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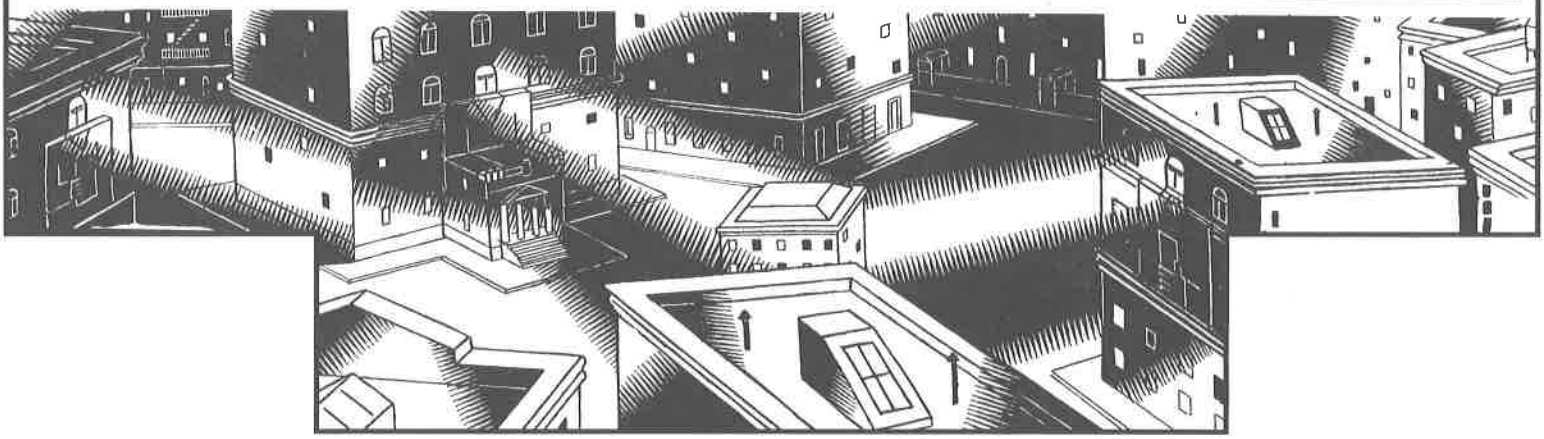
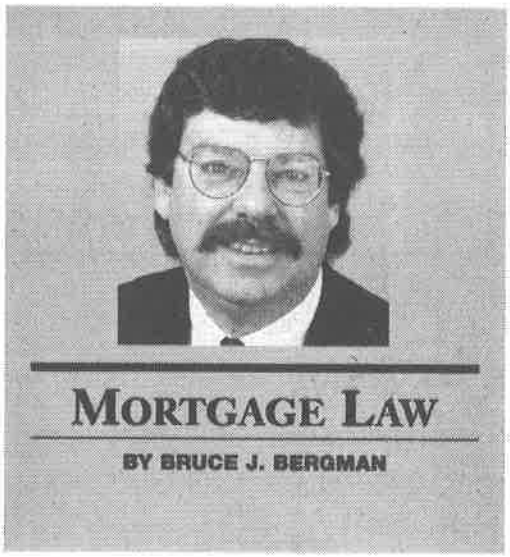
REAL ESTATE UPDATE



Foreclosures:

Assault on the Deed-in-Lieu



MORTGAGE LAW

BY BRUCE J. BERGMAN

WHO would want to launch an attack upon something as innocuous — indeed often beneficial — as a device which settles an action as traumatic as a mortgage foreclosure case? It may not have been perceived or intended in such a way, but a new holding by the First Department poses a hidden threat to some deeds-in-lieu.[1] This hazard arrives, not incidentally, at a time when loss mitigation regarding defaulted mortgages is pursued with ever more pervasive ardor.

To expeditiously arrive at the point, the deed-in-lieu is usually efficacious only when the title is otherwise unencumbered. On some occasions though, a foreclosing plaintiff would be willing to accept a deed-in-lieu even with a less-than-pristine title, so long as the foreclosure could nevertheless continue, to then extinguish the offending liens. An impediment to the foreclosure proceeding, however, is the doctrine of merger, which in turn is readily avoided. Based upon what may be dubious grounds, the mentioned new case imposes merger when it was sought to be avoided, thereby giving serious pause to foreclosing plaintiffs contemplating acceptance of a deed-in-lieu in certain situations.

Returning to a more detailed analysis, mindful that a major component of any foreclosure action is time, which translates into accrual of interest and, consequently, increasing debt, reaching a conclusion to the action is perhaps more exigent in this arena than others. A foreclosure which arrives at a judicial end results, of course, in either the sale of the property to a third party or devolution of title to the mortgage holder who presumably would then sell the property in an arm's-length transaction. If a borrower/owner offers title to the mortgage holder early enough in the foreclosure process, the ultimate goal of the foreclosure is achieved more quickly, and more cheaply — hence, a significant benefit of the deed-in-lieu of foreclosure.[2]

Another goal — or in this context, result — of a mortgage foreclosure is the extinguishment of all subordinate interests. Acceptance of a deed-in-lieu of foreclosure does not bring about the legal equivalent of a foreclosure sale in that sense. Obviously, if a mortgage holder takes a deed-in-lieu, he buys the property burdened by whatever interests attached subsequent to the mortgage. Absent a clean title as revealed by a title search,[3] the offer of a deed-in-lieu of foreclosure would usually be rejected.

There are, however, some instances in which condition of the title is not a dispositive factor. Suppose, for example, a borrower is assiduously blocking the action with tenacious litigation, perhaps much of it transparent, but effective nonetheless in delaying resolution of

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the case. Moreover, that borrower somehow has the resources and the desire to continue the fight interminably, and even beyond the stage of the foreclosure sale. But fearing deficiency liability, the obstreperous borrower has an epiphany and offers a deed-in-lieu, to be rid of the trauma, so long as it includes a waiver of liability for a deficiency judgment. Not surprisingly, title to the property is burdened a plethora of judgments, so that a deed-in-lieu is only a pyrrhic victory for the mortgagee. Although in this condition the title has little value in and of itself, as a method for disposing of expensive litigation the deed has considerable worth — but only if the foreclosure action can continue, notwithstanding the fact that both title and the mortgage now repose in one party.

Another example is the case where the mortgaged premises may physically deteriorate or otherwise rapidly decline in value during the pendency of a contested foreclosure. Although the appointment of a receiver can reduce or eliminate such problems, receiverships can sometimes be delayed by vigorous opposition. Even if such an appointment is obtained with dispatch, not every receiver is efficient. So, the receivership is sometimes not the panacea it has the potential to be. Owning the property, title problems aside, therefore presents a genuine benefit to the foreclosing plaintiff.

Then there is the contested case where the defenses might have arguable legitimacy. That a foreclosure could be lost is decidedly unpalatable. And where there are guarantors, taking a deed-in-lieu cries out for the need to still prosecute the foreclosure to enforce the deficiency against those other parties liable for the debt. In sum, the noted examples suggest that taking a deed-in-lieu intending to still proceed with the foreclosure is a very real scenario.

Enter the sonorous, but functional and important, doctrine of merger. In general terms, the doctrine of merger provides that where legal title to both the property and the mortgage become vested in the same owner, the lesser ownership interest is merged into the greater.[4] As the Court of Appeals tersely stated the proposition, "[W]hen the mortgagee acquires title to the property, there is a merger of the mortgage interest into that of the fee."[5]

As a practical matter, application of the doctrine will cause the mortgage to be extinguished when the mortgagee succeeds to title by virtue of accepting a deed-in-lieu of foreclosure — a result antithetical to the notion that sometimes the foreclosure must progress regardless of the deed-in-lieu.

Although in theory the doctrine of merger would seem to preclude deeds-in-lieu of foreclosure, in practice, merger is easily avoided — a concept not so readily recognized by the new case which prompted this review.[6] As an overarching precept, the doctrine of merger is not favored in equity,[7] which is to say, equity disfavors merger.[8] Whether a merger occurs in any event is a question of fact[9] and the intent of the parties is controlling.[10] Indeed, estates are presumed to remain separate if justice so requires,[11] provided, however, that the rights of third parties and creditors do not intervene.[12]

Critically, when merger does not result from a deed-in-lieu of foreclosure, the mortgage survives as enforceable.[13] Concomitantly, when the mortgage is preserved, suit against other obligors who may not have been released is authorized[14] as it is against the mortgagee himself[15] or his nominee.[16] Case law thus neatly confirms what makes necessary sense: when merger is avoided, the foreclosure can go forward to serve its desired function.

Avoidance of merger is accomplished with comparative ease. The parties' intention controls and intent can be construed from word or deed[17] or from the terms of the documents accomplishing the transaction.[18] In particular, simple language in a deed providing that a mortgage shall not merge with the fee can be effective.[19] Avoidance of merger results also by conveying title to a nominee.[20]

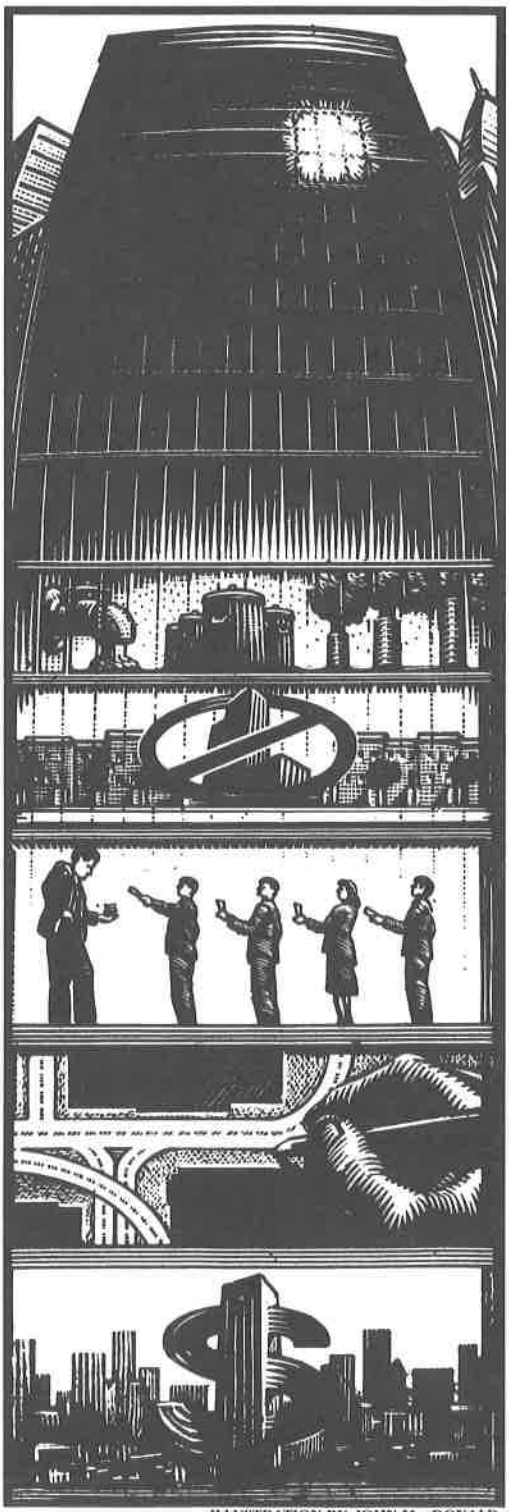

ILLUSTRATION BY JOHN MacDONALD

Even though escaping the consequences of merger requires minimal effort, there are instances where the exercise fails,[21] such as when sidestepping merger would perpetrate a fraud upon a third person. A scenario which explains the point is this. The borrower holds title to mortgaged property through various aliases and alter egos. Both a first and a second mortgage encumber the property and when default on the second mortgage occurs, a foreclosure action is begun. Recognizing that if he obtains the first mortgage he can neatly wipe out the second mortgage which has become his nemesis, the shifty borrower takes the senior mortgage by assignment in the name of a sham corporation. Because apparently different parties hold the first mortgage and the title, the villain seeking to hornswoggle the junior mortgagee does not appear to be in danger of running afoul of merger. Equity, understandably, imposed merger for that fact pattern.[22]

How much beyond blatant fraud decisional law should venture in creating uncertainly about the application of merger is the issue raised by the new case which launched this discussion, *Garan* v. *People*.[23] Relying upon the fraud decision just noted[24] the court in *Garan* found inquiry appropriate into whether a nominally separate entity that took title by a deed-in-lieu of foreclosure during pendency of a foreclosure was truly separate or was an alter ego created to defeat the rights of a subordinate lienor, and if the latter, whether equity was thereby required to intervene and declare a merger. In finding that merger was to be declared, the court based its decision upon these recited factors: the nominee-grantee (1) was newly formed; (2) had the same address as the foreclosing party, and; (3) took title without giving notice to the junior lienor, even though the nominee had knowledge of that party's subordinate mortgage. In addition, after the deed was delivered, the senior mortgagee — for unclear reasons, the court observed — resumed prosecution of its long dormant foreclosure "without even advising the court of such deed."

Maybe scrutiny of the full record is necessary to agree with the *Garan* court. It is possible that an egregious injustice would have been perpetrated absent the invocation of equity. But such is not at all apparent on the face of the decision. Rather, the ruling hints at lack of familiarity with the compelling realities of foreclosure strategy and practice.

The court was obviously troubled by the idea that the deed-in-lieu recipient was the alter ego of the foreclosing plaintiff. But that is the very purpose of creating or maintaining a nominee entity — to avoid confluence of title and mortgage in one party. The nominee most often is the alter ego. An institutional lender will typically form and perpetuate a corporate entity to be the recipient of deeds-in-lieu, and sometimes real-estate-owned properties as well.

Without employment of the nominee, one branch of merger avoidance would vanish, so the concern with the alter ego analysis is perplexing.

That the nominee was newly formed may suggest closeness to the foreclosing mortgagee, but that has never before been a consideration in the merger equation. After all, the foreclosure plaintiff itself could take a deed, without engaging a nominee, and deflect merger merely with a few words reciting that merger shall not result.[25] "Newly formed" is in any event essentially a function of time, creating a distinction without a difference.

Unpersuasive, too, for mostly the same reasons is that the nominee had the same address as the foreclosing mortgagee. Should there have been a benefit for deviousness? Would a different address have manufactured a layer of insulation, and if so, why? While the same address urges a similarity of identity, that is still not the point. A nominee, even just born and in the same offices, nevertheless is a separate entity for merger purposes.

As to giving notice to a junior mortgagee of the conveyance of title, the idea is, if not downright odd, meaningless. Once a lis pendens is filed in an action, subsequent owners are bound by the action just as if they were parties. So if the junior mortgagee had begun its own foreclosure, and filed a lis pendens, the deed-in-lieu would have been of no consequence. If the junior would only later have initiated foreclosure, its search would have revealed the new fee owner. What then is the consequence of, or necessity to, inform the subordinate mortgagee of the title transfer? In the real world, it is simply not done and there is neither compulsion in law or fairness to do so.

Finally, the court was chagrined — although why is not stated — because the foreclosing plaintiff resurrected a dormant foreclosure and made no mention of the deed. But if the deed has no legal consequence to the foreclosure, and it does not, what principle should evoke dialogue with the court? Nondisclosure of anything material should assuredly be condemned. The court never stated why acceptance of the deed was a material fact. And why should enforcement of plaintiff's rights, renewing the old foreclosure, be worthy of censure when neither laches nor the statute of limitations was a factor?

If this case is to be precedent, foreclosing mortgagees encounter a conundrum. It is exquisitely difficult to weigh the principles because the stated reasons for the ruling do not square with prior case law. Only in the general sense that equity plays a role is the ruling consistent with established precepts, but it is in the particulars that the danger lurks. If the holding does not banish use of a nominee altogether — and that would be hard to imagine — it does seem to say that some greater, and heretofore unrecognized separation is necessary. An established entity with a different address would help. Beyond that, the matter is too fact intensive to represent a change in long accepted principles — or so it is to be hoped.

(1) *Garan v. People*, ___ AD2d __, 686 NYS2d 419 (1st Dept. 1999)

(2) For a more extensive review of the advantages and disadvantages of a deed-in-lieu of foreclosure to a plaintiff, see 2 *Bergman on New York Mortgage Foreclosures*, §25.09, Matthew Bender & Co. Inc. (rev. 1999).

(3) In the foreclosure action the source of information would be a foreclosure search.

(4) *Whitestone Sav. & Loan Ass'n v. Allstate Ins. Co.*, 28 NY2d 332, 270 NE2d 694 (1971); *Cambridge Factors Inc. v. Thompson*, 215 AD2d 427 (2d Dept. 1995), *Erhal Holding Corp. v. Nobile*, *New York Law Journal*, July 25, 1994 at 30, col. 3 (S. Ct. Westchester Co., Lefkowitz J.); *200 E. 64th St. Corp. v. Manley*, 44 AD2d 11 (3d Dept. 1974), aff'd. 37 NY2d 744 (1975).

(5) *Whitestone Sav. & Loan Ass'n v. Allstate Ins. Co.*, supra at note 4.

(6) *Garan v. People, supra* at note 1.

(7) *Jemzura v. Jemzura*, 36 NY2d 496, 330 NE2d 414 (1975); *Smith v. Roberts*, 91 NY 470 (1883); *Sheldon v. Edwards*, 35 NY 279 (1866); *Champney v. Coope*, 32 NY 543 (1865); *Long Island Lighting Company v. Commissioner of Taxation and Finance*, __ AD2d __, 652 NYS2d 640 (3d Dept. 1997); *Arch Assets v. AL & LP Realty Co.*, 227 AD2d 295 (1st Dept. 1996); *Riley v. South Somers Dev. Corp.*, 222 AD2d 113 (2d Dept. 1996); *Cambridge Factors v. Thompson*, supra at note 4; *200 E. 64th St. Corp. v. Manley*, 44 AD2d 11 (3d Dept. 1974), aff'd. 37 NY2d 744, (1975); *Becker v. Snowden Dev. Corp.*, 66 Misc2d 1060, 323 NYS2d 79 (S. Ct. 1971); *In re Kalm's Estate*, 45 NYS2d 768 (Surr. Ct. 1944); *James v. Morey*, 2 Cow. 246 (1823); *Starr v. Ellis*, 6 Johns Ch. 393 (1822); *Gardner v. Astor*, 3 Johns Ch. 53 (1817); *Moffatt v. Hammond*, 18 Vesey 385 (1811).

(8) *Riley v. South Somers Dev. Corp.*, supra at note 7.

(9) *Egrini v. County of Suffolk*, 599 NYS2d 457 (1993); In re *Nochomov's Estate*, 206 Misc 290, 132 NYS2d 720 (1954).

(10) *Long Island Lighting Company v. Commissioner of Taxation and Finance*, 235 AD2d 637 (3d Dept. 1997); *Cambridge Factors v. Thompson*, supra at note 4; *Erhal Holding Corp. v. Nobile*, supra at note 4; *In re Marocco*, 46 AD2d 572 (3d Dept. 1975); *200 E. 64th St. Corp. v. Manley*, 44 AD2d 11 (3d Dept. 1974), *aff'd*, 37 NY2d 744 (1975); *Egrini v. County of Suffolk*, 599 NYS2d 457 (1993); *Becker v. Snowden Dev. Corp.*, 66 Misc2d 1060 (S. Ct. 1971); *American Sav. & Loan Ass'n v. Eidelberg*, 54 Misc2d 668 (S. Ct. 1967); *Armstrong v. Germain*, 98 NYS2d 946 (S. Ct. 1949); *Mercantile Liquidation Corp.* v. *Henderson*, 60 NYS2d 428 (S. Ct. 1946).

(11) *Cambridge Factors v. Thompson*, supra at note 4; *Becker v. Snowden Dev. Corp.*, supra at note 10.

(12) *Long Island Lighting Company v. Commissioner of Taxation and Finance*, supra at note 10; *In re Nochomov's Estate*, supra at note 9.

(13) See, *inter alia*, *Central Hanover Bank & Trust Co. v. Roslyn Estates*, 266 AD 244 (2d Dept. 1943, aff'd, 293 NY 680, 56 NE2d 295 (1944); *Egan v. Engeman*, 125 AD 743, 110 NYS 366 (1st Dept. 1908); *Alden Hotel Co. v. Kanin*, 88 Misc2d 546, 387 NYS2d 948 (S. Ct. 1976); *American Sav. & Loan Ass'n v. Eidelberg*, 54 Misc2d 668 (1967); *Mintz v. Kuperstein*, 177 NYS2d 652 (1958); *In re Nochomov's Estate*, supra at note 9.

(14) *Central Hanover Bank & Trust Co. v. Roslyn Estates*, supra at note 13.

(15) *Egan v. Engeman*, supra at note 13.

(16) *Alden Hotel Co. v. Kanin*, supra at note 13.

(17) See cases cited at footnote 10, supra.

(18) *Erhal Holding v. Nobile*, supra at note 4.

(19) *Riley v. South Somers Dev. Corp.*, supra at note 7; *Central Hanover Bank & Trust Co. v. Roslyn Estates*, supra at note 13; *Egan v. Engerman, supra* at note 13; *American Sav. & Loan Ass'n. v. Eidelberg*, supra at note 13.

(20) *Alden Hotel Co. v. Kanin*, supra at note 13, citing, *inter alia*, *Jemzura v. Jemzura*, 36 NY2d 496; *Curtis v. Moore*, 152 NY 159, 46 NE 168; *Abra Holding Corp. v. Jackson*, 30 Misc2d 464, 219 NYS2d 757.

(21) See 2 *Bergman on New York Mortgage Foreclosures*, §§25.06[2] and 25.06[3][b], Matthew Bender & Co. Inc. (rev. 1999)

(22) *Cambridge Factors v. Thompson*, supra at note 4.

(23) Supra, at note 1.

(24) *Cambridge Factors v. Thompson*, supra at note 4.

(25) See, for example, *Central Hanover Bank & Trust Co. v. Roslyn Estates*, supra at note 13; *In re Nochomov's Estate*, supra at note 9; *Egan v. Engeman*, supra at note 13.