Do Second Mortgages Deserve a Second Look?

On Whether Improper Association Foreclosures Are Costing Florida Billions

Everywhere we look these days there is talk of mortgage foreclosure, and for good reason. According to RealtyTrac, approximately 1,000,000 foreclosures were filed in Florida during 2009 and 2010. Florida cities accounted for eight of the 20 highest metro foreclosure rates nationwide, led by Miami at number 5, with 3.71 percent of housing units with a foreclosure filing during 2012. Except for Cape Coral–Fort Myers, all Florida cities in the nation's top 20 documented increasing foreclosure activity from 2011 to 2012. But with all eyes on the carnage of first mortgage foreclosures, we may be overlooking the magnitude of association lien foreclosures and, perhaps more importantly, their costly rapine on second mortgages.

We may want to start paying attention.

Consider that if: (1) association assessment lien foreclosures accounted for 10% of the 500,000 annual foreclosures in Florida, (2) half of these associations *improperly* extinguished a second mortgage, and (3) the average second mortgage bore an initial value of $30,000, then association foreclosures are improperly extinguishing approximately $750 million of investments each year. That's a potential economic loss of $3 billion between 2009 and 2013.

Now consider that this massive economic loss has occurred through a pervasive but correctable misconception: the unchallenged assertion that Florida statutes hold an association lien superior to a second mortgage, no matter when either instrument was recorded—the so-called "superlien." This would be a misconception because association contractual covenants, not the statute, control, and because many association declarations either directly or indirectly incorporate earlier statutory enactments that do not provide for an association superlien. As these covenants run with the land, an association cannot act beyond what was initially promised in its contractual declaration, no matter what

subsequent changes occur in the statute. *See Cohn v. Grand Condo Ass'n, Inc.*, 62 So. 3d 1120, 1121-22 (Fla. 2011) (holding retroactive application of Fla. Stat. Ch. 718 to alter declaration rights is unconstitutional under Art. I, § 10, Fla. Const.).

This misconception of association lien superiority could be significant to every Floridian because as the associations are ubiquitously exercising it to extinguish millions in investments, lenders are passing off the costs onto Floridians and the Florida economy through higher interest rates, tightened lending policies, and tax-funded lender bailouts. If the associations are improperly extinguishing hundreds of millions of dollars in investments, then the associations are ironically subjecting Florida to extraordinary economic costs that the legal community can ameliorate by the assertion and protection of second mortgagees' rights. Conveniently, these rights can be asserted inexpensively by a motion to dismiss set on motion calendar, which the judiciary could readily grant.

We need an examination of how Florida condo and homeowners associations are improperly extinguishing second mortgages now more than ever. In light of Florida's tenuous economic recovery, attorneys and the judiciary would be wise to properly analyze and fully adjudicate the fate of second mortgages.

Recording date has provided lien priority for more than 130 years

Since 1885, the Florida Legislature has continuously resolved that the priority of property encumbrances shall be determined by their official recording numbers, under Florida Statutes Section 695.11: "An instrument bearing the lower number in the then-current series of numbers shall have priority over any instrument bearing a higher number in the same series." This statute is Florida's enactment of the well known "first in time, first in right" common law. *George Mackay & Co. v. Marion Hardware Co.*, 100 Fla. 1532, 1536 (Fla. 1930); §695.11, Fla. Stat. (2012). Thus, a mortgage lien recorded prior to any association lien will bear a lower instrument number, and therefore should have priority over that association lien.

Prior liens are superior to subsequently recorded liens. The priority and superiority of liens is paramount to lienholders because the judicial foreclosure of prior, superior liens extinguishes subsequently recorded liens, while foreclosure of inferior liens does not affect prior, superior liens. *See Martinez v. Reyes*, 405 So. 2d 468, 468 (Fla. 3d DCA 1981).

Associations misuse association statutes to assert lien priority

Because foreclosure of prior liens extinguishes subsequently recorded liens, there is always a race to the front of the line. By indiscriminately invoking "relation back" language in Florida Statute Chapters 718 and 720, associations have lately been cutting their way to the front of the line to extinguish second mortgages recorded prior to association liens—often improperly. The associations continue to do so unrestrained because Chapters 718 and 720 are ambiguously drafted and superficially analyzed. This situation is complicated because there exists a vacuum of case law on point, associated land covenants are long and complex, and second mortgagees are poorly incentivized to defend their liens. Lack of data on the frequency and cost of these improper foreclosures only perpetuates and exacerbates the legal community's oversight.

Florida Statutes §§718.116 and 720.3085 provide an association's *statutory* rights to claim a lien on property for unpaid assessments. §718.116(5)(a), Fla. Stat. (2012); and §720.3085(1), Fla. Stat. (2012). Chapter 718 generally regulates condo associations, and Chapter 720 generally regulates homeowners and master associations (however, the association's declaration ultimately determines which chapter governs). The 2012 enactments of these chapters state that, except as regards first mortgages of record, an association's lien for unpaid assessments is effective from, and *shall relate back* to, the recording of the original declaration of covenants, leading most associations to erroneously assert that all of their liens relate back.

In the context of lien priority, the *relation back doctrine* allows subsequent lienholders to treat their liens as superior to prior claims on a property, despite having recorded later in time, by relating the subsequent lien's recording date to a particular moment earlier in time. *Geiser v. Permacrete, Inc.*, 90 So. 2d 610, 613 (Fla. 1956). The doctrine exists elsewhere to relate amended pleadings back to original pleadings in order to soften the impact of mistakes involving the incorrect identification of parties whose conduct was described in a complaint. *See Krupski v. Costa Crociere S. p. A.*, 130 S. Ct. 2485, 2493 (2010); F. R. Civ. P. 15. In this context of amended pleadings, the relation back doctrine equitably limits the windfall of a prospective defendant who escaped suit during a limitations period only because the plaintiff misunderstood a crucial fact about his identity. Yet, the Florida Supreme Court has held that the relation back doctrine for amended pleadings "is a fiction of law, and should never be applied when it will operate to cut off a substantial right or

defense" to a new matter introduced later in time, though connected with the original document. *Livingston v. Malever*, 103 Fla. 200, 214 (Fla. 1931). Further, in the context of lien priority, where prospective defendants have clearly identified themselves by recording their liens in the public record, the concerns of a defendant's windfall are not present. Thus, the Florida Supreme Court long ago acknowledged the inherently acerbic application of the relation back doctrine in the context of lien priority: "We are conscious of the possibility that [the relation back doctrine] if unrestrained could bring about a harsh application unjustly adverse to the interests of a mortgagee."

These holdings reflect a judicial understanding that limitations must be placed on the employment and enforcement of the relation back doctrine to protect lienholders who conditioned their investment in property on the promise of a particular priority in the lienholder line. So far, Florida appellate courts have yet to provide associations with a clear expression of law regarding the interplay between relation back, lien priority, and the application of Chapters 718 and 720 to second mortgagees.

Interpreting Chapter 718, in 1997 the Third District found no error in a trial court ruling that condo assessments levied pursuant to condominium documents recorded in 1974 take priority over a second mortgage recorded in 1980. *Grondin v. Villa Biscaya Jardines, Phase II, Condominium Ass'n, Inc.*, 692 So. 2d 953 (Fla. 3d DCA 1997). Although the case took place in the '90s, the Third District applied the 1980 enactment of Section 718.116(6), because the condominium documents were silent as to the rights of a second mortgage holder. In finding that the applicable statute is not the most recent enactment, but rather the statute as it existed at the mortgage recording, the Court confirmed the dominance of contract principles in association lien foreclosures. The Third District also implied that because the declaration controls, the earlier enactment would apply only when that document is silent. However, the Court did not explain why it chose the mortgage recording date as the applicable statute year. The Third District may have assumed that as the second mortgagee's contractual rights only vested when it recorded the mortgage, law from that same year should apply to that mortgagee's case. Although a mortgagee should be able to generally rely on the law as it existed at the time it entered the mortgage, the mortgagee should also be able to rely on the law as it existed at the time the association recorded its declaration. Thus, the Third District's assumption would be flawed because an earlier contract—the declaration—had already vested and bound the association.

In 2005, the Fourth District held that a condo association lien was superior to a private second mortgage. *Garcia v. Stewart*, 906 So. 2d 1117 (Fla. 4th DCA 2005). However, the Court did not discuss how it made this determination of lien priority, nor did it discuss the relation back doctrine.

Interpreting Chapter 720, the federal judiciary has been clearer. In 2012, the Middle District held that, under Florida law, in order for an association's lien to have priority over an intervening recorded mortgage, the declaration of covenants must contain specific language that the association lien relates back to the declaration recording or that it otherwise would take priority over intervening mortgages. *In re Jimenez*, 472 B. R. 106, 111 (M.D. Fla. 2012). However, Middle District decisions are not controlling in Florida state courts, where most association lien foreclosures occur.

Working in this vacuum of case law, and despite the Florida Supreme Court's precautionary words regarding the relation back doctrine, associations mistakenly employ recent enactments of Fla. Stat. §§718.116 and 720.3085 to assert, often successfully, that an association lien recorded later in time relates back to the recording of the association's declaration, and thus jumps over second mortgages with priority. If it turns out that even half of these second mortgages are superior to the association liens, but are not defended, then the associations are improperly extinguishing enormous amounts of debt at a startling economic loss.

Equally startling is the paucity of statistics regarding the magnitude of association lien foreclosures in Florida. "Sunshinelist" claims that Florida contains over 22,000 condominium associations and over 16,000 homeowners or property owners associations, for a total of over 38,000 associations. The Florida Department of Business and Professional Regulation records show that Florida has nearly 24,000 active condominium associations alone. One forum posited over 47,000 total associations. But exactly what percentage of Florida's 500,000 annual foreclosures do these associations contribute? If the associations contribute 10% of the foreclosures, or just over one foreclosure per association per year, then the associations may be improperly extinguishing $750 million in Florida each year. Oddly, unlike with mortgage foreclosures, nobody appears to be counting.

The lack of comprehensive and reliable data may be the primary reason why the associations are regularly unopposed in their effort to improperly extinguish second

mortgages and other liens. But other factors compound the association data deficiency, including (1) a poor understanding of the legal relationship between the declaration of covenants and the Florida statutes, (2) that declarations of covenants are large and unwieldy documents that can be difficult to locate in the public records and difficult to quickly scan and digest; (3) that second mortgages are often of lesser initial value and their holders often believe that their defense will cost more than their value; and (4) that many believe that the first mortgagee will inevitably foreclose, extinguishing the second mortgage. Although Florida attorneys and the Florida judiciary may not be able to alleviate the data deficiency, they can mitigate these other factors.

Accurate legal analysis combines contract and statute

While the "relates back" language in §§718.116 and 720.3085 does have teeth, it does not automatically catapult an association's lien into second priority without a case-by-case analysis of the association's declaration and a title report on the property at issue. *See Woodside Village Condominium Ass'n, Inc. v. Jahren*, 806 So. 2d 452, 456 (Fla. 2002) (holding courts must look to statutory scheme and declaration to determine legal rights of owners and association). Upon analysis, the "relates back" language is often more alluvium than panacea. And second mortgagees do not need a clear statement from a case-on-point to prove it; the statutes and related Florida cases suffice.

Chapters 718 and 720 *expressly* limit the scope of the relation back doctrine. Prior to 1992, Chapter 718 did not provide for relation back of association liens. Earlier enactments of Chapter 718 reflected the first-in-time, first-in-right principles of the Florida Recording Act and common law. However, in 1992, the Florida Legislature amended Chapter 718 to incorporate the relation back doctrine, relating back to January 1, 1992, or the recording of the original declaration of condominium, whichever occurred last. In 1993, the Florida Legislature limited the statute to relate back to the latter of April 1, 1992, or the recording of the original declaration. The 1993 enactment remains virtually unchanged today. In 2008, the Florida Legislature incorporated the relation back doctrine into Chapter 720, and expressly made clear that "[t]his subsection does not bestow upon any lien, mortgage, or certified judgment of record on July 1, 2008, including the lien for unpaid assessments created in this section, a priority that, by law, the lien, mortgage, or judgment did not

have before July 1, 2008." Thus, at the very least, the relation back doctrine *per se* does not apply to mortgages and other liens recorded prior to the 1992/2008 cutoffs, unless the association declaration expressly provides this right to the association, as discussed further below.

However, because the Florida Legislature only expressly limited application of the relation back doctrine to *mortgages* recorded prior to the 1992/2008 statutory cut-offs, it failed to recognize that the association *declarations* are also "of record," and that these "of record" contracts already provide obligations and promises that subsequent enactments of Florida law cannot infringe upon. Because many condominiums were founded prior to 1992, and a greater proportion of HOAs were founded prior to 2008, whether an association can apply *post*-1992/2008 relation back statutes to *pre*-1992/2008 declarations is a strictly contractual matter determined by language in each declaration, which mortgagees, as third-party beneficiaries, are entitled to enforce. *Coral Lakes Cmty. Ass'n, Inc. v. Busey Bank, N.A.*, 30 So. 3d 579, 584 (Fla. 2d DCA 2010).

Florida law supports the conclusion that a declaration's language is the true determining factor of whether a pre-1992/2008 association may employ the relation back doctrine that is provided in post-1992/2008 enactments of Chapters 718 and 720. First, a declaration of condominium is "the instrument of instruments by which a condominium is created," it is "the condominiums' constitution," and its provisions serve as "covenants running with the land," setting forth "the restrictions and interests that will govern the condominium until the declaration is amended or the condominium is terminated." *Hovnanian Florida, Inc., v. Division of Florida Land Sales and Condominiums, Dept. of Bus. Regulation*, 401 So. 2d 851, 854 (Fla. 1st DCA 1981) (rev. denied, 415 So. 2d 1360 (Fla. 1982)).

Unless expressly declared otherwise, the date of filing of a declaration of condominium fixes the rights and obligations in that declaration, and the date of declaration recording determines which statutes are applicable to a given cause. *Sans Souci v. Div. of Florida Land Sales and Condominiums, Dep't of Bus. Regulation*, 421 So. 2d 623, 628-29 (Fla. 1st DCA 1982). "Thus, *the law on the date of filing of the [declaration]* engrafts the law of Florida into the documents, as if it were expressly stated in the documents."

With a trained eye, any reader can spot an express declaration provision intended to incorporate subsequent enactments of the Florida statutes. Knowledgeable foreclosure

lawyers quickly scan through a declaration's (a) preamble and definitions, (b) lien and assessment enforcement provisions, (c) final miscellaneous provisions and (d) amendments. The reader is looking for specific language altering lien rights or incorporating new law. For example, an association may protect itself by putting investors on notice of its intent to later supersede investors' interests by directly including language in the declaration that its lien for unpaid assessments *relates back* to the date that the declaration was recorded or that it otherwise had lien superiority over intervening mortgages. An association may also protect itself by directly including language that the declaration will be subject to Chapter 718 or 720 as amended "*from time to time*," invoking the "automatic amendment theory" and putting investors on notice that the declaration will later be altered by subsequent statutory enactments altering lien priority. *Ass'n of Golden Glades Condo Club, Inc., v. Sec. Mgmt. Corp.*, 557 So. 2d 1350, 1352 (Fla. 1990) (holding that investors not bound by changes in Condo Act where no "as amended from time to time" language). In addition, an association may protect itself by affirmatively *amending its declaration* to place any future lenders on notice that its economic position will thereafter be subordinate to the association's claims. If this language is not in the declaration or amendments, then that association cannot apply post-1992/2008 statutes in its lien foreclosure action, and cannot claim superiority over prior second mortgages.

In drafting and recording one of these pre-1992/2008 declarations, an association has "made [a] promise, by and through the [d]eclaration, to induce lenders to extend mortgages on property subject to the [d]eclaration," that the association's liens would never subordinate mortgages recorded prior in time. *Ecoventure WGV, Ltd. v. Saint Johns Northwest Residential Ass'n. Inc.*, 56 So. 3d 126 (Fla. 5th DCA 2011) (holding retroactive application of association lien statute to mortgagee unconstitutional). As discussed above, that contractual promise became forever memorialized upon the declaration's recording date.

Upholding that promise in a present association foreclosure action is the only *equitable* action for the court because the association has already benefitted from its conscientious and intentional choice to subordinate its liens to those liens recorded prior in time by gaining investments in the units of the association. The association's intent to subordinate its liens can be readily inferred by the association's failure to exercise the numerous contractual tools that subordinate prior liens or incorporate future enactments of Chapters 718 or 720.

Once an association has entered into a foreclosure action, its path is chosen. For better or for worse, an association that took none of the above actions to contractually reprioritize its lien or incorporate subsequent enactments of Chapter 718 or 720 cannot do so in the middle of litigation. Instead, many associations "took the opposite tack to entice lenders to finance purchases in its community" by locking their declaration into a pre-1992/2008 regime in which lien priority was and would be determined by recording number.

Upholding a declaration's provisions requiring application of the statute enacted at the document recording date is the only *legal* action for a court because the Florida Constitution prohibits any law impairing, retroactively or otherwise, the obligations and rights imposed by the declaration. Any subsequent statutory change in Fla. Stat. §718.116 cannot constitutionally disturb the association's prior, established contractual choice to be governed by the pre-1992/2008 enactments. Where an association's declaration is expressly subjected to the statutory scheme enacted on the declaration's recording date, or where the declaration is silent on priority of second mortgagees, the lien provisions of the documents should be unaffected by subsequent changes in Florida Statutes because, in interpreting or modifying the declaration contract, the Court must construe all provisions of the declaration against the association-drafter, and the Florida Constitution prohibits any law impairing, retroactively or otherwise, the obligations and rights imposed by the declaration. *Century Village, Inc. v. Wellington, E,F, K, L, H, J, M, & G, Condo Ass'n*, 361 So. 2d 128, 133 (Fla. 1978) (holding that even if there is an ambiguity as to the application of subsequent statute enactments to a condo declaration, the Court must construe against the association).

In sum, where the association's declaration is recorded prior to the effective date of a statutory provision, that statutory provision cannot be applied in that association's lien foreclosure to gain superiority over a second mortgage, unless the declaration of covenants expressly incorporates subsequent statutory enactments. *Tradewinds of Pompano Ass'n, Inc. v. Rosenthal*, 407 So. 2d 976, 977 (Fla. 4th DCA 1981); *Ero Properties, Inc. v. Cone*, 418 So. 2d 434, 435 (Fla. 3d DCA 1982).

This is necessarily so even if the second mortgagee became a beneficiary to the declaration, with enforcement rights, after the effective date of the statute. Therefore, if the Third District ever assumed in *Grondin* that a mortgagee's defenses to an association foreclosure are governed by the statute as it existed on the recording date of the

mortgage, then that assumption communicates an incomplete analysis. Independent of when a mortgagee's rights vest, an association's contractual duties vest on the date of the declaration recording, and an association is obligated to abide by those contractual duties and agreements while pursuing foreclosure in 2013.

Righting the ship: inexpensively correcting association misuse of statutes in foreclosure

A review of association declarations in Florida reveals that a large percentage of these documents are recorded prior to the 1992/2008 cut-offs, and that the majority of these documents are: (1) silent on second mortgages, and (2) provide that the association will be governed under Chapter 718 or 720, "as amended." Based on the foregoing discussion, these associations are therefore governed by Florida law as it existed on the recording date of the declaration of covenants, which is the Recording Act and common law providing priority by recording date.

Once a declaration analysis shows that a second mortgage is not subject to post-1992/2008 enactments of Chapters 718 and 720, an association cannot maintain a subsequent lien foreclosure against second mortgagees because, as the superior lienholder, a second mortgagee is neither a necessary nor a proper party to foreclosure proceedings brought by the association as inferior lienholder. *Cone Int'l Bros. Constr. Co. v. Moore*, 193 So. 288, 290 (Fla. 1940). An association's assertion of priority is thus a mere legal conclusion that cannot survive a Rule 1.140(b) motion to dismiss, set on the regular motion calendar. The knowledgeable judiciary could readily grant this motion.

Salvaging second mortgages matters because lending practices reflect the loss from association foreclosures

In normal market conditions, the interest on a mortgage represents the "price" of the borrowed money. This price includes a premium for the lender that, in turn, includes compensation for the risk that the lender cannot recapture its investment. Thus, more unpredictability creates more risk and higher price or tightened lending. Particularly with second mortgages, which are nonrecourse loans, higher prices on new loans are often the

only way that lenders can recoup any value. By compiling and relying upon loss data based on experience with a large number of borrowers, mortgage lenders can predict with at least some accuracy the likelihood of loss, use this data to price their mortgages more efficiently, and rely on the law of large numbers to predict that only an expected percentage of loans will be lost. "The lender thus spreads the risk of default among all borrowers."

If this article's original hypothetical calculation of loss is anywhere near accurate, then some $3 billion in second mortgages could be improperly extinguished in Florida over four years. This loss, based on uncertain and unreliable legal grounds, is the type of unpredictable loss that upsets the status quo of known lien priority rules, and lending rates based on these rules. And while *loss* uncertainty is bad for lenders, *lender* uncertainty is excruciating for Florida—an economy largely based on the flux of the real estate market. Thus, Florida attorneys and the Florida judiciary should work diligently to create assuredness for lenders, which benefits borrowers and the Florida economy: "Predictability enables lenders both to avoid an increased likelihood of loss on default and to estimate the likelihood of loss with great accuracy. This, in turn, allows lenders to price mortgages with greater efficiency and generally to minimize the loss premium that they charge, which inures to the benefit of borrowers." Therefore, attorneys and the judiciary should be vigilant to prevent improper or premature loss from second mortgages extinguished by improper association lien foreclosures.

Contrary arguments are expected, including that defense of second mortgages is wasteful because it is cost-prohibitive or because first mortgages inevitably foreclose. However, the latter argument fails to address both the rising level of loan modifications and the quantity of unsuccessful first mortgage foreclosures in Florida. As of November 2012, more than 1.1 million homeowners in the U.S. received a permanent modification through the Home Affordable Modification Program, and U.S. numbers have steadily shown a disparity between foreclosures started and finished. This argument also fails to address the lender assuredness derived from the predictability of a proper first mortgage foreclosure, as opposed to the unpredictability of an improper association lien foreclosure. Lenders pooling information calculate anticipated first mortgage foreclosures in their price analysis, but cannot foresee or predict the timing or effect of improper association lien foreclosures.

Further, the lower initial value of second mortgages does not make their defense unworthy or cost-prohibitive. By 2006, more than half of the Alt-A mortgage originations also included a second mortgage, creating a substantial amount of investment. For the most part, these second mortgages are either held by the first mortgagee, or securitized into pool investments that are collectively managed through pooling and servicing agreements. Thus, the major U.S. lenders have both a significant stake in the survival of second mortgages, and a significant degree of information on their rate of survival. Because a court should dismiss an improperly named second mortgagee after a motions hearing, the defense of these second mortgages should not be cost-prohibitive.

Conclusion

The immediate economic loss created by the associations' improper foreclosure of second mortgages could be prevented, particularly where a low-cost motion to dismiss obtains immediate relief. A knowledgeable judiciary that is on the lookout for improper extinguishment of second mortgages greatly reduces the resistance cost. If the message is sent clearly and uniformly to all associations, then associations will eventually self-police to ensure compliance. Thus, the Florida judiciary and attorneys should work to protect the rights of second mortgagees in association foreclosures, in order to create assuredness for lenders, which benefits borrowers and the Florida economy.