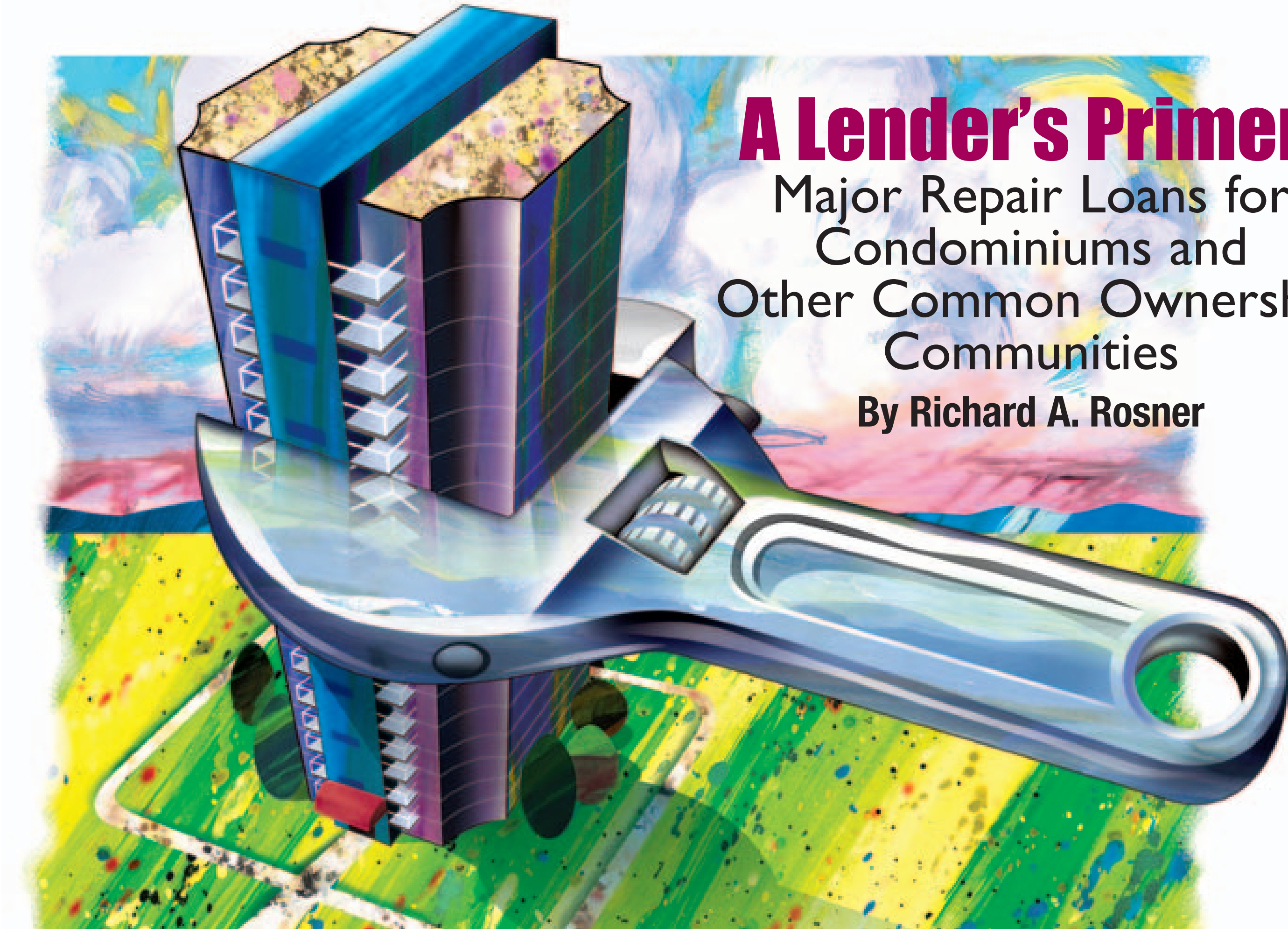

A Lender's Primer:

Major Repair Loans for Condominiums and Other Common Ownership Communities

By Richard A. Rosner

The condominium form of ownership in the United States is the product of enabling legislation enacted the last half of the 20th century. Many condominiums and other recently recognized common ownership communities may be facing major repairs, replacements, and renovations. Providing for such major repairs is more acute if a building was originally constructed as a rental apartment building and converted to a condominium form of ownership after the adoption of a condominium statute. In such a case, the building most likely will be more than a half century old. This article deals with sources for funding the major repairs with emphasis on loans to associations to finance these repairs.

Funding Major Repairs Through Reserves

The ideal source for funding major repairs is from adequate repair and replacement reserves built up by the association over the years. Even if the governing documents mandate the establishment of reserves (a requirement of the Federal National Mortgage Association Guidelines), that requirement does not guarantee that the reserves will be adequate to fund major repairs. The association's board of directors or the association's management company should budget for the cost of the major repairs based on realistic cost estimates updated on a current basis. The board may consider engaging a consultant that specializes in representing associations in the budgeting of major repairs. Even with careful planning, however, the reserves may be inadequate if major structural components (roads, bulkheads, foundations, or roofs, among others) need replacement before the projected expiration of their estimated remaining useful life, or if an unexpected major expenditure was not included in the budget (installing bulkheads resulting from erosion, for example, or unstable waterfront soil conditions). Other options, therefore, need to be considered.

Funding Major Repairs Through Cash Payments or Individual Loans

Another source of funding major repairs is the imposition of a one-time cash assessment that would force all property owners in the community to pay a proportionate share of the expenses. A substantial cash assessment, however, could result in a tremendous hardship on homeowners who do not have the financial wherewithal to pay their share. An assessment also could create divisiveness among the homeowners and could, ultimately, result in homes being placed for sale at below-market prices and in a general decline in the value of homes within the community.

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To address some of these problems, homeowners could be given the opportunity to pay the assessment over time. The association could arrange individual loans for homeowners, as opposed to the association's obtaining a loan, or the homeowner could arrange for his or her own financing. If the association arranges for the homeowner to obtain a loan, the homeowner would sign an interest-bearing promissory note that may or may not be secured by a mortgage on the owner's home. The note and mortgage could run directly to the lender or could run in favor of the association, which, in turn, could assign the same to the lender as security for a loan obtained by the association from the lender.

Alternatively, the association could levy a special assessment for the major repairs and file a lien against each homeowner who does not pay the assessment within the payment period specified in the governing documents (30 days, for example). The lien could then be assigned by the association as collateral for a loan from a financial institution; but this alternative is not desirable to all homeowners because it may violate a loan covenant contained in the homeowner's first mortgage prohibiting involuntary liens and, in addition, may have an adverse effect on the homeowner's credit.

Funding Major Repairs Through Financing Obtained by the Association

A third source of funding, and the primary focus of this article, is for the association to obtain a loan on behalf of some or all of the unit owners to fund major repairs. Not surprisingly, few lenders are familiar with this type of loan, and they need to become comfortable with its mechanics and underwriting.

Amount of Loan

After the association's board of directors determines what major repairs are needed, the board must determine the anticipated costs. The association, acting through its board of directors or a board-appointed committee or the association's management company, should retain the services of engineering and/or architectural firms to determine the scope of the work needed, prepare specifications, and estimate the cost of the project. The association should then obtain bids from reputable contractors for performing the major repairs.

Because the board of directors owes a fiduciary duty to the association's members (the homeowners), it is highly recommended that the bid specifications require a guaranteed maximum construction price and obligate the contractor to post a performance bond or other adequate security to assure lien-free completion of the major repairs. The use of a performance bond will also enhance the association's ability to obtain favorable financing. Incidentally, this procedure should be followed whether or not the association intends to finance the cost of the major repairs.

The governing documents need to be reviewed to determine if the board has the authority to borrow funds to pay for the major repairs.

After the board of directors has determined the need and cost of the major repairs, it should make an application to a lender to obtain a loan commitment to fund the repairs. The board should determine the portion of the cost that is to be funded from cash reserves and/or by a direct payment from homeowners to the association, and how much will be financed. The lender will typically require a portion, usually at least 25%, of the cost of the project to be funded in cash by the association.

Authority for Loan

Concurrently with the board of directors' determining that a loan is necessary, the directors should also ascertain if they have the authority to authorize the major repairs and obtain the financing. Typically, the board has the authority on its own to make repairs and replacements, but not the authority to make capital additions or improvements over a threshold amount. The latter generally requires the vote of a percentage of homeowners as specified in the declaration or other governing documents (typically, a majority of the voting power of the association). The governing documents need to be reviewed to determine if the board has the authority to borrow funds to pay for the major repairs. A situation may exist in which the board has authority to make major repairs but does not have authority to borrow funds.

If the major repairs are substantial or if capital additions or improvements are proposed along with the major repairs, or if the board is unsure if the work should be classified as major repairs or as major improvements, it is strongly recommended that homeowner as well as board authorization be obtained. Sometimes, it is unclear whether the proposed work constitutes a replacement or improvement. For example, courts have held that replacing windows with identical windows is a replacement but that replacing windows with a different type of a window (replacing single pane windows with double pane windows, for example) would constitute an improvement requiring homeowner as well as board approval. Lenders typically will require the board of directors to provide evidence of authorization for a loan and may require an attorney's opinion that the major repairs and loan are duly authorized. The fact that board members are volunteers whose terms of office are limited gives a greater argument for homeowner approval of the major repairs and of obtaining a loan to pay their cost. If the board of directors lacks the authority under the governing documents to effect major repairs or to borrow funds, the board should seek to amend the governing documents at the time it seeks homeowner approval for the major repairs and for authorizing the obtaining of a loan to fund their cost.

This action will alleviate this obstacle for loans to fund future major repairs. It is at this point the board should work hand-in-glove with the association's legal counsel.

Lender Due Diligence

The lender should perform many of the due diligence activities that it would do for any real estate improvement or construction loan. For example, the lender should have its architect, engineer, or construction inspector review the schedule, the plans and specifications, and the cost estimates and bids for the major repairs. In addition, the lender should inspect the property to ascertain whether it is being well maintained. Are the lawns and other landscaping attractive? Are the recreation facilities, if any, maintained? Do the buildings need painting?

The lender should then review the books and records of the association to determine whether the association budget is adequate not only to pay off the loan, but also to maintain the common elements of the community. It should determine how many homeowners are delinquent in the payment of their maintenance fees and what measures the association is taking to collect such delinquencies. It should have its counsel review the declaration, bylaws (code of regulations), resolutions, and the articles of incorporation of the association to determine whether such documents comply with state law and which provisions affect the rights and obligations of a lender. The lender should check the historic sales prices of homes in the community to ascertain whether they have declined in value, have held their value, or have appreciated in value. Naturally, a loan to an association whose homes have held or have appreciated in value is more comforting to a lender than a loan to an association whose homes have declined in value. The lender should also examine owner turnover to determine the stability of the community and, if the documents permit owners to lease a home, the number of leased homes. Generally, a community that has little owner turnover or has a large percentage of owner-occupied homes is a better credit risk than a community that has a high owner turnover and/or a large percentage of investor-owned, rented homes.

The lender should perform many of the due diligence activities that it would do for any real estate improvement or construction loan.

Loan Documentation

The documentation for a loan to an association is similar in many respects to a real estate improvement or construction loan, but with one major exception: the loan generally is not secured by a mortgage on real estate. This deviation is required because a condominium association generally does not own the common elements, including the real estate (the common elements are owned by the homeowners as tenants-in-common). In other types of communities, the homeowners' association does own the common areas but they have little or no value for loan collateral purposes because the common areas are subject to homeowners' association documents that prime any mortgage. Therefore, instead of using real estate as collateral, the loan is secured by a pledge or collateral assignment by the association of assessments (generally a special assessment approved by the homeowners) to the lender, which is similar to the assignment by a commercial borrower of accounts receivable to a lender as security for a loan. The following is a list of the documents that will generally be used to originate, evidence, or secure a loan to an association to finance major repairs.

Loan Application/Commitment. The loan application submitted by the association to the lender sets forth the basis for the loan. At the time the association delivers the application to the lender, the lender will generally require a loan application fee. The loan application is typically on a form provided by the lender and contains the borrower's name, the loan amount, the loan purpose, and the loan term. Sometimes the application will "ripen" into a loan commitment upon acceptance by the lender, but more typically the lender will issue a separate loan commitment. From the association's point of view, the more detailed the loan application and loan commitment, the better. A comprehensive loan application and loan commitment will help avoid future misunderstandings about the loan terms and the loan documents. If a loan does not go forward because the lender is not satisfied with the appraisal, the association's financial records, the condition of the property, or other matters not within the association's control, the lender should refund to the association the application and/or commitment fee, less the lender's direct out-of-pocket expenses.

Loan Agreement. All the documents that evidence or secure the loan flow out of the loan agreement between the lender and association. The loan agreement will contain provisions dealing with the following matters:

- the fees and expenses to be charged to the association;
- conditions for disbursements of loan proceeds, including budget requirements, retainage requirements, permit requirements, and bonding and insurance requirements;
- representations and warranties that the loan documents have been duly authorized and that they do not violate the provisions of the governing documents or any other documents to which the association is bound;
- that the financial statements given by the association to the lender fairly present the financial condition of the association as of the statement dates and that there has been no adverse change in the association's financial condition since those dates;
- that while the loan is outstanding, the association will maintain

its existence and will not amend its governing documents without the lender's prior written consent;
- that the plans and specifications for the work comply with all laws and regulations, including zoning and building laws;
- that the association is not aware that the property contains hazardous or toxic substances or pollutants as defined by federal, state, or local laws or rules and regulations;
- that while the loan is outstanding, the association will covenant not to materially amend or deviate from the approved plans and specifications for the work without the lender's prior approval, will provide funds to cover any cost overruns, will comply with the mechanics' lien laws of the state and will discharge any lien or claim filed for the work, will provide the lender with a list of all homeowners whose assessments are delinquent beyond a specified period of time (60 days, for example), and will file a lien against a delinquent homeowner and initiate collection proceedings if the assessment remains delinquent for a specified period of time (90 days, for example);
- that give the lender the right (but not the obligation) to take over and complete construction if the association defaults; and
- that, if permitted in the jurisdiction where the property is located, provide for the association to pay the lender's legal fees and for both parties to waive their rights to a jury trial.

Promissory Note Evidencing the Loan. Typically, the association will pay interest during the construction period (generally, the first year or two of the loan) and will make monthly payments of principal and interest for the balance of the term of the loan (generally, a term not to exceed five-to-seven years from the inception of the loan). During the construction term, interest typically will be paid from the loan proceeds. Generally, the mortgage note will "float" against "prime" or another recognized loan index during the construction period and will be "fixed" during the loan amortization period.

Security Agreement. The security agreement between the association and the lender will provide for the collateral for the loan to be a special assessment passed by the board of directors and, most likely, also passed by the homeowners. In addition, if the assessment is not uniformly imposed on each homeowner, the association should provide the lender with a schedule showing the percentage interest of each home in the common elements in the community and the amount of the assessment attributable to each home.

> The loan is secured by a pledge or collateral assignment by the association of assessments to the lender.

UCC Financing Statements. UCC financing statements should be prepared and filed, perfecting the lender's security interest in the special assessment and other collateral for the loan.

Collateral Assignments. The following collateral assignments are also commonly used:

- collateral assignment of permits, licenses, contracts, and warranties;
- collateral assignment of architect's and/or engineer's contracts, with acknowledgment of the assignments by the architect and/or engineer;
- collateral assignment of the construction contract with the acknowledgment of the assignment by the general contractor;
- collateral assignment of condominium assessments, to give the lender the right to enforce the assessments against delinquent homeowners, if the association fails to perform such enforcement, and the right to seek the appointment of a receiver;
- collateral assignment of insurance proceeds;
- collateral assignment of the management agreement, with the acknowledgment by the management company of such assignment; and
- collateral assignment of a deposit account and operating accounts to be established by the association with the lender.

Due Diligence. Typically, the following due diligence items will be required:

- *Insurance*—Hazard and liability insurance coverage with evidence of payment of the first year's premium.
- *Legal Opinion*—A legal opinion from the association's legal counsel that the association is a not-for-profit corporation duly organized and validly existing in the state where the common ownership community is located, is in good standing, and has the legal capacity and authority to perform its obligations under the loan documents; that the major repairs have been duly authorized by the homeowners and the board of directors; that the signing, delivery, and performance of the loan documents have been duly authorized by the homeowners and the board of directors and do not violate the governing documents of the association; that the loan documents are valid and binding obligations of the association, enforceable in accordance with their terms; and that the lender has a first lien and perfected security interest in the special assessments securing the loan.
- *Certified Copies of Agreements*—Complete and accurate certified copies of the management agreement, service contracts, and other agreements in connection with the use, operation, management,

maintenance, or repair of the community.

- *Certified Copies of Governing Documents*—Complete and accurate certified copies of the recorded articles of incorporation of the association, condominium declaration, or homeowners' declaration, bylaws (code of regulations) of the association, and all amendments to such documents, certified by the secretary of the association as true, complete, and correct, and a good standing certificate issued by the secretary of state of the state in which the community is situated. The lender may require a covenant from the association that it will not allow the declaration and other governing documents of the association to be amended while the loan is outstanding without the prior written consent of the lender.
- *Resolutions*—Resolutions of the board of directors and of the homeowners authorizing the major repairs, the assessments, and the loan.
- *Financial Information*—Copies of the last three years' financial statements of the association and a schedule of any delinquent homeowners.

Notice to Homebuyers of Assessment and Loan

The lender should make sure that the association provides notice of the special assessment to the prospective purchasers of homes within the community and obtains the assumption by each purchaser of the assessment on the home being purchased. To the extent practicable, the association should also require homeowners who are selling their homes to include a provision in the sales contract disclosing the assessment and requiring the buyer to assume it. In addition, some states have adopted legislation requiring a "seller's residential disclosure statement" form for the resale of homes that specifically requires a seller to disclose any pending or proposed assessments. Of course, by negotiation between the parties, the sales contract can provide for the selling homeowner to pay off the unpaid balance of the assessment attributable to his or her home, in which event the home will be conveyed free and clear of the assessment. If this occurs, the association should pay these funds to the lender and provide the buyer with an acknowledgment from both the lender and the association that the assessment against the home has been paid.

Conclusion

Although a loan to an association does not "fit" traditional loan parameters, the loan, if properly underwritten, should be looked upon favorably by a lender. Not only will the loan enhance the lender's portfolio, but it also will provide the lender with an excellent marketing tool to attract personal and business loans and accounts from the residents of the community. ■