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Subordination Agreements and "60-day Letter" Agreements – Must Associations Sign Them? Should They?

In today's market, low interest rates have caused many residential property owners to seek home equity and refinance loans on existing homes. As we are all aware, however, the United States has experienced an unprecedented devaluation in residential home values over the past few years. This devaluation and the related economic recession have caused a huge number of home loans to go into default, with many local and national lenders becoming insolvent as a result of "writing off" bad loans that will never be repaid. The lenders that have managed to survive in this market are naturally looking for ways to ensure that future home loans, including home equity and refinance loans, are secure and will be repaid. One such effort involves requesting homeowner associations to limit their lien foreclosure rights by signing subordination agreements and "60-day letters."

In deed-restricted communities, the Declaration instrument typically grants the association a lien against a lot or unit to secure the owner's obligation to pay assessments. In most instances, this assessment lien is superior to any lender lien established as part of a home equity or refinance loan. (Note: An assessment lien of similar priority is also created under Texas Property Code §82.113 for condominium communities in our state.)

The foreclosure of a superior association assessment lien will typically "cutoff" or otherwise nullify a lender's subordinate lien under a home equity or refinance loan, leaving the lender with an unsecured loan and a greater risk that the debt will never be repaid. To ameliorate this risk, many lenders are now requesting (or demanding) that associations agree to subordinate their assessment lien to the one securing the lender's home equity or refinance loan. Lenders are also asking associations to execute "60-day letter" agreements, under which the association agrees to notify the lender at least 60 days prior to foreclosing its assessment lien or taking other collection action against the homeowner.

With ever increasing frequency, associations want to know whether they must, can or should execute these agreements.

Subordination Agreements

Is the association required to execute a subordination agreement?

The general rule is that associations are not required to sign subordination agreements. State law establishes no such requirement, and our firm has never seen an instance in which the governing documents for the association require it to agree to such subordination.

Is the association (acting through the board or members) authorized to subordinate its assessment lien?

If an association wants to entertain the possibility of subordinating its assessment lien, it must first look to its governing documents (typically the Declaration) to see whether the board (or, less commonly, the members) is authorized to approve such subordination. Many of the associations we represent are authorized to subordinate their lien (typically through board action) under their governing documents. If the board (or the members) does not have this authority, the association cannot agree to the subordination absent an amendment to the governing documents (again, typically the Declaration) creating that authority.

Should an association agree to subordinate its assessment lien?

Once subordination authority is located in the governing documents (or the documents are amended to grant that authority), the final (and most critical question) is whether it is in the best interest of the association to agree to subordinate its lien. Each board (or, if the members have the authority, the membership of the association) must weight the pros and cons of agreeing to subordination and make its own determination on this issue.

The advantages of subordination are that it increases the likelihood that members will be able to obtain home equity and/or refinance loans in a difficult credit environment. Home equity loan proceeds can then be used (but are not always required to be used) to make improvements to the home, which protects home values. Refinance loans can result in lower monthly mortgage payments, which in theory can free up owner cashflow to help pay assessments to the association.

These advantages aside, subordination can lead to some very significant problems for the association in the future. Chief among these is that the association is giving another lien (in addition to the lien under the primary mortgage) priority over the association's lien. This situation heightens the risk that a superior lien holder will foreclose, "cutting off" the association's lien and leaving it with an unsecured debt (i.e., unpaid assessments and related charges).

Another potential problem with agreeing to a subordination agreement is that it might be appropriate in one instance (e.g., the homeowner has a long track record of paying assessments on-time and will be using the proceeds to improve the property), but not in another (e.g., the homeowner has a history of assessment delinquencies and will not be investing home equity loan proceeds into the property). While granting subordination in the first instance and not in the second may be sound policy, it raises the risk that board will be accused of acting arbitrarily, and a board may feel pressure to approve subordination even in situations where the board believes that there is a significant risk that the owner will default and the lender will foreclose its lien.

In summary, in today's economic environment, homeowners are under ever increasing financial pressure, and a larger number are electing to not pay (or to slow pay) assessments. Given this fact, and the fact that lenders are initiating foreclosure actions more quickly when homeowners become delinquent ("cutting off" the association's lien rights if they are subordinate to the lender's lien), *we strongly advise that our client associations consider whether the risks of subordination outweigh the potential advantages, and that they not sign subordination agreements unless there is a broad consensus that the association should do so after receiving legal counsel.*

"60-Day Letter" Agreements

As discussed above, a "60-day letter" agreement is a contract under which the association agrees to give notice to the lender before the association undertakes certain collection actions, including foreclosure of the association's assessment lien. Failure to notify the lender prior to undertaking the specified collection action can subject the association to financial liability.

Must an association sign a "60-day letter" agreement?

As with subordination agreements, State law does not require an association to sign a "60-day letter" agreement, and our firm has never seen a Declaration instrument or other association governing documents that requires this approval.

Is an association authorized to execute a "60-day letter" agreement?

"60-day letter" agreements differ from subordination agreements in that the association is merely agreeing to take certain procedural steps (i.e., notifying the lender) before exercising its collection and lien foreclosure powers. In our opinion, the ability to self-impose these additional collection procedures typically falls under the general authority of the board to oversee the administration of the association, with no need for the governing documents to expressly authorize this act. That said, each association should seek legal review of their governing documents by counsel to confirm this authority before signing any "60-day letter" agreements.

Should an association sign "60-day letter" agreements?

As with subordination agreements, a board should weight the advantages and disadvantages to the association as a whole of signing "60-day letter" agreements before making any decision on this issue.

The advantages to signing these agreements are similar in nature to those resulting from subordination agreements (i.e., increase in the ability of members to get additional financing, which can lead to additional improvements to the home and/or a decrease in mortgage pressure on homeowner cashflows). Also, at least in theory, notifying a lender (especially one who holds a subordinate lien) that a homeowner is delinquent can cause the lender to pressure the homeowner to pay the delinquent assessments, and in some cases that delinquency may constitute a "default" under the related loan.

The disadvantage to "60-day letter" agreements are somewhat different to subordination agreements but are still significant. First, the execution of these agreements layers in additional collection procedures for the affected properties (i.e., mandatory lender notice), which must be tracked by the association and its manager, leading to greater administrative expense and a greater risk of liability should the required lender notice step be missed.

Additionally, if the lender requesting the "60-day letter" agreement has a lien that is superior to the association's assessment lien (i.e., the loan is a primary mortgage or the association has signed a subordination agreement), providing the lender advance notice of the association's intention to foreclose its lien may cause the lender to foreclose its superior lien during the 60-day waiting period, which again will "cutoff" the association's lien.

In summary, as with subordination agreements, *we strongly advise that our client associations consider whether the risks of signing a "60-day letter" agreement outweigh the potential advantages, and that they not sign these agreements unless there is a broad consensus that the association should do so after receiving legal counsel*.

Firm information

Niemann & Heyer LLP has been representing POAs and specializing in POA law for more than 20 years. Our lawyers have been instrumental in drafting virtually all POA law in Texas, including the Texas Uniform Condominium Act (Property Code Chapter 82) and the Texas Residential Property Owners Protection Act (Property Code Chapter 209). Connie Niemann Heyer is a past president and current board member of the Austin chapter of the Community Associations Institute, and is a lobbyist for the Texas Community Associations Institute Legislative Action Committee.

This article represents the opinion of our attorneys. Other attorneys may have different opinions.