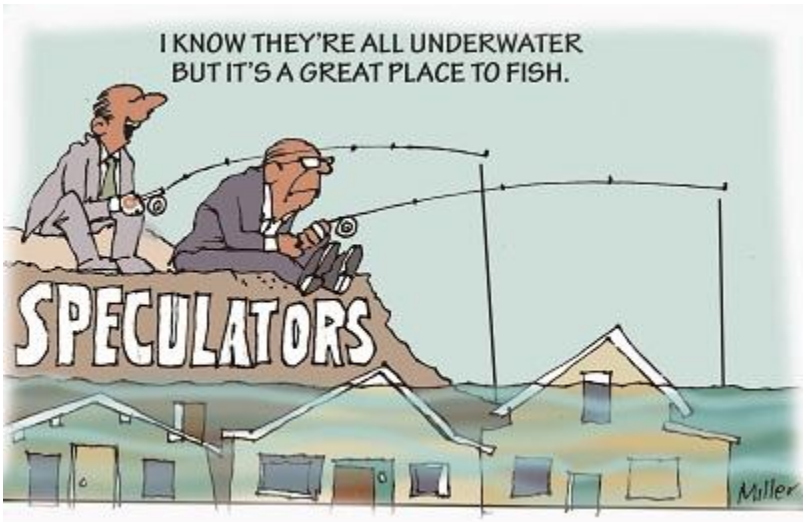
CORPORATE COUNSEL
AMERICAN BAR ASSOCIATION SECTION OF LITIGATION

Winter 2014, Vol. 28 No. 2

Can an HOA "Super-Priority" Lien Extinguish a Lender's Deed?

By Robin E. Perkins – March 18, 2014



It is hard to imagine that a lender's first-position deed of trust on a residence worth hundreds of thousands of dollars could be extinguished by a homeowners' association (HOA) lien for overdue neighborhood assessments, usually no more than a few thousand dollars. But this exact scenario is playing out across Nevada and has been the subject of contentious litigation that has flooded state and federal court dockets for more than a year. Currently, real-estate investors, lenders, and HOAs are anxiously awaiting a decision from the Nevada Supreme Court on the most controversial legal issue in the state: whether the foreclosure sale of an HOA's "super-priority" lien can extinguish a lender's first-recorded deed of trust.

The recent financial meltdown and associated real-estate collapse severely impacted Nevada and its citizens, with the state at one point experiencing the highest foreclosure rates in the country. To combat the effects of the crisis, the Nevada legislature enacted a number of provisions to protect homeowners and encourage lenders to modify loans and reach resolution short of foreclosure. These provisions reduced foreclosure rates, and as a result, opportunities also declined for real-estate investors to purchase distressed properties through lender foreclosure sales. So, with lender foreclosures decreasing, real-estate investors sought to capitalize on another investment opportunity, which has proven to be very profitable, and even too good to be true.

What Is the Fight All About? And Why Is It Only an Issue Now?

In 1991, Nevada adopted, in part, the Uniform Common Interest Ownership Act, codified as

Nevada Revised Statutes section 116.3116 et seq. The statute protects HOAs by creating a lien for unpaid HOA assessments and other related fees. One provision of the statute expressly states that the lien is subordinated to a first security interest, such as a lender's deed of trust. But a later provision grants the HOA a so-called "super-priority" lien position, even before the deed of trust, for the limited amount of nine months of assessments. The statute further allows an HOA to recover those amounts by foreclosing on its lien.

Until recently, HOAs rarely used the statute because prior to the real-estate collapse, Nevada's property values consistently appreciated and HOA assessment default rates were low. But the financial crisis significantly altered Nevada's once-enviable real-estate landscape. When homeowners stopped paying their underwater mortgages, they often also stopped paying their monthly HOA assessments, which typically average between $50 to $100 per month. As a result of the increase in HOA assessment defaults, HOAs began experiencing significant budget shortfalls. In response, struggling HOAs elected to record a lien under the statute and wait for the lender to foreclose. At that time, the HOA would be paid its super-priority lien amount before any other secured interest, including the lender's deed of trust.

But as a result of Nevada's policies protecting homeowners, and related provisions requiring lenders to participate in mediation (among other requirements), the amount of time it took a lender to foreclose substantially increased, often taking a year or more. Consequently, foreclosure sales were delayed and HOAs were no longer able to count on receiving payment, in relatively short order, from the lenders' foreclosure sales.

So, the HOAs took matters into their own hands. HOAs began holding purported foreclosure sales *en masse* on their super-priority liens. But at the HOA foreclosure sales, the properties are auctioned for little more than the amount of the HOA lien, typically between $3,000 and $10,000. Yes—a home with a fair market value of anywhere between $200,000 and $500,000 is sold for pennies on the dollar! It's an incredible deal—some would say literally too good to be true. Yet, real-estate investors are buying these homes at HOA foreclosure sales by the hundreds.

And Litigation Ensues

After the "sale," however, the investor-purchaser cannot obtain title insurance on the property because of the lender's first-position deed of trust. To clear title to its alleged "purchase," the investor must file a lawsuit to quiet title and for declaratory relief. And since late 2012, hundreds of lawsuits have been litigated in Nevada's state and federal courts over the proper interpretation of the statute, specifically whether the HOA sale extinguishes the deed of trust and who holds good title.

The investors' primary argument is that the HOA's super-priority lien should be treated as a "true priority" lien, the foreclosure of which extinguishes all junior liens, including the deed of trust. In response, lenders have asserted four basic arguments.

First, interpreting the statute as extinguishing the deed of trust violates the plain language of the statute. The investors' interpretation is contrary to the express provision that states that the HOA lien is subordinate to the deed of trust. Such interpretation violates the legal principle that all

provisions of a statute must be read harmoniously as a whole, so as not to nullify any one provision. Additionally, the investors' interpretation creates an absurd result—the evisceration of a first-recorded deed of trust so that an HOA's *de minimis* past-due assessments can be satisfied. And there is no need for such an extreme result because the HOA assessments can be paid out of proceeds from the lender's foreclosure of its deed of trust.

Second, as drafted, the statute violates a lender's state and federal due-process rights because it does not require actual notice to the lender of the HOA lien or the pending "foreclosure." Instead, the statute includes only "opt-in" notice provisions, requiring the lender to affirmatively request notice from the HOA. Such "opt-in" provisions have been struck down as violative of due process. *Small Engine Shop, Inc. v. Cascio*, 878 F.2d 883, 893 (5th Cir. 1989). And to date, many Nevada courts have agreed, finding the statute facially unconstitutional and void. *See, e.g.*, *Premier One Holdings, Inc. v. BAC Home Loans Servicing, LP*, No. 2:13-CV-895-JCM, 2013 WL 4048573, at *4 (D. Nev. Aug. 9, 2013) (stating that extinguishment of the deed of trust "potentially violate[s] due process."). Additionally, the statute is an impermissible taking in violation of both the state and federal constitutions. *See United States v. Sec. Indus. Bank*, 459 U.S. 70, 78 (1982) (finding that the government "simply impos[ing] a general economic regulation" that "in effect transfers the property interest from a private creditor to a private debtor" is a taking; and a "takings analysis is not necessarily limited to outright acquisitions by the government for itself").

Third, the purported sale of a property, for pennies on the dollar, is commercially unreasonable and thus void. Interestingly, if the HOA sold the property for a commercially reasonable value, the HOA would be paid its super-priority lien amount, and the remaining proceeds would be remitted to satisfy the lender's deed of trust, in an amount comparable to what the lender would have obtained at its own foreclosure sale. Therefore, simply requiring a commercially reasonable (and fully noticed) sale would arguably resolve these issues—without the need for expensive and protracted litigation.

Finally, the purchaser at the HOA foreclosure sale is not a bona fide purchaser and therefore lacks standing to assert claims to quiet title and for declaratory relief. A bona fide purchaser must take in good faith, for value, and without knowledge of any existing encumbrances. The HOA lien purchaser cannot meet these requirements because paying pennies on the dollar does not satisfy the "for value" requirement, and the investor is fully aware of the lender's first-recorded deed of trust.

After consideration of these and other arguments, Nevada's state and federal courts have entered hundreds of opinions on this issue. While the majority have ruled that foreclosure of the HOA super-priority lien does not extinguish the deed of trust, some courts have disagreed and found that the investor indeed owns the property free and clear. *See, e.g., Bayview Loan Servicing, LLC v. Alessi & Koenig, LLC*, No. 2:13-CV-00164-RCJ, 2013 WL 2460452 (D. Nev. June 6, 2013); *Weeping Hollow Ave. Trust v. Spencer*, No. 2:13-CV-00544-JCM, 2013 WL 2296313, at *3 (D. Nev. May 24, 2013) (holding that "the legislative history and intent of the statute, and a mountain of Nevada state and federal cases all hold that the lender's deed of trust is not extinguished upon a non-judicial foreclosure under the Statute"); *but see 7912 Limbwood Court*

Trust v. Wells Fargo Bank, N.A., No. 2:13-CV-00506-PMP, 2013 WL 5780793 (D. Nev. Oct. 28, 2013).

With so much at stake on both sides of the issue, it is no surprise that there are currently scores of cases on appeal to the Nevada Supreme Court. And while the impact of the decision on Nevada's HOAs, investors, lenders, and overburdened courts will be great, the most substantial effect will be on Nevada's citizens.

The Heart of the Matter: What Is Really at Stake?

As a litigator who has devoted the majority of her practice over the past 15 months to this issue, I can say it is easy to get bogged down in the intricacies and nuances of the legal arguments. But as with any issue affecting the lives of real people, it is important to take a step back and consider the bigger picture and real interests at stake.

The likely result of a ruling against the lenders would be a mass exodus of lenders out of Nevada and, thus, the inability of Nevada citizens to obtain mortgages and buy homes. Indeed, why would any lender make a loan and take a first-position deed of trust if that interest could be completely wiped out by an HOA "super-priority" lien foreclosure that can be conducted without notice and for amounts that do not reflect anything close to the actual or commercial value of the property? Alternatively, lenders may be compelled to increase interest rates for Nevada loans to account for the possibility of extinguishment, surely limiting the number of loans made.

Additionally, residential lending is highly regulated, and potential violations of these regulations abound in accepting an essentially unsecured deed of trust. Moreover, these sales, for pennies on the dollar, have the potential to decrease overall property values in Nevada, at a time when (for the first time in years) values are actually beginning to increase. And notably, if property values do not decline, such result would only evidence the market's determination that these are not actual foreclosure sales or transfers of real property.

Nevertheless, there is no dispute that the statute has real value in providing a mechanism for HOAs to recoup past-due assessments that are vital to HOA operation and funding. But that objective should be tempered and reasonably balanced against the necessity of honoring a lender's deed of trust and protecting the average individual's ability to obtain a loan and buy a home. A lender's ability to make loans is critical to a functioning and healthy real-estate market. If the statute forces lenders to stop lending in Nevada, or to increase mortgage interest rates, the end result is the inability of individuals to purchase homes, numerous vacant properties within any HOA, and still insufficient assessments remitted to fund the HOA.

Moreover, the HOA foreclosure sale circumvents Nevada's policy of protecting Nevada homeowners and encouraging resolution short of foreclosure. While Nevada laws require lenders to participate in mediation with the homeowner and consider options short of foreclosure, HOAs are not subject to any such requirements and are free to foreclose in a relatively short time with minimal regulations. Indeed, some savvy real-estate investors have seized on this situation to the detriment of other vital interests. The investor, after obtaining a home for the price of a used car, typically rents the property to a tenant, often for between $1,000 and $1,500 per month, and

quickly recoups its minimal investment. But this model puts profits ahead of Nevada's homeowners, future borrowers, and residential real-estate market as a whole.

The ultimate result should be that the HOA super-priority lien is only a priority to payment, not title, and the HOA foreclosure sale cannot extinguish the lender's deed of trust. Alternatively, if the Nevada Supreme Court or the legislature finds that the foreclosure extinguishes the deed of trust, there must be additional protections for both the lender and the homeowner, such as mandatory actual-notice provisions, mandatory participation by the HOA in mediation with the homeowner, and sales for commercially reasonable value.

Keywords: litigation, corporate counsel, homeowners association, HOA, Nevada, Uniform Common Interest Ownership Act

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