Foreclosure and the Managing Agent

by Bruce Bergman

How do foreclosure proceedings affect the property manager? A managing agent who does not own the property is not liable to pay any mortgage on the parcel; therefore, it would seem that the agent has no control over possible foreclosure action. But a managing agent may very well have a role to play in the foreclosure. There are, in fact, many reasons why the sophisticated real estate professional should be knowledgeable in this difficult and highly technical area.

- Managing agents *do* sometimes own property in their own right, so foreclosure principles can be important to them as owners.
- Some owners make the managing agent responsible for payment of the mortgage.
- The managing agent may be given an equity position in return for services.
- An owner who is not an experienced real property professional may ask the managing agent for guidance and advice.
- How well the agent manages cash flow can significantly affect whether or not a foreclosure problem arises.
- If a property does go into foreclosure, the blame—correctly or incorrectly—may be attributed to the managing agent, and jeopardize his professional reputation.
- Upon foreclosure of an income-producing property, a receiver will probably be appointed. The receiver can, and very likely will, replace the existing managing agent with a new firm. So, if the building is foreclosed, the managing agent may lose an account.

Consequences of default

If avoiding a foreclosure is in the best interests of a managing agent, it is critical to be alert to how foreclosure can come about.

When a purchaser of property obtains financing, he or she usually executes two documents: a mortgage note or bond, which is the promise to repay the loan, and a mortgage, which pledges the property as security for the debt. In today's complex world of finance, documentation can take myriad forms: multiple mortgages, consolidation agreements, modifications and extensions, deeds of trust, etc. Nevertheless, the basic documents are the note and the mortgage. The note sets forth the monetary obligations while the mortgage, among other things, explains what actions by the mortgagor (owner) allow the mortgage holder (mortgagee) to foreclose.

The most critical portion of the mortgage is the "acceleration clause," which provides that upon the occurrence of certain events, the mortgagee shall have the option to declare the *entire* principal balance immediately due and payable.

Obviously, the acceleration clause is a potent ally of the mortgagee. The owner who had to borrow $260,000 to buy the property probably does not have the cash to rescue it. Even if he or she does have the cash to save the property, the owner will lose both the tax benefits of the mortgage and the liquidity of the cash when the clause is exercised. Consequently, it is essential that the owner and the managing agent avoid the default.

The acceleration clause analyzed

Most of the vital aspects of mortgage foreclosure law are intertwined with the wording of the usual acceleration clause. Accordingly, we shall analyze the most relevant portions of a typical composite acceleration clause (noted in italics) and comment upon the practical and legal consequences of the language.

The standard clause provides that the whole of the principal sum and interest shall become due at the option of the mortgagee:

(a) After default in the payment of any installment of principal or of interest for fifteen days.

Comment: This is the most obvious and most strictly enforced portion of the acceleration clause. Absent fraud, bad faith, waiver, estoppel, or unconscionable conduct, the mortgagee is free to accelerate the balance on the sixteenth day. It should be noted that, though harsh, the mere exercising of this contractual right has not been deemed by the courts to be unconscionable or in bad faith.

Most lenders do not want to foreclose. Foreclosure tends to be expensive, time-consuming and bad for public relations. Nevertheless, when the mortgagor has been a chronic defaulter, or when the lender wishes to get rid of a low interest mortgage in times of higher rates, the lending institution may choose to insist upon its rights. Therefore, neither the owner nor the managing agent can be cavalier in payments to the lender. If a property is running very "close" on income and expense, in order to make mortgage payments on time, the managing agent is well-advised to redouble efforts to collect back rents or postpone an otherwise necessary expense so as to maximize cash flow. Preserving the

mortgage could be entirely dependent upon such prudence.

The mortgagor should not be comforted by the fact that a mortgagee has regularly accepted late mortgage payments in the past. The mortgagor would have the very difficult burden of proving that prior late acceptances misled him or her into believing that the mortgage holder had waived the right to insist upon timely payments. Do not rely upon such an argument with the entire mortgage at issue.

Most acceleration clauses are not self-executing. The expiration of a grace period does *not* mean the mortgage is accelerated; the mortgagee must take some overt, unequivocal action, either by actually starting foreclosure, or, as is most often the case, by sending a letter exercising the option to accelerate.

Until such action is taken, no default exists, which leads to the very important subject of tender of arrears. Suppose the sixteenth day has arrived and the managing agent or owner is busy gathering the sums necessary to make the mortgage payment. Until the acceleration letter arrives, or the foreclosure is instituted, the *full* amount of arrears may be tendered and must be accepted.

Here are the prevailing principles:

- Until acceleration is exercised, arrears may be submitted. After acceleration, arrears may properly be rejected.
- A mere promise to make good is meaningless. Offering a promise—if that is the best that can be done—may be strategically wise, especially if there is a sympathetic lender. But a promise is not a substitute for an actual tender.
- If tender is made on condition that the lender do something in return, it is not a true tender. To stave off acceleration the tender must be unconditional.
- A tender of less than the full amount validly due is also not a true tender. If, for example, late charges have properly been added to the mortgage principal and interest, these must be paid as well.

(b) After default in the payment of any tax, water rate, sewer rent, or assessment for thirty days after notice and demand.

Comment: If the lender is not escrowing for taxes, the managing agent must be scrupulous in attending to the timely payment of taxes and other obligations, lest failure to pay them precipitate acceleration.

Although procedures vary greatly among taxing jurisdictions throughout the United States, generally a municipality or a tax lien purchaser can ultimately divest an owner of title to property if real estate taxes are not paid. Because the mortgage security—the property—would evaporate if title were lost, lenders are justifiably concerned about tax payments. Therefore, careful attention to this responsibility is essential.

However, unlike a default in paying principal and interest, neglect in tax payments is treated with much more leniency in many jurisdictions. The theory is that taxes are a collateral obligation to preserve the security and not a direct obligation. Generally, therefore, in most jurisdictions, the courts will go to great lengths to disallow foreclosure for tax defaults.

Here are some of the factors courts have recognized to offer relief in this area:

- Principal and interest are otherwise current.
- The failure to pay taxes was not willful; rather it was excusable as due to venial inattention.
- Notice of the tax default was not given or, if given, was not unequivocal.
- If notice was given, no opportunity to cure was provided.
- No damage or prejudice to the mortgage holder was demonstrated.
- The mortgagor ultimately tendered the tax arrears or legitimately attempted to do so.

(c) After default on notice and demand either in assigning and delivering the policies insuring the buildings against loss by fire or in reimbursing the mortgagee for premiums paid on such insurance.

Comment: As with taxes, the mortgagee's security could be impaired if property insurance is not maintained. So failure to obtain appropriate coverage and advise the lender accordingly is not just a business judgment but, possibly, a violation of the mortgage.

Although it would be highly unusual for the courts to allow acceleration where there was merely delay in obtaining insurance, total neglect of this responsibility could indeed be the basis of foreclosure.

(d) After the actual or threatened alteration, demolition or removal of any building on the premises without the written consent of the mortgagee.

Comment: In the absence of a mortgage, the managing agent and the owner could make any alterations sound business and economic judgments would dictate. But for obvious reasons, a mortgagee essentially becomes a partner in these decisions. Physical changes could be construed as impairing the security.

Therefore, written permission must be given by the lender if there is even the slightest question that an alteration could be viewed as security impairment. Otherwise, if a court concludes that the security was diminished, the foreclosure will probably go forward. On the other hand, the court could rule that the change actually enhanced the value of the property, in which case the foreclosure would be disallowed. But why take the risk, to say nothing of the costs, when a letter could solve the problem? Again, prudence is in order.

(e) If the buildings on the premises

are not maintained in reasonably good repair.

Comment: The professional managing agent should hardly need this admonition. Financial constraints, however, might limit the repairs the agent would want to perform. If those constraints lead to genuine deterioration—always a question of fact—foreclosure is a possibility because the security is again impaired. The managing agent should realize that too little attention to repair work could be the basis of a foreclosure, and the owner should be kept apprised of deteriorating physical conditions.

(f) After failure to comply with any requirement or order or notice of violation of law or ordinance issued by any governmental department claiming jurisdiction over the premises within three months of issuance.

Comment: Violating a law or ordinance, whether for physical condition or improper business conduct, could cause a municipality to perform corrective work and lien the property or shut down the business. In either situation, the property's ability to support the mortgage is lessened, so the lender's concern is understandable.

Sometimes, though, satisfying municipal building inspectors is difficult. Similarly, it may not be easy to evict a tenant, residential or commercial, who is cited for some zoning violation or for creating a nuisance.

Because the courts are aware of this, they tend to be lenient when foreclosure is based upon breach of this clause, but there must be a sincere attempt to cure the offense. If violations are totally ignored, foreclosure may be granted.

(g) If the mortgagor fails to keep, observe and perform any of the other covenants, conditions, or agreements contained in the mortgage.

Comment: This catchall should suggest to the managing agent that he or she become familiar with the mortgages on property he manages. Not every mortgage is the same. Special circumstances can give rise to unusual terms and conditions. When an owner has left the terms of the mortgage to a lawyer, the managing agent could inadvertently contribute to a foreclosure if he or she is unfamiliar with the requirements of the mortgage.

Other relevant considerations

Even when a manager is doing the best job possible, a foreclosure could still occur. The agent's most diligent efforts to generate income will be of no avail if the owner uses the money to support other properties. Similarly, an owner could decide that a particular major repair should not be undertaken, even if the agent has strenuously urged that it be done.

- Because lenders prefer not to foreclose, most are quite amenable to working to avoid it. In dealing with a lender, honesty and candor are much more effective and appreciated than optimistic promises.
- Not every foreclosure is legally justifiable. If an action is to be defended, and the managing agent can contribute his knowledge to the defense, obviously the manager should cooperate fully with the owner. But participating in a spurious defensive effort may only serve to increase the legal fees added to the amount of the foreclosure judgment.
- Asserting captious defenses to prolong a foreclosure can so increase the cost of the action to the lender that the final judgment amount may exceed the value of the property. If it does, the owner may be personally liable for the resultant deficiency.
- Business as usual should not be assumed during the course of a protracted foreclosure action. Although a mortgagee is not the owner, most mortgages give the mortgagee the right to appoint a receiver during the pendency of the case. The receiver will assume responsibility to collect and disburse. Although the receiver might keep the present managing agent, the receiver is more likely to either perform this function personally or engage a new agent.
- If in fact the owner's position is hopeless, the faster the foreclosure proceeds, the less interest and legal fees accrue. Then, if the property is sold for more than the amount of the mortgage, a surplus may be available for the owner to claim.

Conclusion

The dedicated managing agent can play a very significant role in keeping a property out of foreclosure. Although knowledge of foreclosure law and practice is most often abdicated to counsel, the well-informed agent can do a great service to himself or herself, the esteem of the property management profession, and the owner by being alert and proficient in this field.

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