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FORECLOSURE

Foreclosure Of The Second Mortgage

The nuances of default on a second mortgage are worthy of note

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While there are never any guarantees about anything, when the holder of a first mortgage must foreclose, it proceeds upon the comforting assumption that virtually everything in its path is subordinate and will be swept away by the action. With the main exception of real estate taxes (which in some areas may be quite consequential) there is no threat from senior interests. Quite the opposite is true — by definition — for the posture of the second (or more junior) mortgage. There is senior debt accruing, every day, sometimes at a dangerously high default rate of interest. Depending upon how great the equity cushion was, adding taxes to the equation, a wily borrower could cause the second mortgage to be in genuine jeopardy.



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In sum, concepts and strategy relating to default upon the second mortgage can contain nuances worthy of note. Thoughts from that perspective follow.

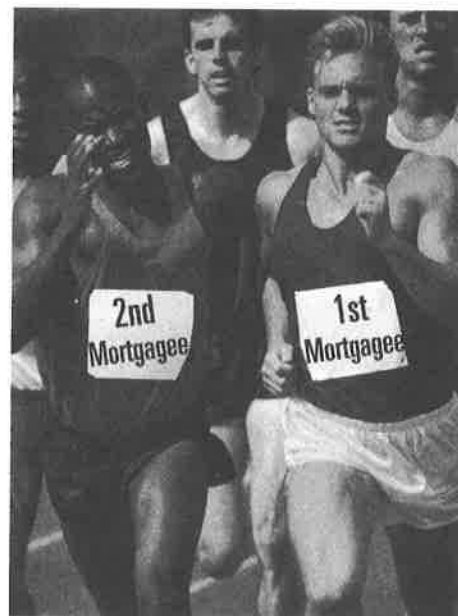
To foreclose or not

If the first mortgagee is foreclosing — or even if it is not — what should the second mortgagee do when default is encountered? From the vantage point of the junior, it should be the most alert participant in the process and probably should have begun its own foreclosure first, based either on default upon the senior or the likely simultaneous (or even earlier) default on the junior. The usual aim is to be in control, not let others influence the course of events.

Assuming such prudence and prudence, the junior should speed first to foreclosure to be the earliest party paid. Of course, if no one bids at the sale, the subordinate mortgagee will succeed to title, be constrained to market the property and likely satisfy the senior mortgage as well to elude extinguishment by the paramount foreclosure. But again, the junior has a modicum of control.

The more intriguing question is what happens if the first and the second initiate foreclosure at around the same time or, worse, if the second is very late to initiate its foreclosure? There are two schools of thought on this. Even if the senior begins initially, or around the same time as the junior, there is no way to predict with certainty how rapidly the senior will progress. They may not be very vigorous in pressing foreclosure. Perhaps their counsel is diffident

or they could simply encounter problems in the case not attendant to a junior foreclosure. Then too, the senior may be more amenable to settlement overtures by the borrower.



Thus, the first mortgagee's action *could* suffer delay. If the second mortgagee has elected to refrain from moving its own case, leaving the cost and effort to the senior, the second will be burdened with all the mishaps of the senior action. Indeed, for example, while the borrower could settle with the senior, there is no assurance of a rush to settle with the junior. In sum, there may be value to the second mortgagee in prosecuting its own case in the event the senior lacks necessary diligence.

The reverse view can be just as compelling though. Once the senior has first commenced foreclosure, the

most likely scenario (although not certain in every case) is that the first foreclosure will remain ahead of any action by the junior - rendering the latter duplicative and non-productive. So, once the senior is "ahead", a subordinate mortgagee may be wise to "tag on" to the first foreclosure. Let them do the work and spend the money (although expenses are generally added to senior debt). If the case is settled, it is reasonable to assume that the settlement will be global. If the action goes to sale, the junior can bid at the sale to protect its position if the equity so dictates.

Electing to sue on the debt.

When there is a default upon any mortgage - second mortgage included - an early issue to be addressed is foreclosure as the method to recoup the loss. In the instance of a junior mortgage, however, should the senior have already completed its foreclosure, then there is no property to foreclose upon and *only* a suit on the debt is available. (The scenario is effectively the same if the senior mortgagee is on the verge of its foreclosure sale.)

If there is no equity in the property, either because the senior debt has grown precipitously through accrual of default interest and/or tax advances, or because the property has declined in value, then foreclosure itself is futile. In such a case, and assuming the borrowers have any other assets, an action on the note is the most economical approach.

Whether to litigate

This heading is genuinely an initial question to ask and answer when a junior mortgagee is served with a complaint for foreclosure of a senior mortgage. Most often, the correct advice is *not* to litigate. That doesn't, by the way, mean do nothing. Here is the heart of the matter. If a lender or servicer is indeed in a junior position, then the inquiry is answered - there typically is nothing to litigate about. The senior is empowered to go forward and, if the case proceeds to a conclusion, extinguish the junior mortgage. Litigating, that is, contesting the issues, such as by

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interposing an answer, just increases the legal fees and, through extended duration, the accrual of interest on the senior debt. Concomitantly, the greater the burden of senior debt ahead of the junior mortgage, the more onerous the cost of rescue if the subordinate lender is the party eventually paying the bill to protect its position.

There is a critical exception to the avoidance of litigation suggestion, however. If the junior believes it is in actuality *senior*, then the issue must be challenged. For example, if your mortgage was executed and delivered first, but unfortunately recorded later, your priority may indeed be senior. It becomes a factual question in many states, but you certainly would not wish to concede the other mortgage's superiority. (If you have title insurance - actually mortgage insurance - you are likely protected under the circumstance and it should be the title company funding the battle after timely filing of a claim.)

Sometimes a foreclosing plaintiff simply misreads its foreclosure search and assumes it is senior when the actuality is to the contrary. You want to be sure of your legal priority and if the seniority attaches to your loan, yes, raise the point in an answer.

Another example is the instance of a once senior mortgagee entering into a modification agreement with a borrower which prejudices junior mortgagees - such as making unauthorized advances and/or increasing the interest rate. To the extent of the new advances and the greater rate, the otherwise senior mortgage can suffer a reversal of priorities

with those who previously had been junior. Of course, fact patterns diverge and case law in the various states can be different. Nevertheless, this is a concept to investigate.

On the subject of litigation, then, definitely scrutinize the applicable facts and law. That most often litigation will not be an option should not serve to reduce vigilance. In the relatively rare event that a junior mortgage has a defense to foreclosure of a purportedly senior mortgage, by all means, rights should be asserted. But in the more common situation of no defense available, spurious litigation (unless there is some special value in undue delay) is best avoided. Consequently, the usual direction to counsel is not "put in an answer for us," but something else.

Something else - the appearance

Other than defaulting in the senior foreclosure - which is never recommended - something less than contesting the case would be pursued. Exactly how this is done, and what it is called, will be somewhat different in the various states. Ultimately, it is the goal that matters more than what the paper may be called.

Typically, a junior mortgagee will desire to participate in the senior foreclosure only at those stages where watchfulness is meaningful. Those would include the computation stage, because it is essential to assure that the quantification of senior debt is accurate. It is too easy for a plaintiff or referee to include expenditures not authorized by the mortgage or simply to make mathematical errors. (Between late charges, insurance and tax advances, interest on advances, default rates of interest, inspection or appraisal fees - among a multitude of others - there is room for mistake.)

Since a judgment of foreclosure and sale involves calculation of the debt as well, that too is a plateau which may deserve investigation - in judicial foreclosure states of course. It may also be the time (as it is in New York for example) where an accelerated procedure to obtain surplus monies is available.

Hence, reservation of notice of application for judgment may be advisable.

Notification of the foreclosure sale date is obviously imperative. That sale is the ultimate event at which a junior mortgagee can rescue its investment - if the numbers so advise.

Essentially, the choice concerning appearance becomes one of full or general appearance, as opposed to some form of limited appearance. (In New York, for example, the latter is referred to as a notice of appearance and waiver.) The general appearance affords notice of everything (even stages of less meaning) and adds more delay to the foreclosure action. A limited appearance, on the other hand, engenders less delay and apprises the junior mortgagee solely of those events the junior has selected as relevant. (The

nuances to these formulations are, not surprisingly, more extensive than can or should be related here. And they differ among the states. Accordingly, details should be discussed with counsel for each jurisdiction.)

Pay now or later

A junior mortgagee should always have the right to satisfy a senior mortgage to protect the subordinate lien. (There is usually no right to reinstate the mortgage - on a junior mortgagee's part anyway - but a foreclosing plaintiff might be amenable to a reinstatement.) Whether and when a senior mortgage should be paid off is much more a business question rather than a legal one. First, of course, the equity has to be there to protect. If it is, the question probably be-

comes, do I pay now or pay later, i.e., at the foreclosure sale.

The response to that last query may in turn depend upon the rate of interest attaching to senior mortgage principal. A very high default rate could urge paying early in the case to avert oppressive interest accrual. A more modest interest rate might suggest that payoff funds are best invested elsewhere, to be kept available either to redeem the mortgage at the last moment or buy at the foreclosure sale.

Conclusion

So, there really are more than a few different considerations attendant to protecting the junior mortgagee. While they differ to some degree in the different states, the essence of the issues is similar - and always worthy of attention. **SM**