HYATT & STUBBLEFIELD, P.C.

The Client Letter

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Bent, Broken, or Unbowed? Community Associations in 2010 and Beyond

The following is an excerpt from Wayne Hyatt's keynote address at the 25th anniversary celebration of the Hawaii Chapter of the Community Associations Institute in October 2010. For a complete copy of the speech and to see Wayne's predictions on the future of community associations, please visit the Resources page at www.hspclegal.com.

First, let me explain what I mean by bent or broken. I think it is important for us all to ask what mistakes have been made and what lessons have been learned. We need to focus on the issue of how well has the community association concept stood up under the test of recent years and the challenges those years presented. Contrary to the position of some commentators, the model still appears to be quite viable and valuable, but it does show serious dents and cracks, calling for the next generational set of adjustments.

Let me address three areas of concern. These areas are financial, people, and the dark side of recent sales. A serious consequence of the financial difficulties of community associations today is their failure to meet obligations to local government. While many of these obligations were assumed on the association's behalf *by* their developers or were, more likely, imposed as conditions of permitting, the obligations remain. Infrastructure is wearing or in some cases is worn out. Associations are under-reserved. These and other associations have difficulty with normal assessments much less special assessments. They find it very difficult to replenish reserves and are unable to meet demands of deteriorating, aging infrastructure. In many cases, banks that would in the past loan to community associations are now unwilling to do so for a variety of reasons, some valid, some not.

From the people perspective, there has increasingly been an over-reliance on volunteers. This has simply produced a mismatch between the volunteer's capacity and the demands upon that capacity. These demands can cover a variety of topics, including the amount of time required to do the job in today's association world, the money required to meet the needs, and the level of experience of many board members. In the past, perhaps operational demands allowed less experienced individuals to be quite successful as board members but now press upon them challenges of a business nature that go beyond their day-*to*-day experience. As time and frustration press more painfully upon board members, their commitment is strained and is frequently replaced by apathetic resistance.

Said another way, the challenges facing community association boards are in many ways straining and perhaps have outgrown the structures available to meet these challenges. Statistics tell us that there are over 1.7 million individuals in America serving on community association boards. Most of them continue to serve admirably, successfully, and too often without the recognition and appreciation they deserve. Pointing out mismatches and challenges is in no way a derogation of the highly successful performance of so many of these 1.7 million people. But structures have become unnecessarily complex, and challenges *have* become daunting. Frequently, those willing to serve regrettably fall into the category of the willingness of the unfit. This not only exacerbates existing challenges but also creates an entirely new set of challenges.

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Transfer Fee Covenants Update

The Federal Housing Finance Agency ("FHFA") was created by Congress as part of the Housing and Economic Recovery Act of 2008. It is the regulator and conservator of Fannie Mae and Freddie Mac and the regulator of the Federal Home Loan Banks. In August 2010, FHFA published notice of proposed rulemaking (No. 2010-N-11) that would restrict Fannie Mae, Freddie Mac, and Federal Home Loan Banks from purchasing mortgages on properties in communities with "private transfer fee covenants." The term "private transfer fee covenants" is broadly construed to include any kind of fee that is payable on future transfers of the property and designed to generate income, regardless of who collects the fee or the intended use of the fee. This would include communities with covenants that provide for collection of such fees as contributions to working capital or capital reserves, for community enhancement, or to fund community councils or other nonprofit entities organized to promote cultural, educational, environmental conservation, historic preservation, and similar purposes.

The notice describes concerns, among others, that private transfer fees would increase homeownership costs; limit property transfers; destabilize the secondary mortgage market; and expose lenders and secondary market participants to risks from potential liens and title defects. FHFA's Acting Director, Edward J. DeMarco, expressed the view that private transfer fee covenants run counter to the government's efforts to increase liquidity, affordability and stability in the nation's housing finance system.

Our firm and a number of other organizations filed comments with FHFA during the notice and comment period, which ended October 15th, urging caution before enacting such extreme measures. There are a number of legitimate and beneficial purposes for imposing and collecting transfer fees. For example, transfer fees may be used to defer the administrative expenses that an owners association incurs in connection with transfers of ownership. The fees collected may be used as a relatively painless way to fund capital improvements or create operating and capital reserves. The fees collected may also fund discretionary programs that otherwise could be only be funded by increasing regular assessments or imposing special assessments.

Although some opponents believe that transfer fees unfairly shift the financial burdens of programs that benefit many to the few who sell their property, they often make a community more affordable for buyers than it would be if those same programs were paid for through higher assessments. Instead, buyers are able to enjoy the benefits while they live there and pay for them out of sales proceeds when they sell their property. By increasing the pool of buyers who can afford to live in the community and enhancing the appeal of the community to those buyers, the transfer fees also benefit those who are selling their homes.

It appears that the impetus for FHFA's proposed rulemaking is the relatively recent use of private transfer fee covenants as a tool to generate an income stream for the developer who records the covenant. In a typical scenario, the developer records the covenant against the land prior to the sale of the first lot. The covenant requires subsequent owners to pay a transfer fee upon each resale of the property for the next 99 years. Each time the fee is paid, the developer and the company selling the concept each receive a portion of the fee. To make it a little more palatable, sometimes a portion of the fee might also go to a nonprofit cause, but the basic idea is to provide a revenue stream for the developer (as well as the company marketing the concept) for decades to come.

We have urged FHFA to withdraw the proposed rulemaking in its entirety and allow state legislatures to address the issue. Seventeen states now have legislation restricting "non-beneficial" transfer fee covenants, and four other states have proposed similar legislation. Alternatively, we have urged FHFA to revise the proposed guidance by exempting transfer fee covenants that impose "beneficial" transfer fees, payable to owners associations or other nonprofit corporations that are devoted to the ongoing benefit of the land encumbered.

The rule, as currently proposed, could render title virtually unmarketable on existing homes that are subject to a transfer fee covenant. In some communities, owners associations have pledged transfer fee income to lenders to secure funds needed to build or renovate community facilities. Any homeowner whose title is encumbered by a transfer fee covenant could find it difficult to sell the property or refinance the mortgage, and, in most cases, the homeowner could not simply terminate or amend the covenant to restore marketability without the affirmative votes of a supermajority of association members.

In addition, Rep. Maxine Waters (D-Cal.) introduced a bill (HR-6260) in the House of Representatives to amend the Real Estate Settlement Procedures Act to prohibit certain types of transfer fees and to make anyone who attempts to collect the prohibited types of transfer fees subject to criminal and civil penalties. The bill has been referred to the House Committee on Financial Services.

FHFA reports that it has not yet completed its review of the comments. We will keep you informed of updates on the transfer fee issues as they are released.

Don't Rush to Make Changes in Club Membership Structures

A great many clubs are having a difficult time selling memberships in these economic times. In many cases, they have a lot of unsold inventory. At the same time, the club might be experiencing an expanding resale wait list. As a result, clubs are trying to think of creative ways to invigorate their sales programs to generate new interest or to tap into a new market.

If your club is considering making a change in the membership structure or offering new types of memberships or new membership arrangements, we encourage you to obtain legal advice before making any changes to ensure that the new structure or offering is permitted by the club documents and is structured to avoid inadvertently creating securities problems.

Depending upon how they are structured and marketed, the offering of club memberships can be considered a securities offering under state and/or federal laws, requiring registration of the offering with state or federal authorities unless an exemption is available. Failure to comply can result in significant liability for the club and those involved in the sale of unregistered securities. Most clubs will want to avoid the extra hurdles and costs that characterization as securities will cause.

In order for a club to create new types of memberships or to offer memberships with different terms or conditions than existing memberships, the club documents must authorize such action. If the club does not currently have such authority, the club documents may need to be amended. If a new type of membership is being created, the club documents also need to address all of the terms and conditions of such type membership, such as provisions for use rights, guest privileges, resignation, and payments to resigning members who hold that class of membership.

The bottom line is that, while the club may be very anxious to generate membership sales and additional dues income, you should not rush into new arrangements or marketing strategies until club management has carefully thought through all of the implications of such new plans. We can help you evaluate any proposed membership arrangements or marketing strategies to address potential problems.

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The third category of concerns involves the dark side of recent years' sales. Investor purchasers buying with the expectation that they would be in and out with great return, the consequences fraudulent transactions, the sales to those who were barely qualified to meet a mortgage much less pay a community association fee have all created issues of a financial nature as well as of comprehension of community association life and responsibility. This has limited the pool of experienced, available, and willing leaders for these community associations, resulting in a two-pronged problem. On the one hand, you have overwhelmed but honest individuals who through their own mistake as well as, in a regrettable number of cases, the blandishments of those seeking to make sales at any justification, have become involved in ownership where they are not capable of meeting the responsibilities of ownership. The other prong obviously is simply those who were dishonest. Whatever the prong, the problem remains.

As one looks at the areas of concern, it is important to ask a significant question. Are these problems systemic, localized, or project specific only? More likely, the problems are some of all of the above, and in some cases, the answer to specific problems will vary by substantive issue. Implicit in all of this is the larger question of: does the community association concept still work and, if not, is there an acceptable alternative? Do we look for that alternative, or is time, skill, and intellectual energy best served by investing them in finding ways to make the community association concept better? One should not ignore the successes nor turn ones back on a process that has served America and Americans quite well for well over a third of a century. Therefore, my conclusion is that we can and must find ways to make the community association concept work not only better today but be better prepared for the surprises of the future.

Most seriously, we must avoid denial. All of us involved in community associations need to acknowledge that community associations can, will, and do fail. Even as we recognize and honor success we should acknowledge the fact that there are serious abiding problems that need to be recognized, addressed, and cured.

I would be remiss if I did not acknowledge the impact upon the vital partner in the creation and operation of community associations -- the developer. There is now a greater fear of using community associations; there is a reluctance because of the mistrust that the community association might not work, and if it does not work, those who are residing within it will turn on the developer. This problem is made worse by the reduction in the number of experienced practitioners on the developer's side. As developers resume development, they need to ensure that they spend as much time understanding the community association aspects of their developments as they do other more traditional aspects.

As a caution to us all, we cannot be lazy, and we cannot be change averse. Following a herd mentality that all community associations are wrong or that one approach fits every

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situation will only lead us into further difficulties. By the same token, those of us involved in community associations at whatever level and whatever position must not be distrustful just as we must not be unjustifiably self assured. We must be willing to seek solutions, collegially and constructively. And we must engage nontraditional groups and organizations.

Unbowed? Hardly. It would be the height of folly and hubris to suggest that community associations are or should be unbowed. All of us involved in the community association industry should be chastened and should learn from the recent past. Now is no time for excessive self rectitude and a refusal to acknowledge problems that have and do exist in the concept. Therefore, it is important to share a few final thoughts. First, the problems with community associations are not yet over. The quality of workout teams and predator investors have presented a mixed bag. The result is, in too many cases, problems are made worse rather than better. This is not to criticize all such investor purchasers because there have been and will continue to be some very shining examples of purchasers who understand what they are doing and who are determined to do it right.

Community associations are still a vital component of the shelter industry. Community associations still reflect a dynamic and evolving private governance model that can and do in most cases meet its responsibilities, engender a sense of community, and provide more than just housing. Simply stated, by and large, community associations are doing their job throughout the United States where there are over 300,000 associations housing some 60 million Americans in 24 million housing units. In spite of the problems, I still believe the future is bright.

Inside News

Wayne Hyatt was the keynote speaker at the 25th anniversary celebration of the Hawaii Chapter of the Community Associations Institute in October. Contrary to rumor, Wayne has not yet retired. While he is spending more time at his Santa Fe home these days, Wayne continues to be a very vital part of the Hyatt & Stubblefield team. We will be sure to let you know when Wayne has actually retired.

Seasons Greetings from Hyatt & Stubblefield, P.C.
We wish you continued success and prosperity in the new year.

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