

for Board Members and Property Managers of Co-ops and Condos™

HABITAT

ARTICLE ARCHIVE

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ABSTRACT *Bankers Trust Company v. Board of Managers* firmly established the priority of a first mortgage over the lien for common charges. A look at why boards and agents should adopt, enforce, and pursue clear and forceful policies with respect to common charge defaults.

ARTICLE One of the most basic tasks assumed by the board of managers of any condominium is the collection of common charges. Common charges are customarily billed and payable every month. The challenge arises when a unit-owner defaults in payment and fails to respond to demand letters, default notices, or letters from the condominium's counsel. The board of managers and management must understand their legal position when unit-owners default and develop policies, procedures, and strategies to cope.

Section 339-z of the Real Property Law provides that a condominium board has a lien on each unit for unpaid common charges, together with interest on the unpaid amount. While this statutory lien will have priority over most others, the same statute specifically grants priority to the holder of any first mortgage. The statute further requires that, on the sale of a unit, all unpaid common charges must be paid for out of the proceeds of the sale.

These three provisions came head to head in *Bankers Trust Company v. Board of Managers of Park 900 Condominium*. In this case, Joseph and Josephine Pal owned two residential condominium units that were subject to a recorded first mortgage held by Bankers Trust. The Pals were significantly in arrears and the board of managers of the Park 900 Condominium filed liens against the units. Since the Pals also defaulted in the payment of their mortgage, Bankers Trust began a foreclosure action. The board took the position that the common charge liens would not be extinguished in the foreclosure action and also asserted that the foreclosure sale was a "sale or conveyance" that would require the payment of the unpaid common charges from the proceeds of the foreclosure. The supreme court's appellate division, and ultimately, New York's highest court, the court of appeals, ruled otherwise.

In its decision rendered on June 8, 1993, the appeals court held that a first mortgage foreclosure sale will extinguish the condominium's common charge lien, as the statute grants the first mortgage priority. (An exception exists: if the foreclosure proceeds exceed the first mortgage, in which case, the excess proceeds are available to pay prior liens, including those for common charges.) The court of appeals also confirmed that a foreclosure sale is not a "sale or conveyance" as set forth in the statute, which envisions a voluntary sale, and thus, the statutory requirement that unpaid common charges be paid out of the proceeds of a sale or conveyance is not applicable.

So what does this mean to a diligent board of managers when faced with a unit-owner's default? In the first case, it is never good practice to let many months of unpaid common charges accrue without taking action, even where the amount on the unit is relatively small or there exists a first mortgage that exceeds the value of the unit. There should be a policy in place that requires a reminder letter be sent to a defaulting unit-owner by the end of the month of the first default. By the second month, an additional demand letter from management and/or from counsel should be sent. Letter-writing does not rule out personal contact between management or a board member and the owner, and it is certainly appropriate to phone the unit-owner or arrange a meeting to amicably resolve things. Often, the unit-owner is suffering a temporary setback and some sort of payment arrangement can be made. Letting significant time elapse before making this contact with a defaulting unit-owner may make settlement more difficult, so early intervention is advised.

Sometimes the unit-owner is not willing (or able) to work out a payment arrangement. Once this is clear, the board should file its common charge lien in order to preserve priority over other creditors. The lien generally sets forth relevant information about the unit and unit-owner and the nature of the arrears as of the time of the filing.

If the condominium's bylaws provide for the collection of legal fees incurred by a unit-owner's default and provide that such fees be deemed common charges, the lien should also include a provision for legal fees. Although the statute is silent on the subject, at least one case has held that the recorded common charge lien will cover common charges and interest accruing following the recording. Thus, unless a court holds otherwise, there seems to be no need to file any further lien, even as subsequent common charges continue to accrue. The lien must be recorded against the unit in the city register's office. Once filed, it establishes the condo's priority over all other liens, with the exception of money payable under the first mortgage, and liens for taxes on the unit. While not required under the law, the defaulting unit-owner should be notified of the filing of the lien.

Having filed the lien, the board has protected its statutory priority, but still has not collected any money. If the unit-owner tries to sell or mortgage the unit, the lien will appear in a title search and payment of the lien will be required by the title company (and the buyer or lender) in connection with the sale or loan.

If the unit-owner takes no action to clear up matters, the board must do more. The board should determine whether or not there is a first mortgage affecting the unit. This can be accomplished by ordering a search from a title company. If there is one, contact the lender to find (a) the amount outstanding under the mortgage; (b) if the unit-owner is also in arrears under the mortgage; and (c) if the lender is going to take prompt legal action to foreclose. Formal notice of the default should be provided to the holder of the first mortgage, since the failure to pay common charges may well trigger a default. It is generally preferable if the first mortgagee takes the lead, since the board will not incur the significant out-of-pocket expense of prosecuting the case but will still be entitled to any excess proceeds to pay its lien.

If there is no first mortgage, or if the first mortgagee fails to take action, the board must decide if it will begin its own foreclosure, a process that can take a year or more to complete. There will be up-front legal and other expenses (sums that can possibly be recovered from the proceeds of the sale), and the costs of the foreclosure could even exceed the amount of the arrears. However, unless the unit-owner capitulates and pays, the arrears will continue and no common charges will be collected.

If the board does begin its own foreclosure, remember: in order to determine the bid to be made at foreclosure, a bidder will take into consideration the unpaid amount under the first mortgage (which will include principal, unpaid interest, late charges, and legal fees) because the foreclosure purchaser will acquire the unit encumbered by the first mortgage.

Also, if the defaulting unit-owner occupies the apartment, further legal action may be necessary to evict the unit-owner after foreclosure. In an up market, where the owner's equity exceeds the mortgage and other anticipated charges, the foreclosure may generate sufficient excess funds to also pay the condominium's lien. However, even if it does not, the new unit-owner must pay common charges, and this is the primary goal of the board's acceleration of the process: to once again have common charges regularly paid.

Whether or not the board elects to foreclose, it also has the option of starting a lawsuit against the owner seeking monetary damages. In New York City, if the amount in dispute does not exceed \$25,000, such an action may be started in civil court. While this is far less burdensome and typically less time-consuming than the prosecution of a lien foreclosure, an action seeking a money judgment would not have the benefit of the sale of the unit to generate proceeds to pay the arrears. If successful, the board would have to obtain a money judgment against the owner, which would become a lien on the unit. But that lien might sit behind a long list of prior lien-holders and judgment creditors. Also, if there is a tenant in the unit, the law provides the board with the right, under certain circumstances, to demand that the tenant pay rent directly to the condominium.

While the decision in the *Bankers Trust* case firmly established the priority of a first mortgage over the lien for common charges, this priority should not dissuade a board from acting aggressively when dealing with common charge defaults. A board of managers, together with its managing agent and experienced counsel, should adopt, enforce, and pursue clear and forceful policies with respect to common charge defaults in order to avoid unnecessarily protracted periods of financial shortfalls.

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