FOCUS ON REAL ESTATE

So you need to prepare a purchase money mortgage*

Even for the non-specialist, the need to prepare a purchase money mortgage can be commonplace. If clients are selling their home, the purchaser may need some or all of the financing from the seller — and that is the true purchase money mortgage. A similar situation could arise for the sale of a commercial parcel.

Mortgage forms are of course readily available, but which ones to use and what all those provisions mean are often open questions. The pointed answer is that the extensively prolix forms of bank mortgages are unnecessarily long and detailed for most transactions - certainly residential. At the same time, the statutory form (RPL §254) and the expanded version available through title companies are too terse regarding some compelling concepts.

So, identifying some critical additions to standard forms should be helpful.

The issue of personal liability

Personal liability for the mortgage debt is a question the seller-mortgagees will ask, although even if they do not, it could become relevant upon default if somehow the value of the property deteriorates to less than the obligation due. In other words, should foreclosure be necessary, if the debt is greater than the equity in the property, the mortgagee suffers a loss (the deficiency) which the mortgagee could pursue upon a post-foreclosure deficiency judgment motion.[1]

The purchasers become personally liable for the debt upon signing a mortgage note, which is a promise to pay. Even if a note is never signed, there is standard language in most mortgages whereby the mortgagor covenants to pay the debt.[2] Therefore, signing the mortgage alone would usually create that personal liability.[3] Should the purchaser insist that the mortgagee look solely to the property for recompense, then personal liability evaporates and no deficiency would be available.[4]

Bruce J. Bergman

Applicable interest rate; usury

Market interest rates nowadays are exceptionally low. It is therefore unlikely that civil usury would even be a consideration. However, because inevitable cycles will ultimately cause rates to rise, awareness of usury principles is appropriate.

The legal rate of interest is 16 percent.[5] An interest rate beyond 16 percent (taking into account items includable as interest, such as points, among others) becomes civil usury and in excess of 25 percent, criminal usury.[6] The controlling principle, though, is that a true purchase money mortgage is excepted from New York usury law proscriptions.[7]

A true purchase money mortgage has been defined as "a mortgage executed at the time of purchase of the land and contemporaneously with the acquisition of the legal title, or afterward, but as part of the same transaction, to secure an unpaid balance of the purchase price."[8] For there to be a true purchase money mortgage, the lender must be the actual seller of the property and must take back a mortgage to secure money used to acquire the property. The true purchase money mortgage is deemed not to constitute a loan or forbearance within the meaning of GOL §5-501,[9] so even if the interest on such a purchase money mortgage is above the legal maximum, it does not constitute usury.[10]

Prepayment

Insofar as a purchase money mortgage may be a favorable investment, the mortgagee might prefer that it never be prepaid. Generally, a mortgage may not be prepaid unless the mortgage documents specifically grant the right.[11] Although prepayment may be allowed if authorized by statute,[12] or where permitted by the conduct of the parties,[13] there is no statutory authority allowing the mortgagor upon a non-residential commercial loan to satisfy the obligation before maturity.[14] But statute [GOL §5-501(3)(i) and 5-501(3)(b)] does provide that for a one to six-family residence the mortgage may be prepaid at any time.

For purchase money mortgages generally then, upon the noted type of property, prepayment is allowed by statute. That statute refers, however, to "the unpaid balance of the loan or forbearance...."[15] Because a true purchase money mortgage does not fit the definition of a loan or forbearance,[16] the statute appears to have no application in the true purchase money mortgage situation. Because case law has not yet tested the point, there might be room for some uncertainty, but the better assumption may remain that absent language specifically permitting it, even the residential purchase money mortgage cannot be prepaid.

Legal Fees[17]

Should the sellers-mortgagees ever need to foreclose, they are likely to be dismayed if they incur legal expense for the privilege. The American rule, of course, is that each party to a lawsuit must bear its own counsel fees.[18] But this general rule can be changed either by statute or contractual agreement of the parties.[19] While no statute in New York obligates a mortgagor in a foreclosure to pay the plaintiff's legal fees, that mandate can appear in the mortgage. Critically, it has consistently been held that legal fees are awardable to a foreclosing plaintiff where the documents so provide.[20]

A widely used standard mortgage form inexplicably provides for legal fee compensation for everything, but then recites in parenthesis "except for foreclosure of this mortgage." It is therefore important to determine if the form employed provides clearly for legal fee reimbursement in the event of foreclosure. If it does not, consider adding the appropriate clause.

If there is such a need, here are some basics. A legal fee clause in the mortgage note alone will be ineffectual for a foreclosure; it must be in the mortgage.[21] Using a percentage legal fee language

See MORTGAGE, Page 20

MORTGAGE...

Continued From Page 5

(such as 15 percent of the sum due) is not recommended. It does not control[22] because reasonableness is always the court's standard.[23] And if the legal fees reasonably incurred are greater than the percentage would provide, they are nonetheless not awardable because the percentage serves as a cap.[24] The best approach is to insert a provision in the mortgage or the rider which unambiguously states that the foreclosing plaintiff is entitled to an award of reasonable legal fees for any collection efforts upon the mortgage including foreclosure.[25]

Late Charges

Lenders generally collect late charges when a mortgage payment is delinquent — and with good reason. There is some cost attendant to pursuing tardy remittances and a lender would not be well-served to grant a borrower unfettered leisure to submit payments with no threat of cost for regular or exceptional lateness. Still further, when payments are late, interest is effectively lost because use of the money was delayed.

By statute,[26] a late charge of 2 percent of the overdue installment may be assessed for payments more than fifteen days overdue. This means that the mortgage must provide a fifteen day grace period although the cap of 2 percent applies only for one-to-six family dwellings.[27]

Due on Sale

Much of this discussion has assumed that the purchase money mortgage held by the seller represented an investment decision. Even if it did, interest rates could rise in the future rendering the return on the mortgage below market. It is, of course, possible too that the purchase money mortgage arose as an accommodation to the purchaser or to facilitate the transaction which might otherwise have been difficult or impossible. If this latter motivation prevailed, then the seller, while amenable to have this purchaser (and his credit) as the obligor, might be unwilling to continue the mortgage relationship with a stranger who buys the property from the original purchaser. And this may not even be a function of a possible dubious credit rating for the new owner. It may simply be that the deal was exclusive to the original purchaser — or that this is no longer a prudent investment.

The seller-mortgagee's solution is a due on sale or due on transfer provision whereby the mortgagee is given the option (it should not be automatic) to declare the entire mortgage balance due if the property is sold or title transferred in any manner. Such a provision has been consistently enforced in a clear majority of cases in New York.[28] Additionally, federal statute (the Garn-St. Germain Depository Institutions Act of 1982, specifically §341) has preempted any state law prohibitions against enforcement of a due on sale provision. Thus, the mortgage drafter can be confident that the clause will serve the purpose.[29]

Default on Senior Mortgage

If the purchase money mortgage is a second mortgage, as can often be the case, a default on the senior mortgage portends extinguishment of the junior purchase money mortgage. It is also more than a theoretical possibility that the borrower could default on the first mortgage while keeping the second current.

To protect the seller–mortgagee in such a situation, default on the senior mortgage (or any prior mortgages) must be recited as an act of default on the junior, allowing for acceleration of the balance due. Although standard forms of second mortgages can be expected to contain such a protective provision, other forms would not and it is a clause to consider for inclusion.

The Further Role of Interest

The rate of interest borne by the mortgage is only a part of the issue of interest when a mortgage goes into default — a subject obscure for many practitioners who don't specialize in the field. A few basics uncover issues which merit attention when a purchase money mortgage is prepared.

After a default, the mortgagee will eventually declare due the entire balance, that is, accelerate the debt.[30] Upon acceleration, if the mortgage is silent regarding the interest rate which applies, the judgment rate (currently 9 percent) will control.[31] If, however, the mortgage contract provides for a default rate of interest to apply, it will be that designated rate which prevails[32] (at least until issuance of the judgment of foreclosure and sale). Once the foreclosure judgment issues, the mortgage merges into that judgment so that interest then accrues at the judgment rate (9 percent).[33] An exception to this latter rule is that if the parties intend to avoid this merger, the note or default rate can control[34] so long as the applicable mortgage provision is clear and unequivocal.[35]

Interest on Default or Maturity

A mortgage loan matures in one of two ways. Either its natural term expires (10, 15 or 30 years for example), or an earlier maturity is declared by acceleration, which can occur at any time during the term of the mortgage. As noted, if the mortgage makes no reference to interest upon maturity, the note rate controls. In times of low interest rates, the judgment rate may represent a fair return. In cycles of higher interest, however, the judgment rate could be woefully deficient and might even provide comfort to a defaulter able to invest money not paid to the lender at a higher rate than is imposed for the default.

In short, the drafter of a purchase money mortgage should address the issue of interest on default and prepare a clause to specify the rate. Bear in mind that even where the interest rate upon maturity would otherwise be usurious, it remains enforceable and cannot be deemed violative of usury statutes.[36]

Interest After Judgment

Regardless of the generous default rate of interest which may have applied, once the foreclosure action proceeds to judgment, the sum due bears interest at 9 percent — which may or may not be an appropriate yield depending upon the circumstances. The longer the delay from judgment to foreclosure sale (or settlement) the longer the sum due bears interest at 9 percent. But it could be a higher rate if the mortgage definitively addresses the point — which the drafter may wish to consider.

Interest on Advances

There are any number of expenditures a mortgage holder may be constrained to pay to protect the lien of the mortgage. If the mortgage is silent in this regard — as standard forms are — then the advances will yield 9 percent. Again, that percentage may or may not be pleasing to the lender, depending upon when the advances are made and what circumstances prevail, not the least of which is the lender's cost of funds. Here too, the mortgage can specify a rate of interest upon advances greater than the note rate and greater than the judgment rate. Possible significant categories of advances a lender might make include hazard insurance premiums, real property taxes, sums due on senior mortgages and costs to cure municipal violations on the property.

Additional Provisions

Are there yet other provisions beyond the standard forms to include in the purchase money mortgage? The obvious answer is a qualified yes, depending upon the particular circumstances or needs of the clients. Thinking about commercial mortgages which can often approach book size suggests that variations on mortgage provisions are — if not limitless — certainly enormous. Although some might have relevance, many are far too recondite to have practical significance in most purchase money mortgage situations. But here are a few more clauses worthy of brief mention.

If the borrower will be afforded the right to prepay, the lender may want to consider a prepayment penalty to compensate for earlier receipt of funds which had been expected to generate interest for a longer period.

If the purchase money mortgage is a first mortgage, or if junior and a senior mortgagee will not be escrowing for taxes, the purchase money mortgage holder may wish to do so. That assures payment of taxes and avoids the possibility of extinguishment of the mortgage through tax defaults.

Should the property be non-residential, the faster and less expensive power of sale foreclosure[37] would be available in the event of default — but only if the mortgage contains a power of sale provision.[38]

Particularly if the property is residential, illegal use, such as if it becomes a drug den, can allow some local municipalities to attack the violation and create a lien senior to the mortgage for those costs. With such an eventuality possible, assuring provision for acceleration and foreclosure in the event of illegal use can be critical.

Conclusion

Most standard forms are unlikely to address the needs of or provide all the real protection for a seller-purchaser money mortgagee. While possible additional provisions are legion, experience urges that a relatively few vital clauses focus upon the genuine concerns of the obligee. The suggestions here are designed both to help and provide the proverbial food for thought.

Bruce J. Bergman, a member of Berkman, Henoch, Peterson & Peddy, P.C. in Garden City, New York, is the author of the three volume treatise, Bergman on New York Mortgage Foreclosures, Matthew Bender & Co., Inc. (rev. 2005), a member of the USFN, the American College of Real Estate Lawyers and a past chairman of the real property law committee and a director of this Association.

1. RPAPL §1371. For a full review of deficiency liability and pursuit of the deficiency judgment, *see, 3 Bergman on New York Mortgage Foreclosures*, Chap. 34, Deficiency Judgments, Matthew Bender & Co., Inc. (rev. 2002).
2. *See,* RPL §254(3).
3. *Neidich v. Petilli*, 71 A.D.2d 999, 420 N.Y.S.2d 301 (2d Dept. 1979); *Carrara v. Carrara*, 29 Misc.2d 907, 214 N.Y.S.2d 80 (Sup. Ct. Westchester Co. 1961); *Goldman v. Rhoades*, 122 Misc. 567, 203 N.Y.S. 548 (Sup. Ct. Schenectady Co. 1923).
4. *See, 3 Bergman on New York Mortgage Foreclosures*, §34.05[1]; Stern v. Itkin Bros, 87 Misc.2d 538, 385 N.Y.S.2d 753 (Sup. Ct. N.Y. Co. 1975).
5. GOL §5-501(1) which refers to Banking Law §14-a
6. Penal Law §190.40 et. seq. *Also see*, 1 *Bergman on New York Mortgage Foreclosures*, §6.03[7].
7. *Szerdahelyi v. Harris*, 67 N.Y.2d 42, 499 N.Y.S.2d 650 (1986); *Mandelino v. Fribourg*, 23 N.Y.2d 145, 295 N.Y.S.2d 654 (1968).
8. *Szerdahelyi v. Harris, supra*, at note 8.
9. *Mandelino v. Fribourg, supra*, at note 8.
10. *Mandelino v. Fribourg, supra*, at note 8.; *Dry Dock Bank v. American Life Ins. & Trust Co.*, 3 N.Y. 344 (1850); *Skidelsky v. Merendino*, 133

continued top of next page

A.D. 149, 518 N.Y.S.2d 822 (2d Dept. 1987).

11. *Russo Enterprises, Inc. v. Citibank, N.A.*, 226 A.D.2d 528, 641 N.Y.S.2d 543 (2d Dept. 1996).
12. *2550 Olinville Ave., Inc. v. Crotty*, 149 Misc.2d 806, 566 N.Y.S.2d 500 (Sup. Ct. N.Y. Co. 1991).
13. *Geller v. Fairmont Assocs.*, 172 A.D.2d 915, 568 N.Y.S.2d 202 (3d Dept. 1991).
14. *Poughkeepsie Galleria Company v. Aetna Life Ins. Company*, 178 Misc.2d 646, 680 N.Y.S.2d 420 (Sup. Ct. Dutchess Co. 1998).
15. GOL §5-501(3)(b).
16. *Mendelino v. Fribourg, supra*, at note 8.
17. For a complete discussion of legal fees in the mortgage foreclosure case, *see* 2 *Bergman on New York Foreclosures*, Chap. 26.
18. *Alyeska Pipeline Sav. Co. v. Wilderness Soc'y*, 421 U.S. 240, 95 S. Ct. 1612 (1975); *First Nat'l. Bank of Highland v. J & J Milano, Inc.*, 160 A.D.2d 670, 553 N.Y.S.2d 448 (2d Dept. 1990).
19. *Chapel v. Mitchell*, 84 N.Y.2d 345, 618 N.Y.S.2d 626 (1994); *Hooper Assocs. v. AGS Computers, Inc.*, 74 N.Y.2d 487, 549 N.Y.S.2d 365 (1989).
20. *Matter of Nicfur-Cruz Realty Corp.*, 50 B.R. 162 (Bankr. S.D.N.Y. 1985); *GreenPoint Sav. Bank v. Tornheim*, 261 A.D.2d 360, 689 N.Y.S.2d 193 (2d Dept. 1999); *Kenneth Pregno Agency, Ltd. v. Letterese*, 112 A.D.2d 1032, 492 N.Y.S.2d 824 (2d Dept. 1985).
21. *Lipton v. Specter*, 96 A.D.2d 549, 465 N.Y.S.2d 59 (2d Dept. 1983), *app. denied*, 61 N.Y.2d 608, 475 N.Y.S.2d 1026 (1984); *Fourth Fed. Sav. Bank v. Nationwide Associates, Inc.*, 183 Misc.2d 165, 701 N.Y.S.2d 814 (1999).
22. *Coniglio v. Regan*, 186 A.D.2d 709, 588 N.Y.S.2d 888 (2d Dept. 1992).
23. *Kamco Supply Corp. v. Annex Contracting, Inc.*, 261 A.D.2d 363, 689 N.Y.S.2d 189 (2d Dept. 1999); *Matter of First Nat'l Bank of East Islip v. Brower*, 42 N.Y.2d 471, 398 N.Y.S.2d 875 (1977).
24. *Mead v. First Trust & Deposit Co.*, 60 A.D.2d 71, 400 N.Y.S.2d 936 (4th Dept. 1977).
25. For examples of such provisions which do and not suffice, *see* 2 *Bergman on New York Mortgage Foreclosures*, §26.05.
26. RPL §254-b
27. For a more detailed review of late charges, *see* 1 *Bergman on New York Mortgage Foreclosures*, §1.10.
28. *See, inter alia, Beacon Fed. Sav. & Loan Ass'n v. Marks*, 91 A.D.2d 1010, 457 N.Y.S.2d 881 (2d Dept. 1983); *Bonady Apartments, Inc. v. Columbia Banking Fed. Sav. & Loan Ass'n*, 119 Misc.2d 923, 465 N.Y.S.2d 150 (Sup. Ct. Steuben Co. 1983).
29. Because there is much nuance to the subject of the due on sale clause, attention is invited for more detail to 1 Bergman on New York Mortgage Foreclosures, §4.11.
30. The concept of acceleration is multifaceted and further explanation is found at 1 *Bergman on New York Mortgage Foreclosures*, Chap. 4, Default and Acceleration.
31. *See, inter alia, Metropolitan Sav. Bank v. Tuttle*, 290 N.Y. 497, *reh'g denied*, 291 N.Y. 634 (1943); *Title Guarantee & Trust Co. v. 2846 Briggs Ave. Inc.*, 283 N.Y. 512, *reh'g denied*, 284 N.Y. 685 (1940); *Ferris v. Hard*, 135 N.Y. 354 (1892); *Heimbinder v. Berkovitz*, 263 A.D.2d 466, 693 N.Y.S.2d 200 (2d Dept. 1999).
32. *See, inter alia, Heimbinder v. Berkovitz, supra, citing, inter alia, Kaiser v. Fishman*, 187 A.D.2d 623, 590 N.Y.S.2d 230 (2d Dept. 1992); *Marine Mgt. v. Seco Mgt.*, 176 A.D.2d 252, 574 N.Y.S.2d 207, aff'd., 80 N.Y.2d 886, 587 N.Y.S.2d 900 (1992); *Ward v. Walkley*, 143 A.D.2d 415, 532 N.Y.S.2d 426 (2d Dept. 1988); *Citibank, N.A. v. Liebowitz*, 110 A.D.2d 615, 487 N.Y.S.2d 368 (2d Dept. 1985).
33. *See, inter alia, Taylor v. Wing*, 84 N.Y. 471 (1881); *Banque Nationale De Paris v. 1567 Broadway Ownership Associates*, 248 A.D.2d 154, 669 N.Y.S.2d 568 (1st Dept. 1998); *European Am. Bank v. Peddlers Pond Holding Corp.*, 185 A.D.2d 805, 586 N.Y.S.2d 637 (2d Dept. 1992); *Emery v. Fishmarket Inn of Granite Springs, Inc.*, 173 A.D.2d 765, 570 N.Y.S.2d 821 (2d Dept. 1991).
34. *Banque Nationale De Paris, supra; Marine Mgt. v. Seco Mgt., supra.*
35. *Id.*
36. *Klapper v. Integrated Agricultural Management Co., Inc.*, 149 A.D.2d 765, 539 N.Y.S.2d 812 (3d Dept. 1989); Flynn v. Dick, 13 A.D.2d 756, 215 N.Y.S.2d 382 (1st Dept. 1961). For further explanation and case law authority explaining why interest upon default does not violate usury proscriptions, *see*. 1 *Bergman on New York Mortgage Foreclosures* §6.02[3][g].
37. RPAPL Article 14. For a complete review of power of sale foreclosure, *see*, 1 *Bergman on New York Mortgage Foreclosures*, Chap. 8, Non-Judicial Foreclosure.
38. For a form of power of sale provision *see*, 1 *Bergman on New York Mortgage Foreclosures* §8.02[2].