Unique Concerns When Foreclosing Junior Liens on Real Estate in Ohio

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There has been some significant activity recently involving the rights and obligations of junior real estate lienors in Ohio who file foreclosures to realize on real estate liens. The purpose of this post is to discuss that activity and remind lenders and their counsel of one important right of senior lenders that has not changed.

1. In December 2018 Governor Kasich signed an amendment to Ohio's Residential Mortgage Lending Act. *Inter alia*, the change provides a new notice requirement for all actions to collect a debt secured by residential real property if the foreclosed lien is a second mortgage or junior lien. Titled *Collecting debt on junior liens* Ohio Revised Code Section 1349.72 now states in part:

- Before a person **collecting a debt secured by residential real property** collects or attempts to collect any part of the debt, the person shall first send written notice as described in division (B) of this section via United States mail to the residential address of the debtor, if both of the following apply:
  - **The debt is a second mortgage or junior lien on the debtor's residential** real property.
  - The debt is in default.
- The written notice shall be printed in at least twelve-point type and state the following:
  - The name and contact information of the person collecting the debt;
  - The amount of the debt;
  - A statement that the debtor has a right to an attorney;
  - A statement that the debtor may qualify for debt relief under Chapter 7 or 13 of the United States Bankruptcy Code, 11 U.S.C. Chapter 7 or 13, as amended;
  - A statement that a debtor that qualifies under Chapter 13 of the United States Bankruptcy Code may be able to

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protect their residential real property from foreclosure.

- Upon written request of the debtor, the owner of the debt shall provide a copy of the note and the loan history to the debtor. . . .. (bold added)

For purposes of this post, the point is that a new notice requirement now impedes the junior lienor's path to the courthouse in a foreclosure case. Since many residential real property foreclosures are personal / consumer matters, experienced counsel already knows that there is a notice requirement under the Fair Debt Collection Practices Act. Best practices will include developing a checklist and forms for sending required notices that meet both federal and state law. So far as I am currently aware, there is no reason that the notices cannot be sent simultaneously.

2. Ohio Condominium Associations recently lost an appellate decision that relegated the priority of liens for unpaid dues and assessments to the date that notice of the lien was filed. See, *The First Filed Real Estate Interest Has Priority, Sometimes* (5/7/19) discussing *Harbour Condominium No. 3 Association v. Gentile et al.*, 2019 WL 645207 (Cuyahoga Cty. App. Feb. 14, 2019). The *Harbour Condominium* case acknowledges and then disagrees with several trial court decision-makers (judges and magistrates) who had given lien priority to condo associations from the date that condo declarations were filed.

If the *Harbour Condominium* case is followed, it would seem that the new notice requirements of O.R.C. Section 1349.72 apply to many foreclosure cases brought by condo associations since those liens will probably be a "junior lien" as their priority date will be much later than otherwise would be true.

3. When a junior (or senior) lienor starts a real estate foreclosure case in Ohio, they must file title work that identifies all other lienors. See O.R.C. section 2329.191 and related statutes. It is common to include senior lienors as defendants[1] when a junior lienor begins a foreclosure case. In fact, some courts seem to require that senior lienors be made defendants. See, for example, Hamilton County, Ohio Court of Common Pleas Local Rule 45(E)1(d) and Cuyahoga County, Ohio Common Pleas Local Rules 24 and 27.

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Junior lienors routinely want to include senior lienors as defendants in foreclosure cases so that the real property can be sold free and clear of liens. At this time, I want to address situations where the senior lienor does not want to have its lien removed from the property even if the priority of that lien is not disputed.[2]

The tension is between the common law equitable concept of "lien marshalling" and Ohio Revised Code Section 2329.20 and related cases. Lien marshalling is the is a doctrine that protects junior creditors by limiting the rights of an over-secured senior creditor so that assets or the value in assets that in reality is free of the senior's lienor's claims are available to the junior creditor for execution and debt collection. *Homan v. Michles*, 194 N.E.2d 162, 164 (Sandusky Cty. App. 1963) ("Thus if a senior creditor has a lien on two different parcels of land, and a junior creditor has a lien on only one of such parcels and the prior creditor elects to take his whole demand out of the parcel of land on which they both have liens, the junior creditor is entitled either to have the senior creditor thrown upon the other fund or to have the prior lien assigned to him for his benefit. If, to prevent delay to the paramount creditor having the lien on all, he is allowed to take the proceeds of the sale of the tract on which both have liens, the other will be subrogated to the lien of the first, to that extent, against the other tracts.") The clear purpose of marshalling is to provide some money to junior creditors without damaging the senior creditors. *Id.*[3] and see *Jackson Production Credit Assn. v. Perry,* 1984 WL 5628 (Vinton Cty. App. Aug. 31, 1984).

Ohio Revised Code Section 2329.20 provides in part:

In all cases in which a junior mortgage or other junior lien is sought to be enforced against real estate by an order, judgment, or decree of court, **subject to a prior lien thereon**, **and such prior lien, and the claims or obligations secured thereby, are unaffected** by such order, judgment, or decree, the court making such order, judgment, or decree, may determine the minimum amount for which such real estate may be sold. In such a case, the minimum amount [sheriff's sale [price] shall be not less than two-thirds of the difference between the appraised value of the real estate as determined in that section, and the amount remaining unpaid on the

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claims or obligations secured by such prior lien. (bold added)

The implication of Section 2329.20 is clearly that senior liens can be left on property after the sheriff's sale because property can be sold "subject to a prior lien" and that senior lien is "unaffected." But, do those liens have to be left unaffected or can marshalling apply and the property be sold free and clear of all liens?

The current trend in Ohio case law is to permit the senior lien creditor to determine if its lien will remain "unaffected" by a sheriff's sale initiated by a junior lienor. *Village of Woodcreek Condominium Owners Association v. Diedenhofer*, 2016 WL 1133404 (Clermont Cty. Com. Pleas Feb. 29, 2016) is a case involving a foreclosing condo association and a prior bank mortgage. In that case, the court said this:

The plaintiff and the Bank disagree as to whether the plaintiff may foreclose on Ms. Diedenhofer's property and have it sold free and clear of the Bank's mortgage, which is not in default. . . . The clearest case involving a mortgage on this inquiry is *Metropolitan Mortgage Co. v. Nugent Furniture* Co., 40 Ohio App. 302, 179 N.E. 362, 11 Ohio Law Abs. 7, (6th Dist. 1931). . . . [In that case the] appellate court resolved the issue by holding that **the trial court "was without power to order the whole premises sold, thereby foreclosing the lien of the first mortgagee without its consent and before maturity of the debt."**

Both parties cite to the later case of *Society Bank & Trust Co. v. Zigterman*, 82 Ohio App.3d 124, 126, 611 N.E.2d 477 (3d Dist. 1992), which adds little clarification. The court observed that "[i]t has long been the law that a mortgagee with an interest senior to all others is not a necessary party in a foreclosure action initiated by a lienor with an interest acquired subsequent to another's interest in the same property." When the senior mortgagee is not a party and the property is sold, the purchaser takes the property subject to the senior mortgagee's prior mortgage. . . . This begs the question, when a senior mortgagee is a party to the foreclosure initiated by a junior lienholder, must the property be sold free and clear of the senior mortgagee's mortgage if the junior lienholder demands it? . . .

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Notably, the statute [2329.20] does not require the court to order the property sold subject to the first mortgage. Rather, it states instead that the court may determine a minimum amount for the sale, being not less than two-thirds of the difference between the value of the property as appraised and the amount remaining unpaid on the first lien. … In analyzing R.C. 2329.02, the Fourth District Court of Appeals has opined that when there are multiple liens against a property, as in this case, "the equitable principle of marshalling liens provides that proceeds will be applied to all lienholders' claims, in order of their priority. The court expressly noted that under R.C. 2329.02 **"there are limits to the right of a junior lienholder to compel sale of property. If a senior mortgagee does not consent to acceleration of its interest, the property may only be sold subject to the continuing mortgage."** . . .

A more useful case is *Jackson Production Credit Association v. Perry*, 4th Dist Vinton No. 409, 1984 WL 5628 (Aug. 31, 1984). In quoting *Metropolitan*, the *Perry*Court reaffirmed that "**there are limits to the right of a junior lienholder to compel sale of property, if a senior mortgagee does not consent to acceleration of its interest, the property may only be sold subject to the continuing mortgage."** . . .

Accordingly, the court finds that in a foreclosure sale Ms. Diedenhofer's property must be sold subject to the Bank's first mortgage . . .. (bold added)

The lesson for counsel foreclosing a junior real estate lien are these: pay attention to state law notice requirements, not just the well-known FDCPA requirements, and consideration must be given to how you handle senior lienors. If in doubt and it matters to you, try to create conditions that may cause the senior lienor to consent to a sheriff's sale free and clear of its lien (for example, asking for a receiver who might imperil the property owner's payments to the senior lender can cause the senior lender to want to exit its lien/credit position).[4]

P.S. One closing consideration about the interplay of credit bids[5] at the sheriff's sales and the senior lienor's decision on how its lien will be treated:

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- If the foreclosing junior lienor thinks it might want to credit bid at the sheriff's sale, it will have to advance cash (up to the bid amount) to pay all prior liens that are being removed from the property – always taxes and perhaps the senior creditor's lien. This is another consideration when planning for how the senior creditor may react to the junior lienor's foreclosure because a senior creditor who chooses to permit its lien to be removed will have to be paid; and
- On the other side, a senior creditor cannot credit bid at a sheriff's sale if its lien will remain on the property after the sale. That fact could lead the senior lienor to participate in the foreclosure case and put its lien "in the case."

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[1] This practice often does not apply to taxing authorities who have a first lien under state law because many counties have a local rule on this point. Taxing authorities should be included if the foreclosing creditor intends to challenge the amount or priority if the taxing authority's claim.

[2] I have seen this fact situation in two circumstances: when the senior lienor has a larger relationship with the property owner that the senior lienor does not want to disturb; or where the property sale might not produce proceeds sufficient to pay the senior lien in full and the senior lienor believes that the more time will improve its position.

[3] "The power to compel a party who has two funds to resort to the one on which others have no claim will only be exercised when it will work no injustice to any party connected with the litigation. As the principle of marshalling originated in courts of equity for the very purpose of preventing injustice to a junior lienholder, a court of equity will not interfere when such interference would work injustice either to the common debtor or to other persons under circumstances where it would be inequitable to apply the principle.

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. . . Cases throughout the United States seem to be in full accord that a junior creditor of a common debtor cannot, under the guise of the doctrine of marshalling assets, require a senior creditor, who is additionally secured by the common debtor's surety, to resort first to the surety's property before having recourse to the property of the principal debtor." (citations omitted).

[4] Sometimes just the firm resolve of a junior lienor to proceed with a sheriff's sale will convince the senior lienor to exit its lien position through the sale. Most banks I know do not want an unknown new owner of their collateral who has no personal liability for the debt; that situation is the senior lienor's risk of a sheriff's sale subject to the senior lien when the property purchaser does not assume the debt (assuming the senior lienor would permit an assumption).

[5] A credit bid at a sheriff's sale "allows a secured judgment creditor to bid on property up to the amount of the debt owed, in lieu of making a cash bid." *Fannie Mae v. Hicks*, 77 N.E.3d 380 (Cuyahoga Cty. App. 2916). This permits a bidding creditor not to transmit cash to the sheriff if that cash would be returned to the bidding creditor in recognition of the secured debt's lien that is being released through the sale.

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