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Coates' Canons Blog: A Foreclosure Fiasco

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When done properly, a property tax foreclosure can be an efficient method of satisfying old property taxes while transferring property to new owners who are more likely to pay future property taxes. When not done properly, a tax foreclosure can produce a hornets' nest of litigation. A recent decision from the North Carolina Court of Appeals offers an example of the latter unfortunate situation.

In Henkel v. Triangle Homes the Village of Sugar Mountain was foreclosing on a slope-side ski house for $2,500 in municipal property taxes. The property owners were facing other tax problems as well; the IRS had recorded two liens on the same house for over $1.7 million (!) in federal income taxes.   The property was appraised at only $175,000, meaning there was no way that a foreclosure sale would produce enough funds to satisfy both the federal and the Sugar Mountain tax liens.

Normally that would not be a problem for a local tax collector, because federal law (26 U.S.C. § 6323) gives local taxes on real property priority over federal tax liens even if the federal tax liens arose first. (The default rule for lien priority is "first in time, first in right," but federal and state statutes often trump the default rule—see this blog post for more.)

The federal government's generosity comes with a catch, however. In order for a local property tax lien to gain priority over a federal tax lien, the local government must give advance notice to the IRS of a local tax foreclosure sale. (For more details on the IRS notice requirement, see page 36 of my thrilling new book, *In Rem Foreclosure: Forms and Procedures*.)

For some reason, Sugar Mountain did not give the IRS notice of the village's tax foreclosure. Perhaps the village failed to find the federal liens when it did a title search on the property. Or perhaps the village knew of the liens but forgot to send advance notice to the IRS. Regardless, the lack of notice to the feds led to big trouble.

The village was the only bidder at its foreclosure sale on November 13, 2013. It submitted a bid of $6,673, presumably the total amount of taxes, interest, costs, and attorneys' fees owed on the property.

It turns out that not only did the village fail to give the IRS notice, but it was pursuing the property tax foreclosure at the same time the IRS was also foreclosing on the property. The day after Sugar Mountain held its foreclosure sale, the IRS conducted its own foreclosure sale for the federal tax liens. This raises a ton of questions about what the village knew about the IRS foreclosure and when it knew it and why the village didn't act on that information before conducting its own foreclosure sale. More on that below.

The village sent a representative to the IRS sale and informed the IRS of the village's foreclosure sale the day before. The IRS then informed potential bidders at its foreclosure sale of the village's prior foreclosure sale and that the village had agreed to assign its winning bid and interest in the property to the high bidder at the IRS sale. At the ensuing auction, Everett Henkel was the high bidder at $172,000. (The fact that the IRS was able to attract a bid at market price for the property while the village couldn't attract a single bidder other than itself raises even more questions about the village's foreclosure effort.)

The plot thickened four hours later, when Triangle Homes, Inc. submitted an upset bid in the Sugar Mountain foreclosure. Triangle did so despite being informed of the IRS foreclosure sale and being warned that Triangle was very unlikely to obtain clear title on the property.

Triangle's insistence on moving forward with its upset bid was unusual. Its conduct soon moved from unusual to

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potentially fraudulent. Just a few days after the upset bid period closed, Triangle contracted to sell the property to a third party for $144,000. Triangle promised to provide the buyer with clear title to the property, conveniently failing to mention that the IRS had just sold the same property to somebody else. (The real estate agent who facilitated this dubious sale was later investigated by the N.C. Real Estate Commission and voluntarily turned in his broker's license.)

In December 2013 Henkel took the steps needed to complete his purchase of the property in the IRS foreclosure, although he could not obtain a deed until after the federal 180-day redemption period ended. In January 2014—again with full knowledge of the IRS foreclosure sale to Henkel—Triangle had the superior court confirm its purchase of the same property in the Sugar Mountain foreclosure.

Triangle recorded its deed to the property in April 2014. After the federal redemption period ended, Henkel obtained a deed to the property from the IRS and recorded it in June 2014. Four months later, Triangle sued Henkel in a "quiet title" action, asking the state court to rule that Triangle was the sole owner of the property.

Triangle's argument rested entirely on the fact that it recorded its deed first. It's true that North Carolina is one of the few remaining states with a pure "race" deed recordation system. (My real property law expert colleague Chuck Szypszak reports that it's only us, Delaware, and Louisiana–read all about the process in his excellent law journal article.) G.S. 47-18 says that the first party to record an interest in real property has a superior interest to all other parties even if that property interest was previously conveyed to another party and the recording party had notice of the prior transfer.

In other words, if the same property is sold to two parties then party that wins the race to the register of deeds office and records its deed first takes priority even if that party knew that the property had already been sold to somebody else. The "race" system is why North Carolina real estate attorneys are usually very diligent about immediately recording deeds after closings.

The court rejected Triangle's argument, concluding (correctly) that the race statute did not apply here. The federal tax liens had already been recorded and were senior to Sugar Mountain's property tax liens because the village failed to give the IRS the notice required by federal law. When Sugar Mountain foreclosed on the property and sold it to Triangle, it did so subject to the previously recorded, senior IRS liens. When the IRS foreclosed on its liens and sold the property to Henkel, it exstinguished all junior liens including Sugar Mountain's property tax liens.

In a nutshell, Triangle purchased the property subject to the IRS liens. When the IRS sold the property for its senior liens, it terminated Triangle's interest in the property which was based on the village's junior lien. Henkel took the property free and clear of all tax liens. The fact that Triangle recorded its deed first is irrelevant because Triangle's interest in the property had been terminated by the IRS foreclosure. As the court observed, "Winning the race to the courthouse does not upset the rules of lien priority established by state and federal law."

The court rejected Triangle's claim to the property, leaving Henkel as the sole and rightful owner—one who hopefully pays his property taxes on time.

What lessons does this case teach local tax collectors?

Most obviously, don't forget to give advance notice to the IRS of a local tax foreclosure. Otherwise you'll be selling the property subject to the federal lien. If your buyer isn't made aware of that unfortunate fact, litigation is likely.

If you discover another lien on the property late in your foreclosure process, you need to take steps to remedy that problem before you get to sale. Ideally, you should amend your complaint and/or judgment to add the newly discovered lienholder as a party and give that party sufficient notice of the upcoming foreclosure sale. Sadly not all courts and clerks will permit that approach. If not, you should dismiss the existing foreclosure and start over with proper notice to the newly discovered lienholder.

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Equally important is the need to stop and reconsider your property tax foreclosure when you learn that another creditor (the IRS, the state, or a private lender, perhaps) is already moving forward with its own foreclosure. In most situations, the local property tax will be senior to the other lien being foreclosed. If so, one option would be to let the other creditor do your work for you: simply give notice to the other creditor that you expect to be made a party to the foreclosure and be paid first if the property is redeemed or sold.

What happens if a senior lienholder moves to foreclose on property in your jurisdiction? You are likely to be out of luck if the sale doesn't produce enough money to pay off both the senior lien and your property tax lien.

The good news is that very rarely will another lien be senior to your property tax lien. As the Sugar Mountain case demonstrates, federal tax liens are senior to local property tax liens only when the local government fails to give the IRS proper notice. The only other type of lien that could be senior to a property tax lien is a state tax lien that was recorded by the Department of Revenue before the property tax lien automatically arose (which occurs on January 1 each year). From what I hear across the state, the DOR records lots of tax liens but very rarely if ever actually moves to foreclosure those liens. If you come across a senior state tax lien, you might be able to negotiate with the DOR for your (usually much smaller) property tax lien to be paid first at your foreclosure sale.

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