Splitsville?

Can Community and Condominium Association Liens Impair Your Delaware Mortgage Loans?

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Delaware lenders confront declarations of restrictive covenants recorded prior to the lenders' mortgages on a daily basis. These covenants typically "run with the land" (title to real estate) and often vest community, homeowner, and condominium associations with the contractual power to impose mandatory assessments on the real estate collateral, coupled with the right to place liens on the property for unpaid assessments. These associations and lien rights are present in virtually all residential and commercial condominiums, and are also positively ubiquitous in non-condominium residential developments created after the mid-1970s. They are even frequently encountered with commercial real estate in office and industrial parks, as well as large retail centers. Assessments are the critical life blood for many associations to insure amenities and common areas, operate and perform maintenance and repairs, make replacements or incur capital expenditures in all aspects of their development projects.

At Delaware common law, these contractual liens for assessments, attributable to periods after recordation of the mortgage, did not generally have priority over the mortgage lien, since they were construed as liens arising after recordation of the mortgage. This general rule of thumb has changed in Delaware, however, primarily due to the 2009 adoption of the Delaware Uniform Common Interest Ownership Act ("DUCIOA"),[1] based on the Uniform Common Interest Ownership Act ("UCIOA") promulgated by the National Conference of Commissioners on Uniform State Laws.

DUCIOA establishes a "split lien" priority status. If DUCIOA applies to the mortgaged real estate (as discussed below, this will generally be the case with residential developments and community associations created after September 2009), then the association ("HOA") has a lien prior to all encumbrances that arise after the recordation of the HOA's declaration except for tax liens and the liens of first and second mortgages; however, the first and second mortgage priority does not apply to HOA assessments for the six month period arising prior to the mortgage foreclosure filing.[2] To obtain this "super priority" status over mortgages (for the six months of assessments), the HOA need only have recorded in the county in which the real estate is located, a document that contains the name of the association, the address, a contact telephone number, a contact e-mail address and a web-site address; and shall have recorded at any time, but not less than thirty days prior to the sheriff's sale in the foreclosure of the bank's mortgage, a statement of lien which shall include a description of such unit, the name of the record owner, the amount due and the date due, the amount paid for recording the statement of lien and the amount required to be paid for filing a termination thereof upon payment, and the signature and notarized statement of an officer of the association that the amount described in the statement of lien is correct and due and owing.[3]

Moreover, the bank may have a bigger problem than just having foreclosure sale proceeds applied to six months of HOA assessments first, before application to the mortgage debt. There is currently much controversy in states that have adopted a version of the UCIOA over whether this six month priority just means that such amount is paid first to the HOA at a first mortgage foreclosure action, or whether this provision (by its mere presence) establishes a "true priority lien" instead, enabling the HOA to extinguish the mortgage lien entirely upon HOA lien foreclosure (unless the mortgage holder steps up and pays off the HOA lien).

Three published court decisions (from Nevada, the District of Columbia, and Wisconsin) hold that split-priority statutes establish such "true priority" over the HOA liens. In other words, this concept means that even though the HOA liens prime the mortgage only as to a limited amount and the mortgage lien is superior to the remaining balance of assessments owed, if the HOA forecloses on its lien, that foreclosure sale extinguishes the entire prior mortgage as a subordinated lien.[4] These cases created considerable turmoil in the lending industry and a "chilling effect" on residential condominium financing. The most prominent trade associations came together to issue a policy statement condemning these decisions.[5] The reaction of the Federal Housing Finance Authority ("FHFA"), Fannie Mae, and Freddie Mac to these decisions was forceful. With respect to mortgages held by Fannie Mae or Freddie Mac, they have taken the position that pursuant to the Housing and Economic Recovery Act of 2008, HOAs cannot foreclose on their superior assessment liens without the prior consent of FHFA, as long as FHFA is acting as conservator.[6] FHFA then issued a policy statement that it will not grant such consent.[7] At one point, more than 1,000 cases in Nevada were being litigated to determine whether first mortgages were given proper notice in HOA lien foreclosure actions.[8] FHFA, Fannie Mae and Freddie Mac even attempted to file a class action lawsuit with respect to these thousands of Nevada foreclosure actions;[9] ultimately the court did not certify the class action but did rule that a homeowners' association foreclosure of its super priority lien cannot extinguish a Fannie Mae or Freddie Mac mortgage. Note that this ruling only applies to Fannie Mae and Freddie Mac loans given the limited scope of the decision.[10]

How does a bank determine if it has a "DUCIOA problem" with its Delaware mortgage loan? The first step is to determine if these lien provisions in DUCIOA apply to the real estate. Residential condominiums established prior to September 30, 2009 and commercial condominiums, regardless of when formed, are subject to the Delaware Unit Property Act ("UPA")[11] instead of DUCIOA, unless the unusual step is taken in the declaration of voluntarily "choosing" to be governed by DUCIOA.[12] Also, even if formed on or after September 30, 2009, residential condominiums and non-condominium HOAs with small numbers of units (less than 20) or, in the case of non-condominiums, that have small annual assessments, are exempt from the DUCIOA lien provisions.[13] Residential condominium and non-condominium projects that do not pre-date DUCIOA and do not qualify for the foregoing exemptions are subject to DUCIOA's treatment of HOA liens.

The UPA does not itself create a statutory lien right; it instead simply permits HOA liens to be pursued in actions filed against the real estate, resulting in a judgment lien if successful.[14] HOA liens reduced to judgment will be inferior to prior-recorded mortgages under Delaware's general first-in-time, first-in-right recording rule.[15] There is no "super priority" provided in the UPA.

Even if DUCIOA rears its ugly head, there is still hope for the bank. DUCIOA's lien provisions are prefaced with "except as otherwise provided in the declaration."[16] A well-drafted (from the bank's perspective) declaration of covenants will so "otherwise provide," by using specimen language such as in the following example[17]:

(continued on p. 16)

(continued from p. 15)

> Subordination of the Lien to Mortgages. The lien of the assessments provided for herein shall be subordinate to the lien of any Mortgage. Sale or transfer of any Lot shall not affect the assessment lien. However, the sale or transfer of any Lot pursuant to a mortgage foreclosure or any proceeding in lieu thereof, shall extinguish the lien of such assessments as to payments which became due prior to such sale or transfer. No sale or transfer shall relieve such Lot from liability for any assessments thereafter becoming due or from the lien thereof. No amendment to this Section shall affect the rights of the holder of any Mortgage on any Lot (or the indebtedness secured thereby) recorded prior to recordation of such amendment unless the holder thereof (or the indebtedness secured thereby) shall join in the execution of such amendment.

Another example of overriding declaration language that is palatable to mortgage lenders might read as follows:

> If a mortgagee of a first mortgage of record or other purchaser of a Unit obtains title to the Unit as a result of foreclosure of a first mortgage, or through the other remedies provided for in the first mortgage, such purchaser, its successors and assigns, shall not be liable for, and such Unit shall not be subject to, a lien for the payment of Common Expenses assessed prior to the acquisition of title to such Unit by such purchaser pursuant to the foreclosure sale, or through the other remedies provided for in the first mortgage; provided, however that the purchase of any such Unit as a result of any such foreclosure of a first mortgage, or through the other remedies provided for in the first mortgage, shall be without prejudice to the Association's right to recover from the selling or prior Unit Owner any past due or delinquent assessments. Any lien for Common Expense assessments or other charges that the Association has on any Unit shall be subordinate to the lien of the mortgage on the Unit, if the mortgage was recorded before the delinquent assessment was due. Any lien for Common Expense assessments shall not be affected by the sale or transfer of a Unit, unless a foreclosure of a mortgage is involved, in which case the foreclosure will extinguish the lien for any assessments that were payable before the foreclosure sale, but will not relieve any subsequent Unit Owner from paying further assessments.

What is the take-away here? Regardless of whether DUCIOA applies, Delaware bankers should always review (or better yet, have a bank closing attorney review) the lien and mortgage lender protection provisions provided in the copy of the recorded declaration of covenants that will be included with the title work for the mortgaged real estate. If these provisions don't contain the language the lender wants, then the bank will need to further investigate whether DUCIOA applies and, if so, determine whether it can live with the prior lien risk or require an escrow from the borrower for HOA assessments.

Eugene A. DiPrinzio's practice emphasizes the handling of complex commercial real estate transactions and the representation of financial institutions and other lenders involving commercial mortgage loans, asset-based lending, loan modifications, workouts and restructurings. In addition, he has represented numerous property developers and borrowers in connection with their overall real estate transactions on a primary basis. Gene also has been engaged in many substantial leasing transactions on behalf of landlords and tenants and has successfully represented building owners in prosecuting their property tax assessment appeals. As counsel to title insurers, he has assisted with the closing of numerous portfolio and multi-state transactions.

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Notes:
1- 25 Del. C. § 81-101 et seq.
2- Id. § 81-316(b) ("except as otherwise provided in the declaration, a lien under this section is prior to [a first or second mortgage lien]… for an amount not to exceed the aggregate customary common expense assessment against such unit for 6 months as determined by the periodic budget adopted by the association pursuant to § 81-315(a)").
3- Id.

4- SFR Investments Pool 1, LLC v. U.S. Bank, N.A., 334 P.3d 408 (Nev. 2014); Chase Plaza Condo Ass'n v. JP Morgan Chase Bank, N.A., 98 A. 3d 166 (D.C. Ct. App. 2014); Summerhill Vill. Homeowners Ass'n v. Roughley, 289 P.3d 645 (Wn. App. 2012).
5- Am. Bankers Ass'n, Am. Financial Svcs. Ass'n, Ass'n of Mortgage Investors, Housing Policy Council of the Financial Svcs. Roundtable, Mortgage Bankers Ass'n, Securities Industry and Financial Markets Ass'n Structural Finance Industry Group, Statement of Principles: HOA Super Priority Liens (July 23, 2015), www.aba.com/Advocacy/LetterstoCongress/Documents/StatementofPrincipalsHOASuperLiens.pdf.
6- 12 U.S.C. § 4617(j)(3) ("[n]o property of the Agency shall be subject to levy, attachment, garnishment, foreclosure, or sale without the consent of the Agency").
7- Federal Housing Finance Authority, FHFA Statement on HOA Super-Priority Lien Foreclosures (Apr. 21, 2015), http://www.fhfa.gov/Medical/PublicAffairs/Pages/Statement-on-HOA-Super-Priority-Lien-Foreclosures.aspx.
8- Am. Bankers Ass'n, supra, app. at 2.
9- Heather Howell Wright, FHFA, Fannie and Freddie File Defensive Class Action in Nevada, JDSUPRA Business Advisor (Oct. 14, 2015), www.jdsupra.com/legalnews/Fhfa-fannie-and-freddie-file-defensive-47111/.
10- See Skylights LLC v. Byron, 2015 U.S. Dist. LEXIS 82048 (Dist. Ct. Nev., June 24, 2015), Case No. 2:15-cv-43-GMN-VCF; Fed. Hous. Finance Agency v. SFR Investments Pool 1, LLC (Dist. Ct. Nev. May 2, 2016), Case No. 2:15-cv-01338-GMN-CWH.
11- 25 Del. C. §§ 81-119, 81-122(a).
12- Id. §§ 81-119, 81-122(c).
13- Id. §§ 81-117, 81-118.
14- See id. §§ 2233, 2234, 2236. These UPA statutes read as follows:
§ 2233 Assessment of charges. All sums assessed by resolutions duly adopted by the council against any unit for the share of common expenses, chargeable to that unit shall constitute the personal liability of the owner of the unit so assessed and shall, until fully paid, together with interest thereon at a rate not to exceed 18% per annum from the thirtieth day following the adoption of such resolutions, constitute a charge against such unit which shall be enforceable as provided in the next section.

§ 2234 Method of enforcing charges. Any charge assessed against a unit may be enforced by an action at law by the council acting on behalf of the unit owners, provided that each action, when filed, shall refer to this chapter and to the unit against which the assessment is made and the owner thereof. Any judgment against a unit and its owner shall be enforceable in the same manner as is otherwise provided by law.

§2236 Unpaid assessments at time of execution sale against a unit. In the event that title to a unit is transferred by sheriff's sale pursuant to execution upon any lien against the unit, the council may give notice in writing to the sheriff of any unpaid assessments for common expenses which are a charge against the unit, but have not been reduced to lien pursuant to § 2234 of this title, and the sheriff shall pay the assessments of which the sheriff has such notice out of any proceeds of the sale which remain in the sheriff's hands for distribution after payment of all other claims (emphasis added), which the sheriff is required by law to pay, but prior to any distribution of the balance to the former unit owner against whom the execution issued.
15- Id. §§ 2106, 2118.
16- 25 Del. C. § 81-316(b).
17- Capitalized terms in both of these examples are intended to be defined in the applicable declaration where they may appear.