not reject the affirmative covenants, but was permitted to reject the contractual obligations. See, e.g., *In re Steaks to Go, Inc.*, 226 B.R. 35 (Bankr. E.D. Mo. 1998).

An analogous argument could be made that, although the developer would remain bound by covenants that run with the land, it could reject the contractual aspects of the declaration under Bankruptcy Code § 365. An association should be prepared for the possibility of this argument, which taken in a light least favorable to the HOA, would mean that the developer could discontinue the services provided to the association as well as the day-to-day operation and maintenance of the association and its property.

**Rejection of the Development Agreement**

Like the declaration establishing the HOA, the development agreement
between the village and the developer most likely contains unfulfilled contractual obligations on the part of both the village and developer. The development agreement should contain certain regulations or restrictions on the use of the development parcel and is likely recorded in the development’s chain of title. Because of the similarities between the development agreement and the HOA’s declaration, the arguments in favor and against the developer’s rejection of the development agreement are the same: there are covenants running with the land that cannot be rejected and executory contractual obligations that potentially can be rejected. Unless the homeowners and the association are specifically affirmed in the development agreement as intended third-party beneficiaries of the agreement, however, the association and the individual homeowners will not have standing to enforce its terms under most state laws. Richland Calabasas L.P. v. City of Calabasas, 45 Fed. Appx. 661 (9th Cir. 2002) (unpublished opinion). The developer’s potential ability to reject the development agreement and not complete the remaining infrastructure of the development is cause for alarm for the association, its homeowners, and the local municipality. Those ramifications are discussed below.

Developer’s Other Contractual Obligations

The easement agreement entered into by the developer with the adjacent landowner would be classified as a noncontractual property right that could not be rejected under Bankruptcy Code § 365. If any of the contract purchasers seek to enforce their townhome purchase contracts, any contract executed pre-petition by the developer that has not closed is deemed executory, even if the townhomes are under construction or completed with occupancy permits. In re RLR Celestial Homes, Inc., 108 B.R. 36 (Bankr. S.D.N.Y. 1989). If the developer entered into any of the HOA service or management contracts itself and not on behalf of the HOA, the developer has the right to reject those executory contracts under Bankruptcy Code § 365 as well. The developer’s bankruptcy and ensuing rejection of the project’s service contracts could leave the homeowners with a financially distressed association and no maintenance, upkeep, or other services vital for the operation of the HOA.

Funds in Escrow: What About the Pool (of Money)?

In the above hypothetical situation, two escrow accounts are at issue: one holding earnest money of the 30 townhomes that are under contract but not yet closed (“Purchase Escrow”); and one in which the developer deposited sums collected at closing to help fund the construction of the security gate, clubhouse, and pool (“Pool Escrow”). The terms of the purchase contracts govern the terms of the disbursement of the Purchase Escrow and hopefully escrow agreements were executed by the developer and each purchaser to govern the Pool Escrow.

Under Bankruptcy Code § 541(d), any property in which the debtor holds legal title subject to the equitable interests of another, such as property held in trust, is not a part of the bankruptcy estate. E.g., Begier v. IRS, 110 S. Ct. 2258 (1990). Thus, to determine the status of the Pool Escrow, state law adjudicating each party’s exact interest in the escrow funds is instructive. The bankruptcy trustee in In re Atlantic Gulf Communities, 369 B.R. 156, 162–63 (Bankr. D. Del. 2007), sought the turnover of the escrow account securing the purchase of lots, arguing that under New York law, the debtor had both legal and equitable title of the escrow account. Under New York law, a depositor retains the right to funds in an escrow until the conditions of the escrow are met. Id. at 162. The bankruptcy trustee contended that, because the escrow contained funds from only the debtor, the debtor’s title was more than an equitable interest; thus, the escrow funds should not be excluded from the estate under Bankruptcy Code § 541.

Any funds of a debtor earmarked as “escrow funds” may not maintain that designation if a debtor disburse those funds, regardless of whether the debtor had the lawful right to disburse the funds. Careless accounting or intentional misappropriation of escrow funds by the developer does not appear to weigh into a bankruptcy court’s analysis of the fund’s owner. If the developer mistakenly deposits escrow funds into its operating account, even though that act may violate state law, nevertheless...
only the funds that remain in the escrow account are excluded from the bankruptcy estate. See In re Keown, 28 B.R. 949 (bankr. E.D. Penn. 1983). Even if the bankruptcy trustee is able to recover finds formerly held in escrow, those funds are considered recovered for the benefit of the estate under Bankruptcy Code § 550(a) and not for a particular escrow or account of the debtor’s that may have been in effect. In re First Capital Mortgage Loan Corp., 917 F.2d 424, 427 (10th Cir. 1990). Once any funds held in escrow are disbursed by a bankrupt debtor, for whatever reason or justification, those funds lose their status as being exempt from the debtor’s estate. An HOA may not be able to rely on any escrow funds as a source of recovery against a bankrupt debtor if that escrow has been disbursed.

**Drawing on the Letter of Credit and the Village’s Involvement**

Once the developer’s bankruptcy is filed, certain creditors are stayed from continuing to pursue their claims under Bankruptcy Code § 362. As previously noted, the developer would likely reject, or at least attempt to reject, the development agreement between itself and the village. The rejection, if successful, would constitute a default under the development agreement; and because the developer has not yet completed the project’s infrastructure, the village would have a right to draw on the letter of credit (LOC) that the developer submitted in connection with the terms of the development agreement.

The debtor or creditors might attempt to argue that the village’s pursuit of the LOC violates the automatic stay under Bankruptcy Code § 362. As previously noted, the developer would likely reject, or at least attempt to reject, the development agreement between itself and the village. The rejection, if successful, would constitute a default under the development agreement; and because the developer has not yet completed the project’s infrastructure, the village would have a right to draw on the letter of credit (LOC) that the developer submitted in connection with the terms of the development agreement.

Apart from the LOC, the association still may have open issues relating to whether the infrastructure improvements installed or proposed by the developer are dedicated to and accepted by the village. The HOA cannot assume that the development’s infrastructure is or would have been publicly dedicated. One of the allures that homeowners’ associations present to municipalities is that some are structured so that the association and the homeowners pay for most or all of the development’s infrastructure maintenance and repair. The development agreement and the development’s plat of subdivision should speak to the issue of whether the streets, sidewalks, sewers, light poles, and the like were dedicated to the village and, if not, the time and means for such dedication. Most municipalities are not required to accept dedication of privately owned infrastructure. The owner bears the burden of proving the dedication and acceptance. See Leisuretowne Ass’n, Inc. v. Township of Southampton, 2008 WL 4239448 (N.J. Super. Ct. App. Div. Sept. 18, 2008). The association should work with the local municipality to effectuate the acceptance of the development infrastructure to alleviate the association’s responsibility of care and maintenance. The HOA should be aware that acceptance is not automatic and that the village is not required to accept the dedication. First Illinois Bank of Wilmette v. Valentine, 619 N.E.2d 834 (Ill. App. Ct. 1993). Until the acceptance, the infrastructure is the responsibility of the association.

**Unpaid Taxes and Assessments**

Depending on state law requirements and the declaration’s terms, a developer may be responsible for payment of homeowners’ assessments as the “homeowner” of any unsold units. If so, the developer may be able to absolve itself of the unpaid assessments due and owing through the date the bankruptcy is discharged because courts allow a homeowner to reject the debt of association assessments as part of the bankruptcy. In re Rivera, 256 B.R. 828 (Bankr. M.D. Fla. 2006). Under Bankruptcy Code § 523(a)(16), however, once the bankruptcy is discharged, the developer cannot discharge post-petition assessments if the developer still maintains possession of any of the remaining townhomes. See 11 U.S.C. § 523(a)(16); In re Rivera, 256 B.R. 828 (Bankr. M.D. Fla. 2006).

In contrast to assessments, the unpaid taxes on the development are likely non-dischargeable debts that the developer must account for in its bankruptcy. Under Bankruptcy Code § 523, any property taxes incurred before the commencement of the case and payable after one year before the date of the filing of the petition are exempt from discharge. If the unpaid property taxes ripen into a recorded or other statutory lien against the property, the lien is still exempt from discharge under Bankruptcy Code § 523. E.g., In re Work, 58 B.R. 868 (Bankr. D. Or. 1986).

**Control of and Encumbrances on the Common Areas**

From a real property perspective, one of the most significant differences in condominiums and homeowners or other common interest community developments is that, in the former, the common elements are owned by all of the unit owners as tenants in common; in the latter, the common elements generally are owned by the association with rights granted to the homeowners to use
such common areas via the property’s declaration or master deed. Before the association’s ownership of the common areas, the developer owns and controls the common areas. Assuming state law does not regulate the issue of the developer’s control or ownership of common areas in HOAs, an artfully drafted declaration keeps the control and ownership of the common areas in the developer for as long as possible. A declaration could go so far as to keep the control and ownership of the common areas in the name of the developer until the developer believes that the association is ready and able to take control and ownership of the common areas. If state law does regulate common area control, most require conveyance of the common areas on a certain percentage of homes sold or a certain number of years from the date of recording of the declaration. UCIOA § 3-103(c) (§ 3-103(d) in UCIOA 2008 amendments).

As part of the developer’s financing of the project, the mortgage or trust deed recorded against the project likely encumbers the entire project, including the unsold homes and common areas. When the developer goes into bankruptcy and the common areas are not conveyed to the association, the common areas remain in the possession and control of the developer with the developer’s mortgage encumbering the same. While the developer is insolvent and the bankruptcy proceeding continues, the maintenance of the common areas could wane unless the bankruptcy court appoints a receiver—which, as mentioned above, the homeowners could advocate. If the homeowners somehow gain control of the association and can maintain the common areas under the terms of the declaration, this control would be subject to the ownership of the developer and mortgage or trust deed of the developer’s lender. Under normal circumstances, when the developer does convey the common areas to the HOA, most states require the release of all liens on the common area before the conveyance. See, e.g., UCIOA § 4-111(b).

The HOA or the collective homeowners, acting on behalf of the HOA, can petition the bankruptcy trustee to effectively sell the common areas of the development to the HOA free and clear of any liens under Bankruptcy Code § 363(f). Although the specifics and complexities of a Bankruptcy Code § 363 sale go beyond the scope of this article, the association should be aware of such a possibility. A Bankruptcy Code § 363 sale will not convey the common areas free and clear of a lienholder’s interest if the price of the estate property is equal to or less than the aggregate amount of all claims held by creditors who hold a lien or security interest in the property being sold. Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC), 391 B.R. 25, 40–41 (B.A.P. 9th Cir. 2008).

The hodgepodge of common areas in an HOA (streets, curbs, sidewalks, security gates, and the like) are valuable to the HOA owners they serve but have no value in the open market. Attempting to establish a value is therefore unproductive. See, e.g., Breezy Knoll Ass’n, Inc. v. Town of Morris, 946 A.2d 215 (Conn. 2008) (holding that the common areas of an HOA have nominal value because of encumbrances that solely benefited the association’s neighborhood resident members). The valuation element of selling the common area of the project to the HOA is but one of the issues that could prevent a Bankruptcy Code § 363 sale of the common areas to the HOA.

The difficult task of obtaining control of the common areas or gaining a release of the developer’s mortgage on the common areas can also rest on how the declaration is drafted and the association is structured. If the declaration specifically provides that the developer will convey the common areas to the association free and clear of encumbrances, an association can seek to quiet title in favor of the association under that provision. See, e.g., Razak v. Marina Club of Tampa Homeowners Ass’n, Inc., 968 So. 2d 616 (Fla. Dist. Ct. App. 2007). But, if the governing declaration does not require the conveyance of the common areas to the association, the association cannot claim an absolute future interest in the common areas. An association’s claims to the common areas via promissory estoppel, constructive or equitable trust, or implied equitable estate have been held unpersuasive if the declaration gives the developer only the option, but not the requirement, to convey the common areas to the association. See In re Fairfield Pagosa, Inc., 97 F.3d 247 (8th Cir. 1996).

Because the developer’s mortgage was recorded before the recording of the declaration and the homeowners’ purchases of their townhomes, the homeowners were placed on notice of the mortgage’s encumbrance of the common areas. This element of record notice to the homeowners precludes many arguments that the homeowners or an association might otherwise have to obtain title to the common areas free and clear of the mortgage. Sun Valley Hot Springs Ranch, Inc. v. Kelsey, 962 P.2d 1041 (Idaho 1998).

**Conclusion**

Because of the relative immaturity of case law addressing noncondominium HOAs and lax state regulation, this article unfortunately presents more issues than it resolves. Much of this article’s guidance may be moot because many developers would simply liquidate through a Chapter 7 bankruptcy filing. In the instances when a developer looks to reorganize through Chapter 11, however, a homeowners’ association will face a number of complex issues. With an inactive developer in bankruptcy, court intervention will be necessary for the homeowners to do even the most mundane tasks on behalf of the association. Turning over the association, obtaining an accounting of any escrows held by the developer, or receiving clear title to the common areas will not come easily or cheaply. In undertaking to represent homeowners facing a developer’s bankruptcy, counsel should hedge the expectations of the homeowners because few issues present straightforward or predictable outcomes. Most will require litigation. Proactive homeowners and good bankruptcy counsel can minimize the financial distress of the HOA and limit the damage to the project and the association, which will undoubtedly be left with some of the fallout from the developer’s bankruptcy.