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HOA Superpriority Litigation Intensifies In Nevada

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For the last three years in Nevada, lenders and homeowners' associations have been battling over the interpretation of Nevada's version of the Uniform Common Interest Ownership Act, which provides a limited superpriority lien for HOAs to recover past due assessments. One critical provision of that act, codified as NRS 116.3116 et seq., states that a first recorded deed of trust has priority over an HOA lien, except for nine months of past due HOA assessments, which is granted a "superpriority" status over the first recorded deed of trust. NRS 116.3116(2).

This language, which grants priority to the first recorded deed of trust and simultaneously limits that priority, has spawned a great deal of litigation in Nevada. Originally, the dispute centered on whether an HOA's foreclosure of a relatively nominal amount, typically between $3,000 and $10,000, extinguished the existing first priority deed of trust, with unpaid balances in the hundreds of thousands of dollars. Lenders argued the superpriority lien was a priority only to payment, not title. Real estate speculators, purchasing these properties in bulk at HOA foreclosure sales for literally pennies on the dollar, countered that the HOA's foreclosure sale extinguished the deed of trust, resulting in clear title to the property.

After almost two years of intense litigation, the Nevada Supreme Court issued a long-awaited opinion addressing some, but certainly not all, of the issues raised in this ongoing conflict. In September 2014 the Nevada Supreme Court issued its ruling in SFR Investments Pool 1 v. U.S. Bank. 334 P.3d 408, 409 (2014), reh'g denied (Oct. 16, 2014) (SFR). In a 4-3 decision, the court held that:

1. The statute splits the lien of the HOA into a "superpriority piece" and a "subpriority piece."
2. The superpriority piece consists of the "last nine months of unpaid HOA dues and maintenance and nuisance-abatement charges and is prior to the first recorded deed of trust.
3. The subpriority piece consists of "all other HOA fees or assessments" and is subordinate to the first recorded deed of trust.
4. The superpriority piece can be foreclosed nonjudicially and such a sale will extinguish the first recorded deed of trust.
5. Provisions contained in the covenants, conditions and restrictions for the HOA that subordinate the entire HOA lien to a first recorded deed of trust, often referred to as "mortgage protection clauses," are unenforceable.

6. A lender could pay the amount the HOA claims it is owed in order to avoid a foreclosure and later sue for a refund of amounts overpaid.

The Rationale and Impact of the SFR Decision

Generally, the SFR opinion and related opinions from lower courts, justify extinguishment by suggesting that the lender is in the best position to pay the HOA liens as a protective advance. However, as lenders argue and detailed below, the statute does not require affirmative notice to the lender. Thus it is impossible to pay a lien for which the lender receives no notice. Moreover, collection agencies hired by the HOA commonly refuse to release a lien unless the lender pays amounts that are not part of the superpriority piece, including excessive and unsubstantiated attorneys' fees and collection costs.

Many critics rationalize this position by demonizing lenders, suggesting a David versus Goliath scenario, pitting the HOA as financially strapped and struggling to fund community expenses, against the lender, with its purported deep pockets, who should be responsible for paying these liens in spite of the absence of any legal obligation to do so. The reality is, however, that HOAs receive only a small portion of the amount paid at an HOA foreclosure sale. The majority of the sale proceeds are retained by the collection agency that conducts the sale. Those same collection agencies often refuse to timely respond to lenders' requests for payoff statements (which must be provided within 10 business days of the request), demand outrageous and unsubstantiated attorneys' fees and costs and hold distressed properties hostage until the lender pays every cent they demand, even if that amount far exceeds the superpriority portion of the lien.

Indeed, in SFR, the Nevada Supreme Court suggested that a lender should simply pay the HOA all amounts demanded in order to stop the HOA foreclosure sale and then take appropriate legal steps to recoup any excess amounts paid. But just three months later, the court held in another case that the voluntary payment doctrine barred recovery of payments made to an HOA to stop a pending foreclosure. Nevada Association Services Inc. v. The Eighth Judicial District Court, 338 P.3d 1250 (Dec. 9, 2014).

In Nevada Association Services, the owner of several properties acquired at a lender's foreclosure sale did as the Nevada Supreme Court suggested — paid the amount of the disputed assessments and sued for a refund. Yet the Nevada Supreme Court held that the overpayment could not be recovered from the HOA pursuant to the voluntary payment doctrine which essentially "provides that one who makes a payment voluntarily cannot recover it on the ground that he was under no legal obligation to make the payment." (For a more detailed discussion see "Nevada Supreme Court holds that Voluntary Payment Doctrine Prohibits a Party from Recovering Amounts Wrongly Paid to Homeowner's Association in Order to Prevent Foreclosure," B. Olson (April 30, 2015). Accordingly, the Nevada Supreme Court's suggested remedy for the lenders was, shortly after SFR, held to be an unfeasible option.

After SFR, many real estate speculators took the position that the court's ruling resolved the pending issues and that they owned the properties free and clear of the first priority deed of trust. But that position ignored a number of critical issues not addressed by the SFR opinion. (A list of some of the issues that were not resolved by SFR were summarized in "Lenders Beware: the Nevada Supreme Court Holds that Foreclosures of Homeowners' Association Liens May Extinguish First Priority Deed of Trust," B. Olson (Sept. 30, 2014) Those remaining issues are still being hotly litigated and continue to inundate Nevada courts.

What Are the Ongoing Issues?

HOA Foreclosure Sales May Violate the Supremacy Clause and May Be Preempted by Federal Statute.

Several lenders have successfully argued that the statute undermines and impedes federal laws and policies regarding mortgage lending and thus violates the supremacy clause of the U.S. Constitution. Many mortgages in Nevada (as in other states) are insured by the federal government through a Housing and Urban Development or Veterans Administration-sponsored program or agency,or are owned by Fannie Mae or Freddie Mac (currently under federal conservatorship). The government's insured interest in the property is subject to the supremacy clause because the statute interferes with important federal policies and programs.

With regard to properties under federal conservatorship, the Federal Housing Finance Agency issued a press release on April 21, 2015, referencing 12 U.S.C. § 4617(j)(3) (part of the Housing and Economic Recovery Act), stating that this law "precludes involuntary extinguishment of Fannie Mae or Freddie Mac liens while they are operating in conservatorships and preempts any state law that purports to allow holders of homeownership association liens to extinguish a Fannie Mae or Freddie Mac lien, security interest or other property interest."

Nevada courts are split regarding the applicability of the supremacy clause in these cases. Some judges in the U.S. District Court for the District of Nevada have ruled that the supremacy clause applies and prohibits the extinguishment of the federal insured security interest. In Washington & Sandhill the court found that "in situations where a mortgage is insured by a federal agency under the FHA insurance program, state laws cannot operate to undermine the federal agency's ability to obtain title after foreclosure and resell the property" and accordingly, the supremacy clause barred application of the statute to the extent it would extinguish the federal interest. Washington & Sandhill Homeowners Association v. Bank of America NA, No. 2:13-CV-01845-GMN-GWF, (D. Nev. Sept. 25, 2014) (appeal docketed, No. 14-17032). Additionally, another judge in the District of Nevada recently ruled that "[a]llowing an HOA foreclosure to wipe out a first deed of trust on a federally-insured property ... interferes with the purposes of the FHA insurance program. Specifically, it hinders HUD's ability to recoup funds from insured properties. Accordingly, the court reads the foregoing precedent to indicate that a homeowners' association foreclosure sale under Nevada Revised Statute 116.3116 may not extinguish a federally-insured loan." Saticoy Bay LLC v. SRMOF II 2012-1 Trust, No. 2:13-CV-1199-JCM-VCF, (D. Nev. Apr. 30, 2015) (appeal docketed, No. 15-16092). At least one Nevada state court judge has agreed, finding that the supremacy clause rendered the attempted foreclosure of a federally insured secured interest invalid, and that the interest could not be extinguished through such a sale. Saticoy Bay LLC Series 6915 Silver State v. Wells Fargo Bank NA, et al, Case No. A-13-690842, Eighth Judicial District Court, Clark County, Nevada (reh'g filed).

Meanwhile, other Nevada federal and state court judges have found the supremacy clause inapplicable. For example, in Freedom Mortgage v. Las Vegas Development Group, the court rejected the supremacy clause analysis, and instead relied upon a stricter preemption analysis in concluding that there is no conflict between the statute and federal law. No. 2:14-CV-01928-JAD-NJK, 2015 (D. Nev. May 19, 2015). The court in Freedom Mortgage also rejected the lender's property clause argument, holding that the provision of insurance by a federal entity or instrumentality is not an ownership interest. The court further found that the lender or servicer lacks standing to make the claim, which must be asserted directly by the federal entity. Id. Contrary to that decision, however, other judges in the district of Nevada have rejected a similar standing argument, holding that a lender or servicer do have standing to assert the supremacy clause and the federal entity need not be a party to bring these claims. Saticoy Bay

LLC v. SRMOF II, 2015; Thunder Properties Inc. v. Wood, No. 3:14-CV-00068-RCJ-WGC, (D. Nev. Apr. 28, 2015).

HOA Foreclosure Sales May Violate the Due Process Clause.

Another key issue in the wake of SFR is the argument that the statute, on its face, violates the due process clause of the U.S. and Nevada Constitutions. The statute does not require actual or affirmative notice to the lender or the beneficiary of the secured deed of trust. Instead, it only requires notice if the lender first “opts-in” by making a written request for notice. Indeed, several Nevada state court judges have recently dismissed a speculator’s quiet title action based on a finding that the opt-in provisions violate the due process clause. See e.g., Cano-Martinez v. HSBC Bank USA et al, Case No. A-13-692027, Eighth Judicial District Court, Clark County, Nevada (reh’g filed); Saticoy Bay LLC Series 350 Durango v. Wells Fargo Home Mortgage, et al, Case No. A-13-688410, Eighth Judicial District Court, Clark County, Nevada.

Specifically, in Cano-Martinez the court found that “[t]he statute violates the due process clauses of the Fifth and 14th Amendments of the United States Constitution because its ‘opt-in’ notice provisions do not mandate that reasonable and affirmative steps be taken to give actual notice to lenders and other holders of recorded security interests prior to a deprivation of their property rights. Because the statute does not require the foreclosing party to take reasonable steps to ensure that actual notice is provided to interested parties who are reasonably ascertainable (unless the interested party first requests notice) it does not comport with long standing principles of constitutional due process.” Cano-Martinez, Case No. A-13-692027. Notwithstanding that victory for lenders, several other courts have rejected this argument and found that the statute, at least on its face, comports with due process.

HOA Foreclosure Sales May Be Commercially Unreasonable.

Yet another issue is whether the sale of a property for pennies on the dollar is commercially reasonable. The Nevada Supreme Court expressly declined to address this in SFR stating that “we note but do not resolve U.S. Bank’s suggestion that we could affirm by deeming SFR’s purchase ‘void as commercially unreasonable.’” SFR, 334 P.3d at 418. Accordingly, the parties continue to litigate the question of whether a property sold for what typically amounts to 1 to 5 percent of fair market value is commercially reasonable, such that it can deprive lenders of their substantial interest in the property. A related defense is that the purchaser acquiring the property under these circumstances is not a bona fide purchaser for value, thus rendering the foreclosure sale voidable.

HOA Foreclosure Sales May Violate the Takings Clause.

Parties also continue to litigate whether HOA foreclosure sales violate the takings clause of the U.S. and Nevada Constitutions. A taking occurs where private property is taken, for a public use, without just compensation. HOA foreclosure sales satisfy each element of a takings analysis. First, the lender’s secured interest is private property. Second, the HOA serves a quasi-municipal function by stepping into the shoes of the local government, servicing and maintaining roads, community parks, landscaping and other public spaces, which otherwise would remain the responsibility of the city or municipality. And the legislature’s enactment of the statute satisfies the “state action” requirement. Third, the lender’s compensation is not simply unjust, it is nonexistent. Lenders typically receive no compensation from the sale, because generally there is no effort or attempt by the HOA to seek a commercially reasonable sales price that might garner excess proceeds to satisfy all or part of the lender’s interest.

Many HOA Foreclosure Sales Simultaneously Foreclose on the Superpriority and Subpriority Portions of the Lien.

A final ongoing issue is that most HOAs simultaneously foreclose on both the superpriority and subpriority portions of the lien. Many lenders argue that a "combined" foreclosure of the superpriority and subpriority pieces is not a valid foreclosure of the superpriority portion and, as a result, does not extinguish the first priority deed of trust.

The Nevada Legislature's Recent Amendments to the Act

In response to the unprecedented volume and impact of litigation on this issue, the Nevada Legislature devoted a significant amount of energy to amending the act during its recent session, which just ended on June 1, 2015. A number of proposed amendments were hotly contested and debated, with substantial lobbying efforts made on behalf of the speculators, HOAs, lenders and the federal government.

Ultimately, on May 28, Nevada Gov. Brian Sandoval signed Senate Bill 306 which substantially revised the statute. First, it now expressly requires actual notice to the lender or beneficial interest holder. Second, it expressly limits the "superpriority" amount by capping the costs that can be included in the superpriority calculation at approximately $1,365 and prohibiting the inclusion of attorneys' fees in the superpriority lien amount. Third, it provides a newly-created 60-day right of redemption for any interested party. Notably, despite substantial efforts at the eleventh hour, the Legislature was unable to pass an amendment eliminating extinguishment as the consequence of an HOA foreclosure sale. The revised statute takes effect Oct. 1, 2015. While it is not retroactive, these new provisions will likely diminish investor interest in the HOA foreclosure market.

Where Does This Leave Nevada Citizen Homeowners and the Nevada Economy?

At the end of the day, how does the ongoing litigation and newly-amended statute impact Nevada's citizens and its still recovering economy? Most importantly, homeowners who fail to pay their HOA assessments may still lose their home, but will have 60 days after the foreclosure sale to exercise their right of redemption. If the homeowner does not exercise his or her redemption rights, he or she will likely be evicted and may ultimately be liable to the lender for the outstanding balance of the original mortgage loan.

Notably, when a lender forecloses, it must pursue its deficiency judgment against the borrower within six months, and is limited to collecting the difference between the amount outstanding on the loan and the purchase price at the foreclosure sale. NRS 40.451 et seq. On the other hand, when an HOA forecloses, the lender is arguably absolved of that obligation and is free to pursue all outstanding amounts due under the note. Moreover, while a lender must satisfy rigorous standards evidencing its authority to foreclose and participate in legislatively mandated mediation with the homeowner, under the statute an HOA can foreclose quickly without complying with any similar requirements.

Additionally, the threat of extinguishment will continue to affect Nevada's real estate market and related sectors of the economy. Representatives from the U.S. Federal Housing Finance Agency and the Mortgage Bankers Association have suggested that this statute could significantly limit mortgage lending in Nevada and that Nevada residents will likely face higher loan fees, interests rates, and down payment requirements. These results will not only hamper an individual's ability to purchase a home, but also a homeowner's ability to refinance or sell. Ironically, if empty properties within an HOA cannot

be sold due to the inability of potential purchasers to obtain an affordable mortgage, the HOA will not receive monthly assessments from the vacant property and could suffer the same harm, or worse, for which the statute seeks to provide relief. Finally, the majority of real estate speculators purchasing HOA foreclosures utilize the properties as rentals. This practice may, depending upon the HOA, violate the HOA's covenants, conditions and restrictions and reduce the value of the properties located within the HOA and the overall appeal of the community.

Nevada courts at all levels are struggling to resolve these important issues. Litigants are now looking to the appellate courts, both state and federal, for guidance. In fact, the Ninth Circuit has scheduled oral argument, in record time, on a number of HOA superpriority cases pending before it. It appears the Ninth Circuit recognizes the urgency here and may be preparing to issue comprehensive rulings on a number of these outstanding constitutional and statutory questions. In the meantime, the parties continue to litigate thousands of cases in Nevada in an effort to protect millions of dollars of residential property interests.

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