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Condominium Act

Economic Necessity of Lien Priority of First Mortgages

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IN *Bankers Trust Company v. Board of Managers of The Park 900 Condominium*,[1] the Court of Appeals was called upon to construe one of the most important provisions of New York's Condominium Act, RPL §339-z, which declares the superior priority of the lien of a first mortgage of record over the subsequently filed lien for unpaid common charges of a condominium's board of managers.

The Court held that the lender's mortgages of record on residential condominium units (which consisted of two consolidated and cross-spread equivalent-in-lien first mortgages on each of the units) had priority over subsequently filed liens of the board for unpaid common charges. The Court resolved an issue, in favor of commercial lenders and against condominium boards, which had split the i.a.s. courts.[2]

The Court's implicit rationale was that once the lender's junior mortgages were consolidated into first mortgages, the subordinate status of the lender's junior mortgages disappeared. The subsequently filed liens of the Board for later accruing common charges were necessarily inferior in lien to each of the earlier consolidated first mortgages. This was so, notwithstanding that the Board's liens, once filed, "primed," *i.e.*, jumped in priority, certain other previously filed liens.[3] Thus, foreclosure of the lender's consolidated first mortgages relegated the Board to surplus monies (if any)[4] or to an action at law against the former owner of the foreclosed units.

The Court of Appeals' decision in *Park 900* relied upon the explicit language of RPL §339-z and the meaning of priority under RPAPL Article 13. It was consistent with an important economic underpinning of The Condominium Act: to accord superior lien priority to first mortgages as the inducement for lenders to provide residential condominium financing on terms similar to those available for traditional home mortgage loans. Indeed, the Appellate Division decision in *Park 900* addressed the legislative history,[5] which demonstrated that the Legislature had intended the superior priority for first mortgage liens as an impetus for condominium project construction and for condominium unit acquisition financing.[6]

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But the Condominium Act is even-handed. The economic necessity of priority of a first mortgage to encourage financing is balanced by additional remedies given only to condominium boards. Prompt recourse by a board to its supplemental legal and equitable remedies should facilitate recovery of delinquent common charges from unit owners.

'Park 900'

The lender was the assignee of a series of "purchase money" and other mortgages previously held by another bank on two units in the Park 900 condominium. The lender also advanced additional monies secured by new mortgages on each of the units. The prior and new mortgages were consolidated and cross-spread, so that the lender held two consolidated first mortgages on each unit.[7] The condominium board subsequently filed notices of liens on both units for later accrued unpaid common charges.

The lower court rejected[8] the minority line of cases arising from *Saldivia*, which had held that RPL §339-z created a "hybrid priority," because it declared the superiority of the lien of a first mortgage while at the same time mandating that liens for unpaid common charges be paid upon a "sale or conveyance" of the liened unit.

The rationale of *Saldivia* was that a judicially compelled foreclosure was equivalent to a voluntary "sale or conveyance" under RPL §339-z. Under *Saldivia*, a board's lien for unpaid common charges had to be paid: (a) out of the proceeds of the foreclosure of the first mortgage (whether or not the lender was first paid in full), or (b) by the foreclosure purchaser (if the purchaser was obligated to pay the board's lien, the purchaser would bid less at the foreclosure sale).

In either case, the foreclosing first mortgagee's net recovery would be decreased because the board's subordinate lien would not be cut off on the foreclosure sale (although other subordinate liens would be).

The lower court, however, held that: (i) the "sale or conveyance" language of RPL §339-z applied only to a voluntary, not to a forced judicial foreclosure, sale; and (ii) the Legislature had not intended to exclude condominium board liens from the scope of RPAPL §1353 which extinguishes subordinate liens upon foreclosure of the prior lien. The Appellate Division affirmed, as did the Court of Appeals.

Notably, during the pendency of the board's appeal to the Appellate Division, it moved unsuccessfully in the trial court to declare one of the lender's mortgages to be a second mortgage, to enable the board's liens to gain at least some superiority. The court denied that motion;[9] and the board, in its brief to the Court of Appeals, expressly acknowledged that the lender held two consolidated first mortgages.[10]

The *Park 900* decision carries out the economic rationale of the Condominium Act.

The 1964 Condominium Act was enacted to enable persons to own and hold title to specific residential units in multi-unit structures, similar to ownership of free-standing single family houses, with each unit owner able to obtain separate financing for the particular unit.[11]

The Act created a new form of real estate in New York, by which each unit "could be separately owned, mortgaged, insured or otherwise dealt with as any other piece of individually owned real estate."[12] Each residential condominium unit could be owned sold and mortgaged separately, with foreclosure upon one unit not affecting the ownership of other units in the condominium project.[13] As a result, each unit would have the benefits of "the favored treatment provided by the Banking Law for mortgages upon one-family residences."[14]

The Act facilitated one-family ownership by encouraging lenders to make first mortgage single unit, multi-unit or blanket project loans, secure in the knowledge that their mortgages, when recorded, would have the same superior priority as first liens on any single family residence.[15]

In assessing the credit risk the lender would know that the only subsequently created lien that could prime its perfected first mortgage would be a claim for unpaid real estate taxes; and, the lender would know that its mortgage lien must be paid in full before the board of managers would be entitled to any portion of the sale proceeds arising out of the lender's foreclosure action.[16]

1969 Amendment

RPL §339-z and §339-ff were amended in 1969 to provide that a board's lien would also be subordinate to any subordinate mortgage of record held by the Job Development Authority of the State of New York (JDA). *See*, Laws of 1969, Ch. 489, §§ 1 and 2. The amendment enabled the JDA to make its usual second mortgage loans, even though the security was a condominium unit (this was necessary because RPL §339-ff, as first enacted in 1964, had precluded state bodies and regulated lenders from securing loans on condominium units other than by first mortgages).[17]

The 1969 amendments were addressed, primarily, to RPL §339-ff which had prohibited JDA second mortgages to be secured by condominiums although the JDA was established to make subordinate mortgage loans.[18] RPL §339-z also was amended, so that JDA second mortgages would receive the same "treatment accorded first mortgages of record in that they do not become subordinate to liens for subsequently accruing unpaid common charges."[19]

The Legislature, cognizant of the economics of condominium financing, treated JDA second mortgages as having the same priority over a lien for unpaid common charges as was accorded to first mortgages.

Notably, the Attorney General had unsuccessfully opposed the amendment on economic grounds. He had argued that the bill could "jeopardize the rights of unit owners . . . and may destroy [a condominium's] viability in that [the bill] may cast upon other unit owners the burden of sustaining the losses incurred by reason of the preferred position of Job Development Authority lien."[20]

1974 Amendment

The 1974 amendment permitted the declaration of an exclusively non-residential condominium to provide that the lien for common charges would be superior to any mortgage liens of record.[21] This permissive change in priority of liens was enacted to enable

> lending institutions and developers [in exclusively non-residential condominiums] to decide whether such procedure would be superior to the present absolute requirement that first mortgage liens pre-

cede liens for common charges in priority.[22]

This 1974 amendment, permitting the declaration of an exclusively non-residential condominium to change the normal lien priorities, recognized that potential lenders must be made aware of such change in priorities before deciding whether to make loans secured by the liens granted by the borrower.

The rationale, at least in part, reflected the flexibility of allocating a larger proportion of expenses to non-residential units, which was added by the 1974 amendments to RPL §339-i(2) and §339-m.[23]

1988 Amendment

RPL §339-z was amended again in 1988,[24] to give Urban Development Corporation (UDC) subordinate mortgage liens the same priority over board liens that had been given to JDA subordinate mortgage liens in 1969. This enabled the UDC's "gap financing" to be utilized for high risk projects, it being recognized that in many instances "the private sector lender's participation is conditioned upon receiving a sole first mortgage position."[25]

UDC subordinate mortgages obtained the same lien priority protection as first mortgages of record, 14 years after it was explicitly recognized that the foreclosure of the lien of a first mortgage (in other than an exclusively non-residential condominium) would, as a matter of law, cut off the subordinate lien of a board for unpaid common charges.[26]

Proposed Amendments

Recent unenacted proposals show that the Legislature continues to be fully aware of the economic impact of RPL §339-z upon condominium ownership and financing. Nevertheless, the Legislature has not changed the established superior priority of first mortgages.

Senate Bills S.5183, S.5183-A and S.5183-B would have granted a "super priority" in a residential condominium to a board's lien for unpaid common charges, either: (i) to the extent owing in excess of six months of assessments (S.5183, S.5183-A), or (ii) accruing during the six months prior to foreclosure of the lien of a first mortgage of record (S.5183-B).

Supporting memorandum notes that S.5183-B was proposed to limit the amounts which non-defaulting owners would need to contribute to make up condominium budget shortfalls in the event of foreclosure against one or more units.

Assembly Bill A.438, Senate Bill S.2887, proposed in 1993, would have granted priority to a condominium board lien over a first mortgage lien, similar to that proposed (but not adopted) in 1991 by S.5183-B, "to the extent of . . . unpaid common charges . . . which would have become due during the six months immediately preceding the date on which the first delinquent installment of the mortgage was due."[27]

Supporting memorandum stated that A.438 would "protect the interests of the non-defaulting condominium owners by protecting their interest in the common charges owned by sponsors or other defaulting owners."

None of the proposed 1991 and 1993 bills to amend RPL §339-z were enacted because of the Legislature's fear that to do so might result in lenders requiring an escrow deposit as security for payment of common charges (as urged, unsuccessfully, by the Board in the *Park 900* case), an imposition which has long been recognized as detrimental to the development of condominiums.[28]

Notably, when Rhode Island enacted a statute granting a board's lien a five year super priority, the outcry by lenders was so great that the statute quickly was amended to limit super priority to an amount equal to six months' assessments.[29]

Alternate Remedies

Although a mortgage lender initially must choose between mortgage foreclosure or suit on the debt (RPAPL §1301), the Condominium Act gives to a condominium board various remedies to collect unpaid common charges, with the right to pursue such remedies simultaneously.

RPL §339-z subordinated a board's lien to a first mortgage lien and real estate taxes, and then to JDA and thereafter to UDC second mortgage liens. But the Act compensates a board for its junior lien position by granting to the board other rights and remedies to collect unpaid common charges.

First, pursuant to RPL §339-aa, the board's lien "primes" all other previously filed liens;[30]

Second, RPL §339-aa also authorizes a board to sue on the debt and to foreclose its lien for unpaid common charges at the same time,[31] notwithstanding the prohibition upon a mortgage lender as set forth in RPAPL §1301;

Third, the Condominium Act explicitly provides for a direct cause of action by a board against a defaulting unit owner — RPL §339-v(1)(f) requires that a condominium's by-laws provide a method of payment for and collection of common charges; and

Fourth, RPL §339-j states that the failure of a unit owner to comply with the condominium's bylaws (or rule, regulation, decision or resolutions adopted by the board pursuant to the bylaws) entitles the board of managers to sue for the sums due, for damages or injunctive relief or both.[32] RPL §339-j also provides that where a unit owner flagrantly or repeatedly violates the bylaws, the board of managers may compel the unit owner to post adequate security to assure future compliance.

This special treatment accorded by the Condominium Act to a board's ability to recover unpaid common charges balanced the subordination of a board's lien to the lien of a first mortgage in recognition of the Legislature's awareness of the economic effect of RPL §339-z and the need to provide an "absolute requirement [of] . . . priority" of lien to first mortgages of record.[33]

Balancing the grant of the superiority of lien to lenders is preserved by the Legislature's grant to a condominium board of additional rights and remedies not available to mortgage lenders.

It is clear too that the Legislature, the Appellate Division and the Court of Appeals in *Park 900* (the legislative history of the Condominium Act and the several proposed bills discussed in this article having been submitted to the Court of Appeals), are each fully aware of the economic impact of the order of lien priority found in RPL §339-z and the alternate remedies available to a board of managers.

Conclusion

The *Park 900* decision, sustaining the priority of lien of the lender's two consolidated first mortgages, rests upon the express language of RPL §339-z. The decision also rests upon the economic rationale for the Legislature's grant of superior priority to the lien for the balance due on a first mortgage of record as expressed in the legislative history of The Condominium Act, to provide the incentive for condominium construction and acquisition financing.

Balancing the grant of the superiority of lien to lenders is preserved by the Legislature's grant to a condominium board of additional rights and remedies not available to mortgage lenders. If a board of managers vigorously enforces its rights and remedies against a defaulting unit owner, the interests of the other unit owners can be adequately protected.

(1) 81 NY2d 1033 (1993), *aff'g*, 181 A.D.2d 274 (1st Dep't 1992), *aff'g*, ___ Misc. 2d ___, *NYLJ*, 6/26/91, p. 23, col. 1 (Sup., N.Y. Co.; Gammerman, J.).

(2) The majority of cases sustained the superior priority of lien of first mortgages. *E.g.*, *Fed'l Nat'l Mtg. Assoc. v. Hirsch*, NYLJ, 12/30/92, p. 29, col. 6 (Sup., Rockl. Co., Lefkowitz, J.), *Prudential Ins. Co. of America v. Ward*, 154 Misc. 2d 968 (Sup., N.Y. Co., 1992), and at least 16 others.

By contrast, a minority of cases found, in some manner, priority of the condominium boards' liens. *See*, *East River Savings Bank v. Saldivia*, *NYLJ*, 10/11/89, p. 21, col. 4 (Sup. N.Y. Co.; Lebedeff, J.), and its progeny.

(3) R.P.L. §339-aa; *Washington Fed'l Svg. & L. Assoc. v. Scheider*, 95 Misc. 2d 924 (Sup., Rockl. Co. 1978).

(4) 81 NY2d, at 1036.

(5) 181 AD2d, at 278-279.

(6) *E.g.*, *Memorandum of Joint Legislative Committee on Housing and Urban Development*, McKinney's Sess. L., pp. 1839-1840; Governor's Bill Jacket Accompanying Ch. 82, Laws of 1964, The Condominium Act, 2/25/64 *Report of the State Banking Department on the Condominium Act*, at p. 3.

Accord, *Marine Midland Bank, N.A. v. Valeria Assoc., L.P.*, *NYLJ*, 2/15/94, p. 28, col. 2 (Sup., Westch. Co.; Lefkowitz, J.). (Absent priority, "the premise underlying section 339-z and rationale of [*Park 900*], would be negated as lenders would refrain or severely restrict condominium construction financing if unpaid common charges in an indeterminate amount have priority.").

(7) *See*, Record on Appeal in *Park 900*, pp. 50-130; 35-38.

(8) *NYLJ*, 6/26/91, at p. 23, col. 2.

(9) In *Societe Generale v. Charles & Company Acquisition, Inc.*, 157 Misc. 2d 643 (Sup. N.Y. Co. 1993), a Court "split" a consolidated first mortgage, extending the rule that consolidation of a third or more junior lien with a first lien can not "prime" an intervening pre-existing second lien [*e.g.*, *Skaneateles Svgs. Bk. v. Herold*, 50 AD2d 85 (4th Dep't 1975), *aff'd on Op. of App. Div.*, 40 N.Y. 2d 999 (1976)]. That Court ruled that a board's subsequently filed lien for later accrued unpaid common charges nevertheless "primes" a pre-existing consolidated first mortgage to the extent of the additional monies advanced and new mortgage made after the initial loan, thereby creating a "split priority." The *Societe Generale* Court, which effectuated a "split priority" similar to the "hybrid priority" of *Saldivia* — a concept rejected in *Park 900* — may not have been aware of all of the facts of the *Park 900* case.

(10) *See*, Board's Main Brief in Court of Appeals, pp. 7-8.

(11) *Memorandum of Joint Legislative Committee on Housing and Urban Development*, McKinney's 1964 Session Laws, pp. 1839-1840, at p. 1839.

(12) Governor's Bill Jacket Accompanying Ch. 82, Laws of 1964, the February 25, 1964 *Report of the State Banking Department on the Condominium Act*, at p. 1

(13) Feb. 25, 1964 *Ten-Day Bill, Budget Report*, at p. 1

(14) *Report of the State Banking Department*, *supra*, at p. 3.

(15) The superior priority of lien accorded first mortgages was done "with an eye toward assuring the future availability of financing." Winokur, "Meaner Lienor Community Associations: The 'Super Priority' Lien And Related Reforms Under The Uniform Common Interests Ownership Act," 27 *Wake Forest Law Review*, No. 2, pp. 353-359, at p. 358, n.19 (1992) (hereafter, "Winokur").

(16) *Report of the State Banking Department*, *supra*, at p. 5; p. 6, n.1. *See also*, "Winokur," at p. 359: "[I]t would be folly to ignore the needs of mortgage lenders, whose [loans] have from the start been crucial to" ... condominium projects.

(17) Governor's Bill Jacket Accompanying Ch. 489, Laws of 1969, *Memorandum of the Job Development Authority* (submitted by Assemblyman Henderson to the Hon. Robert R. Douglass, Counsel to the Governor).

(18) Assemblyman Henderson's memorandum, see fn. 23.

(19) The title to Laws of 1969, Ch. 489, §§ 1 and 2 reads, in relevant part: "to afford such [JDA] mortgages the same *protection from* **liens** for common charges as is afforded first mortgages" (emphasis added). McKinney's Session Laws of 1969, p. 763.

(20) May 21, 1969 *Attorney General's Memorandum For The Governor*, at p. 2 thereof.

(21) Laws of 1974, Ch. 1056.

(22) *See*, p. 3 of the *Judiciary Committee Supporting Memorandum* submitted to the Hon. Michael Whiteman, the Governor's Counsel, by Harvey Felton, Esq., Counsel to the Judiciary Committee; *Accord*, May 10, 1974 *Attorney General's Memorandum For The Governor*, at p. 4 thereof.

(23) *Association of the Bar of the City of New York, Bulletin No. 4, Report No. 47*, at pp. 139, 140.

(24) Ch. 672, § 1, Laws of 1988.

(25) *See*, Governor's Bill Jacket Accompanying Ch. 672, Laws of 1988, the *Bill Memorandum*.

(26) *Association's Report*, *supra*, Note 23, at pp. 141-142.

(27) Assembly Bill A.438.

(28) "An additional argument against the 'super priority' lien [of a condominium board] has been that lenders facing a loss of priority would demand that each new homebuyer escrow six months' assessments to protect lenders against the risk of having to pay defaulted assessments. ... [S]uch an escrow requirement would inappropriately increase development costs and home purchase costs to potential buyers already coping with high housing costs and, more recently, a troubled economy." "Winokur," at p. 391.

(29) *Compare*, R.I. Public Laws of 1991, ch. 247, §1, and Public Laws of 1991, ch. 369, §1, *with* R.I. Public Laws of 1992, ch. 8, §1.

(30) *See* Note 3, *supra*.

(31) Thus, the last sentence of the first paragraph of RPL §339-aa provides: "Suit to recover a money judgment for unpaid common charges shall be maintainable without foreclosing or waiving the lien securing the same, and foreclosure shall be maintainable notwithstanding the pendency of suit to recover a money judgment."

(32) Such statutory permission to simultaneously have recourse to equitable and legal remedies is an exception to the general rule that one is not entitled to an injunction if that party has an adequate remedy at law for damages. *E.g.*, *Grogan v. St. Bonaventure Univ.*, 91 A.D.2d 855 (4th Dep't 1982); *Chicago Research and Trading v. New York Futures Exchange, Inc.*, 84 A.D.2d 413, at 416 (1st Dep't 1982) ("Injunctive relief will be afforded only in those extraordinary situations where the plaintiff has no adequate remedy at law and such relief is necessary to avert irreparable injury [cit. om.]").

(33) *See*, May 10, 1974 *Attorney General's Memorandum*, Note 22, *supra*.

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