Banking Tips For Lending To Calif. Homeowners Associations

By **Alex Grigorians and Alan Linch** (June 1, 2023)

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Recent challenges in the financial markets, coupled with recent changes in California law to bank remedies following a default, have placed a brighter spotlight on California lending, including on homeowners association banks and borrowers.

Combined with the wave of California housing legislation designed to streamline development entitlements, more multifamily housing is being built in the state, and as a result, more HOAs are being formed, often with lending needs such as funding capital improvements or making repairs to common areas or other HOA assets.

This article outlines several HOA lending practice tips and provides an overview of current remedies for banks under the Davis-Stirling Act.

The Davis-Stirling Act and Its Role in HOA Lending

Since its passage in 1985, the Davis-Stirling Act has been the primary body of California law governing residential common interest developments. The act is the foundation for every HOA in California, providing a self-governance framework through its rules on HOA assessments, standard disclosures, insurance and reserve requirements.

Importantly, most HOA loans are secured by special assessments approved by the HOA membership, and the owners are responsible for their individual portions of the assessment.

California is not a so-called super lien state like 22 other states, where HOAs are able to recover some money they might have otherwise lost from unpaid maintenance fees. Instead, when a California HOA loan goes into default, banks typically have the right to collect HOA assessments directly from the delinquent homeowner.

Regular Assessments vs. Special Assessments

As a first step, California banks should understand the difference between the two types of HOA assessments covered by the act: regular assessments and special assessments.

For each assessment type, HOAs may not impose or collect an assessment or fee that exceeds the amount "necessary to defray the costs for which it is levied."[1]

Regular assessments are customarily levied annually and collected in monthly installments or as otherwise specified by the HOA's governing documents, such as bylaws or certain covenants, codes and restrictions, or CC&Rs.[2]

Special assessments are levied on an as-needed basis to meet expenses of an extraordinary or capital nature and may be payable in a single installment or over an extended period.

Banks that programmatically lend to HOAs should also consider the act's additional special assessment rules, as follows:

- Special assessments may be imposed against a particular owner in order to reimburse the association for any costs incurred in connection with that owner's violation of the governing instruments, including the CC&Rs, bylaws, or rules and regulations of an HOA.

- Boards must exercise prudent fiscal management in maintaining the integrity of the reserve account, and may, if necessary, levy a special assessment to recover the full amount of the expended funds within certain time limits.[3]

- Except for emergencies defined in California Civil Code Section 5610, special assessments may not in the aggregate exceed 5% of the HOA's budgeted gross expenses for the fiscal year without approval of a majority of a quorum of the members.[4]

- The board may, at its discretion, extend the date the payment on the special assessment is due, although any such extension shall not prevent the board from pursuing any legal remedy to enforce the collection of an unpaid special assessment.[5]

Practical Tips in California HOA Lending

Critically, banks must understand that an HOA's cash flow belongs to the HOA and not the bank. As a result, banks should further secure their interests in the following ways:

1. Ensure that the HOA has the authority to provide the HOA collateral needed to secure a loan.

The scope of the HOA's authority to pledge future income is dependent on the HOA bylaws and CC&Rs and may be contingent on membership approval of a special assessment and approval authorizing the board to enter into a loan agreement with a bank. Civil Code Section 5735(a) provides the following requirements for such assignment and pledges:

(a) An association may not voluntarily assign or pledge the association's right to collect payments or assessments, or to enforce or foreclose a lien to a third party, except when the assignment or pledge is made to a financial institution or bank chartered or licensed under federal or state law, when acting within the scope of that charter or license, as security for a loan obtained by the association.

(b) Nothing in subdivision (a) restricts the right or ability of an association to assign any unpaid obligations of a former member to a third party for purposes of collection.

HOAs' authority to borrow is also addressed in California corporations law, which allows

corporations to obtain bank loans subject to any limitations found in the bylaws and CC&Rs.[6]

California's courts have weighed in on this interplay.

In Springs Villas II HOA v. Parth in 2016, California's Fourth Appellate District held that an HOA president or board member taking out a loan secured by HOA assets without a member vote cannot "close her eyes to matters as basic as the provisions of the CC&Rs and Bylaws of the Association and at the same time claim that she exercised business judgment."[7]

2. Recognize the scope of any HOA loan delinquency.

The bank's remedies in the event of an HOA loan default are generally guided by the scope of the delinquency. If a limited number of members are delinquent, foreclosed upon or declare bankruptcy, HOAs typically absorb these costs by adjusting the HOA budget.

If the number of delinquencies are significant and simply adjusting the HOA budget is insufficient to address the delinquency, the HOA has the option to pursue any remedies available to HOAs under state law as provided in Civil Code Sections 5700-5740.

A common scenario is that a bank would have the ability to increase the burden on all owners through higher dues or special assessments to make up the lost revenue.

3. Understand your default remedies.

Generally, following a default, banks, as the special assessment assignee, may step into the shoes of the assignor and therefore have all valid rights or remedies that the HOA assignor has.[8]

Such rights are influenced by the scope of the delinquency and include the ability to pursue all remedies the HOA would have to collect from the HOA member. Below is a summary of HOA remedies that would also be available to banks:

Late Charges

Special assessments are considered delinquent 15 days after they become due unless the HOA's bylaws or CC&Rs provide otherwise.[9]

For delinquent assessments, the HOA may recover any of the following unless otherwise provided by the HOA's bylaws and CC&Rs: (1) reasonable costs incurred in collecting the delinquent assessment, including reasonable attorney fees; (2) a late charge typically not exceeding 10% of the delinquent assessment or $10, whichever is greater; and (3) interest on all delinquent assessments, reasonable fees and costs of collection, and reasonable attorney fees at an annual interest rate not to exceed 12%, commencing 30 days after the assessment becomes due.[10]

Recording Liens

Banks are permitted to take a lien against bank accounts and have the right to force a special assessment in the event of a default. Civil Code Section 5700 details the following lien enforcement options for HOAs and a bank's assignees:

- After 30 days following the recording of a lien, enforce the lien in any manner permitted by law, including sale by the court, sale by the trustee designated in the notice of delinquent assessment or sale by a trustee;

- File an action against the owner of a separate interest to recover sums for which a lien is created pursuant to the special assessment payment and delinquency process; or

- Take a deed in lieu of foreclosure.

Foreclosure

Foreclosure is typically the remedy of last resort for HOAs and a bank's assignees to collect assessment debts.[11]

Before initiating foreclosure on an owner's separate interest, the HOA must first offer the owner, and if requested by the owner, the option to participate in dispute resolution pursuant to the HOA's meet-and-confer program or the act's alternative dispute resolution program.[12]

Binding arbitration is not an option if the HOA intends to initiate a judicial foreclosure.[13] The HOA must strictly comply with the act's notice requirements when recording notice of a delinquent assessment; otherwise, the assessment lien is not valid, was recorded in error and may not be enforced by judicial foreclosure.

In addition, delinquent regular or special assessments less than $1,800 may not be collected through judicial foreclosure unless the assessment is secured by a lien that is more than 12 months delinquent or for owners of separate interests in timeshare estates.

Remedies that may be sought before the lien is delinquent for 12 months include (1) filing a small claims court action; (2) recording a lien allowing foreclosure if the amount owed equals or exceeds $1,800 or becomes more than 12 months delinquent; or (3) any other manner provided by law, except for judicial or nonjudicial foreclosure.

An HOA or bank assignee must also accept partial payment made by an owner of a separate interest in a common interest development toward such a debt

and must apply that payment first to assessments owed, although this requirement does not apply for debts delinquent for over 12 months.[14]

Nonjudicial Foreclosure

Subject to the limitations for delinquent amounts under $1,800 noted above, nonjudicial foreclosure is also a remedy HOAs and assignee banks may pursue in the event of assessment delinquency. However, nonjudicial foreclosure is subject to a right of redemption, with a redemption period that ends 90 days after the sale.[15]

Civil Actions

HOAs, and in some cases bank assignees, have standing to institute, defend, settle or intervene in litigation, arbitration, mediation or administrative proceedings in its own name as the real party in interest and without joining the members, to enforce the HOA bylaws and CC&Rs.[16]

HOA Loans: A Win-Win Proposition

The bottom line is that while the California rules for HOA loans differ from traditional loans, HOA loans provide strong value creation opportunities for HOAs and banks.

HOAs are able to navigate large scale improvements or address financial shortfalls while still maintaining authority over their cash flows. Adding HOA loans to portfolios is an excellent strategy to increase a bank's deposits, at relatively low risk. With the security provided through rights to HOA assessments, banks may confidently plan on a reasonable return on investment.

Naturally, there is some level of risk involved on both sides of the transaction. But with proactive planning, banks can secure their interests without impediments from the HOA itself in the event of a default, with various remedies ranging from late fees to foreclosure on individual HOA member properties.

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[1] Civil Code 5600(b).

[2] Civil Code 5605(a).

[3] Civil Code § 5515(e).

[4] Civil Code §5605(b).

[5] Civil Code § 5515(e).

[6] Corp. Code §7140(i).

[7] Palm Springs Villas II HOA v. Parth (2016) 248 Cal.App.4th 268.

[8] Bush v. Superior Court (1992) 10 Cal.App.4th 1374, 1380; Casa Eva I Homeowners Ass'n v. Ani Construction & Tile, Inc., (2005) 134 Cal.App.4th 771, 783.

[9] Civil Code 5650(b).

[10] Id.

[11] Civil Code § 5720.

[12] Civil Code § 5705(b).

[13] Id.

[14] Huntington Cont'l Townhouse Assn., Inc. v. Miner (2014) 230 Cal.App. 4th 590, 606.

[15] Civil Code 51715(b).

[16] Civil Code 5980(a).