Before You Proceed With Foreclosure, Know Exactly What The Mortgage Says

Thousands Of Dollars Can Be Lost For The Lack Of A Few Words

BY BRUCE J. BERGMAN

It belabors the obvious to suggest that precisely what a mortgage says plays such a critical role in how much a servicer will recoup upon a foreclosure action, either through settlement or final conclusion of the case.

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Although servicers are rarely involved with mortgage preparation (unless they also originate mortgages or if they have authority to settle cases through modifications) verbiage of the documents is nonetheless critical to servicers because they must assure that all that can be enforced and collected is enforced and collected.

> *Success in a foreclosure can be a function both of servicing expertise and draftsmanship. Servicers can only collect what the documents allow.*

Consequently, "success" in a foreclosure can be a function both of servicing expertise and draftsmanship.

Consider these facts

The truth of this observation is perhaps best explained by a real life example in highlighting issues of interest on the debt, interest upon advances and recompense for late charges and legal fees.

Assume this scenario, representing a compendium of not uncommon events:

The Bash-Um partnership, a group of "sharp" operators, spends $5 million to purchase a shopping center worth $6 million. They pay only $500,000 in cash, financing the balance through a $2 million first mortgage from Bank A, a $2 million second mortgage from Bank B and a purchase money third mortgage from the seller for $500,000.

Bash-Um's monthly mortgage payment to both A and B, each self-amortizing for 10 years at 14% interest, is $31,053.40. Bash-Um, for its own reasons, fails to remit mortgage payments to any of the lenders.

The first payment to each lender is due on Jan. 1. At the end of February, aggressive Bank A, despairing of

WHAT COULD HAVE BEEN

This is what lender B could have collected if the mortgage documents had been more artfully drafted and subsequently pursued.

■ Mortgage principal	$2,000,000.00
■ Interest, 2 years @14%	$560,000.00
■ Late charges, 4 months @5%	$6,210.68
■ Pay off first mortgage	$2,594,605.34
■ Interest on advance to satisfy first mortgage, 3 months @14%	$9,081.11
■ Disbursements in foreclosure	$1,500.00
■ Insurance advance	$80,000.00
■ Interest on insurance advance, 2 years @14%	$22,400.00
■ Tax advance	$100,000.00
■ Interest on tax advance, 2 years @14%	$28,000.00
■ Legal fees	$30,000.00
TOTAL	**$5,431,797.13**

Bash-Um's good intentions, accelerates the full balance of the principal and interest due on its mortgage.

Taking a desultory position, and believing that a more gracious approach is best, B refrains from accelerating until the April installment is overdue.

(The holder of the third mortgage has never been a creditor and waits eight months before finding an attorney who can finally urge him to proceed. His mortgage will be cut off by foreclosure of either the first or second mortgages and is not relevant to this example.)

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Foreclosure begins

Both banks institute foreclosure: A first, B some three months later.

Bash-Um, transparently claiming fraud to have been perpetrated by each bank, interposes an answer, delays both foreclosures for two years and causes both banks to incur $30,000 in legal fees. (Costs and disbursements to each bank in their respective foreclosures are $1,500.)

While each bank, of course, required an insurance policy at their loan closings, Bash-Um produced only a binder which, surprisingly, was accepted. Unfortunately, the binder was in error and no insurance was ever placed on the shopping center. Still further, during the course of the litigation Bash-Um never paid any real estate taxes.

Bank A's servicing department was so inefficient, or so unsophisticated, it did not worry about the lack of insurance (even though the mortgage could have been extinguished if taxes remained unpaid). Here, B was more astute and to protect its position, advanced $80,000 for insurance and $100,000 for taxes during the period of the litigation.

As the foreclosure cases lumbered

to their respective conclusions, A's advantage in starting first meant that its foreclosure would cut off B's mortgage, unless B paid off A in full. That is just what B had to - and did - do, some three months prior to its own foreclosure sale.

Holes in documents

Assume further that B's mortgage documents, unfortunately relying only upon a standard form, made no provision for legal fees or late charges, and was silent on the subject of interest upon default as well as interest upon advances.

A's mortgage, meanwhile, wisely drafted by polished practitioners, took all this into account.

A diligently crafted mortgage is a critical element in the collection and foreclosure process and is worthy of attention.

Presume finally that Bash-Um was quite content to collect the substantial rents earned at the shopping center for the two years the case was in litigation, all the while making no repairs or improvements whatsoever, supplying no services to the tenants and, as noted, conveniently avoiding the expenses of insurance and taxes.

As a result, from the time of purchase until the property was lost in foreclosure, Bash-Um earned far in excess of its $500,000 cash investment in buying the shopping center.

To B's consternation, two years of physical neglect, added to the spreading reputation of the shopping center as a place not to rent or shop, has reduced its value from $6 million to the vicinity of $5.5 million.

When B adds up all the sums owed to it (the upset price), it aggregates $5,174,343.20. Fortuitously, at B's foreclosure sale an outside bidder pays $5, 432,000.

(The difference between the foreclosure sale price and the amount owed B goes into a surplus to benefit, in this case, the third mortgagee.)

What B got, and didn't

Based upon this recitation, the consequences to B are outlined in the accompanying chart.

B obtained at the foreclosure sale all that its mortgage documents allowed it to recoup. Theoretically, it was made whole and might view the loan and the foreclosure as an ultimate success, even though certainly fraught with problems.

But did B actually obtain sums to which it could and, it is urged here, should have received?

To explain why the suggested answer is "no," take a look at a graphic delineation of what B could have recouped had its mortgage been more carefully drawn.

The difference between what B actually received and what would have been available if it used the same mortgage terms A employed is $257,453.93 - hardly an inconsequential sum.

Why it happened

How this resulted is simple.

Because B's mortgage said nothing about interest on default, it earned only the judgment rate of 9% for the principal for two years instead of the mortgage rate of 14%. (The mortgage could have specified that 14%, or any other lawful percentage, or the "highest rate allowed by law" was to apply on default.) Having neglected the point, B in essence gave an advantage to Bash-Um upon defaulting and the loan yielded $360,000 in interest instead of $560,000.

When B wisely satisfied the first mortgage in full, that very substantial advance yielded interest not at the mortgage rate of 14%, but at the judgment rate of 9%. Since that ad-

UPSET PRICE AT FORECLOSURE

This is the debt owed to B when the shopping center was brought to a foreclosure sale.

■ **Mortgage principal**	$2,000,000.00
■ **Interest**, 2 years @ judgment rate of 9% (this is the percentage available in New York, presented as an example)	$360,000.00
Pay off first mortgage:	
■ Principal	$2,000,000.00
■ Interest @ 14%	$560,000.00
■ Legal fees	$30,000.00
■ Disbursements	$1,500.00
■ Late charges, 2 months @5%	$3,105.34
	$2,594,605.34
■ Interest on advance to satisfy first mortgage, 3 months @9%	$5,837.86
■ Disbursements in foreclosure	$1,500.00
■ Insurance advance	$80,000.00
■ Interest on insurance advance 2 years @9%	$14,400.00
■ Tax advance	$100,000.00
■ Interest on tax advance, 2 years @9%	$18,000.00
TOTAL	**$5,174,343.20**

vance was made for only a short period of time, the difference of $3,243.25 is not especially significant, but represents a loss nevertheless. Had B obliged to satisfy the first mortgage earlier, the interest on this advance would have obviously been a greater factor.

Since B's mortgage never contemplated late charges, the $6,210.68 it could have recovered was never collected.

Advances for taxes and insurance were quite large. But that total of $180,000 generated interest for two years at only 9%, rather than 14%. The loss of return there was $18,000.

Counsel to B in the foreclosure earned $30,000 in bringing the action to its conclusion. While B paid the bill to its attorney, absent the legal fee provision in the mortgage, it could not be reimbursed for that expenditure out of the foreclosure sale proceeds.

In sum, then, the point should be clear. A diligently crafted mortgage is a critical element in the collection/foreclosure process and is particularly worthy of scrupulous attention.

The parallel observation specifically for the servicer is to be aware of precisely what the mortgage will allow. Armed with that knowledge in advance, supervise the foreclosure to maximize the available results. ■

FYI

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