CALIFORNIA COURT OF APPEALS LETS RECEIVERS LOAN JUMP IN FRONT OF LENDER'S PREVIOUSLY FIRST LIEN

by Ruby J. Chavez, Esq. and Jonathan D. Fink, Esq.

One of the earliest lessons we learn about the taking of real property security for a loan is the rule of "First in time is first in right." In other words, absent an agreement to the contrary by the senior secured party, an earlier recorded lien will have priority over a later recorded one. Indeed, many loans would not be made at all unless the lender was assured of being in first position on the real property security.

A recent decision by a Court of Appeal in California recognizes another exception to the rule—one that does *not* require the senior lender's acquiescence and, in fact, one that can be imposed even over the senior lender's objections.

In the case of *City of Sierra Madre v. Hildreth*, the borrowers, owners of residential real property in the City of Sierra Madre ("the City") had engaged in years of unpermitted work on their real property, apparently with the notion of building a tasting room and wine cellar. Their various projects generated several warnings and orders from the City to stop the work, all of which the borrowers ignored. It was only when their projects led to the encroachment on adjoining property and a serious subsidence of the land that the City got around to filing an action against the homeowners and asked the court to approve the appointment of a receiver as the borrowers refused to comply with the City's orders and were continuing to perform unpermitted work.

The lawsuit also named the beneficiary of the senior deed of trust securing a loan on the property, who was unaware of, and had not approved, the unpermitted work by the borrowers. The beneficiary did not oppose the City's application for a receiver and the trial court approved the appointment, finding that unpermitted construction at the property caused a public nuisance under the City's municipal code as well as under the California Health & Safety Code. The receiver determined that significant remediation was required to undo the damage caused by the borrowers' unpermitted work and obtained estimates of what the remediation would cost. To fund the remediation, the receiver then proposed borrowing $250,000.00 from an institutional lender and securing the loan with *a first priority* receiver's certificate. Despite the beneficiary's objection to the undermining of its senior lien position, the court authorized the first priority receiver's certificate. The court provided the beneficiary with the option of funding the work itself; however, the beneficiary declined to do so. The beneficiary appealed the order granting the super-priority lien.

Among the primary arguments raised by the beneficiary on appeal was that there was no California statute that expressly authorizes a super-priority lien in favor of a court appointed receiver, let alone for a lender from whom the receiver has obtained a loan for the benefit of the receivership property. The beneficiary pointed out that the Court of Appeal for the Fourth District of California in *City of Chula Vista v. Gutierrez*, 207 Cal. App. 4th 681 had already rejected the claim that *Health & Safety Code* §17980.7 provided for such a lien, and noted that if the legislature intended to provide a priority lien it would have done so. Nonetheless, on February 26, 2019, the Court of Appeal for the Second Appellate District of California ruled that, under *Code of Civil Procedure* §§ 564 and 568, as well as case law going back to 1915, a court has broad authority to approve super-priority liens in aid of a receivership in an appropriate case.

Although the Court of Appeal noted that the granting of super-priority liens should be infrequent and may bring about harsh consequences, it did not find that the trial court abused its discretion in awarding a super-priority lien in this case. The Court of Appeal considered that the homeowners refused to abate the nuisance on the property, the beneficiary chose to take no action, neither the homeowner nor the beneficiary chose to fund the remediation, and no lender would loan money to the receiver for the remediation unless it was secured by a super-priority lien on the property. In the end, the Court of Appeal found that courts have the discretion to determine the priority of receivership certificates, citing a 1915 case entitled *Title Ins. & Trust Co. v. California Development Co.* (1915) 171 Cal. 227, 233 where the California Supreme Court affirmed a decision giving receiver's certificate priority over the other indebtedness on the property. The Court of Appeal distinguished the *Chula Vista* case on its facts, which involved an attempt by the receiver to recover its attorney fees from the senior lender (rather than the value of the

property since the receiver had neglected to record its court-approved lien) years after that lender had already foreclosed on the property and sold it to a third party.

In considering the equitable arguments that the beneficiary did not contribute to the nuisance and that the once performing loan would be stripped to nothing or next to nothing, due to a receivership it did not request, the Court of Appeal simply pointed to the fact that the property had minimal value or perhaps even negative value absent the remediation. It was not in dispute that the minimal value was caused by the homeowner's actions and arguably by the City's inaction. Even though the beneficiary was not the cause—or even aware of the unpermitted construction, the Court of Appeal concluded by stating that it is untenable for the beneficiary to bear none of the costs of the remediation and yet receive a windfall once the receiver had paid to have the work done. The Court of Appeal glossed over the beneficiary's arguments that it was inequitable for the parties that contributed to the years of unpermitted construction, the homeowners and/or the City, to not be made to bear the cost and risk of the remediation instead of doing so by displacing and drastically reducing the senior beneficiary's equity position in the property. It should be noted that the receiver has also indicated his intent to seek to recover his fees and costs from the proceeds he holds from the sale of the property, leaving the beneficiary with no recovery from the sale of the property. However, the beneficiary's position is that the Judgment entered in the trial court limits him to seeking repayment of his fees and expenses from the borrowers.

The risk going forward is that other cities will emulate the City of Sierra Madre by going into court to seek authority to have a receiver appointed to remedy code violations or nuisances by using the beneficiary's equity as the guarantor of payment. Receivers will have little to no incentive not to spend whatever monies they deem fit to remediate these properties, up to and above the entire value of the property as long as a court approves. It is inevitable that the receiver will also seek to invoke the super-priority lien for recovery of his or her own fees. For their part, courts generally will continue to defer to the receiver, who is supposed to be a neutral party.

A senior lienholder facing a code violation riddled property has several good options though. At minimum, it (or its loan servicer) needs to remain vigilant in order to detect and, if possible, prevent borrowers who are committing waste on the security, whether by engaging in unpermitted work or otherwise. This is especially true where the senior lienholder learns of any code violations by, or nuisance claims against, the borrowers before a lawsuit is filed by the governmental entity and before a receiver is ever sought, let alone appointed. Once it learns of such violations or claims, the senior lienholder needs to be proactive in working with the borrowers and, where involved, the appropriate governmental entities to attempt to address and resolve the issues. ***This is true even if the borrower is still residing in the property and the lender has not yet completed its' foreclosure. Too many servicers have gotten themselves in trouble taking a "hands off" to approach to pre-foreclosure code violations***.

The senior lienholder should also weigh carefully the costs of funding any cure against the existing *and potential* equity in the security to evaluate whether it is cost-effective to do so with the realization that, if it does not do so itself, a super-priority lien might deprive it of any recovery from the security. If the senior lienholder will not be funding the cure itself, it needs to be more diligent in the litigation and, if grounds exist, seek to oppose the receiver from the start rather than seeking to limit the receiver's authority after he or she has already been appointed. If the senior lienholder loses its priority as a result, and there is insufficient equity left to repay the loan, there might still be remedies it can pursue against the borrowers, *e.g.* for fraud or waste but that only helps if the borrowers have other assets with sufficient equity. While foreclosure by the senior lienholder before a lawsuit by the governmental entity can be filed and/or a receiver can be appointed, might seem tempting in these scenarios, the foreclosure process is not always so nimble or quick and, more importantly, once the senior lienholder forecloses, it becomes the one directly on the hook for the remediation and the costs of any receivership.

While there are no guarantees of success here, a failure to be proactive and/or to vigorously oppose where grounds exist greatly increases the risk of loss of the senior lien position. Absent diligence and a strong stand, the senior lienholder might well find itself with a deed of trust that has now merely become only suitable for framing.

If you have any questions about the *City of Sierra Madre* decision, its impact on your servicing practices or a particular loan involving code violations, please feel free to contact Ruby Chavez at rchavez@wrightlegal.net or Robert Finlay at rfinlay@wrightlegal.net.

Ruby J. Chavez, Esq.
rchavez@wrightlegal.net

Jonathan D. Fink, Esq.
jfink@wrightlegal.net

Jonathan Fink is a Partner in WFZ's California Office.

Disclaimer: The above information is intended for information purposes alone and is not intended as legal advice.