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FORECLOSURE

Heed The Deficiency Judgment

Servicers who don't obtain a deficiency judgment could be without an insurable interest when an insurance claim is made on a foreclosed property.

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It is unfortunate that subjects this important sound like they are obscure and pedantic. This one certainly is not. Real danger lurks here because of the sometimes forgotten principle that once a foreclosure is over - if a deficiency has not been pursued - a lender's insurable interest is gone and no insurance claims can be made. This is true in New York and many other states and is well worthy of explanation.

First, let's look at a speculative scenario to illustrate this point. Just before a mortgage foreclosure sale is scheduled, a portion of the house is destroyed by fire or suffers some other hazard loss, such as broken pipes causing water damage. An insurance claim is filed whereby the lender should be the sole payee because the mortgage is in default. The foreclosure sale is conducted, but a deficiency judgment is never sought.

When the servicer follows up with the insurance company asking where the payment is, they are advised that there is no insurable interest remaining and therefore nothing will be paid.

Here's an alternative scenario. Everything is the same, except that the foreclosing plaintiff is due the sum of \$100,000 at the foreclosure and bids the full amount of its debt. A few days after the sale, they call the insurance company and are told that since the foreclosing plaintiff bid in its full debt, they have been "paid" in full, so there is nothing for insurance to compensate and no check will be sent. With one possible exception to be discussed later, the insurance company is right; the lender and servicer have a serious problem.

The applicable law (in New York and many other states) is that if a foreclosing plaintiff bids in full debt or, regardless of its bid, never pursues a deficiency judgment, then taking back the property is deemed to be full satisfaction of the debt. If the debt has been satisfied, then there is no insurable interest in the property.¹

Note too - and this is more for the commercial case - if the mortgage documents prohibit seeking a deficiency judgment, consummation of the foreclosure sale extinguishes a plaintiff's claim to fire insurance proceeds.²

Protective action

Because of the noted principles and peril, servicers should consider some protective action. First, if a fire or other hazard loss is incurred prior to the foreclosure sale, consideration can be given to refraining from holding the sale until insurance proceeds have been paid.

Second, because there may be compelling reasons to move the foreclosure along, the sale can be held, but the servicer should authorize pursuit of a deficiency to establish the shortfall and thus be in a position to claim the insurance proceeds.

Finally, if insurance proceeds are at issue, the servicer should be careful never to bid above the perceived value of the property. In many states (and certainly in New York), as part of the deficiency formula, the borrower is given credit for the greater of the amount bid at the sale or the value of the property on that day.

Hence, every dollar bid above the value of the property diminishes, and ultimately extinguishes the deficiency that can be claimed - even if in actuality the property is not worth the amount of the debt. To the extent that certain investors may obligate a servicer to bid full debt, the consequences of that need to be understood.

Having noted this very dangerous relationship between insurance proceeds and a deficiency, it should be observed that there is a new case in New York which offers an exception to the rule that neglect to pursue a deficiency bars a claim to insurance proceeds.

This exception arises where the mortgage itself provides that the proceeds from a fire insurance policy are first to be applied in reduction of the mortgage debt, with only the balance to be paid by the mortgagor. If that occurs, the lender's claim to proceeds is a

contractual right, unaffected by non-pursuit of a deficiency.³

Whether *your* mortgage contains such a provision is an imponderable, but it's worth looking for. Indeed, it is something that mortgage drafters should address with dispatch.

In the end, these nuances can be challenging, but the practical effects are critical. It's certainly worthwhile to be informed.

¹Bellusci v. Citibank, 611 N.Y.S.2d 958 (3d Dept. 1994); Cohen v. New York Property Ins. Underwriting Ass'n, 160 A.D.2d 287, 554 N.Y.S.2d 477 (1st Dept. 1990); Builders Affiliates v. North River Ins. Co., 91 A.D.2d 360, 459 N.Y.S.2d 41 (1st Dept. 1983); Equitable Life Assurance Soc'y of the United States v. Great Atlantic Ins. Co. of Del., 69 Misc.2d 714, 330 N.Y.S. 2d 840, aff'd, 40 A.D.2d 773, 337 N.Y.S.2d 983 (1st Dept. 1972).

²First Fed. Sav. & Loan Ass'n of Rochester v. Dietz Int'l Public Adjusters Inc., 143 A.D. 2d 45, 531 N.Y.S.2d 801 (1st Dept. 1988.)

³TIG Insurance Company v. Wilshire Credit Corp., __ A.D.2d __, 703 N.Y.S.2d 501 (2d Dept. 2000).

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