"FIRST" DEEDS OF TRUST NOW SECOND IN LINE?

Recent decisions in Nevada and the District of Columbia have held that a homeowner or a condominium association's (HOA) lien may extinguish an existing first deed of trust in the event of foreclosure. Most recently, in *SFR Investments Pool 1, LLC v. U.S. Bank, N.A.*, the Nevada Supreme Court upheld the foreclosure of a piece of property for $6,000, which satisfied the HOA lien and completely wiped out the $885,000 first mortgage/deed of trust properly held and recorded by U.S. Bank. The HOA sold the property for little more than its lien. Someone got a windfall! How did this happen? Under the Nevada Common Interest Ownership Act, the HOA was required to give notice to the mortgage lender, and apparently it mailed a notice. The bank, which was then charged with knowledge of the foreclosure, could have paid off the HOA lien and avoided the loss of its security interest but apparently failed to notice the notice. As the Nevada Supreme Court said when the bank attempted to undo the foreclosure, the injustice the bank decried was "of its own making."

Oh, if this were only a Nevada problem. Nevada, the District of Columbia, and twenty other states[1] have adopted some version of the Uniform Common Interest Ownership Act of 1982. These provisions entitle associations to a statutory lien for the collection of common assessments in an effort to give associations the maximum authority in collecting unpaid common expenses. Part of the association's lien is given a "superlien" priority, and is therefore senior to any prior encumbrance to the extent that the common assessments become due and payable during the six (or nine) months prior to the institution of foreclosure. Thus, the foreclosing on the association's superlien effectively wipes out all junior liens and encumbrances on the property, leaving the lender suffering a loss and the HOA (or the investor) achieving a huge windfall.

States that have enacted some form of the Common Interest Ownership Act have widely different notice requirements to the lender. Under the Nevada statute, the HOA is required to notify the owner and any holder of a recorded security interest encumbering the property, which has notified the association of its security interest in the property. The District of Columbia, however, has **no notice requirement** whatsoever. In both Nevada and D.C.

cases, the HOA timely recorded their lien and notice of the foreclosure was mailed to the mortgage holder and it got overlooked.

This is a serious problem with loads of "gotcha" exposure. Reserving funds for the HOA lien and getting a specific recognition agreement with the HOA are common sense steps to reduce the risk. Also it behooves servicing shops to reinforce processes to react quickly to a HOA notice. (Note that title policies are not much help. The HOA lien, like tax liens, is prior in right to the mortgage and the title policy won't change that. So lenders are on their own.)

But there are practical problems. In the detritus of the most recent housing meltdown, homeowners associations have often collapsed. Massive turnovers often mean it is not clear who is acting as the homeowners association, how to find it and how to notice it. And often the HOA is not obligated to give the lender recognition, not even obligated to tell the mortgage lender how much is due, and certainly is not obligated to provide a type of notice really designed to flag the issue for the servicer.

Common sense would suggest that the HOA would just as soon get a check from the lender and call it a day, but there have been concerns in the market that HOAs and investors are gaming the system to achieve a windfall of free and clear ownership of properties. While there may be some element of urban myth to this notion, we think it has to be taken seriously. Lenders, it's time to heighten servicing attention to these issues. It's important to have determined at the time the loan is originated whether the property is in an HOA state, it's important to create reserves to cover perhaps as much as one year HOA exposure, it's important to figure out who is the HOA, get a recognition agreement and stipulate how notice will be delivered.

More on this later; we are expecting the various rating agencies to weigh in and that will affect the securitization market broadly. The problem is not going away.

[1] States that give either homeowner's associations, condominium associations, or both a superlien for common assessments are: Alabama, Alaska, Colorado, Connecticut, Delaware, District of Columbia, Florida, Hawaii, Illinois, Maryland, Massachusetts, Minnesota, New Hampshire, New Jersey, Nevada, Oregon, Pennsylvania, Rhode Island, Tennessee, Vermont, Washington, and West Virginia.