

Bent, Broken, or Unbowed?

Community Associations in 2010 and Beyond

Introduction

It is an honor to be asked to speak at the 25th anniversary dinner for the Hawaii chapter of the Community Associations Institute. Not only is this a special occasion in recognition of 25 years of service and growth for the Hawaii chapter, but it is also a thought-provoking exercise. I congratulate the chapter for 25 years of leadership, and I express my appreciation for the opportunity of being with you tonight to discuss a matter near and dear to my heart.

Let me first make a few comments about my perspective and approach. I am, as I have long been, an attorney representing developers in the creation and structure of condominiums, homeowner associations, and planned communities. But I am still a teacher. I still am and have also long been a seeker looking for answers and new approaches, recognizing problems that exist in our industry and in the planned community concept itself. So it is with that background that I share some thoughts with you this evening.

Obviously, my comments are one man's opinion, and they may be fraught with error and, in some cases, a bit over the top in looking for new approaches. However, my comments are framed by input from a number of colleagues, friends, and law partners.¹ While I sincerely appreciate their input, any errors and excess hyperbole are mine alone.

As I look at and seek to comment upon where we are in the community association field today and where we may find ourselves in coming years, the crystal ball is cloudy. This

¹ Pete Halter, Evan McKenzie, Ken Chadwick, Brent Herrington, and my partners Jo Anne Stubblefield and Jan Bozeman.

cloudiness arises for a number of good reasons, and it is probably appropriate to comment upon the nature of the fog. There are several layers of obfuscation.

First, the economy is still unsettled, and our industry is hung over. It is unnecessary for me to comment upon the problems ranging from excess production to foreclosures to the challenges presented by the financial markets. These are widely known and partially understood. However, the economy remains a major cause of the current situation as well as a cause of that situation's slow recovery. Another layer of fog arises from the sad fact that experience has been overtaken by events. Today's challenges and circumstances surpass the general level of operational acumen that was tailored and tested in a different, more positive era in which success, perhaps in some cases, came too easily. Skills and wills were not honed for a more difficult time. Today's challenges are unique to a different environment and are not met by commonly embraced practices and guidelines. In other words, business as usual no longer will address the challenges faced in this industry.

It has often been said that greed created the current situation and fear is keeping the situation in tact. Fear has replaced greed, and so long as people are subliminally or otherwise afraid of taking action, they become static with dangerous results. Situations which could otherwise be handled with a bit of courageous risk taking simply become exacerbated. Until there is a renewed commitment to going forward and to cleaning out the underbrush as one prepares the field for new planting, the fog will remain, and it is difficult to predict how things will be resolved until there is a commitment to resolve them.

It is also dangerous to engage in nostalgia. People say they wish to have the good times again, but the times will not be the same, and indeed there is good evidence that the most recent

"good times" were not in actuality good at all. Therefore we need new ideas, we need to strive for new approaches, and to redefine what is a "good time."

Several General Observations

Before venturing into more specific discussions, a few general observations are perhaps warranted. In part these observations explain the nature of the fog just discussed, but they also are free standing considerations that frame any discussion of the present situation and the prospects for improvement in the future. One overriding concern might be the fact that many experienced, highly qualified people who had previously been employed in the industry are gone. Major developers and senior, mid-level, and junior personnel in development companies, managers, service providers, and other professionals have all moved on to retirement, other jobs, or the limbo of "seeking other opportunities." This can and most likely will have a profound impact on the near term as others have to work through a learning curve and who, alarmingly frequently, do not bring the scars that exemplify the rubric of "mistakes made and lessons learned."

Another people-related issue is that many of those who created the mess are now trying to cure it; however, these people still do not understand community associations, community association law, or community association practice. This is perhaps most obviously seen as lenders and various investment vehicles seek to buy condominium and homeowners associations that are in distress and immediately seek to exercise dominion as if it were not encumbered by a set of covenants and other legal impediments that dictate how and when an owner might act. More on this in a bit.

Sadly, community associations have also failed to meet their obligations. The lack of accountability for performance in the privatization of public responsibilities devolved onto

private actors creates a serious problem not only for the community associations but also for local government. As the experience and the lingering hangover of this lack of accountability permeates future permitting and development processes, community associations are going to face greater scrutiny and increased reluctance on the part of local government.

There is also more interest in community associations and community association law and practice from those who ignored them in the past. This should be encouraged by those of us in the industry, and we should seek to engage these newly interested individuals and entities in a mutually beneficial, educational discussion. However, some see different opportunities in the current situation.

Some seek to create a new paradigm. Some seek to reform by suggesting new approaches to the old paradigm. Some seek to expand their own horizons and territorial jurisdiction by accreting community associations to their own methodology. And some seek to reposition their organizations to be more helpful. Regrettably, some seek simply to exploit. But within these various goals there are a number that can be quite helpful not only to the newly interested organization but also those engaged in community association activity.

However, one also finds a considerable amount of unfocused anger as well as those who are intent on engaging in the blame game. Some do this for their own aggrandizement and professional advancement. It is much easier to be a critic, and in American society, particularly in the scholarly society, critics are extolled while reasoned supporters are dismissed as sycophants. Therefore, it is harder to renew and go forward when those who need to be convinced wish to remain firmly determined that all is broken and unsalvageable.

Anger can be a very valuable tool and is certainly one of the recognized stages in the process of grief. Much of what has been experienced in the housing industry as a whole and in

the community association field specifically over the last several years could produce grief and engender legitimate, healthy anger. It is when anger becomes unfocused and a tool rather than a condition that it becomes dangerous. Regrettably, there are those who are now commenting on or engaged in discussing community associations who fall prey to this trait.

Unrelated to the previous discussion of anger, it is important to note that there is a new generation assuming leadership in the field. Not only is this the result of the aforementioned passing of the baton from many of the older generation, but it is also a reflection of the process of aging, natural retirement, and the fact that there are bright, interested, and engaged individuals, coming into the field. This should be encouraged, but hopefully we will not lose some of the history. These new leaders should build upon the accomplishments as well as the mistakes of their predecessors and not have to repeat their mistakes. Both the new and the old leadership cadre should embrace new ideas, energy, and skills; moreover, they must at all costs avoid a sense of entitlement or the perception that they believe that, because they are where they are and who they are, they know everything there is to be known and have all of the skills necessary to meet difficult, troubling times.

Bent or Broken?

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 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.

As previously mentioned, 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 overreliance 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 have 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. It is

important to note quickly that the 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.

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 of liar loans and 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.

What are some of the impacts?

Perhaps the most grievous impact of the bent and broken nature of community associations is upon the condominium form of ownership and the millions of unit owners. First, there are condominium projects that are doing quite well, are well financed, and are extremely well led. But they suffer the stigma of being called "condominium." Not for the first time in our industry's history, condominium has taken on a bad connotation. Thus, it is more difficult to sell, to finance, and to operate these otherwise well structured, well administered, and happy places to live.

The more serious side of the condominium experience is in the low and moderate income condominium, particularly condominium conversions that were done in haste, sold in the fever, and left to languish.

The homeowner association has done better than the condominium, although the HOA represents in many cases a greater demand on infrastructure and a greater responsibility that is frequently unmet. Resort homeowner associations have suffered more from the economy than from the structural problems inherent in the community association concept.

And lastly, I would be remiss if I did not acknowledge once again the impact upon the vital partner in the creation and operation of community associations - the developer. Please consider with me the long term impact on the development industry. 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 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. For example, community associations and public administrators have too long ignored each other. There is

much to learn each from the other, and experience has shown that qualified city managers have made excellent managers of large scale homeowner and property owner associations. By the same token, no organization should accept in whole cloth community association experience just as they should not reject that knowledge and experience.

Some Categories of Prophecy

Let me quickly address some categories and make some "predictions." An important caveat is that some of these suggestions are far out and may lead only to a pleasant chuckle on the part of the reader. However, they may also spark consideration that will lead to other ideas that will be better and more appropriately address a perceived problem. Experience has also shown, however, that sometimes the far out suggestion turns ultimately into the workable solution.

The categories are structural, operational, and regulatory.

Structural

Less tiers or layers of governance must mark future structural approaches. Too many projects have produced too many associations with too many separate governance bodies. Concomitant with the previous suggestion will be fewer boards of directors, and perhaps professional boards with special purpose entities that are created to meet some of the board responsibilities.

Less elaborate structures, projects, and amenities will lessen the obligations of board members and will be a reflection of the leaner project structures certainly to come as developers refocus their attention in a less elaborate way and build and sell smaller houses, smaller projects, and more focused amenitized projects.

The creative use of Internal Revenue Code section 501c(3) and (4) organizations had begun before the economic turn, and the appropriateness and utility of these organizations will continue and will in all likelihood be advanced. Not only do they provide creative tools, but they also have the certainty of the Internal Revenue Code and the Internal Revenue Service.

At the same time, the "transfer fee" is most likely a vanishing tool as valuable as it has and could have been. The abusive approach of some coupled with over aggressive regulatory responses has damaged if not fatally struck that tool. Consequently, developers and their counsel as well as association boards and their counsels will have to look for new, more acceptable alternatives to fund special, highly valuable services to the community association, its members, and the greater community.

Large developer subsidy agreements will, in my judgment, be a thing of the past as developers look for less demanding financial alternatives. By the same token, developers, their marketing departments, and counsel will consider rejecting the "one approach fits all" methodology for association governance too often seen in the past. It has been suggested that there might be associations with less regulation, less control in which individuals receive common area maintenance but are otherwise existing in a more laissez-faire governance environment. There is no reason that this approach could not or should not be employed. It simply requires people to think differently. An association that meets the "public works department" responsibilities but otherwise is free of regulatory or community building might well fit certain developments. Others would want a more fully developed regulatory as well as public services type approach. While I reject the sometimes heard argument that drafters are engaged in "corporate

managerialism" and are all corporate lawyers utilizing boiler plate, I do urge that drafters and developers must get out of their comfort zone and look for new approaches. The times are changing, and our documents, approaches and thinking must change as well.

There will be more professional management with a greater demand for experience, certification, and especially people savvy individuals engaged in the management business.

Operational

The Tea Party is not just for politics, and this phenomenon can and will be reflected in community association governance. Perhaps without the rubric of the Tea Party mantra or name, the phenomenon will be experienced in community associations.

The result of this will be more pressure on boards, old documents, and the system. It will further erode board authority and create a greater clamor for member governance or at least members more actively engaged in governance. While this can be a positive thing it can also result in dysfunction; however, one should not discourage or impede the injection of fresh ideas, but one should acknowledge the potential difficulties in implementation of such an approach. Apathy and resistance remain all too common, but replacing them with fierce involvement and mistrust will not necessarily be a positive.

While there will be reduction in intranets within communities, the social network phenomenon will be more obvious in association operation, and this is not necessarily a force for good. Bullying, whether at the schoolyard level, in the corporate boardroom, or in the community association is never a good thing. Bullying and misinformation do not create community. Social networking can have an impact within governance, within interpersonal relations, as a tool for stirring up litigation, and all of these can be both

positives and negatives. Regrettably, the likelihood is at least in the short term they will be negatives.

Outside the community, social networks can be used for publicizing a community, reviewing the community, and affecting sales and resales. The phenomenon of buyers wanting to know what others think about the product before they buy is well established in today's market place, and this will translate into the real estate market as well.

The reserve fund crisis continues, and as Brent Herrington has noted, community associations have been "eating the seed corn." An apt, prosaic explanation of exactly what has happened. Reserve funds have been depleted, not replenished, and in too many cases used not for capital expenditures but for operational ones. The inability and/or unwillingness to replenish simply makes this problem worse and invites regulatory intervention.

Regulatory

Pressures are building for regulatory activity. Some of these pressures are well informed and well intentioned while others may be less so. There is a need to tread carefully here but there may well be a need for some types of regulatory intervention. The question becomes: what kind, how, and by whom? At what level, local, state, or federal? Clearly there needs to be surgical not a hatchet response. And more seriously and less commonly seen to date, regulators or legislators need to understand more about the community association concept and the problems it faces before they simply respond with a proposed regulation or piece of legislation. Too often, the grand stand is more attractive than the learning curve.

But there is the possibility of federal and several state legislatures or regulatory interventions. There is also the possibility of lenders' increasing their requirements especially on the condominium and its finances.

There are proposals for new approaches or for more oversight through existing approaches during the period of developer control. These could examine reserve funds, audited financial statements, more transparency in governance, greater training of buyers and board members, greater involvement by owners pre-transition, and less subsidies with a more pay-as-you-go approach to ensure a greater fiscal viability.

Disclosures on resales as well as new sales would make a great deal of sense, and in today's environment, might reduce some of the problems that result from ignorance or inexperience. Regrettably, however, disclosures too frequently simply become a part of a bulk package neither read nor understood.

Conclusion

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 as previously noted, 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 made worse rather than made 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.

And throughout the fog and the dismay, there is some very good news indeed. 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 thousand associations housing some 60 million Americans in 24 million housing units. The 1.7 million board members are facing the governance and business responsibilities everyday and, in an overwhelming number of cases, doing their jobs well.

More importantly for the future, there is a Community Associations Institute and other organizations seeking to address problems, educate those involved in the industry, and advance the level of knowledge and experience and practice. And for the purposes of tonight, one would be remiss if one did not acknowledge the dynamic, experienced chapter here in Hawaii that for 25 years has provided a level of leadership that has marked the success of community associations throughout these beautiful islands. And lastly and most importantly of all, there are people like you here tonight, the leaders of your associations, your management companies, your law firms, the development entities and other organizations vital to the community association process. Because of people like you, in spite of the fog and in spite of the problems, the future is bright and for that I extend to you a sincere mahalo and aloha.