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Preserving Investments Through Careful Drafting

When a mortgage debt falls hopelessly into default, the lender is thrust into the arcane and highly technical arena of mortgage foreclosure. While there should be little doubt about a successful outcome, too often, losses result. Why that occurs and how to avoid it can be quite intriguing.

Generally, success or failure in foreclosure can be seen as a function of three aspects in varying combinations. First, it obviously helps to have a reasonably prudent loan. The larger the equity cushion, the less likely a loss will be incurred. But the quality of appraisals can vary. Geographical areas can become distressed. Property can become run down if portfolio management is less than vigilant. Finally, a favored customer may not be the subject of scrupulous scrutiny when the loan originates. So, the careful loan cannot always be relied upon.

How a foreclosure is prosecuted is also a major factor. The skill of an attorney who specializes in this rather recondite area can easily be the difference between success and failure. Even if an expert practitioner is always engaged, however, he or she is bound to foreclose upon the mortgage documents given to him.

Thus, the terms of the mortgage instrument will play a significant role in the outcome of the case. Although each factor is important, perhaps the most neglected is the area of mortgage drafting. Upon analysis, why this is so, is not difficult to appreciate.

When a loan is made on an equity, rather than a credit basis, a well honed

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appraisal should advise the lender as to the reasonableness of the investment. Should experience demonstrate that faulty appraisals have been obtained, there is room for the lender to use appraisers with more expertise and thus solve that problem.

Where the foreclosure actions are perhaps clumsily handled, the lender can turn to especially experienced attorneys who should then be able to prosecute foreclosures in a more rapid fashion, thus curing that difficulty.

However, if the problem lies with deficiencies in the mortgage documents, this may not be so readily apparent. The attorneys prosecuting the actions are bound to live with the terms of the mortgage documents they receive. Perhaps they are not aware of the nuances in the papers which could make foreclosure easier. Even if they do have the requisite knowledge, they may not be the counsel retained to prepare such documents and communicating the deficiencies they observe to the lender, while in the midst of heavy litigation, may be cumbersome. The converse is that the drafters of the documents may not be the attorneys who actually do the foreclosures, thus insulating them from the practicalities of this highly specialized area. It is not unlikely that the best remedies in foreclosure can be hindered by the mortgage documents themselves.

Legal fees

Mortgage foreclosures tend to be rather obscure, time-consuming and often expensive. Especially when a foreclosure becomes protracted, resulting from vigorous defenses or a bankruptcy, among other reasons, legal fees incurred by the lender can be quite substantial. If these fees are not included in the foreclosure judgment, because the mortgage documents did not so provide, when the value of the property is close to the loan amount, such fees could be the difference between a loss and being made whole.

Of critical importance, many standard forms of a mortgage do *not* contain a clause allowing for legal fees in a foreclosure. Rather, they provide reimbursement for legal fees developed in protecting the lien of the mortgage but that is something quite different from a foreclosure action. Hence, in formulating the mortgage documents and adapting forms, the drafter must be aware of this difference. In addition, in some states, a legal fee clause in foreclosure in the note alone is insufficient. It must be in the mortgage.

Keeping in mind that the legal fee clause is essential, there are two ways to prepare it. One method is to provide for "reasonable" legal fees. The attorney for the foreclosing lender is advised to keep meticulous time records in the foreclosure action so that when the court considers the award, these records will support the claim. What the lender pays the attorney is not the measure. Rather, it is the amount of time reasonably engendered by the circumstances of the case at the attorney's usual hourly rate. Whether the court accepts the attorney's regular billing rate is problematical and depends upon counsel's experience, standing in the legal community and years in practice. What is significant here is that house counsel is *not* entitled to a separate legal fee award as they are deemed employees of the lender. Consideration should be given to the engagement of outside counsel to recoup this substantial outlay.[1]

An alternative approach is to set forth legal fees as some percentage of the outstanding loan balance. Here is an example of a proven clause:

> "In the event the holder of this mortgage is required to retain legal counsel for the purpose of commencing foreclosure proceedings hereunder, a sum equal to ___% of the unpaid balance collaterally secured hereby shall be added to said indebtedness as fair and reasonable legal fees and deemed secured hereby in addition to costs, allowances and additional allowances as provided by law."

Often, this yields a more favorable result and at the very least gives the court more latitude to grant reasonable fees based upon actual hours expended, which can often be less than the percentage. The only possible shortcoming of this method is that courts in some states may view the percentage as a cap or maximum. But foreclosures so heavily litigated as to engender legal fees in excess of the percentage are rare enough so that this approach should prove advantageous in the majority of instances.

As many real estate practitioners are aware, it has become increasingly more common for a defaulting mortgagor to file a petition in bankruptcy. This creates still further legal costs. Therefore, it is a good idea to consider a clause providing for legal fee reimbursement specifically for bankruptcy litigation in addition to legal expense in the foreclosure action itself.

Bear in mind that the more legal fees that go into the foreclosure judgment—or are paid directly by the mortgagor—the less the responsibility of the bank to pay these fees. Still further, it creates considerable pressure on the defaulter to make good his obligation because the more he delays and litigates, the more it will cost *him.*

Interest on default

Because foreclosures tend to be lengthy under the best of circumstances, particularly when vigorously defended, the rate of interest generated upon default is vital. In New York, for example, what is called the "legal" or "judgment" rate is 9 percent, considerably below market levels. If a mortgage is silent as to interest upon default, the applicable percentage will

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be that 9 percent or the comparable state percentage.

If litigation is protracted and if the mortgage is large, the lost interest can be quite substantial. Hence, the remedy is for the mortgage to specify that upon default, the balance will bear interest at that rate in the mortgage, perhaps 14 percent, just to use a typical example. The mortgage could even specify a higher rate, such as the highest rate of interest allowed by law. The result is that even on default, the principal of the loan yields a respectable return, thus diminishing any damage caused by a foreclosure mired in convoluted litigation.

A valuable corollary to the concept of interest when a default results is interest on advances. Suppose a mortgagor allows insurance to lapse. The lender then must pay the premium to protect the security. Again, if the mortgage makes no reference to such eventuality, the money advanced to pay the insurance will yield only that low "legal" rate. But the mortgage could (and should) recite that insurance advances incur interest at the mortgage rate or some higher percentage. In a large mortgage portfolio, this concept becomes quite significant.

To be sure, insurance is not the only advance a lender is likely to make. When real property taxes are not paid or when the escrow for that is overdrawn, the lender must pay those taxes or the lien of the mortgagee will be extinguished by a tax deed to the taxing authority or as in New York City, an *in rem* action. So, sums paid by the lender for taxes should also bear interest at the mortgage rate.

When the lender is holding a second mortgage position, he or she may be required to protect its lien by making payments upon or satisfying a prior mortgage. These advances, too, should have an interest rate greater than the judgment or "legal" percentage.

Duration of interest on default

In most jurisdictions, the last step before advertising the sale is entering of judgment. But once the judgment is obtained, the total amount owed the lender will only bear interest at the judgment or legal rate unless the mortgage provides to the contrary.

Unfortunately for lenders, the mere obtaining of a judgment does not assure that the litigation is at an end. There is always room for dilatory tactics by the defaulting mortgagor—legitimate or otherwise. He or she may choose the eve of sale to file for bankruptcy, which is then the cause of extensive delay. He or she may suddenly claim that process in the foreclosure was never served and request an opportunity to submit an answer. A defaulting mortgagor may come forward with a host of other claimed reasons to show cause to stay the sale.

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If successful with any of these efforts, the lender's judgment could yield that relatively low "legal" rate of interest for an extended period. This could, in turn, severely jeopardize a loan where the margin between the sum due on the mortgage and the value of the property is "close." The solution is to provide language in the mortgage that states the contract rate of interest will apply until the property is sold or until the full amount due is paid, which ever comes later.

Other fees

Suppose the mortgagor submits a check with insufficient funds in the account to cover it—hardly an unknown occurrence. The fee incurred by the lender for a bounced check is inconsequential. But some mortgagors do that with regularity. Multiplied through a large portfolio, those expenses become matters of substance.

If the lender is not escrowing for taxes, determining the status of tax payments could require searches. Over a large portfolio, the costs of these searches can become expensive.

Other examples of peripheral charges that can mount up are those incurred in processing insurance loss payments, ownership transfers, easements, extensions or modifications, reduction certificates, satisfactions and assignments, among many others.

If the mortgage does not provide reasonable reimbursement to the lender for these charges and expenses, recompense will not likely be available. The mortgage should so specify and the value of that is noteworthy.

Due on sale clause

Today's mortgage at 12 percent or 13 percent may be a poor investment some years in the future. Obviously, a lender is bound by his contract just as the mortgagor is. But without the requirements found in government subsidized mortgages, (such as FHA) a mortgage need not be assumable.

This was a lesson learned in the late 1960s and early 1970s when quiescent mortgage rates suddenly became volatile. Therefore, most mortgages today should, and prudently do, contain what is called a due on sale or due on transfer clause. This gives the lender an opportunity to keep a portfolio competitive.

The key here is not so much to include the clause, because it is quite well known, but to draft the clause very carefully to cover the desired contingencies. Without attempting to analyze all the law in this area, the idea is to prepare a very broad due on sale clause. For example, if the mortgagor is a corporation, a stock sale could effectively nullify the due on sale clause, unless the clause is specific enough to cover that contigency.

If, in a gesture of fairness, the lender's mortgage provides that his or her consent to a sale will not be unreasonably withheld, the due on sale clause has probably just been rendered entirely ineffectual.

So, if this clause is to be employed in your mortgage, consult at length with counsel and make sure he has read all the case law in your jurisdiction so your due on sale provision accomplishes what you expect. *continued*

Receivership

Unlike the other clauses mentioned which are not infrequently overlooked, a paragraph empowering a lender to appoint a receiver in foreclosure has long been considered standard. Banks should make certain that such a clause is, indeed, in their mortgage documents. Of course, there is a difference between having the clause in the documents and actually employing it under appropriate circumstances.

Suppose a defaulting mortgagor concludes that his or her economic interests are best served by interminably delaying the foreclosure. While running interest at a high rate, together with the imposition of legal fees, provide a modicum of protection for the lender, the consequences of extensive delay can still be damaging. This can occur where the mortgaged premises are an apartment building, group of stores or other income producing property.

It may be to the mortgagor's advantage to collect rents, neglect repairs, thus allowing the property to severely decline in value. That jeopardizes the lien of the mortgage because at the conclusion of the extended litigation, the property may be worth less than the bank's total investment.

The best way to solve this not so uncommon problem is to obtain the appointment of a receiver as authorized by the mortgage documents. It is at least something which should always be considered. If the lender believes the property may be reduced in value during the action or that the mortgagor may allow the premises to run down, a receivership is definitely in order. Where litigation is expected to be protracted, it can be considered for a one-family house foreclosure.

A receiver stands in the shoes of the owner. Once he or she is appointed and qualifies, he or she has the right to collect all rent due or to become due arising out of the premises. The income is collected, insurance is maintained, taxes are paid and repairs are made. Thus, the value of the property is preserved. In addition, any income left over goes to reduce the mortgage. Thus, a dual purpose is served. Still further, the mortgagor's interest in delaying the foreclosure is greatly diminished, if not entirely eliminated. Many favorable settlements have been obtained as a result.

Significantly, receiverships are most often obtainable without notice to the mortgagor. When he finds out, the mere existence of the receiver is frequently enough to solve the problem. To be sure, a mortgagor could choose to litigate the issue rather than capitulate. But it is quite difficult to set aside a skillfully obtained receivership. Technical objections rarely succeed and constitutional challenges have been rejected.

Experience with foreclosures demonstrates that the hints discussed in this article can go a long way towards preserving investments and making foreclosure actions less traumatic.

The next time a problem arises in a foreclosure, consider whether other language in the mortgage documents could have provided a solution. If the answer is yes, you have found a clause to revise. Meanwhile, even if your form of mortgage is time tested, there is always room for improvement and the search to improve the documents should always be a priority. □

[1] See: Bergman, "Mortgage Foreclosures—A Need for Outside Counsel?" *Mortgage Banking* p. 78 (October 1981).