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The Real Cost of Bad Debt

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How to Define It and What to Do about It

by Kenneth M. Arnold, MBA, CAM

In community associations, owners defaulting on their maintenance fees and assessments or paying them late have created a dilemma for owners, boards of directors, and property managers. This disruption in cash flow may be a manifestation of the mortgage crisis, but the real tragedy is that it affects people who worked hard for their down payment, borrowed within their means, budgeted well, and believed that they could afford their homes. It's a conundrum that requires skill and acumen to understand before it can be managed. The real cost of bad debt cannot be entered in a field on a spreadsheet or added as a budget line item, for the hardship and damage runs much deeper than the numbers show.

The figures alone do not tell the full story because there is a ripple effect and a cycle of pain that run parallel to these delinquencies. The fees owed the association are obvious, butother intangible yet very real costs are hidden and hurtful. Inadequate cash flow causes problems such as increased expenses for good paying members, reduced services, tension among neighbors, attrition in qualified board members, increased exposure to liability, a reduced quality of life, and ultimately a loss of community prestige that reduces property values. Before bad debt can be managed, it must be defined. From an emotional standpoint, it could be said that all delinquent debt is bad.

The reality is that most debt owed to an association—even that which is overdue—is collectible eventually. For our purposes, let's call the past due accounts receivable misbehaving debt. It's annoying and can considerably increase current costs to the on-time paying owners, but these debts are eventually paid and make their way into the association's coffers.

Also, misbehaving debt comes in many varieties and time cycles. The money deposited into the association's bank account three months late hurts less and costs less than money that is recovered years after it first went delinquent. What needs to be defined are the degrees of misbehaving debt and what can be done about them. Then we need to delineate further and determine if and how debt can be collected.

> The most important thing to remember is that a community association is just like any other business and should move aggressively to collect misbehaving debt and should limit its bad debt to only the amounts that are truly not collectable, which is a lot less than most people think.

Debt starts to misbehave when the unit owner is either unwffling or unable to pay maintenance fees and special assessments on time. It achieves a higher degree of misbehavior when an owner walks away with the intention of abandoning the unit and never pays maintenance fees ever again. These are two wide-ranging scenarios, but in both cases money can be recovered and the association can be made whole. In better times, this debt may have accounted for up to only five percentof a community association's budget. Today in Florida it is not uncommon to see that figure reach upwards of 25to 50 percent or more. As a result, it is incumbent upon associations to pay attention to their cash income (their "actual" income) in addition to their accrued income (their "expected" income) and to know how much of their expected income is misbehaving.

Collections are time consuming, can be expensive, and require specific knowledge of related practices and laws. Tmly effective debt collection efforts need to be handled by professionals who strictly adhere to the Fair Debt Collection Practices Act to protect the debt collector or property manager and the association from substantial liability.

The effects of misbehaving debt take a particularly heavy toll on the board of directors and the on-time paying owners in the associations. The board spends hours agonizing over budgets late at night, arguing over whether to raise mainte nance fees, make special assessments, or dip into the association's reserve funds. Their stress levels increase as they consider the options, which they may feel are few and limited. Personalities start to conflict, despair sets in, and a feeling of helplessness overcomes these directors. Property managers are put under pressure, resulting in reduced services and an unhappy community.

Facilities are neglected, preventative maintenance is postponed, and aesthetics are put on the back burner. Perhaps the pooi deck resurfacing project gets put off until next year, which could expose the association to liability if someone slips. Security service is cut back, thereby weakening a deterrent to vandalism and theft. The landscaper is asked to fix something for which he is not trained, licensed, or insured. Eventually hard decisions have to be made, such as whether to pay the water bill or the insurance. The more unhappy people are, the less likely they are to pay their maintenance fees on time, and the cycle of pain gets worse and worse. This is the real cost of misbehaving debt that cannot be calculated or characterized in numbers alone. All debt starts out as misbehaving debt, but when does it become the more problematic bad debt? Bad debt can be defined as accounts receivable that are deemed uncollect able and are therefore written off after the failure of reason able efforts to collect them. There is a process that an association, just like any other business, needs to go through before that money should be declared lost for all time.

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To classify uncollectable money as bad debt, misbehaving debt must go through a recovery process ideally directed by a professional, accredited, licensed, and insured collection agency specializing in community associations, and with the experience necessary to maximize the amount collected. Every effort must be made to collect that money, and although legal action as a remedy is a useful tool, it is not the only solution to collections problems that an association can use to retrieve their money adhere to the Fair Debt Collection Practices Act to protect the debt collector or property manager and the association from substantial liability. The good news is that associations and property management companies do not have to do this work, or pay out of pocket for these services, when and as they are performed.

There are collection professionals who wifi advance all the costs and fees necessary to collect these debts, making it easier for the association to proceed and perform collections correctly and efficiently. The association also has the option to take the delinquent accounts receivable to the private sector and monetize those assets (accounts receivable are real assets) to bring financial relief to the association. There are a number of corn
panies in Florida that will give associations non-recourse, zero interest, and no term advances for an assignment of the late fees and interest. This is a proven and viable option that many associations don't even know exist.

Finally, some people feel that when the bank forecloses, the process is over and the association is-stuck with bad debt or more commonly called a write-off. Foreclosure does not extinguish debt and owners who have walked away from their obligations to associations can be liable for the debt they left behind. Companies specializing in collections of this type of debt can collect from personal accounts or other property owned by the debtor. Also, this debt can be collected on a 100 percent contingency fee basis, and some companies will even pay the legal costs and fees involved, so there can be absolutely no risk to the association.

The most important thing to remember is that a community association is just like any other business and should move aggressively to collect misbehaving debt and should limit its bad debt to only the amounts that are truly not collectable, which is a lot less than most people think.

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