2 Cases Highlight Superpriority Lien Risks For Lenders

By **Michael O'Donnell and Michael Crowley** (January 14, 2021)

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It is not novel or noteworthy that liens for property taxes and homeowner association dues can affect prime mortgages with disastrous consequences for lenders.[1] However, two recent decisions from New York and Nevada reaffirm that lenders need to be diligent in paying off these liens before the sales occur.

Budram

New York's Appellate Division, Third Department, recently issued a decision that reemphasized the need for mortgagees to remain aware of tax liens that may extinguish their mortgages.[2]

In Wells Fargo Bank NA as Trustee for Carrington Mortgage Loan Trust, Series 2006-NC3 Asset-Backed Pass-Through Certificates v. Budram, the court held that a tax sale foreclosure extinguished a mortgage on a property and that the mortgage was not reinstated when the city later quitclaimed the property back to the borrowers as part of the borrowers' bankruptcy action.

Specifically, in 2006, the defendant homeowners purchased a property and encumbered it with a mortgage that later was assigned to the plaintiff lender. The defendants later defaulted on the loan, and the plaintiff brought this foreclosure action, moving for summary judgment in July 2014.

In August 2014, however, the city of Schenectady, New York, acquired title to the property via a tax foreclosure. A few days later, the defendants filed for Chapter 13 bankruptcy, staying the plaintiff's foreclosure action. In March 2018, the bankruptcy proceeding closed and, in June 2018, the city quitclaimed the property back to the defendants pursuant to a stipulation that had been entered in the bankruptcy.

With the conclusion of the bankruptcy action and the stay lifted, the plaintiff asked the trial court to decide its pending summary judgment motion from 2014. The defendants opposed the motion, arguing that the August 2014 tax sale extinguished the mortgage and that the plaintiff's action was moot.

In response, the plaintiff argued that the June 2018 transfer of the property back to the defendants acted as a rescission of the tax sale, and that this rescission reinstated the mortgage. The trial court agreed that the tax sale extinguished the mortgage and dismissed the action.

On appeal, the Third Department affirmed the trial court's decision. The court found that the tax sale foreclosure extinguished the plaintiff's lien on the property pursuant to New York's Real Property Tax Law 1136.

In doing so, the court rejected the plaintiff's argument that the defendants had redeemed the property, finding instead that the defendants did not pay the required amount by the redemption date.[3] Thus, it found that:

Any transfer of the property from the City back to defendants after the execution of a tax deed to the City cannot be considered a redemption of the property, nor was it a rescission of the tax foreclosure. Inasmuch as plaintiff's mortgage interest was extinguished upon the conveyance of title to the City in fee simple absolute in August 2014, the court properly denied plaintiff's motion for summary judgment and, pursuant to CPLR 3212 (b), granted summary judgment to defendants dismissing the mortgage foreclosure action.[4]

The court further noted that the defendants had filed a motion in the bankruptcy to reclassify the plaintiff's interest in the property as unsecured for the purpose of the Chapter 13 bankruptcy plan disbursement, and that the plaintiff never opposed that motion. Accordingly, the court affirmed the trial court's holding that the mortgage was extinguished and this action was properly dismissed.

This decision is in tension with another firmly established line of New York case law that states that only a "bona fide purchaser (other than the owner) on an unconditional sale of real property pursuant to a regular foreclosure" acquires a clear and absolute title free of the original mortgage.[5]

Indeed, when such a situation had arisen where a defaulting mortgagee attempted to purchase their property back at a subsequent foreclosure sale, courts had held that "equity, disregarding the forms of title which defendant has managed to acquire, will consider him as the owner of the land subject to the complainant's mortgage."[6]

Budram, on the other hand, appears to provide at least a workaround to the traditional rule where the mortgage was extinguished and the borrowers regained title from an unrelated third-party buyer at a foreclosure sale as opposed to repurchasing the property themselves.

Critical to this holding, however, is the third party being the city of Schenectady, the bankruptcy court approval of the transfer, and the lender's failure to appear in the tax foreclosure and bankruptcy.

Mahogany Meadows

On the same day the Third Department issued this decision, the U.S. Court of Appeals for the Ninth Circuit issued a decision in Wells Fargo Bank NA v. Mahogany Meadows Ave. Trust in which it affirmed that the Nevada statute allowing for a homeowner association sale of a property that extinguished the lender's deed of trust did not violate the takings or due process clauses.[7]

In that case, the homeowners fell behind on their dues and the association ultimately foreclosed on the property to satisfy the lien, resulting in a $200,000 deed of trust being extinguished by a $5,332 public auction sale, because homeowner association liens have superpriority status in Nevada.

This is just the latest in a string of harsh decisions for lenders relating to homeowners associations foreclosing on properties for back dues.[8]

Conclusion

Budram and Mahogany Meadows serve as reminders to lenders to beware of superpriority liens that may extinguish their mortgages or deeds of trust. When presented with superpriority foreclosures, the lenders must act quickly to satisfy such liens or they will risk losing all interest in the collateral property.

In Budram, the court specifically noted that "the record lacks any indication or assertion by plaintiff that it made any attempt to protect its mortgage interest in the tax foreclosure proceeding or in the bankruptcy proceeding."[9] Lenders should take note and implement proper monitoring procedures to redeem the liens if their borrowers do not.

There are multiple opportunities to redeem during a tax foreclosure or homeowner association foreclosure and they all should be docketed and monitored to see if the borrower has paid.[10] But if the borrower has not paid and final judgment is looming, the lender should redeem.

Indeed, given the interest rates of tax liens being as high as 18%,[11] it may be wise to redeem earlier and not let interest eat the equity in the collateral property.

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[1] Deutsche Bank Nat'l Tr. Co. v. SFR Investments Pool 1, LLC, 382 F. Supp. 3d 1114, 1120 (D. Nev. 2019) (holding nonjudicial sale for HOA liens extinguished deed of trust);) N.J.S.A. 46:8B-21(b)(1) (providing superpriority status to six months of condominium liens).

[2] See Wells Fargo Bank, N.A. as Tr. for Carrington Mortg. Loan Tr., Series 2006-NC2 Asset- Backed Pass-Through Certificates v. Budram, 188 A.D.3d 1324 (N.Y. App. Div. 2020).

[3] See RPTL 1110(2) ("The redemption period shall expire two years after lien date.").

[4] Budram, 188 A.D.3d at 1326.

[5] Dorff v. Bornstein, 277 N.Y. 236, 240 (1938) (emphasis added); Holland v. Fulbert, Inc., 49 A.D.2d 86, 90 (N.Y. App. Div. 1975).

[6] Id.

[7] Wells Fargo Bank, N.A. v. Mahogany Meadows Ave. Tr.,79 F.3d 1209 (9th Cir. Nov. 5, 2020).

[8] JPMorgan Chase Bank, N.A. v. SFR Investments Pool 1, LLC, 200 F. Supp. 3d 1141, 1171 (D. Nev. 2016); Deutsche Bank Nat'l Tr. Co. v. SFR Investments Pool 1, LLC, 382 F. Supp. 3d 1114, 1120 (D. Nev. 2019).

[9] Budram, 188 A.D.3d at 1327.

[10] N.Y. Real. Prop. Tax §1110 (providing for the redemption of tax foreclosures in New York).

[11] Administrative Code of City of N.Y. §11-224; N.J.S.A 54:5-32.