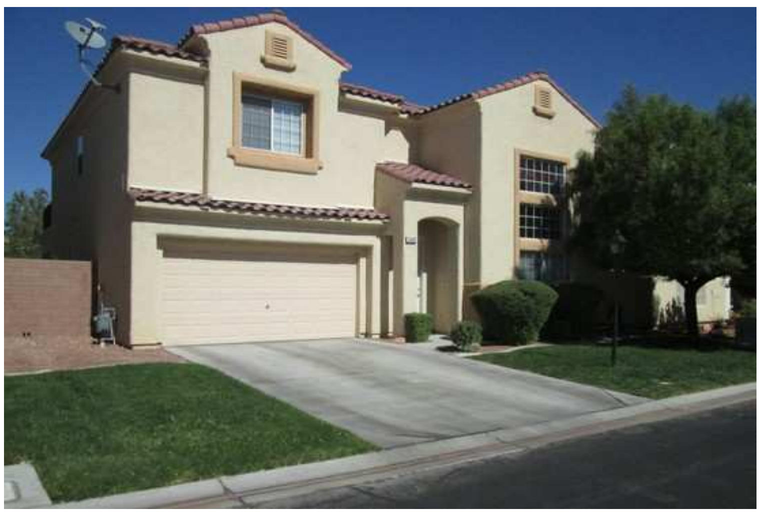
U.S. NEWS

Foreclosure Dispute Pits Mortgage Lenders vs. Investors

With 'Millions—Perhaps Even Billions' at Stake, Nevada Case Could Reverberate Across Housing Market

By JOE LIGHT

Oct. 14, 2014 5:24 p.m. ET



A home in Las Vegas that a homeowners association foreclosed on and sold to SFR Investments, which fixed it up. Lenders are challenging such sales. *SFR Investments*

Mortgage lenders and housing investors are squaring off in Nevada over a court decision that has allowed thousands of foreclosed homes to be sold for pennies on the dollar, in a case that could have big implications on an already-tight home-loan market across the country.

At issue are homeowners associations and the liens they put on properties when a homeowner stops paying dues. Homeowners associations enforce rules in a community and collect dues to maintain common areas and pay for repairs.

Like lenders, homeowners associations can foreclose on homes to recoup delinquent payments, an option that many have taken after waiting years for lenders themselves to foreclose, a scenario that has left homes without dues-paying owners and some HOAs strapped for cash. Nevada and about 20 other states have laws that allow HOA liens to get priority over first mortgages.

The result, according to a recent state court decision, is that homes can be put up for auction by HOAs—without the blessing of the mortgage lender—and sold, extinguishing the first mortgage and allowing the investor to get title to the home. Such sales often are for an amount equal to or slightly above the HOA dues in arrears.

In a court filing Tuesday, the Mortgage Bankers Association wrote that because of the decision, "mortgage lenders stand to lose millions—perhaps even billions—of dollars in security interests."

Lenders nationwide have argued that HOAs should have to foreclose through the court system and shouldn't have the power to wipe away entire mortgages. But in a closely watched case in September involving Bank of America Corp. , the Nevada Supreme Court said they can do so, and sent the case back to a lower court. Last week, Bank of America requested that the state Supreme Court reconsider.

If the decision stands, some investors expect to receive a windfall. "This is one of the greatest returns in real estate that I've ever seen," said Jay Bloom, a director of First 100 LLC, an investment firm that bought more than 1,000 homes in states including Nevada and Washington. Many homes purchased by investors were sold for only a few thousand dollars, but had values in the hundreds of thousands of dollars.

Debra Still, chief executive of Pulte Mortgage LLC, said her company and others are still wrapping their heads around the decision and researching its implications. But one thing seems certain, she said: "This is unexpected and a dramatic change from what was common and customary.…It's not going to help loosen credit."

David Stevens, president of the Mortgage Bankers Association, said that if the decision stands, banks will have to account for it by raising mortgage rates in Nevada.

It isn't yet clear who would get hit with the bulk of the losses. Most mortgages are pooled into securities and are owned or handled by multiple parties, including mortgage investors and servicers. Investors and mortgage-finance giants Fannie Mae and Freddie Mac could assign blame to the servicers for not protecting their interests in the properties.

To the extent that Fannie Mae and Freddie Mac aren't able to recover the money, taxpayers could potentially take the loss. A spokesman for the Federal Housing Finance Agency, which regulates Fannie and Freddie, said in a statement, "FHFA is concerned with the decision and is reviewing its significant implications for housing finance."

The case brought to the Nevada Supreme Court involved a Las Vegas home purchased in 2007 with an $885,000 mortgage originated by Bank of America. The homeowner defaulted on the mortgage the next year. The Southern Highlands Community Association foreclosed on the home and sold it at auction in September 2012 to SFR Investments Pool 1 LLC, a closely held investment company. SFR paid $6,000, the amount owed to the HOA by the delinquent homeowner.

Bank of America scheduled its own foreclosure sale for December 2012 but SFR filed to stop the sale, arguing that the HOA auction extinguished the $885,000 mortgage. (The case was actually brought against U.S. Bank, the trustee for the securities associated with the home's mortgage, but was litigated by Bank of America.)

Bank of America won a lower-court decision, but the state Supreme Court reversed it and sent the case back to the lower court. The justices who supported SFR said that the bank could have stopped the problem by paying the lien itself. Bank of America spokesman Richard Simon said the court's interpretation that Nevada law doesn't require HOAs to go through the courts "sacrifices lenders' and homeowners' interests, while giving third-party investors an unjustifiable windfall."

In court filings on Monday and Tuesday, a group of lenders and the Mortgage Bankers Association argued that sometimes HOAs won't tell them the amount due or won't accept payment from the banks.

Chris Hardin, who manages SFR, said the firm's returns have been reduced by legal bills and expenses in maintaining the properties, but he still expects to make a significant return. TwinRock Partners, an investment-management firm, purchased about 100 homes at Nevada HOA sales in the past two years that it hopes to sell at a huge profit. One example: a home originally purchased by homeowner Garrett Pattiani for about $300,000 in 2006. Mr. Pattiani said he had an interest-only mortgage and gave up his home in 2008 after his payment was set to balloon.

TwinRock bought the home in May 2013 from the homeowners association for $11,000. "Lenders should have been aware of this risk," said TwinRock Chief Executive Alex Philips, who said he expects investors overall will triple their money after accounting for investment fees and expenses. Real-estate information site Zillow.com estimates that Mr. Pattiani's former property is worth about $184,000.

"I would have bought it for $11,000. I could have afforded that," Mr. Pattiani said. "That guy made a lot of money."

Write to Joe Light at joe.light@wsj.com