REPRINTED FROM

SERVICING MANAGEMENT

THE MAGAZINE FOR LOAN SERVICING ADMINISTRATORS ■ VOL. 7, NO. 7 MARCH 1996

FORECLOSURE

Assault On The Second Mortgage

Danger Lurks When You Find Yourself In A Junior Position

BY BRUCE J. BERGMAN © 1996

Even for those servicers that may not regularly handle second mortgages, sometimes circumstances unexpectedly push them into a junior position and those frequently in a second spot know many of the lurking dangers.

Bruce J. Bergman

One of the inherent infirmities in the second mortgage (obviously) is that because it is junior, it is subject to extinguishment by foreclosure of a senior mortgage. Subordinate mortgage holders understand this, of course, and the concept enters into the business decisions made when lending money under that circumstance.

It's one thing to know where you stand, but quite another when an owner and a first mortgagee might conspire to wipe out the second mortgage. Could they get away with it? Perhaps not, says a new case in New York.[1]

Bruce J. Bergman, a partner with Certilman Balin Adler & Hyman in East Meadow, N.Y., is outside counsel to a number of major lenders and servicers and author of the two-volume treatise, ***Bergman on New York Mortgage Foreclosures, Mathew Bender & Co. Inc. (Rev. 1995).*** *He is a member of the National Association of Foreclosure Professionals, the American College of Real Estate Lawyers, an adjunct associate professor of real estate with New York University's Real Estate Institute, where he teaches the mortgage foreclosure course, and on the faculty of the MBA's School of Mortgage Banking.*

Just the facts

The facts tell the story.

Partnership SMZH executed a note and mortgage for $675,000 to Raynes. Later there was a second mortgage which was assigned to the Goldbergs.

On Jan. 1, 1991, owner/mortgagor SMZH defaulted on the mortgage and never made another payment. By June 1991, with the Raynes' senior mortgage still in default, it was assigned to Aubrey Equities Inc. (Aubrey). Significantly, the Goldbergs asserted that the consideration for assignment of the senior mortgage was only $10.

The new holder of the senior mortgage, Aubrey, accelerated in August and a foreclosure ensued. But more than meets the eye was going on here and the second mortgage holder (the Goldbergs) knew it. So instead of just monitoring the senior foreclosure to see if the case would be settled, or if a surplus would emerge (if the equity was sufficient the second could bid at the senior sale), the Goldbergs interposed an answer.

Two defenses

That answer contained two affirmative defenses. The first asserted that a principal of Aubrey (the first mortgagee) was also a partner of SMZH (the owner) and that SMZH defaulted solely to eliminate the Goldbergs' junior mortgage.

The second defense was that Aubrey purchased the senior mortgage for the solitary purpose of foreclosing, which if true would be a violation of New York's Champerty Statute.[2]

It's one thing to know where you stand, but quite another when an owner and a first mortgagee might conspire to wipe out the second mortgage.

Adopting the usual strategy, plaintiff Aubrey moved for summary judgment in the foreclosure and it was granted. In the absence of special circumstances, that a person was both a shareholder of Aubrey and a partner of SMZH, did not impinge upon the rights of the corporation or the partnership to operate. So, the lower court said, the Goldbergs' claim of fraud was no more than speculation.

As to champerty, the judge found no violation because there was no demonstration that the main purpose of assignment of the note and mortgage to Aubrey was for the purpose of commencing a lawsuit.

A new view on appeal

Happily for second mortgage lenders, a different view emerged on appeal.

The Appellate Division ruled it clear that the rights of a second mortgage will not be extinguished by a senior foreclosure sale if the junior can demonstrate a collusive or fraudulent scheme between the owner and the first mortgagee/assignee which was designed to wipe out the junior mortgage interest. (The court cited ample authority for the proposition.[3])

But how was the junior mortgagee to make this showing when the best it could do was infer or speculate?

The appellate tribunal held that the junior was entitled to discovery regarding the assertion of fraud perpetrated by plaintiff Aubrey and owner SMZH. (Discovery should also be available, the court found, on the issue of piercing the corporate veil.[4]) Important, too, was the holding that summary judgment is inappropriate where there are likely to be defenses dependent upon knowledge in the possession of the party moving for summary judgment (here the plaintiff, Aubrey) which could be revealed by discovery.[5]

Concerning champerty, the higher court thought issues of fact existed as to the intent in assigning the mortgage to Aubrey because of the uncertain relationship between Aubrey and SMZH (through their common principal). This was highlighted both because the transfer - the assignment - was apparently for a token consideration and because the mortgage was already in default when it was assigned. So, discovery was held necessary to explore this defense as well.

All this does not mean that the junior mortgagee won the case. It does mean that the junior could inquire into the unusual circumstances and expose a scheme if one existed.

The key maxim is that a first mortgagee and the owner may not be able to join forces to banish a second mortgagee. SM

---

[1]Aubrey Equities Inc. v. SMZH 73rd Associates, Misc.2d, 622 N.Y.S.2d 276 (1st Dept. 1995)

[2]Judiciary Law §489. That statute prohibits a corporation from taking an assignment of a note with the intent of bringing an action on it so long as it is established that suit commencement was the primary purpose of the assignment. (Limpar Realty Corp. v. Uswiss Realty Holding, 112 A.D.2d 834, 835-836, 492 N.Y.S.2d 754; 1015 Gerard Realty Corp. v. A&S Improvements Corp., 91 A.D.2d 927, 928, 457 N.Y.S.2d 821)

[3]Dorff v. Bornstein, 277 N.Y.236, 14N.E.2d 51; Lawrence Ave. Group, USA v. Parnes, 134 A.D.2d 172, 520 N.Y.S.2d 762; Holland v. Fulbert Inc., 49 A.D.2d 86, 371 N.Y.S.2d 509 appeal dism. 39 N.Y.2d 772, 385 N.Y.S.2d 31, 350 N.E.2d 408

[4]CPLR 3212 (f); Watson v. Work Wear Corp., 202 A.D.2d 231, 608 N.Y.S.2d 459; Baldasano v. Bank of N.Y., 199 A.D.2d 184, 605 N.Y.S.2d 293)

[5]Terranova v. Emil, 20 N.Y.2d 493, 497, 285 N.Y.S. 2d 51, 231 N.E.2d 753