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Date	Place	Subject
June 3-4	Denver, CO	**Secured Transactions,** cosponsored by Continuing Legal Education in Colorado, Inc.
June 3-4	Cambridge, MA	**New Dimensions in Securities Litigation: Planning and Strategies,** cosponsored by Massachusetts Continuing Legal Education-New England Law Institute, Inc., and the Securities Litigation Committee of the Boston Bar Association
June 3-5	Boston, MA	**Land Planning and Regulation of Development,** cosponsored by Massachusetts Continuing Legal Education-New England Law Institute, Inc.
June 10-12	San Francisco, CA	**Tax and Business Planning for the Growth Oriented Business**
June 10-12	New York, NY	**Civil Practice and Litigation in Federal and State Courts**
June 11-12	Washington, DC	**Legal Issues in the Coal Industry**
June 13-18	Boston, MA	**Advanced Business Tax Planning,** cosponsored by Boston University School of Law
June 13-18	Boston, MA	**Labor and Employment Law,** cosponsored by Boston University School of Law
June 13-18	Villanova, PA	**The Bankruptcy Code Reexamined and Updated,** cosponsored by Villanova University School of Law
June 18	Some 65 cities	**Bankruptcy Representation and the New Bankruptcy Code**
June 20-25	Madison, WI	**Estate Planning in Depth,** cosponsored by Continuing Legal Education for Wisconsin and the University of Wisconsin Law School
June 20-25	Madison, WI	**Civil Trial Practice,** cosponsored by Continuing Legal Education for Wisconsin and the University of Wisconsin Law School
June 28-July 2	Boulder, CO	**Environmental Litigation,** sponsored with the cooperation of the University of Colorado School of Law
June 28-July 2	Boulder, CO	**Modern Real Estate Transactions,** sponsored with the cooperation of the University of Colorado School of Law
July 11-16	Stanford, CA	**Postgraduate Course in Federal Securities Law,** cosponsored by Stanford Law School
July 11-16	Stanford, CA	**Basic Law of Pensions and Deferred Compensation,** cosponsored by Stanford Law School

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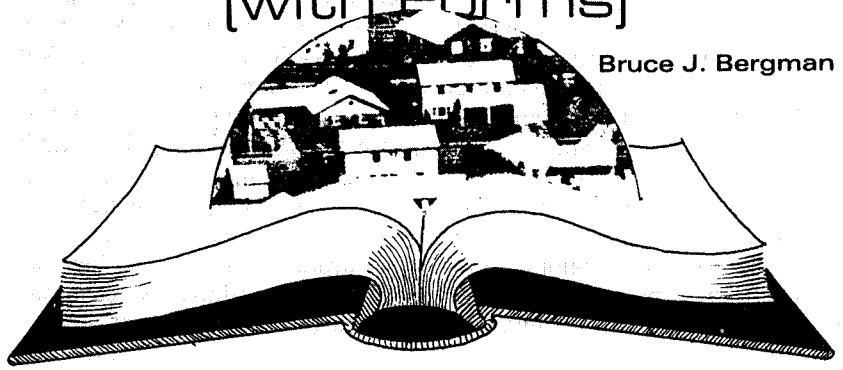
A Guide to Mortgage Foreclosure Strategy and Mechanics [with Forms]

Bruce J. Bergman



Mortgage foreclosure strategy stresses the importance of timely acceleration, the avoidance of a waiver of nonpayment, a settlement stipulation, receivership, and a deed in lieu of foreclosure. Relevant forms are interspersed in the text.

The successful prosecution of a mortgage foreclosure action is much more than the ritualistic adherence to statutory requirements and form-book suggestions. Indeed, strategy, leverage, and

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an appreciation of the nuances of foreclosure practice are essential to serving the interests of the client properly.

The holder of a mortgage—the mortgagee—who sells a house and takes a purchase money mortgage expects to be paid. He does not know how to proceed when a monthly payment is missed. He needs the guidance of counsel. The institutional lender, too, may be in a similar situation, even though presumably a bank is more sophisticated and understands precisely what to do. Often, however, this is not the case, in part because institutions allow public relations considerations to affect what should be economic and legal decisions. The expertise of the lawyer is particularly meaningful then.

POLICIES • Timing is critical in preserving the mortgage investment, and failure to proceed expeditiously can seriously diminish the value of the real property standing behind the mortgage note or bond. The longer a default is allowed to continue, the harder it is for the defaulting mortgagor to find the funds to reinstate the mortgage. If foreclosure follows, should the mortgage amount exceed or only approximate the actual value of the property at the time of the sale, the mortgagee may not recoup his investment. Furthermore, during the period of default, the hardpressed or ill-motivated mortgagor could "bleed" the property or allow it to run down.

The problem with mortgage banks is that they sometimes confuse public relations and compassion with sound economic policy. The only truly effective method to deal with defaults, especially when a portfolio is massive, is to have a time system.

Every mortgage payment has a due date, followed by a grace period of however many days the particular mortgage form provides. The mortgagee may choose to ignore a default for a certain number of days before, and even after, the grace period. The moment must come, however, when a prearranged system should invoke collection procedures by telephone or letters, or both. There then must come a day—preferably sooner than later—when the collection effort is deemed a failure, triggering the most important step toward foreclosure, the acceleration of the principal balance.

Of course, special situations will require some deviation from the system's schedule. These exceptions must be kept to a minimum lest every situation become special. Otherwise, a mortgage portfolio will become unmanageable and the ability to protect the investment will be seriously weakened.

Acceleration

The key to the successful collection of arrears or foreclosure is leverage and dealing from a position of strength. The power the mortgagee needs can be obtained by acceleration—declaring the entire principal balance immediately due and payable. A typical acceleration clause is this standard clause in New York wherein the mortgagor covenants:

That the whole of said principal sum and interest shall become due at the option of the mortgagee upon default in the payment of any installment of principal or of interest for fifteen (15) days, or upon default in the payment of any tax, water rate, sewer rent, or assessment for thirty (30) days after notice and demand, or upon default, after notice and demand, either in assigning and delivering the policies insuring the building against loss by fire or in reimbursing the mortgagee for premiums paid on such insurance, as hereinbefore provided, or upon default, after a request, in furnishing a statement of the amount due on the mortgage and whether any offsets or defenses exist against the mortgage debt, as hereinafter provided. An assessment that has been made payable in installments upon the application of the mortgagor or lessee of the premises shall nevertheless, for the purpose of this paragraph, be deemed due and payable in its entirety on the day that the first installment becomes due or payable or a lien.

Acceleration clauses have been upheld as valid and enforced by the courts, which have rejected arguments that they represent a penalty or forfeiture.

Because self-executing acceleration clauses are rare, the mere failure of a mortgagor to honor particular conditions of the mortgage does not automatically accelerate maturity. In addition to an acceleration clause in the mortgage and an act that falls within the terms of the clause, the mortgagee must unequivocally elect to declare the total principal due.

Acceleration results primarily from the most common default, the failure to pay principal and interest. Acceleration is available for defaults of other types, but they may very well be treated differently by the courts. For example, a failure to pay taxes is generally viewed with less severity than the neglect of a monthly payment. Consequently, acceleration may not be applicable for every variety of default, so that a lawyer should check the case law in his jurisdiction before proceeding.

The exercise of the right of acceleration must be unequivocal. It cannot be a threat to take some action in the future. A written demand for an overdue payment must be followed by a statement of acceleration.

An unequivocal election may be exercised by writing a letter couched in the appropriate language or by actually instituting a foreclosure action. Because it saves the time in-

volved in gathering the documentation necessary to start a foreclosure action, analyzing the foreclosure search, and preparing the summons, complaint, and lis pendens, a letter is the preferable option. Although most mortgages in most jurisdictions do not require any written demand or a letter declaring the entire principal balance due, a mortgagee should be advised to write an acceleration letter anyway.

The Acceleration Letter

The acceleration letter must be sent in accordance with any mortgage terms concerning communication between the parties, by registered, certified, or regular mail. Certified mail is the most commonly prescribed mode of transmittal. Since astute mortgagors may be expecting certified correspondence and often refuse to accept it, mail the letter by both certified and regular mail, thus virtually assuring its receipt.

Regardless of whether the letter is sent by counsel or the mortgagee, its language is very important. Two forms are suggested, which can be tailored to the actual situation:

Re: Mortgage Loan No. _____

Dear _____:

By reason of your failure to pay the monthly payments of $ _____, which became due on the _____ day of _____ and _____, the mortgagee, _____, does hereby elect to declare the entire mortgage indebtedness immediately due and payable, and formal demand is hereby made upon you for the payment of the principal balance of $ _____, together with the interest at the rate of _____ per cent per annum from _____, which interest, computed to _____, amounts to $ _____ (the daily rate is $ _____).

The total amount owing as of the date hereof for which demand of payment is hereby made amounts to $ _____.

Very truly yours,

_____

Certified Mail RRR
Regular Mail

Re: Mortgage Loan No. _____

Dear _____:

As you have been previously advised, you are in default on your mortgage loan with _____.

In accordance with the provisions of the mortgage note and mortgage executed by you, the bank hereby demands immediate payment in full of the outstanding balance of principal in the amount of $ _____, interest at _____ from _____ to this date of _____, late charges of $ _____, and $ _____ representing an overdraft in your escrow account, for a total amount due and owing of $ _____.

Very truly yours,

_____

Certified Mail RRR
Regular Mail

The Results of Acceleration

Once the mortgagee accelerates, he has the upper hand. He need not accept arrears, and if he does choose to do so, he sets the terms.

Thus, if the mortgagor is a chronic defaulter whom the mortgagee has constantly been calling and writing, once the balance has been accelerated, the mortgagee need not accept arrears any longer, but he may insist henceforth upon full satisfaction of the mortgage.

In addition, if the particular loan was made at an interest rate well below the current market, no matter how tardy the mortgagor has been, until the entire balance is validly accelerated, arrears must be accepted. After acceleration, however, the mortgagee is free to foreclose or, in the alternative, insist that the mortgagor enter into a mortgage modification or extension agreement at a higher rate of interest.

The recoupment of legal fees is another consideration. In many states, unless the mortgage specifically provides for the payment of legal fees in a foreclosure action—and many mortgages do not—the mortgagee must absorb some portion of legal costs even if the action proceeds to judgment and sale. After acceleration, however, if the mortgagee desires to reinstate the mortgage, he can demand that all legal fees incurred be paid as a condition of reinstatement. Although the mortgagor may deem this condition unfair, the mortgagee is not obligated to reinstate after acceleration and is thus in a position to impose any requirements that he deems suitable to his own circumstances. Clearly, recent increases in legal fees make this factor ever more important.

AN INADEQUATE TENDER • A valid acceleration of a mortgage can be undermined if the mortgagee or his lawyer or employee subsequently accepts any payment that may be deemed a

waiver of acceleration. All employees of the mortgagee or his lawyer must be instructed to reject any payments after acceleration and all files should be so marked.

The following rules apply to mortgage payments before and after acceleration:

- Before acceleration, the defaulting mortgagor has an absolute right to tender all that he owes, including late charges or any other fees sanctioned by the mortgage and the law of the jurisdiction.
- Less than full payment of all sums in arrears can be rejected, even before acceleration.
- Full payment prior to acceleration must be actually tendered. A promise to pay or a suggestion that "it will be taken care of" is not a tender.
- An inadvertent acceptance of all or part of the arrears after acceleration may not be a waiver if the mortgage note contains a clause that the acceptance of arrears will not be deemed a waiver. Although such a clause may not be effective in every jurisdiction, it should be included in every mortgage.
- Partial payments may be accepted pursuant to an appropriate stipulation.

If a mortgagee does allow the mortgage to be reinstated, a payment that covers only the arrears of principal and nothing else need not be accepted. Thus, if a residential mortgage is in arrears for three months at $900 per month, $2700 is due, together with possible late charges of two per cent per month, totaling arrears of $2754. A payment of $2700 can be refused, but if it is accepted, the acceleration is waived.

To refuse an inadequate payment, reject the tender with a letter stating that since the entire indebtedness has been declared due, the mortgagee will not accept anything less than total payment.

Dear _____:

We have received certain check(s) from you purportedly submitted as payments towards your mortgage.

However, as you have been informed, the entire principal balance of the mortgage has been accelerated and has become due. We need not, and will not, accept anything less than full payment.

Accordingly, the sum(s) submitted by you are rejected and returned herewith, as follows:

[List checks]

Please feel free to discuss this matter further with us.

Very truly yours,

_____

SETTLEMENT STRATEGY • Despite the existence of cases that have dragged for many months, and even years, while a settlement was being negotiated, delay can be very dangerous for the mortgagee and should be avoided.

Often, the source of the problem is a misunderstanding of the strategy of settlement. While most foreclosures are settled, defaulting mortgagors usually either cannot or will not honor their obligations until further procrastination is impossible. They may try to buy time to sell the property, hesitate to obtain a loan from family or friends, or be loath to encumber some other valuable possession. Whatever the reason, they will not do anything until they absolutely must. Hence, continuous pressure is essential to a favorable and expeditious conclusion.

A foreclosure should not be held in abeyance pending a promised resolution. On the contrary, the foreclosure should proceed as if no settlement were possible until the very moment an agreement actually results.

To appreciate this point fully, an awareness of the typical steps in a mortgage foreclosure is helpful. Using New York as an example, the stages are as follows:

- Collection procedures;
- Acceleration;
- Summons and complaint;
- Answer;
- Motion for summary judgment, or trial, if contested;
- Referee's computation;
- Judgment of foreclosure;
- Publication of Notice of Sale;
- Sale; and
- Closing.

Each step is a prerequisite to the next and must be methodically pursued. A mortgagee who wishes to accept a settlement offer may wish to stop further action so as not to scare the mortgagor and in order to keep legal fees from increasing.

Rather than allow the defendant's ability or inability to pay to control the progress of the foreclosure, however, the action should continue without costing the mortgagee any legal fees. Most attorneys peg their fees in foreclosures to progress in the case. Although the amounts vary from community to community, the following is an example of recent fees for an uncontested residential foreclosure:

Submission of file to counsel for analysis	$ 350
Preparation of summons and complaint	$ 650
Appointment of referee	$ 850
Judgment of foreclosure	$1,000
Sale	$1,200

Thus, if the summons and complaint have been served and an

answer was not interposed, counsel would be entitled to $650 plus disbursements. If, at this point, the defaulting mortgagor suggests full payment within 30 days, the mortgagee should proceed with the appointment of a referee. While counsel will now be paid $850 rather than $650, his fee is to be borne by the mortgagor as part of any settlement. The mortgagor should be advised unequivocally that the action goes forward until the day that money is in hand, and whatever legal expenses accrue in the meantime will be paid by him. Approaching the situation with this stance insures faster settlements upon terms most favorable to the mortgagee.

THE SETTLEMENT STIPULATION • Having validly accelerated the principal balance, the mortgagee can decide when a settlement offer is to be accepted. If the arrears are substantial, he may allow the mortgagor some months to pay the sums due. Stopping further procedure in the case to accommodate the terms of settlement is quite different, however, from withdrawing the action.

Below is a suggested form of stipulation that protects the mortgagee:

It is hereby stipulated and agreed by and between the undersigned as follows:

1. Notice of the pendency of this action was filed in the Office of the County Clerk of _____ County on _____, and an amended notice of pendency [if applicable] was filed in said office on _____.

2. The defendant _____ was served under the provisions of [cite procedural sections of local law], but has not appeared or answered. [If applicable, recite the answers submitted and the date.]
If there was any question about the technical propriety of service of process, the mortgagor has now waived any possible claim of defect.

3. Said defendant has no defense to this action and does not intend to interpose any answer herein. [Or, the defendant withdraws his answer and counterclaim and waives any defenses purportedly set forth therein.]
If the mortgagor has some claimed defense in reserve or if he stated one in the answer, that, too, is waived and is unavailable for use later should the settlement fail and the litigation be revived.

4. Said defendant agrees to make or cause to be made the following payments at the respective times hereinafter set forth by checks made payable to [counsel] _____ as attorneys for [mortgagee] _____.

[Date]	*Check no. _____, dated _____, received subject to collection*	$_____
[Date]	*One-half of the balance of the arrears and all counsel fees and disbursements to be paid*	$_____
[Date]	*The remaining balance of the arrears*	$_____

[This list can contemplate many payments.]
The schedule of payments is now absolutely clear. Any violation will trigger a renewal of the foreclosure action, as a later clause will state.

5. These payments shall be applied first to the counsel fees and disbursements of [counsel] _____, which are as follows:

Counsel fees		$_____
Proceedings for order to publish and appoint guardian ad litem, and the preparation of consent, affidavit and answer of guardian ad litem		$_____
Disbursements:		
Foreclosure search	$_____	
Index Number fee	$_____	
Filing fee lis pendens	$_____	
Service of process	$_____	
Advertising summons	$_____	
Guardian ad litem's fee	$_____	
Xerox, postage, and telephone	$_____	
		$_____
	Total	$_____

Obviously, the categories and amounts of legal fees and disbursements vary by jurisdiction and case. They should, however, be listed specifically, so that there is no confusion about the reasons for the payments.

6. The remainder of the aforesaid payments shall be allocated in such manner as [mortgagee] _____, in his sole and absolute discretion, shall determine from time to time, provided that they shall be applied to interest charges, the reduction of principal, late charges, and any other disbursements that [mortgagee] _____ may incur for the protection of the security of his mortgage.

7. It is understood that late charges incurred during the lifetime of this stipulation are to be imposed and paid from the aforesaid allocation.
Without this clause, there might be a question as to whether late charges continue to accrue. There is no reason for late charges to be forgiven.

8. The annual interest rate mentioned in plaintiff's mortgage note and

mortgage is hereby changed to _____ per cent per annum, increased from _____ per cent per annum, effective on the date of this stipulation, _____ 198__.

9. Plaintiff's mortgage note and mortgage described in the complaint are not to be deemed reinstated until defendant shall have timely and fully completed all of the foregoing payments. Upon completion of all of the foregoing payments, the mortgage will be reinstated according to its terms, except that the interest rate will be _____ per cent per annum, effective _____ 198__.

Here is another example of maintaining leverage. Until the mortgagor fully complies, the mortgagee has conceded nothing.

10. Notwithstanding the increase in the annual mortgage interest rate, the amount of the monthly mortgage payment for principal and interest, exclusive of real estate taxes and insurance, if any, shall not be increased; instead, the entire remaining balance of the mortgage indebtedness shall be fully paid not later than _____.

This clause presupposes a balloon payment at the end of the term. The particular situation may warrant an increase in monthly payments, in which event the new terms would be stated here, very much in the language of the mortgage note or bond.

11. In addition to the payments of principal and interest payable pursuant to the mortgage note or this stipulation ("the installments"), defendant will pay to [mortgagee] _____, [if at any time required by mortgagee _____], on each date and in the manner specified in the mortgage note or this stipulation for the payment of an installment, an amount ("the Escrow Fund") that would be sufficient to pay the taxes payable, or estimated by [mortgagee] _____ to be payable, together with insurance premiums, during the ensuing twelve (12) months, divided by the number of installments due during such twelve (12)-month period. If the amount of the Escrow Fund shall exceed the amounts due pursuant to this paragraph, [mortgagee] _____ will credit such excess against future payments to be made to the Escrow Fund. In allocating such excess, [mortgagee] _____ may deal with the person(s) shown on the records of [mortgagee] _____ to be the owner(s) of the mortgaged property. If the Escrow Fund is not sufficient to pay the items set forth above, defendant shall pay to [mortgagee] _____ upon request, an amount that [mortgagee] _____ shall estimate as being sufficient to cover the deficiency. Until expended or applied as provided above,

any amounts in the Escrow Fund shall constitute additional collateral security for the debt and shall not bear interest, except as required by law. In the event that the foreclosure action will be discontinued, the provisions of this paragraph shall survive with the same force and effect as if they were originally embodied in the mortgage note and mortgage.

These additional terms of the mortgage extension agreement will vary in different jurisdictions. Depending upon local law and custom, the terms of the extension may be embodied in a separate agreement, rather than in the stipulation.

12. Plaintiff will take no further affirmative steps in this action so long as defendant complies with all of the covenants to be performed by defendant under this stipulation. If, however, defendant will default under any of the provisions of this stipulation for seven (7) or more days, plaintiff, at his option, will have the right to obtain a Judgment of Foreclosure and Sale without notice, including all the intermediary steps, like the appointment of a Referee to compute, and subsequent steps such as a foreclosure sale. In the event of a foreclosure sale, plaintiff will send a notice of sale to defendant.

If the mortgagor fails to comply, the mortgagee has received some money in hand and he can proceed with the foreclosure action from the point where he had stopped.

13. If, under the provisions of this stipulation, plaintiff shall actually proceed with this action after a default on the part of defendant under any of the provisions of this stipulation, defendant shall be given credit for all the sums actually paid by him to [mortgagee] _____, allocated in accordance with the provisions of this stipulation. However, it is understood that defendant shall not be entitled to receive any refund or credit for the attorneys' fees or disbursements paid to [counsel] _____.

14. The provisions of this stipulation shall survive the discontinuance of this action.

15. This stipulation may be executed in counterparts, which, when taken together, shall constitute this stipulation.

This clause allows separate stipulations to be signed by both parties, thus saving mail time back and forth.

Dated:

_____ 198

[City and state]

By: _____
Attorney for Plaintiff

_____
Defendant

While this suggested form of stipulation is comprehensive, it cannot cover every case. For example, if the mortgagee had not been escrowing for taxes, a paragraph should recite that all real estate taxes becoming a lien on or after a certain date shall be paid by the defendant as and when they become due and payable, and defendant shall submit receipted tax bills to the mortgagee or his counsel within 15 days after each respective item becomes due.

RECEIVERSHIPS • One of the most potent weapons available to the mortgagee, which is inexplicably neglected on too many occasions, is the appointment of a receiver. When the foreclosing mortgagee believes that the property may decline in value during the course of the action or that the defaulting mortgagor or other party in possession may allow the premises to deteriorate, the mortgagee may have a receiver selected to preserve the property and collect the income.

Receivers are most often sought for income-producing commercial properties and apartment houses, although they may be employed also for one- and two-family homes when the parcels are endangered or if the foreclosure action is expected to be protracted.

In many jurisdictions, the mechanics of arranging for the receiver's appointment are not particularly difficult. In New York, for example, a receiver can be appointed ex parte. A covenant "that the holder of this mortgage, in any action to foreclose it, shall be entitled to the appointment of a receiver," must be construed as meaning that the mortgagee, his heirs, successors or assigns, in any action to foreclose the mortgage, shall be entitled, *without notice* and without regard to adequacy of any security of the debt, to the appointment of a receiver of the rents and profits of the premises covered by the mortgage; and the rents and profits in the event of any default or defaults in paying the principal, interest, taxes, water rents, assessments or premiums of insurance, are assigned to the holder of the mortgage as further security for the payment of the indebtedness (emphasis supplied). N.Y. Real Prop. Law §254 (McKinney 1968).

Thus, if the mortgagee has been unable to collect the mortgage payments on an apartment building and the acceleration letter has brought no response, he may ask his counsel to institute the foreclosure proceedings. A foreclosure search is ordered, which, among other items, sets forth

all the necessary parties that must be served in order to terminate all other interests and transfer good title at the foreclosure sale. Almost invariably, the search will reveal multiple necessary defendants, such as judgment creditors, mechanic's lienors, subordinate mortgagees, and governmental authorities to whom taxes may be due. One of the possible defendants, usually a major bank or the state or federal government, is bound to be easy to locate for the service of process.

Counsel prepares the summons, complaint, and lis pendens and files them with the county clerk. Once that is done, the easily locatable defendant is served on the very same day. Now the action has been begun. If the motion for the receivership, which need not be served on anyone, has been prepared, it can be given to the court, and in a day or so, the receiver is appointed.

It may even be done faster, depending upon local practice. Sometimes counsel can "walk the papers through the court" and have the receivership order on the very first day. If a particular receiver is desired, he can sometimes be brought to court and the judge persuaded to appoint him immediately.

Obviously, this procedure is subject to considerable local variation, but speed is usually possible. The mortgagee maintains the leverage.

Once the receiver is appointed, he proceeds to "qualify." In New York, for example, that requires the filing of an oath and bond with the County Clerk. His next step is to send to all tenants and occupants of the premises a notice that all rents are to be paid to him, or to his managing agent if the order made provision for an agent. This notice is widely referred to as a "Notice to Attorn."

Imagine the mortgagor's shock when he learns that all the money he was planning to collect during the pendency of the foreclosure is now going to a court-appointed receiver, with the net ultimately to the mortgagee. That dismay has often precipitated immediate settlements very favorable to the mortgagees.

Possible Pitfalls

Once the mortgagor discovers the receivership, rather than capitulate, he could become litigious. But it is extremely difficult to set aside receiverships that have been properly obtained. Technical objections rarely succeed, and constitutional challenges have been consistently rejected.

If the matter is ultimately settled, a condition of the settlement should be the mortgagor's obligation to pay all legal fees, including those engendered by the receivership. If a settlement is never reached and the property is sold, the increased legal fees resulting from the receivership will, most probably, never be recouped. Nevertheless, a receivership usually leads to a settlement, so that

the risk of higher legal fees is worth taking.

Another consideration is compensation of the receiver. The amount, however, is hardly so oppressive as to be discouraging. In New York, for example, a receiver is entitled to five per cent of the sums received and disbursed by him. If the order appointing the receiver authorized him to engage a managing agent and/or an attorney, the agent's commission and the attorney's reasonable fees will also have to be paid.

Before deciding upon a receivership, the pros and cons should be weighed. A receivership presents the mortgagee with a considerable amount of power and control. Although the receiver is viewed as agent of the court, he has some practical obligations to the mortgagee, particularly since the mortgagee will have much to say about the receiver's commission. If the receivership is likely to force a settlement, the slight possibility that it may entail additional disbursements, commissions to the receiver and the managing agent, and fees to the receiver's attorney, is not too important. The income that would otherwise have gone to the defaulting mortgagor should exceed the expenses.

DEED IN LIEU • If a satisfactory settlement cannot be reached with the defaulting mortgagor, a deed in lieu of foreclosure may be the best option for the mortgagee. The procedure, however, is fraught with technical pitfalls. For example:

• Taking a deed in lieu of foreclosure gives the mortgagee title subject to whatever encumbrances may have already attached to the property. Therefore, a title search must be ordered, and a careful analysis of the results made.

• As part of the transaction, the mortgage debt must be canceled, lest the courts deem the new deed as a deed absolute given as security for a debt—in other words, another mortgage. Since an assignment of the mortgage may save mortgage taxes, if possible, only the mortgage note should be canceled.

• Since only a bona fide purchaser for value is protected against unrecorded interests, in states where the cancellation of antecedent debt is not treated as value, the transaction must recite value.

• If there is equity in the property above the mortgage debt, the transaction may run afoul of the Bankruptcy Act as a preference.

Since this is only a partial list of possible problems, a deed in lieu of foreclosure should be approached with caution and meticulousness.

Defaults During Construction

The factors that must be weighed before accepting a deed in lieu of foreclosure in a one-family home situation are quite different from those that are involved in a default on a large commercial parcel, such as a shopping center or apartment complex, or a project in the midst of construction where a construction loan lender is the mortgagee.

A default during construction forces the mortgagee to face certain immediate problems:

• He must act quickly to avoid a shutdown of construction.

• He must guard against vandalism and physical deterioration.

• The permanent financing may be lost.

• Any action involves the risk of waiving rights against third parties such as bonding companies or guarantors.

Even if the mortgagee can expeditiously secure the project under construction physically and has a satisfactory legal position against third parties, he must evaluate a number of details prior to accepting a deed in lieu of foreclosure:

• What are the net worth and liquidity of the borrowers and any guarantors?

• Is the value of the mortgaged property sufficient to justify a reduction or release of liability if a deed is taken?

• Would the mortgagee willingly own the property and can he resell it easily?

• Can the property be used in conformity with law and can a certificate of occupancy be obtained readily?

• What percentage of the project has been completed?

• What contractors, suppliers, and materialmen remain unpaid?

• What is the quality of the work done to date and does it conform with the plans, specifications, and requirements of any contract vendee or any permanent lender?

• Is there a need for remedial work and what is the cost?

• Could the defaulting mortgagor do a better job of completing, marketing, and managing the property than the mortgagee?

• Are any rights, such as franchises, zoning variances, or permits, held personally by the mortgagor and are they transferable?

• Is the defaulting mortgagor uniquely equipped to handle a sensitive local problem, such as union or minority matters?

• How would foreclosure affect the marketing program for a property such as a condominium?

• What federal or state regulatory problems might foreclosure entail?

• If the foreclosure were to lead to

litigation—something that the "deed in lieu" would avoid—what is the quality of the expected defenses?

- How long could a foreclosure action take?
- What would be the consequences of a protracted foreclosure with respect to project deterioration, legal costs, and lost opportunities for investment?
- Are there subordinate liens that would be eliminated in a foreclosure but which would survive a deed in lieu?
- Can the necessary consents to a negotiated workout be obtained from bonding companies, guarantors, or franchisors?
- How much does the mortgagor owe others and how vigorously are those creditors pressing him?
- Is insolvency imminent?
- If the mortgagee takes title and advances further funds, will those monies be at risk if creditors attack the transfer as void or voidable?
- Does the mortgagee have other investments with the mortgagor?
- Will the commencement of a foreclosure precipitate a bankruptcy?

Clearly, the benefits of taking a deed in lieu of foreclosure, particularly when something other than a small business or a residence is involved, must be balanced against the very significant dangers inherent in the process. However, if the decision is made to accept a deed in lieu of foreclosure, the deed must be supported by a carefully conceived affidavit of the defaulting mortgagor or mortgagors that solves the basic problems.

Using the premises of a large store owned by a husband and wife and two partners as an example, the following affidavit to be submitted with a deed in lieu of foreclosure covers typical problems and is applicable in New York:

STATE OF _____)
: ss.:
COUNTY OF _____)

_____, _____, _____, and _____, being duly severally sworn, depose and say:

We, the owners in fee of premises _____, are over twenty-one years of age and reside respectively at:

(a) _____ residing at _____;
(b) _____ residing at _____;

(c) _____ and _____, husband and wife, residing at _____.

These premises have been in our possession since _____, the date of the conveyance to us, and our ownership and possession has been uninterrupted, continuous, open, notorious, hostile, and adverse to all others and exclusive of the right or claim of any other person or persons, and our title has never been disputed or questioned. We have not contracted with any person for the purchase of said premises and we do not know of any facts by reason of which our possession or title may be called in question or any claim to any part of the premises or any interest therein adverse to us may be raised. There are no fixtures in the building that have been bought on the basis of a conditional sales agreement, either filed or unfiled.

_____, who is over the age of twenty-one years and who is the same person who joined in the execution of the deed of said premises, has never been married to any other person now living and has not been known by any other name within the last ten years.

No unpaid or unsatisfied judgments of record have been entered against any of us in any Court of this State or of the United States, and the said premises are free from all taxes, liens, encumbrances, or charges of every nature and description, save and except:

Case #:
Perfected:
Court:
Attorney:
Debtor:
Creditor:

List all the judgments or liens, giving sufficient details so that they may be specifically ascertained. Whether the mortgagee wishes to take subject to any judgments or liens or demands that they be satisfied first is an economic decision to be made on a case by case basis.

No proceedings in bankruptcy have ever been instituted by or against any of us in any Court or before any officer of any state or of the United States, nor have we or any of us at any time made an assignment for the benefit of creditors.

There are no suits or proceedings pending anywhere against any of us or affecting said premises, no pending claims for accidents, work, labor, and

services, or for work, labor, and services that could cause the filing of a mechanic's lien or other legal claims with respect to said premises.

We have not executed as to any other property any bonds secured by mortgages or any extension agreements in or by which any of us assumed the payment of any mortgage debt, and none of us are liable on any notes, endorsements, guarantees, or other contingent indebtedness.

The said premises are to be conveyed by us to [mortgagee] _____, the holder of the first mortgage covering said premises, and none of us will be rendered insolvent by such conveyance.

The attention of the deponents has been called to the following judgments, which are not against any deponent, but against some person or persons with the same or similar name:
List these judgments in the same way as the prior encumbrances were noted. Title reports often list judgments against persons of similar names; it is important, therefore, to have the mortgagors' statement that the judgments are not against them.

Neither we nor any of us have purchased any fixtures, equipment, or articles of personal property, installed or to be installed in the subject premises, for which payment has not been made in full or for which a chattel mortgage or conditional bill of sale could be filed.

The subject premises have no value over and above the amount of the mortgage held by [mortgagee] _____ and the judgment(s) enumerated above.

The consideration for the deed herein is ten dollars and full release of all liability under the existing note and mortgage held by the grantee.
In New York, for example, the cancellation of an antecedent debt is deemed a valuable consideration, even though there is a failure of consideration when a mortgage is granted for an antecedent debt.

The said conveyance is not given by us as a preference against any other creditor, is an absolute conveyance, and is not given as collateral security. No agreement, either written or oral, exists between us or any of us and the grantee whereby it is understood or agreed that said premises are to be reconveyed by the grantee to the grantors within any specified time, on or before any specified date, or at any time.

This affidavit is made to induce [mortgagee] _____ to accept a deed to said premises and to induce the [title company] _____ to insure the title thereto, knowing that said grantee and the said [title company] _____ rely upon the truth of the foregoing statements.

_____
_____
_____
_____

Severally sworn to before me
this day of 198__.

_____
Notary Public

PROSECUTING THE FORECLOSURE ACTION • The principles that have been discussed so far are basically applicable to all jurisdictions. The actual procedure in a foreclosure, however, differs, to a significant extent, in each state. Nonetheless, some general guidelines apply throughout the United States.

Title Search

If an actual foreclosure sale is to take place, a good title must be transferred to the highest bidder. Not only must there be meticulous conformance with all the procedural aspects, but all interests in the property must be terminated. Therefore, a title search is necessary. In states where title companies conduct title searches, a foreclosure search should be ordered, which, among other things, will cite all necessary parties defendant. Title companies normally provide only $1,000 of title insurance on the search; hence an analysis of the search by counsel is required.

Where the custom is to use the abstract and opinion method, an abstractor will digest the title history of the property and counsel will have to form his own opinion as to necessary defendants. Some necessary parties are subordinate mortgagees, judgment creditors, mechanic's lienors, tenants or other parties in possession, municipalities with claims for franchise or corporate taxes, and the federal government.

Failure to include a necessary party could require another proceeding after the foreclosure sale is completed.

Pleadings

A common method to initiate the foreclosure is to file a summons, complaint, and lis pendens with the county clerk in the county where the property is situated and to serve the various parties. Because good title must be transferred at the foreclosure sale, service of process must be very carefully supervised. For example, serving a managing agent of a

corporation who was not actually authorized to accept service of process could be disastrous for the foreclosure when discovered after the sale.

Most defendants will default or simply file a notice of appearance and waiver in foreclosure, hoping that the property will be sold for an amount greater than the mortgage, against which excess they will be able to claim after the foreclosure in what is often referred to as a "surplus money proceeding."

Although foreclosures are not frequently contested, the submission of an answer can lead to extensive litigation. The more common defenses are usury, fraud, laches, and the statute of limitations. If an answer is filed, the plaintiff can move for summary judgment, which is usually successful, or immediately notice a trial of the issues raised.

Presale Procedures

In many states, when there is a default or after the adjudication of the issues, upon plaintiff's motion the court appoints a referee to compute the sum due to the foreclosing mortgagee pursuant to the terms of the mortgage.

If there has been a default, the referee's computation obviously is not an adversary proceeding and is often accomplished by mail. When an answer is filed, the answering party has the right to appear and contest the referee's computation at a hearing.

After the referee completes his computations, the plaintiff prepares and submits a judgment of foreclosure and sale—ex parte, if no one answered, and on notice to parties who did put in answers. The judgment will normally name the particular publication or publications in which notice is to be given to the public of the fact that the property is being sold. How often the publication must be made is also in the order and is a function of local statute, as are the contents of the notice of sale.

The Sale

When the appointed day arrives, the referee is in charge of the sale at the place selected by the court, usually the county courthouse or the local village or town hall. The conduct of the sale is controlled by the "terms of sale," which are usually found in the judgment. For example, bidders are normally required to present with their bid cash or a certified bank check for at least ten per cent of their bid price.

The referee conducts an auction and if there are no bids, the plaintiff "bids in" for a nominal sum and presents a deed for the referee to sign. If there are bids but they are less than the plaintiff's "upset price"—the amount in the judgment plus interest—the plaintiff usually bids just up to the upset price and becomes the owner without actually paying any consideration.

If there is a bid over the upset price, the successful bidder signs the terms of sale, as does the referee, pays his minimum deposit, and proceeds to a closing at some subsequent date, usually within about 30 days. At the closing, the bidder receives a referee's deed.

A foreclosure sale is especially technical, and except for the most elementary foreclosure, a specialist may well be engaged to handle it.

CONCLUSION • The mortgage foreclosure case truly requires a "feel" or sense of how to proceed. Strategy and leverage play a significant role in a lawyer's ability to achieve a successful result for his client, the mortgagee.

To preserve what is most often a very significant investment by his client, a lawyer should:

- Insist that the mortgagee closely monitor defaults so that his position does not become irretrievable.
- When the need for action arises, accelerate the principal balance as soon as possible with the requisite unequivocal writing.
- Advise the client of the practical necessity of a firm stance.
- Not withdraw the action even when a settlement is reached.
- If the property is in danger of declining in value or if the action will take a long time, explain the benefits of a receivership to the client so that he will at least consider the option.
- If obtaining a deed in lieu of foreclosure is the best course of action, be exceptionally careful in preparing the affidavit of the defaulting mortgagor in support of the deed.

In a good many states the mortgage is given in the form of a *deed of trust.* The borrower conveys title to the land to a person (who is usually a third person but may be the lender) to hold in trust to secure payment of the debt to the lender. In a deed of trust the trustee is given the power to sell the land without going to court if the borrower defaults. The purpose of a deed of trust mortgage is to avoid judicial foreclosure, which may be costly and time-consuming, and to avoid the statutory right of redemption from a judicial foreclosure sale. There is a strong tendency for courts and legislatures to recognize the deed of trust mortgage as merely another form of security device, however, and to extend the same protection to borrowers giving a deed of trust mortgage as is offered to the ordinary mortgagor. Nonetheless, local law varies widely in many details.

J. DUKEMINIER & J. KRIER, PROPERTY 621 (Little Brown, Boston, 1981).

For Further Study

Articles in *The Practical Lawyer*

Provisions for Subletting or Assigning a Commercial Lease, by Bernard H. Goldstein, THE PRACTICAL LAWYER, April 1982, p. 31.

When To Choose Accelerated Recovery over Straight-Line Depreciation, by Christopher R. Hoyt, THE PRACTICAL LAWYER, January 1982, p. 27.

The New Capital Cost Recovery Rules, by John J. Sexton and James P. Parker, THE PRACTICAL LAWYER, October 1981, p. 43.

The Installment Sales Revision Act of 1980, by Mark Lee Levine, THE PRACTICAL LAWYER, March 1981, p. 11.

A Due-on-Sale Clause for an Equity Owner, by Bernard H. Goldstein, THE PRACTICAL LAWYER, January 1981, p. 57.

Alternative Residential Mortgages for Tomorrow, by William Griffith Thomas, THE PRACTICAL LAWYER, September 1980, p. 55.

The Tax-Free Exchange of Realty under Section 1031, by Bernard Balmuth and Morton A. Frankfurt, THE PRACTICAL LAWYER, April 1980, p. 67.

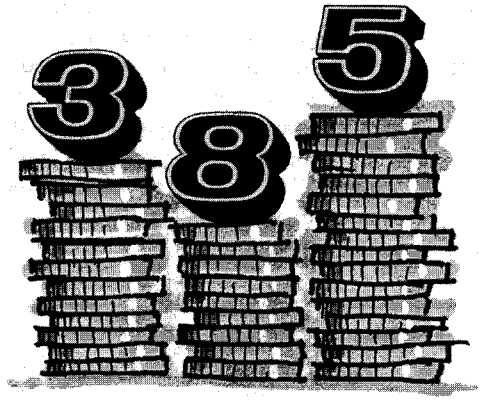
How To Prepare a Contract of Sale for Commercial Real Property, by Richard Ridloff, THE PRACTICAL LAWYER, July 1979, p. 11.

The Negotiation of Construction and Permanent Loan Commitments, by Marvin Garfinkel, THE PRACTICAL LAWYER, March 1978, p. 13, and April 1979, p. 37.

Drafting a Tax Escalation Clause in a Lease, by Bernard H. Goldstein, THE PRACTICAL LAWYER, January 1979, p. 63.

The Tax Consequences of Selling or Leasing a Home, by Paul E. Anderson, THE PRACTICAL LAWYER, June 1978, p. 57.

The Consequences of Taking Property By Regulation, by Gideon Kanner, THE PRACTICAL LAWYER, April 1978, p. 65.



The New Debt-Equity Treasury Regulations Under Section 385

Frank J. Gould

The new Treasury regulations, effective July 1, 1982, describe when straight debt and hybrid instruments are classified as debt or equity, and how to treat cash advances, debt instruments for which inadequate or excessive consideration was given, and locked interests.

The Internal Revenue Service ("Service") has recently enacted debt-equity regulations under the Internal Revenue Code ("Code") section 385, which will become effective on July 1,

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