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Consultant's Corner

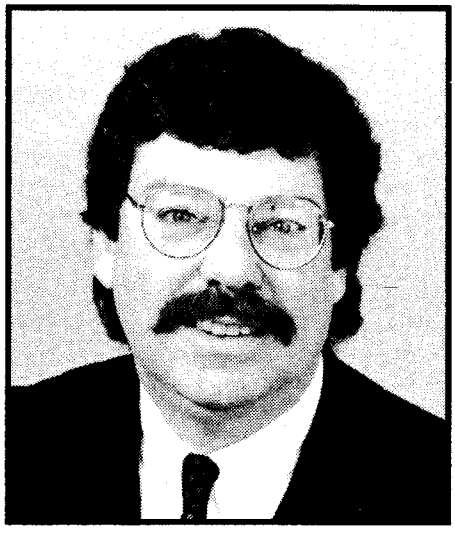
Mortgage Foreclosure - A Modern Primer For Corporate Counsel

By Bruce J. Bergman

Everything house counsel needs to know about mortgage foreclosure? That may not only be too demanding an assignment, but it would certainly be overly prolix and unduly dependent upon one's particular perspective. But because this can be an especially daunting arena - to say nothing about pointedly specialized - an overview should provide some comfort.

But first, an opening assumption. Unless you represent a bank or other real estate lender, or unless you regularly hold mortgages as collateral for debts, exposure to mortgage foreclosure is most likely to arise when the corporation holds a judgment attaching to property which is being foreclosed upon, or if the corporation is a lessee at such a property. In other words, the most common vantage point is as a defendant. However, just as prosecuting a foreclosure (obviously) requires an understanding of the process, so too does defending it.

Perhaps the first question to ask - and answer - is, who should be in the trenches for these cases?[1] If it's prosecuting the action (as opposed to appearing in and monitoring someone else's foreclosure) outside counsel is often a good choice. The foreclosure action is a unique elicitor of multiple callings. It is not a casual pursuit and tends to be hostile ground for the generalist. It requires a thorough knowledge of real estate law (real estate titles in particular) *and* litigation.



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Even the skilled litigator benefits from doing this every day because foreclosure nuances are especially acute and vital practice aspects can vary considerably even from county to county within a state. A qualified real estate attorney could be mired in the litigation aspects while a solid litigator could stumble on the real estate intensive portions. Then too, mindful that one of the most common parries to the foreclosure action is a bankruptcy petition, the need for a bankruptcy expert is virtually inevitable. And maybe here is the ultimate persuader in favor of the outside specialist. Although a mortgagee's legal fees can frequently be recovered in a foreclosure case[2] - that usually will *not* apply where counsel was in the employ of the plaintiff.[3] This, then, may not present the venue to be so bold as to learn on the job.

Duration (And Bankruptcy)

Closely akin to the query "what's a foreclosure all about?" is the question, "how long does it take?" Of course, that depends upon what state and county you are in and what complications may arise in the case. There are, though, some benchmarks.

In New York, for example, a garden variety uncontested foreclosure consumes approximately nine to thirteen months. Any case in New York City is likely to add quite a number of months to the prediction. New Jersey is longer still.

Commercial, as opposed to residential, foreclosures are prone to more issues, both because the matters are likely to be inherently more complex and because the mortgagor usually has some wherewithal to stave off the impending doom. Consequently, commercial foreclosures will more often be litigated and, thus, consume considerably more time. How much time is an imponderable, and it's the same as asking any attorney how long litigation will take. The answer isn't susceptible to precise assessment.

Another factor which can significantly affect duration is a bankruptcy filing. Any petition in bankruptcy (Chapter 7, 13 or 11) imposes an automatic stay. Chapters 11 and 13 require submission of a plan, which grafts many more months on to the process. The Chapter 7, or straight bankruptcy, will usually engender less delay, but the hiatus is still usually measured in a number of months.

Because a mortgage is a secured interest, it is *not* discharged in bankruptcy. Personal liability for the debt can be extinguished, but the security for the debt (the property) remains. Filing the petition can actually help assure payment to the secured party, the mortgagee. So, while bankruptcy portends delay, it can be constructive and is only very rarely fatal to the mortgage holder.[4]

Time, And The Vital Concepts Of Deficiency And Surplus

From the mortgage holder's point of view, a mission is generally to speed through the foreclosure as quickly as

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possible. Time translates into the accrual of interest, the possible deterioration of the property during the course of the case and the ultimate loss those dual circumstances presage. Believing a different motivation is in control, borrowers typically support delay, hoping that time will somehow lead to rescue.

Time, in turn, bears a relationship to generation of a surplus (an amenable circumstance for all) or a deficiency (an unwelcome occurrence for all). It would be correct to observe that those foreclosures which actually proceed to a foreclosure sale result in neither a surplus nor a deficiency.

A surplus emerges when the sum bid at a foreclosure sale exceeds the sum decreed due to the foreclosing lender. A deficiency may be viewed as the converse of a surplus, although the reverse correlation is not so exact. The deficiency is the difference between the sum due the foreclosing lender, inclusive of interest (to which is added the amount owing on all prior liens and encumbrances, also with interest, plus costs and disbursements of the action), and the greater of the market value of the foreclosed property on the date of the foreclosure sale or the proceeds of the foreclosure sale.

All parties to a foreclosure should be to some degree concerned about whether either a surplus or a deficiency will result. One way to gauge the importance of these possible events is to note the effect upon parties when there is neither a surplus nor a deficiency.

Suppose for illustration a mortgage loan of $400,000 on a property worth $500,000. (The concept would be the same for a $40,000,000 loan upon a property worth $50,000,000.) Assume that the mortgage bears interest at 10% and that the borrower defaults upon the initial payment. Presume further that the foreclosure consumes one year of time to reach the juncture of a sale. The judgment of foreclosure and sale will have decreed that the sum due the foreclosing lender totals $450,000, consisting of $400,000 in principal, $40,000 in interest, with the remaining $10,000 consisting of accrued late charges, an escrow overdraft to pay taxes, legal fees, costs, disbursements and allowances.

On the final assumption that the value of the property had remained stable at $500,000 during the course of the foreclosure, there is a reasonable likelihood that the highest price bid at the foreclosure sale will be that sum due the lender of $450,000. If the lender receives all the money due to it, it has neither necessity nor legal grounds to seek recompense from anyone liable for the debt - most often the borrower. Hence, there is no deficiency.

Nor is there a surplus. So long as the amount bid is no higher than the amount due the lender, no money is "left over." All proceeds go to the lender so nothing remains against which anyone can claim.

Since most - but certainly not all - mortgage loans are designed at the inception to be prudent, there is most often a "reasonable" relationship between the quantum of the loan and the value of the property it secures. The foreclosure sale *should* make the lender whole. The greater the positive disparity between the sum due the lender and the value of the property, the greater is the likelihood of a surplus. Only when the property is worth less than the amount due the lender can there be a possibility of a deficiency.

That what may be usual can readily become unusual should be immediately apparent. For example, if the foreclosure under discussion raced ahead in six months and the property precipitously increased in value by 10% during that time, the numbers would clearly be different. Then, the sum due the lender would be $430,000 (10% interest for six months instead of a year would total $20,000 rather than $40,000). With a 10% increase in value, the property would be worth $550,000. Under these circumstances, the difference between the total owed the lender ($430,000) and the market value of the property ($550,000) is a whopping $120,000. This suggests a considerable probability that any number of bidders would be most anxious to bid well above the upset price. Every dollar bid above $430,000 then becomes surplus.

Although surplus is of no consequence to the foreclosing party (who cannot receive more than the debt), or to senior encumbrances (whose liens remain attached to the property), surplus is meaningful to the owner of property (usually, but not always the borrower) who was divested of title by the foreclosure, as well as the holders of all interests of record *junior* to the foreclosed mortgage. Each of these persons or entities shares in the surplus in order of their respective priorities.

Returning to the converse - the deficiency - different assumptions in the scenario could reverse the result. Suppose that instead of taking one year, the foreclosure is contested and takes two years to complete. Now the interest component of the debt increases from $40,000 to $80,000. Assume also that the litigation adds $10,000 in additional legal fees and that the property declined in value by 10% rather than remaining stable or increasing.

Given the newly recited facts, the sum due the mortgage holder aggregates $500,000. With the property now worth $450,000, it is apparent that no one will bid a sum sufficient to make the lender whole at the foreclosure sale. The probability is that the lender will simply succeed to title by bidding a nominal sum at the sale. The lender will be deemed to have received $450,000 - the value of the property. Having been owed $500,000, however, the loss, or deficiency, is $50,000. Whoever is personally liable for the mortgage debt can then be subjected to a motion to obtain a deficiency judgment.

Who Is Liable For The Obligation?

Inherent in the concept of mortgage foreclosure is sale of the property to satisfy the debt. But what if the property is worth less than the sum due to the mortgage holder? That, of course, is the noted deficiency situation which then leads to contemplation of who the parties might be who are liable to the mortgagee.

Although it is a more expansive subject than this, anyone who has promised to pay the debt is a person so liable. Conspicuous in this category are signers of the mortgage note (or bond) and guarantors. They will typically (and in New York, for example, *must*) be made defendants in the foreclosure action so that any shortfall can be assessed against them.

That such people or entities could be in jeopardy suggests that a mort-

gage holder might choose to forego a lengthy and possibly tortuous foreclosure, opting instead for an action at law on the note or guarantee. That could be a faster route to success and, if the obligors have the proverbial deep pockets, maybe the most efficacious way to proceed.[5]

One thing mortgagees most often cannot do is foreclose and pursue the monetary obligation simultaneously. Most states have a one action rule or an election of remedies statute which prohibits an oppressive dual assault.[6]

How Much Is Due The Lender?

The quantum of peril to those liable for the mortgage debt is a critical item in the process. Of course, the debt consists of principal and interest. Interest is generally a more momentous category than might first appear. If a mortgage is silent on the subject, upon default the principal bears interest at the contract or note rate - which is in essence the expected rate of return. If, however, the mortgage provides for some *other* rate to apply on default, it is that different and almost inevitably *higher* percentage which will apply. That might be 15%, or 20%, or 24% or, as is so in New York, *any* rate of interest. Because interest on default is deemed neither to be a loan or a forbearance, it cannot run afoul of usury prescriptions![7]

But there is still more to it, some of consequence, some of less importance. Typically, a lender is entitled to recoup sums in a number of categories. Disbursements is one. Actual out of pocket expenditures in the foreclosure process, e.g., index number, process service, foreclosure search, legal advertising, referee's fees, can be added to the foreclosure judgment. So too can late charges, but only up to the time the mortgage balance was declared due.[8] Among other sums are what various statutes may refer to as costs and allowances.

Of usually greater significance are legal fees. Where either statute or the mortgage contract call for such recompense to the lender - and most often one or the other does prevail - the amount will be added to the judgment. Especially in a heavily litigated case, these sums can be quite substantial.

Also in the category of meaningful are advances made by the plaintiff to protect the lien of the mortgage, such as taxes, insurance and advances to senior mortgagees. Depending upon the nature of the property, these can be weighty amounts. And then there is the matter of interest upon those advances. Here, the same concept controls as with interest on the principal. If the mortgage is silent, the note rate applies. But if separate provision is made, a higher rate can apply. It is therefore easy to observe how a mortgage debt can precipitously rise well past expectations of the uninitiated.

Acceleration

When a lender decides to move in the direction of foreclosure, it need not be overly aggressive. Rather, the goal will be to gain as much control as the law allows and to deal from a position of strength. Indeed, the stronger the position, the more gracious the mortgagee can afford to be.

An appropriate action for a lender faced with a loan default is to declare due the entire balance of principal and interest due on the mortgage because of the default. This option is called "acceleration," and it is contained in every mortgage contract. Once acceleration is manifested, the lender is usually not required to accept a tender of arrears.

The significance of the right to accelerate is considerable. Acceleration tends to have a chastening effect on defaulters. It allows the lender to rid itself of the chronic defaulter that is causing too much staff time, expense, and annoyance. Moreover, acceleration enables the lender to demand reimbursement for any legal expense incurred as a condition for reinstatement. This demand can be made even in the absence of a legal-fee clause in the mortgage documentation because the choice of accepting or rejecting reinstatement lies solely with the lender.

Acceleration can be accomplished through a letter to the borrower, or by actually filing foreclosure papers with the court (the latter must specify the lender's election to accelerate). If a letter is sent, it must be delivered as set forth in the mortgage (i.e., if the letter specifies certified or registered mail, there must be compliance). The letter's content must be clear. For example, demanding payment of arrears within a certain number of days and advising that failure to respond will then result in acceleration or foreclosure is not a valid acceleration.

Receiverships In Foreclosure[9]

Notwithstanding that mortgagee's counsel is armed with all the techniques to solve the early problems in a foreclosure, a mortgagor could choose nevertheless to litigate. This situation can then be exacerbated by physical deterioration of the property, resulting in diminution of the mortgage security to the point where the mortgagee will sustain a loss.

A permutation of this idea relates to a commercial property - for example, a shopping center or an apartment building. The mortgagor subjected to a foreclosure, knowing the case will ultimately be lost, embarks on a course of action to "bleed" the property. He collects all the rents and profits but neglects repairs, payment of taxes and insurance and every other possible cost. This turns a handsome profit for the mortgagor and funds a protracted defense to the foreclosure. Under these circumstances, one need not expound at length upon the expected deteriorated value of the mortgaged property at the conclusion of the foreclosure.

In response to this very real dilemma, the mortgagee has a great asset in the ability to appoint a receiver. In a foreclosure action, when the lender believes that the property may decline in value during the progress of the case or that the mortgagor or some occupant may allow the property to depreciate or be vandalized, the appointment of a receiver is available to preserve the premises for the benefit of the mortgagee.

The receiver stands in the shoes of the owner. Once appointed and qualified, the receiver has the right to collect all rent due or to become due arising out of the premises. The receiver collects the income, maintains insurance, pays taxes and makes repairs. The property is, therefore, preserved. In addition, any excess income is applied in reduction of the mortgage and consequently a twofold

purpose is served. Still further, the mortgagor's interest in delaying the foreclosure is greatly diminished, if not entirely eliminated.

Conclusion

How does one adequately sum up a subject as expansive as mortgage foreclosure? The ready answer is that it is not achievable. Even a delineation of but a few subjects excluded exposes the futility of the endeavor: mortgage collection procedures, settlement strategies and devices, defenses to foreclosure, parties to the foreclosure action, venue of the case, drafting the pleadings, advice in responding to the foreclosure complaint, deed in lieu of foreclosure, the foreclosure sale and closing, eviction after foreclosure.

Ultimately, foreclosure is a startling combination of law and practice, the chemistry of the relationships and the strategies. But living with it every day reveals that it is much like every other area of the law; when it is understood viscerally, it is not so mysterious. Maybe this will serve as a beginning.

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[1] *For more discussion on the point, see "Mortgage Foreclosures: A Need for Outside Counsel?" 42* Mortgage Banking *78 (Oct. 1981)*

[2]See *2* Bergman on New York Mortgage Foreclosures, *Chap. 26, Legal Fees (Matthew Bender & Co., Inc. 1995); "You Can Claim Legal Fees, Correct?" 6* Servicing Management *61 (Oct. 1994); Attorneys' Fees in Mortgage Foreclosure; Who Pays and Who Doesn't", 60* New York State Bar Journal *26 (July 1988)*

[3]See, *for example,* Matter of Thompson *v.* Chemical Bank, *84 Misc.2d 721, 375 N.Y.S.2d 729 (1975); 2* Bergman on New York Mortgage Foreclosures, *§26.06[4] (Matthew Bender & Co., Inc. 1995)*

[4]*Although a Chapter 7 can never be fatal, there is some potential jeopardy with a Chapter 11 filing. In the latter instance, to the extent that a secured lender may be undersecured, a bifurcation of the debt can be ordered between the secured and the unsecured portions. The secured part of the mortgagee's claim cannot exceed the debtor's equity in the property. A bifurcation, in turn, can lead to what is known in common parlance as a cramdown where the plan of reorganization is forced upon even those creditors who objected to the plan. (Chapter 13 filings in commercial cases would be quite uncommon, but the same principles apply. For residential Chapter 13 filings, bifurcation is generally not available.)*

[5]See *1* Bergman on New York Mortgage Foreclosures, *§7.13 (Matthew Bender & Co., Inc. 1995)*

[6]6. See *1* Bergman on New York Mortgage Foreclosures, *Chap. 7, Initiating the Foreclosure and Election of Remedies (Matthew Bender & Co., Inc., 1995)*

[7]See *1* Bergman on New York Mortgage Foreclosures, *§6.02[3][g]*

[8]See *1* Bergman on New York Mortgage Foreclosures, *§6.02[3][g]*

[9]*"Confirmed at Last - Yes Virginia, There Are Late Charges, And in New York Too",* New York Law Journal, *Jan. 26, 1994, at 5, col. 2*

[10]*For more on this subject see: "Receivership is an Effective Tool - Servicers Can Outwit the Crafty Delinquent Borrower," 4* Servicing Management *6 (Feb. 1993); "Appointing and Paying Receivers in the Mortgage Foreclosure Action", 62* New York State Bar Journal *34 (Jan. 1990); 1* Bergman on New York Mortgage Foreclosures, *Chap. 10, Receiverships in the Foreclosure Action (Matthew Bender & Co., Inc., 1995)*