



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, D.C. 20410-0500

OFFICE OF GENERAL COUNSEL

Legal Opinion: CIM-0124
Index Number: 3.135
Subject: Refinancing - Sec. 223(f)

MEMORANDUM FOR: Louis N. Smigel, Acting Assistant General Counsel, 2AC

THROUGH: Richard A. Hauser, General Counsel, C

FROM: John J. Daly, Associate General Counsel for Insured Housing, CI

SUBJECT: FHA-insured Refinancing under Section 223(f) of New York 202 Projects:
Maria Isabel, CABS, and Aquinas Housing

This memorandum responds to a December 6, 2001 memorandum (“Opinion”) from former Assistant General Counsel Sara Manzano to John Daly, Associate General Counsel for Insured Housing. That memorandum concluded that the proposed refinancing of the above-referenced Section 202 properties under Section 207¹ pursuant to Section 223(f)² of the National Housing Act is legally barred by Section 207. In addition, we received a copy of the Deed and Land Disposition Agreement for the CABS Senior Housing Development Fund (“CABS Covenant”) which was attached to your note to our office dated January 31, 2001.³ For the reasons expressed below, we have no legal objection to the proposed transactions.

The Opinion states that the New York City Land Disposition Agreements (“Covenants”) preclude the refinancing of the Section 202 properties with FHA-insured mortgages pursuant to the Section 223(f) program under the laws of the State of New York. The basis expressed for this position is that these Covenant restrictions conflict with HUD’s statutory requirement that a mortgage insured pursuant to Section 223(f) be a first lien as commonly given in the jurisdiction where the property is located. In addition, the Opinion appears to be grounded in the proposition

¹ 12 U.S.C. 1713(a)

² 12 U.S.C. 1715n(f)

³ Based on our review of the Deed and Covenant, we agree with your statement that the Covenant limits the exercise of a right of reversion to the period of construction. Therefore, this restriction no longer would be operative because the period of construction ended years ago.

that restrictive covenants that survive foreclosure would “prime” the first lien status of a mortgage that is security for a loan to be insured by FHA.

“First Lien”

Section 207 of the National Housing Act (“Section 207”), in defining acceptable mortgages, provides:

(a) As used in this section –

- (1) The term "mortgage" means a first mortgage on real estate in fee simple, ... and the term “first mortgage” means “such classes of first liens as are commonly given to secure advances (including but limited to advances during construction) on, or the unpaid purchase price of, real estate under the laws of the State in which the real estate is located....⁴

Our research has not revealed any cases in New York that define a “first lien.” It is clear, however, that under both Section 207 and New York law, a mortgage is a security interest in real estate. In the 1892 case cited in the Opinion, a mortgage is defined under New York law as “any conveyance of any interest in real property intended by the parties to be security for the payment of a debt or the performance of some other obligation. Burnett v. Wright, 135 N.Y. 543 (1892). The word "lien," however, is used in the Opinion to connote almost any manner of claim or interest in real estate, including the Covenants. This interpretation can lead to legally unsupportable conclusions regarding the relationship of "liens" to other encumbrances, especially about which one should have recordation priority. This crucial distinction between liens and encumbrances is clarified in the cases discussed below, several of which are cited in the Opinion.

In Marine Midland Bank v. Marcal Enterprises, Inc., 91 Misc.2d 810, 398 N.Y.S.2d 782 (1977), a case of first impression in New York, the plaintiff sued to foreclose a mortgage and included as a defendant the United States of America which had leased a portion of the subject property. The plaintiff further claimed that existence of the lease would make the property virtually unmarketable at a foreclosure sale. The court held that, although a lease is an estate or interest in real property, it is not a lien. Relying on the following definition of lien, the court stated that clearly "a lien is a security interest in real property."

In its broadest sense and common acceptance a lien is understood and used to denote a legal claim or charge on the property, either real or personal, *as security for the payment of some debt or obligation.*

Id. at 783 (citing Ansonia Nat'l Bank v. United States, 147 F.Supp. 864, 865 (D.C. Conn. 1956) (emphasis added). The court held that the United States leasehold was an ownership interest and not a security interest. Therefore, plaintiff's action did not provide

⁴ 12 U.S.C. 1713(a)(1).

a basis for suing the United States under a statute⁵ permitting the United States to be named as a party in any civil action or suit in state court to foreclose a mortgage or other lien upon real or personal property on which the United States has, or claims, a mortgage or other lien. Id.

Notably, the Ansonia case, upon which the court in Marine relied, further defines a lien as "*the right which a creditor has of detaining in his possession the goods of his debtor until the debt is paid.*" Id. at 865. (emphasis added). In that case, an owner of land agreed not to erect any building on a twelve foot strip of his land which adjoined land being acquired by the United States for post office purposes. In an action against the United States under the same statutory authority, the court held:

In the instant case, there is no debtor-creditor relationship between the plaintiff and the United States. Moreover, even if the United States has some rights in relationship to plaintiff's use of land, the United States has no interest in that land out of which it could be satisfied if those rights were abused. Whether this agreement constituted an easement by grant or merely a covenant is immaterial. The fact that the United States has neither a lien or mortgage interest in the land is sufficient to deprive this court of jurisdiction over the action.

Ansonia Nat'l Bank v. United States, at 865. It is clear from this case that what distinguishes recorded encumbrances, such as the Covenants, from recorded FHA-insured mortgage liens is the distinct differences in the remedies available for non-performance. A mortgage lien is based upon a financial obligation and the ultimate remedy for violation of the mortgage is foreclosure. The remedies for a violation of a covenant, on the other hand, are directed at assuring compliance with an agreement, such as to maintain the property for elderly housing. Under the general provisions of § 501 of the CABS Covenant,⁶ the non-breaching party may seek specific performance and money damages for violation of the Covenant. Pursuant to the more specific provisions set forth in § 503,⁷ the non-breaching party may bring suit to cure the breach of the covenant. The

⁵ 28 U.S.C. § 2410(a).

⁶ See page 35, § 501 of the CABS Covenant which states, in relevant part, that:

in the event any party hereto shall fail to comply with or violate any of the provisions of this Agreement, then and in that event the other party hereto may institute such actions or proceedings as it may deem advisable as well as proceedings to compel specific performance and the payment of all damages, expenses and costs.

⁷ See also page 42, § 503, Paragraph B which provides, in pertinent part:

The City shall have the right in the event of any breach of the covenant...and the United States shall have the right in the event of any breach of the covenant...to exercise all the rights and remedies, and to maintain any actions or suits at law or equity or other proper proceedings to *enforce the curing of such breach of agreement or covenant*, to which it or any other beneficiaries of such agreement

remedy of foreclosure, however, would not be available because there is no security interest in land out of which these rights could be satisfied, if abused.

Nature of Restrictive Covenants Versus Mortgage Liens

Even when a restrictive covenant such as the Covenant survives foreclosure, lien priority would depend upon the nature of the restrictive covenant and whether it is a lien or encumbrance. An encumbrance is any right to, or interest in, land which may subsist in another to the diminution of its value, but consistent with the passing of the fee. Creative Living, Inc. v. Steinhauser, 78 Misc.2d 29, 355 N.Y.S.2d 897 (1974). Encumbrances may include a broad spectrum of rights or interests in real estate that constitute a burden on the property which can impair its free use or transfer. Encumbrances, therefore, include mortgages, judgments, liens, leases, deed restrictions, covenants, easements, and other limitations on the ownership of real estate. Id. Although liens are included with the meaning of encumbrances, not all encumbrances are liens. A restrictive covenant may, or may not, be a lien. Whether a restrictive covenant constitutes a lien (i.e. creates a security interest) would depend on the specific terms of the covenant and the remedies for violation of such covenant.

Inchoate Lien

The Opinion states that restrictive covenants may give rise to an inchoate lien. In support of this position, the Opinion cites to Neponsit v. Property Emigrant Industrial Savings Bank, 278 N.Y. 248, reargument denied, 278 N.Y. 704 (1938). Neponsit involved an action brought by a property owners' association to foreclose a lien arising from a breach of a deed covenant requiring landowners to pay a fixed sum of maintenance fees. Plaintiffs sought to foreclose upon an alleged lien arising from the covenant contained in a deed of conveyance of land. Significantly, the covenant explicitly stated that any unpaid charges would "become a lien on the land and shall continue to be such lien until fully paid." Id. at 251. In addition, the covenant expressly vested in the property association the right to bring "all actions against the owner of the premises...for the collection of such charge and to enforce the aforesaid lien," including foreclosure. Id. at 254. Liens of this nature which are recorded prior to the insured lender's first lien would affect first lien status adversely because the deed covenant in Neponsit expressly created the lien, and the remedy of foreclosure was available. Based on our review of the CABS Covenant, it does not expressly create a lien, and it is our understanding that all of the Covenants are similarly drafted.

Recordation and Priority

Several cases are cited in the Opinion in support of the position that any restrictive covenants that are recorded prior to HUD's first mortgage survive foreclosure and thus "prime" the first lien status of the FHA insured mortgage. The word "prime" is used vaguely in the Opinion to mean "recorded prior to and therefore take priority."⁸ In other words, the Opinion

or covenants may be entitled. (emphasis added).

⁸ The term "prime" has been defined as follows: "To take priority over." Black's Law Dictionary, Seventh Edition, at 1210.

stands for the proposition that *any* encumbrance recorded prior to the insured lender's first lien would adversely affect its first lien status. This position, however, has no support in any of the case law cited in the Opinion. For example, the Opinion cites to Maidment et al. v Newbridge Properties, Inc., et al., 53 N.Y.S.2d 581 (1945), where "it was held that the mortgage lien was not subject to restrictive covenants set forth in deeds of conveyance made by the mortgagor *after* recording of the mortgage." (emphasis in original). Indeed, this is the general common law rule of "first in time first in right." Metropolitan Life Insurance Co. v. United States, 9 A.D.2d 356, 194 N.Y.S.2d 168 (1959). The Maidment case, however, does not stand for the proposition that restrictive covenants recorded *prior* to the FHA-insured mortgage necessarily would have an adverse effect on first lien status⁹ nor does it hold that all restrictive covenants are liens. In fact, based on the definitions of lien set forth in both the Marine¹⁰ and Ansonia¹¹ cases, restrictive covenants that do not constitute liens, even though recorded before the insured mortgage, would not prime the mortgage's first lien status under New York law.

Rejection of Title

The Opinion cites a line of cases in support of the position that restrictive covenants, such as the proposed Covenants, justify the rejection of title. Isaacs v. Schmuck, 245 N.Y. 77 (1927); O'Hara v. Bronx Consumers Ice Co., 254 N.Y. 210, 172 N.E. 472 (1930). These cases involved actions by prospective purchasers to recover down payments from the sellers. In both the Isaacs and the O'Hara cases, the courts held that when prospective purchasers bargain for property without restrictions (or subject to specifically enumerated restrictions), any restrictions that exist outside of those contemplated or bargained for in the proposed contract justify the rejection of title and the return of the purchaser's down payment. A prospective purchaser of any HUD-insured or HUD-owned property surely would have knowledge of any duly recorded restrictive covenants that would limit the use of the property. Unlike the purchasers in the cases cited, buyers of HUD properties would make an informed decision and *may* reject title. A purchaser's rejection of title, however, is not mandatory. Acceptance or rejection is dependent upon the needs of the purchaser and the nature of the bargain. This concept of rejection of title by a purchaser, however, has no bearing on the issue of the first lien status of the FHA insured mortgage and is not relevant to the issue of the quality of the lien held by the insured lender.

Title Policy/Marketability

In a transaction involving FHA mortgage insurance, there must be compliance with the statutory "first lien" requirement. The status of the first lien on an FHA insured mortgage is established through a title insurance policy. See 24 CFR 200.61; HUD Handbook 4430.1, Paragraph (1-10) (The title policy must show the insured mortgage as the first lien.). We understand that a title company in New York has indicated that it will insure the first lien status

⁹ See Estate of Dresner v. State, 242 A.D.2d 627, 662 N.Y.S.2d 780 (1997) (although chronological priority of liens is a factor to be considered in determining priorities, it is not dispositive).

¹⁰ 398 N.Y.S.2d 782, 783.

¹¹ 147 F.Supp 864, 865.

of the FHA-insured mortgage in the proposed transactions. We are not certain whether the Covenants will appear as informational items or exceptions to the title policy. In any event, the Covenants then would raise the issue of marketability. Handbook 4430.1 provides at the outset of the above-cited paragraph that the Director of Housing Development is responsible for making a determination about whether any title exceptions adversely affect project value or marketability. In addition, the HUD Form 7 Closing Instructions indicate under item 5(a)(3) that exceptions falling within a "doubtful" zone may be waived by the local Director and "where there is such a waiver, the closing attorney will rely thereon." This procedure remains in effect so the Housing program office is charged with making an administrative policy determination about whether a particular exception on the title policy adversely affects the value or marketability of a project, including any covenants that run with the land.

Conclusion

Not all restrictive covenants are liens. In fact, restrictive covenants that do not constitute liens, even though recorded before the insured mortgage, do not prime the mortgage's first lien status. Even when a restrictive covenant survives foreclosure, lien priority would depend upon the nature of the restrictive covenant and whether it is a lien. In addition, the concept of rejection of title by a purchaser has no bearing on the issue of the first lien status of the FHA insured mortgage and is not relevant to the issue of the quality of the lien held by the insured lender. Whether the Covenants adversely affect the value or marketability is a matter to be resolved by program administrators. In short, the Covenants do not expressly create liens (i.e. a security interest in land out of which these rights could be satisfied, if abused), and as such, the remedy of foreclosure is not available.

For the reasons expressed above, we have no legal objection to the proposed transaction provided: (1) a title company in New York in fact insures that the FHA-insured mortgage is a first lien; (2) the opinion by counsel to the mortgagor does not disclose any defect in title that would raise questions about the first lien status; and (3) Field Counsel or FHA administrators are not made aware of any liens which otherwise would jeopardize the first lien status of the insured mortgage. The position expressed in this memorandum should be applied by HUD closing attorneys in this and other transactions with similar encumbrances.

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McKenzie-John	Hopkins	Potts

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CI Date	C Date	
Daly	Weidenfeller	
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