SOME THOUGHTS ON OBTAINING SURPLUS MONIES

By: Bruce J. Bergman

It should happen more often, but pursuing surplus monies arising from a mortgage foreclosure sale is certainly a welcome occurrence. In judicial foreclosure states, mortgage foreclosure is the legal action, although there are peripheral aspects to the case, among others, deficiency judgments, eviction after foreclosure and surplus money proceedings.

While deficiency judgment matters these days are probably more often the subject of focus, the less persistent surplus money issues remain important and are slowly, and blessedly, returning to prominence. Here is a scenario to highlight the point. (It's overly optimistic, but an easy way to demonstrate the concept.

The mortgaged property is worth $200,000. Lender A holds a first mortgage of $100,000. Lender B holds a second mortgage of $50,000. At the foreclosure sale, A "bids in its judgment" of $100,000. Because the sale would extinguish B's mortgage, B can protect itself by bidding $101,000. If no one else bids, B will own the property (worth $200,000) at a cost of $151,000 (the aggregate of what it bid and the amount of its mortgage.) Since the premises can theoretically be sold for $200,000, B will recoup its investment — **and,** the $1,000 it bid over A's upset price is surplus which B can claim and receive in a surplus money proceeding.

Extending the fact pattern, if someone else bids $102,000, B can bid $103,000 and the principles remain the same. The only difference is that the surplus which comes back to B (our second mortgagee) is now $3,000. This applies all the way up to a bid of $150,000, which is the combination of the total due to both A and B. Given the numbers in the example, B can continue its bidding up to this $150,000, which is the combination of the total due to both A and B, knowing that the excess over what was due A, and up to what was due B, is part of the surplus claim. Beyond $150,000, the dollars flow to surplus claimants **junior** to B.

Unfortunately, in these economic times, a shortfall arising from a mortgage foreclosure tends to be more common than the reverse of the equation — the emergence of surplus monies. Even if surplus was to be more frequently encountered, it is not **so** often relevant to lenders generally.

Indeed, for the holder of a **first** mortgage, surplus monies are almost invariably **irrelevant**. The most a foreclosing lender can derive from foreclosure sale proceeds is all the money due to it. (Whether the judgment of foreclosure and sale assures full compensation is a different and sometimes more elusive issue.) Therefore, that the foreclosure sale may yield a bid price in excess of the amount due pursuant to the judgment is of no benefit to the foreclosing first mortgagee.

It is typically only the encumbrancer in a **junior** position to whom surplus has meaning. Whether he (or it) is a junior mortgagee, or judgment creditor, or lienor of some other variety, the theory in judicial foreclosure venues is that when the foreclosure sale extinguishes that subordinate lien as against the real estate, the lien is transferred from the real estate and attaches to the resultant personality — the excess money generated, called the surplus.

Obviously, then, a mortgage holder in a junior position is expectedly a zealous pursuer of surplus monies. But the leaden procedures to obtain surplus monies in some states can distinctly dampen the joys of expectation. New York, though, has a helpful, handy device known in lender and lawyer parlance as "1351 relief" — worthy of a quick review here.

First, the standard method to garner surplus monies (in New York) is to institute a surplus money proceeding. This cannot be begun until a minimum of three months after the foreclosure sale. Even then, the methodology (motion, hearing, referee's report, motion to confirm report, order directing distribution of surplus funds) underscores that a second mortgagee would be fortunate to receive a check six months after the foreclosure sale.

This is where the shortcut approach helps. Applicable solely to a second mortgagee, the procedure is that the claim can be paid from surplus immediately out of foreclosure sale proceeds — all without necessity to wade through a time consuming surplus money proceeding.

So, when does a lender care about the surplus money proceeding itself?

— When it has a junior mortgage, but circumstances will not support the special treatment of §1351, such as perhaps when there is more than one other mortgage on the property.

— When the lender has some other subordinate lien against the borrower — and thus against the property. This could arise, for example, from a suit on the mortgage note (for which execution on the mortgaged property is barred) or from some other debt or obligation.

In either such instance, the lender then **does** care very much about surplus monies and how they are obtained.[1] The law and mechanics here are broad and tedious, urging lengthy discussion in some other forum at some other time. Suffice it to say, though, (New York) statute[2] is clear that notice of a surplus money proceeding is to be given to anyone who has appeared in the action or filed a claim against the surplus monies. It is reasonable to expect — and is certainly recommended — that a lender with **any** junior position would **at least** appear in the foreclosure, thus assuring notice to it of a surplus money proceeding.

There is yet another layer of notice. Other statute[3] (in New York) provides that where a hearing is scheduled upon the issue of surplus monies (which is almost always), notice must be given not only to those who have appeared or filed claims, but in addition, to anyone with a recorded lien against the property. As a practical matter, one needs **some** interest of record to be able to claim against surplus in any event. Thus, with a record interest, you should be able to participate in surplus even if you neither appeared in the foreclosure action nor filed a claim.

Perhaps the only effortless aspect of surplus money proceedings is now sundered (or at least rendered uncertain) by a recent decision in New York.[4] In a decidedly roundabout way, the case rules

(Continued on page 18)

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[1] As a demonstration of how convoluted this otherwise apparently simple topic really is, the surplus money chapter in *Bergman on New York Mortgage Foreclosures* is no less than 77 pages in length inclusive of supplement!

[2] RPAPL §1361 (2)

[3] RPAPL §1361 (3)

[4] *Long Island Savings Bank* v. *Ostor,* ____ Misc.2d ____, 591 N.Y.S.2d 704 (1992).

Report From The Finance Board

Federal Housing Finance Board Washington, DC

In June, the U.S. Senate Committee on Banking, Housing, and Urban Affairs held hearings to review the Department of Housing and Urban Development's report to Congress concerning the Federal Home Loan Bank System. Similar hearings were conducted in May by the House Subcommittee on General Oversight, Investigations, and the Resolution of Failed Financial Institutions, chaired by Congressman Floyd Flake.

These hearings demonstrated that, despite some differences, there is a consensus on most FLHBank System issues and on the reforms that are needed for the System to continue fulfilling its housing finance mission far into the future.

To build on this growing consensus, the Federal Housing Finance Board has asked each FHLBank to host a forum in its District by the end of September. Through these forums — as well as through official hearings planned by the Finance Board for later this fall — we are seeking public comment on three very important issues:

1) The *contribution* of the System and its members to housing and community development lending.

2) The *capacity* for the System to support community lenders and community-based lending.

3) An appropriate corporate and regulatory *governance structure* for the System.

The FHLBank District meetings will give System leaders and other interested parties an opportunity to speak their minds and to respond to a range of questions affecting those issues. Among the questions to be considered:

- How can the System facilitate housing and community development lending through the existing network of community-based lenders?
- How should the community development mission of the System be defined, with regard to types of lending and collateral requirements compatible with the safety and soundness requirements of the System?
- How is the changing membership base affecting the System?
- Building on the success of the Affordable Housing and Community Development Programs, how can we demonstrate the contribution that member institutions make through the regular advances program?
- What type of corporate and regulatory governance structure would enable the System to better realize its public purpose, while ensuring continued safety and soundness?

The perspective that the System itself can bring to these questions is very important. Consequently, our plan as Finance Board Directors is to participate personally in as many District roundtable meetings as we can.

Where we are unable to participate ourselves, we will be represented by Finance Board staff. We also have asked the FHLBanks to send us the record of these roundtable sessions so we can make them a part of the official record of our own hearings in Washington.

At the same time, it is important for everyone to understand that the meetings at the District level are being sponsored by the FHLBanks themselves, not by the Finance Board. Each FHLBank will conduct its meeting as it thinks best. But the FHLBanks' common purpose is to have participants air their views on System issues.

We encourage members to participate in their District roundtables where possible or to send us their thoughts in writing. Member views are as critical now as they have been at any time in the past two years of analysis and study.

The FHLBank public forums will help to shape the legislative package that will be submitted to Congress early next year. In turn, that proposal will affect the FHLBank System and its housing finance mission for years to come.

With that prospect before us, we hope that all members will devote some thought to the issues affecting the System. And we look forward to hearing what you have to say, either at the District FHLBank forums or in writing.

Federal Home Loan Bank System Financial Highlights

Year to Date through July 31, 1994

(Millions)

	SYS	BOS	NYK	PIT	ATL	CIN	IND	CHI	DSM	DAL	TOP	SFR	SEA
AVERAGE BALANCE SHEET													
1. Advances & Other Loans	$103,330	$7,041	$13,474	$6,443	$10,607	$4,971	$5,990	$5,045	$7,263	$8,191	$5,317	$22,065	$6,923
2. Investments	80,942	6,616	6,310	8,126	7,918	5,681	3,490	6,323	4,309	8,401	4,455	11,725	7,590
3. All Other Assets	2,940	84	382	130	303	99	87	98	123	334	126	1,032	142
4. Total Assets	187,211	13,741	20,166	14,699	18,828	10,750	9,567	11,466	11,695	16,926	9,898	34,821	14,655
5. Total Liabilities *	175,008	12,741	18,876	13,956	17,425	9,937	8,958	10,802	10,947	16,011	9,324	32,355	13,676
6. Total Capital	12,203	1,000	1,289	743	1,403	813	609	664	748	915	573	2,466	980
INCOME STATEMENT													
1. Net Interest Income	$702.7	$47.8	$88.7	$36.0	$76.5	$44.8	$34.7	$42.8	$50.8	$59.8	$29.0	$138.1	$53.8
2. Prepayment Fee Income	64.2	1.6	1.3	1.6	13.1	0.1	13.8	1.1	3.3	9.5	0.3	18.2	0.4
3. G/(L) from Debt Retirement	(16.8)	(1.2)	0.0	0.6	(5.2)	0.0	0.0	(1.1)	0.0	(9.3)	0.0	(0.5)	0.0
4. Net Prepayment Fees	47.4	0.4	1.3	2.2	7.9	0.1	13.8	0.0	3.3	0.1	0.3	17.7	0.4
5. Other Non-Interest Income	23.3	1.0	5.2	6.5	4.0	4.2	3.6	1.4	5.9	1.0	8.5	(19.0)	1.0
6. Operating Expense	116.0	7.7	10.1	12.1	13.1	9.8	6.8	6.9	10.6	9.2	8.1	15.8	5.9
7. AHP Assessments	59.6	3.8	8.0	2.9	7.1	3.7	4.1	4.0	4.7	4.3	2.6	10.1	4.5
8. FHFB/OF Assessments	13.3	1.0	1.4	1.0	1.5	0.8	0.7	0.7	0.8	1.0	0.6	2.7	1.1
9. GAAP Net Income	584.5	36.6	75.8	28.6	66.7	34.8	40.4	32.6	44.0	46.6	26.4	108.3	43.7
10. Adjusted Net Income **	619.3	37.1	77.6	32.5	72.7	38.6	29.4	32.7	45.4	49.7	27.4	122.0	54.2
MEMO:													
11. "Earned" Prepayment Fees *	82.2	0.8	3.1	6.1	13.8	3.9	2.8	0.1	4.7	3.3	1.2	31.4	10.8
12. Dividends	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
13. REFCORP	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
RATIOS													
1. Return on Average Assets	0.54%	0.46%	0.65%	0.34%	0.61%	0.56%	0.73%	0.49%	0.65%	0.47%	0.46%	0.54%	0.51%
2. Return on Average Equity	8.2%	6.3%	10.1%	6.6%	8.2%	7.4%	11.4%	8.5%	10.1%	8.8%	7.9%	7.6%	7.7%
3. Adj. Return on Avg. Equity	8.7%	6.4%	10.4%	7.5%	8.9%	8.2%	8.3%	8.5%	10.5%	9.4%	8.2%	8.5%	9.5%
4. Wtd. Avg. Dividend Rate	6.14%	7.31%	8.26%	6.00%	5.63%	5.28%	5.13%	5.63%	8.29%	4.17%	6.69%	4.86%	7.54%

* Includes bonds, discount notes, deposits and other liabilities

** Adjusted for income that would have amortized into interest income if prepayment fees and gains/losses on debt retirement had been deferred instead of being recognized.

Totals may not add due to rounding.

Preliminary data; System balance sheet and income statement totals have not been adjusted for inter-bank transactions and other appropriate entries.

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SURPLUS MONIES

(Continued from page 10)

a judgment creditor (not necessarily a mortgagee) unable to claim against surplus unless a claim **was** filed.

The decision is based upon an offhanded earlier appeals tribunal ruling[5] which let stand a lower court decision which had precluded a judgment creditor from seeking surplus where no claim was filed. This new view appears patently incorrect and is one of those cases where the frequently obscure nature of foreclosure slips through the judicial process. And precisely because the point is so arcane, it is not soon likely to be again the subject of contention.

So, must you separately file a claim in New York to be entitled to surplus monies where a surplus money proceeding is instituted? We don't think so, but in the face of the noted case law, it would be foolish not to. Do you care? In the rare instances where you really have a claim to surplus, sure. Every success has meaning and you should know how to achieve success.

[5] *Eastern Federal Savings and Loan Association* v. *Sabatine*, 76 A.D.2d 899, 429 N.Y.S.2d 46, App. Dism., 53 N.Y.2d 839.