Protecting The Appraisal Through Mortgage Foreclosure

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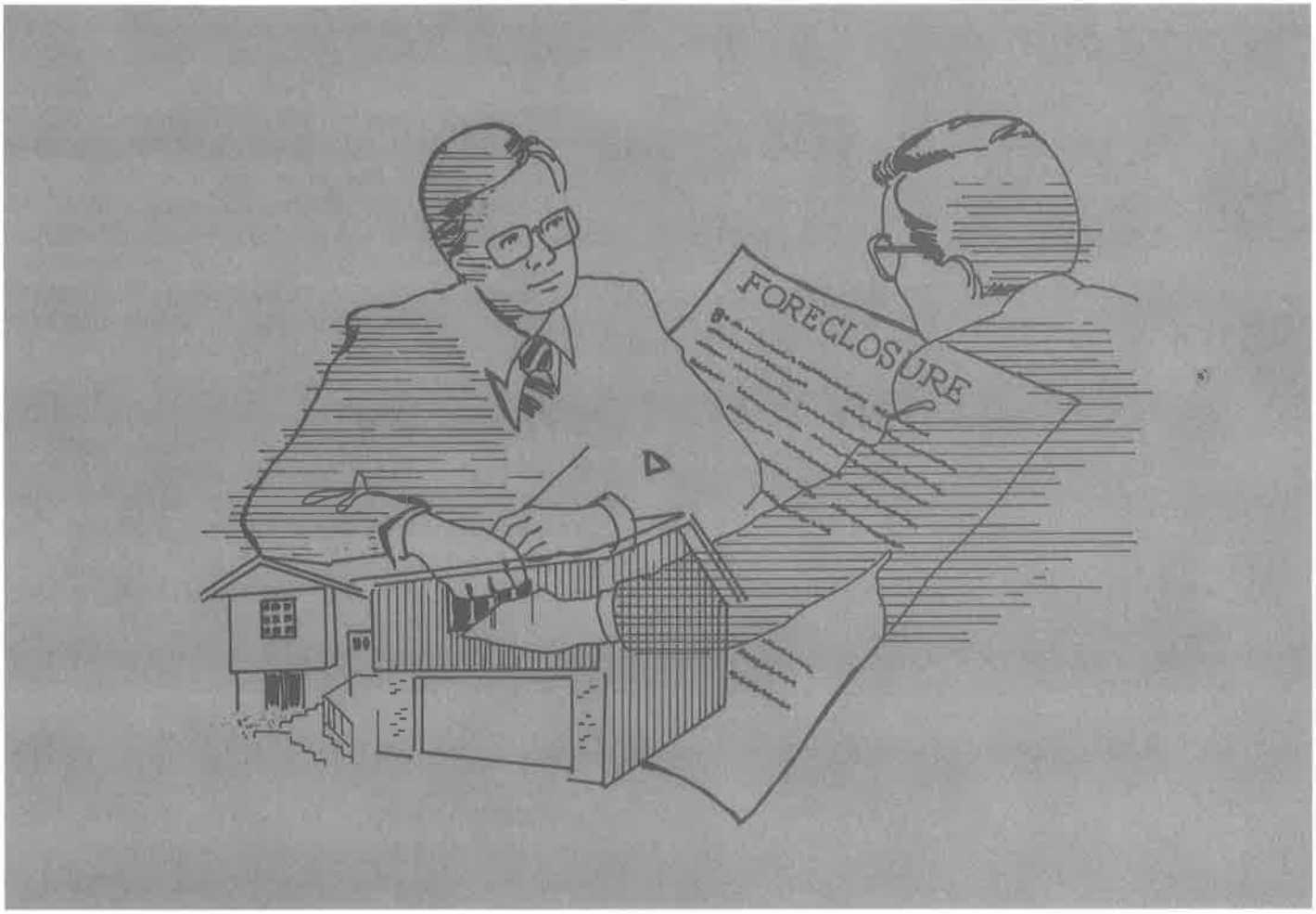

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by Bruce J. Bergman

INTRODUCTION

Since mortgage foreclosure is often viewed as a harsh action, and further because it is seen as poor public relations, some lenders tend to adopt an apparently gracious approach to defaults. While this posture may assuage the conscience, it tends to be counterproductive for reasons not so readily apparent. Moreover, when a loan "goes bad", criticism may ultimately devolve to the appraiser. Often though, the unsatisfactory result is not at all the appraiser's fault. Why the appraiser may *not* be the source of the problem should be of interest.

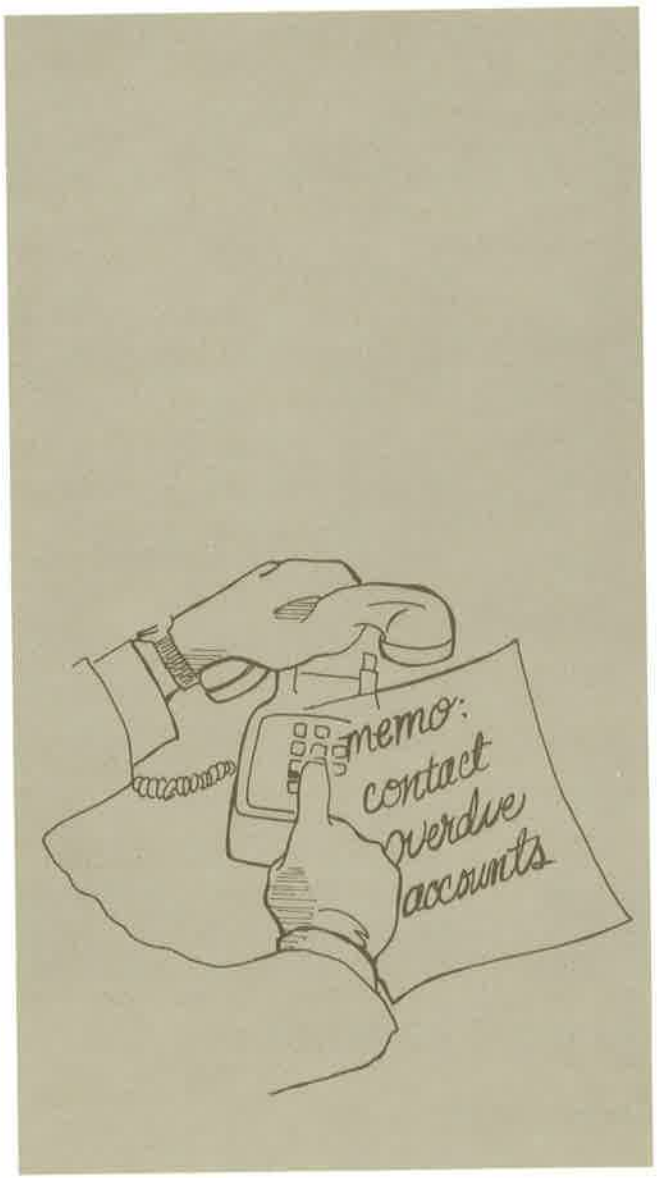
Unless a loan is made to a customer based solely upon a business relationship, equity in the mortgaged property will obviously be a factor in placing the loan. In turn, the margin of equity will be determined by the appraisal. Once the appraisal has been submitted, how close the appraised value will be to the loan becomes the lender's business decision. Once a judgment is made, the preservation of the investment will primarily be a function not of the appraisal, but rather of the loan documents themselves and the method of enforcement.

CAREFULLY DRAFTING THE MORTGAGE

While the art of mortgage drafting is a subject itself worthy of a series of articles, there are some very helpful guidelines to be observed which serve well to protect a lender.

Because foreclosures are often lengthy actions--particularly when heavily litigated--the rate of interest generated upon default is critical. In most jurisdictions, the "legal" rate (also called the judgment rate) is around nine percent, well below market rates. If a mortgage is silent as to what the rate of interest is to be when the mortgagor defaults, the applicable percentage is likely to be that legal or judgment rate.

If the default is upon a substantial loan for a protracted



period, the margin between the appraisal and the loan amount is subject to serious erosion. Thus, the remedy is for the mortgage to specify that upon default, the balance bears interest at the contract rate (i.e., the rate on the mortgage) or at some specified higher rate. This latter percentage could be the highest legal applicable rate. Consequently, even on default, the principal of the loan bears a respectable rate of interest which in turn diminishes or eliminates damage caused by delay in either collecting the debt or selling the property in foreclosure.

The quantum of legal fees to the lender is another area of self help. Foreclosures can be expensive, again, particularly when defenses create convoluted litigation. If the lender bears the expense of the suit, the loan which was once a good investment suddenly became less so.

One might assume that all mortgages provide legal fee recompense to the lender. While for most sophisticated lenders that is true, it is not uniformly the case. Furthermore, the computation of these fees may not always be favorably worded in the documents.

Note first that so called standard mortgages do *not* necessarily contain a legal fee clause. The drafter must be careful in adapting forms to be certain that this contingency is checked. In some jurisdictions, a legal fee clause in the bond or note alone is insufficient. It must be in the mortgage itself.

Once the clause is contemplated, there are two ways to reach the desired end. One is to provide for "reasonable" legal fees. An alternative is to peg those fees as a percentage of the outstanding principal balance. Although most often subject either way to judicial scrutiny, the latter method usually yields a better result. Howsoever the legal fee clause is drafted, that expense is often not recoverable if the lender employs house counsel.[1] Therefore, consideration should always be given to engaging outside counsel. Because foreclosures tend to be arcane, attorneys especially skilled in this area are normally more efficient in prosecuting the action than a generalist might be.

Another essential factor in the realm of legal cost relates to bankruptcy. A prime defensive tactic of defaulting mortgagors is to file a petition in bankruptcy. The moment that occurs, the lender is barred from going forward with his foreclosure. Removing the property from the jurisdiction of the Bankruptcy Court then entails further legal work. Since typically the bankruptcy filing comes after the lender has had legal fees computed on his judgment, the mortgage should provide that legal fees incurred by the lender in Bankruptcy Court are an *additional* item of compensation to be added to the debt.

Clearly, this recitation of terms to consider in preparing the mortgage documents is far from comprehensive, although the cited suggestions are probably the most important in preserving the investment. Briefly, some other concepts worthy of note are the following:

- When providing for a rate of interest on default, have it continue until the date the property is actually sold in foreclosure or until the debt is fully paid, whichever comes later.
- Include a late charge provision so that tardy payments do not cause losses.
- Provide payments by the mortgagor for bounced checks and investigation of insurance and tax status. In the aggregate of a large portfolio, these can become expensive.
- Old loans at low interest rates can be reduced if the mortgage contains a due on sale clause. Because this is a relatively new area dating back only to the late nineteen sixties, very careful attention to the case law here is important.

MONITORING DEFAULTS

While lenders understandably seek to avoid fore-

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[1] See: Bergman, "Mortgage Foreclosures–A Need For Outside Counsel?", 42, Mortgage Banking, 78, (1981).

closure, that attitude should not create a casual approach to defaults. Experience shows that the borrower in default is less likely to save himself if quietly left to his own devices. The longer he is allowed to drift, the more likely it is that the situation will become irretrievable.

The lender best protects himself by meticulous vigilance to payment arrears. Absent a system which monitors defaults, control is apt to be lost. Thus, there should be a system keeping close watch upon defaults.

Every mortgage payment has a due date followed by a grace period–most often fifteen days–although it could be more or less. Once the grace period has expired, the lender must determine how many additional days–if any–he will wait before phone calls or letters urge the mortgagor to become current.

Some truly special circumstances may require deviation from the system, but deeming a default "special" must be sparingly used. Almost every defaulter has a story. If the lender, in the exercise of compassion, accepts every excuse as valid, most defaults would continue in perpetuity. Since time can be an enemy of the investment, a modicum of strength is in order. There must come a time when collection efforts are recognized as fruitless, triggering the next step–acceleration of the principal balance.

ACCELERATION–THE KEY TO FORECLOSURE

Another vital element in preserving the investment is the judicious use of leverage. This is obtained by acceleration, which is declaring the *entire* mortgage balance immediately due and payable.

Authority for this is found in the typical acceleration clause in the mortgage providing in essence that upon the happening of certain events, one of which is failure to make a payment when due, the lender has the option to declare the entire loan balance due. Assuming the existence of a standard acceleration clause and an act violative of its terms, acceleration is accomplished by an *unequivocal* election by the lender to declare the total principal and interest due. This election may be manifested either in a letter to the mortgagor or by the act of actually starting the foreclosure.

The recommended practice is to accelerate by letter so time is not lost in transmitting the file to counsel and awaiting his preparation and service of legal papers. If the letter method is used, it must be an absolutely *unequivical* demand to pay the entire principal balance. A mere request for arrears or a threat to do something in the future will not suffice.

This correspondence must be sent in accordance with the specific terms of the mortgage. While regular mail is the usual mode of transmittal, some mortgages may specify certified or registered mail, in which event there must be compliance. However, even if regular mail is all that is technically required, the preferred method is to send the notice by *both* certified and regular mail. A return receipt

will defeat the mortgagor's argument that the letter was never received. Adding regular mail covers the situation of the sharp defaulter who declines to accept a certified letter.

Once the letter is sent, the lender may proceed from a position of strength.

WHY ACCELERATION IS CRITICAL

Once the lender has manifested the election to accelerate, it need no longer accept a tender of arrears. But if it chooses to do so, it will be upon *its* terms.

There are two ways to look at this. First, assume the situation of the chronic defaulter. He is constantly in collection and the lender's staff is regularly calling and writing, expending time and money in the process. Without acceleration, this collection problem is endless because the mortgagor is always free to tender arrears at his leisure. However, once the lender accelerates, arrears need not be accepted and the lender may insist upon full

satisfaction of the mortgage.[2]

A corollary benefit of acceleration in addition to leverage is that the lender can demand as a condition of reinstatement that any legal fees incurred be paid. The mortgagor may find this objectionable, but the lender is simply not obligated to reinstate after acceleration. This factor is important if the mortgage did not otherwise provide for legal fees and becomes increasingly so as the amount of legal fees charged the lender increase.

MAINTAINING LEVERAGE

Most real estate professionals have either experienced or heard about foreclosures which were mired in litigation for many months or years while settlement was considered. While this could just have been the result of encountering a vigorous defensive posture, it is often a consequence of laxity or bad strategy on the lender's behalf.

The oft-encountered lender's error is to generously halt the foreclosure as soon as the mortgagor either promises to make up arrears or to satisfy by selling the property. But promises are often broken, no matter how well intentioned they may have been. Even if the mortgagor truly intends to sell the property, desiring to do so and actually completing the transaction are two different things.

While most foreclosures are settled, experience dictates that defaulting mortgagors either cannot or will not honor their obligations until their position is about to become irretrievable. Thus, continuous pressure is essential to a favorable and expeditious conclusion.

To understand the concept, be aware that foreclosure actions in most states typically proceed in ritualistic steps, each one of which is a prerequisite to the next. If an acceptable settlement is offered–be it full payment, tender of arrears over time, or recasting the mortgage–lenders are tempted to hold the action in abeyance while awaiting a resolution. This is the mistake.

What if the conclusion doesn't come to fruition in the promised thirty or forty-five days? The obvious response is that the lender is sitting in place wondering when or whether payment will be forthcoming. Meanwhile, lost interest mounts, the case is no nearer a resolution and the appraisal has become more precarious.

This can and should be avoided. Each step in the foreclosure should be assiduously pursued which can be done without causing the lender to incur additional legal fees.

Here is an example to explain the point. Suppose the summons and complaint have been served in the foreclosure. No answer has been filed and counsel is now entitled to an $850 fee plus disbursements. The mortgagor surfaces with a promise to make good his arrears within thirty days. Should the lender wait that period or direct counsel to proceed with the next step–appointment of a referee? The latter is strongly recommended.

Although correct that the attorney's fee rises to, say $1,100, at the next stage of the case, that fee is borne by the mortgagor as a part of any settlement. He should be unequivocally advised that all goes forward until the day the money is in hand and any resultant legal fees are his responsibility. This constrains compliance. If the promise is not kept, the foreclosure is that much nearer the end.

EMPLOYING THE RECEIVER

What happens when a defaulting mortgagor decides that it is in his best economic interests to interminably delay a foreclosure? It happens not to be that hard to do. This can occur especially 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 and ultimately do very nicely–in other words, to "bleed" the property. That surely can jeopardize the appraisal.

The best method to solve that problem–and again to maintain leverage–is to obtain the appointment of a receiver. It is at least something which should always be considered. If the lender believes the property may decline 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 also be considered for a one family house foreclosure.

A receiver stands in the shoes of the owner. Once he is appointed and qualifies, he has the right to collect all rent due or to become due arising out of the premises. He collects the income, maintains insurance, pays taxes and makes repairs. He thus preserves the value of the property. 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. Constitutional challenges have been rejected.

DEED IN LIEU OF FORECLOSURE

Sometimes the concept of a deed in lieu of foreclosure–if offered by the mortgagor–may be the lender's best option if the goal is to save the time attendant to a foreclosure action.

In essence, the mortgagor says to the lender that he will walk away from the property and give back a deed if the

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[2] This statement is correct for most mortgages in most jurisdictions. However, mortgage forms promulgated by some governmental agencies, such as the Federal National Mortgage Association (FNMA) allow tender of arrears at any time prior to judgment.

lender will not pursue a deficiency judgment against him personally.

The problem with a deed in lieu of foreclosure is that it is laden with technical pitfalls which must be recognized. For example, the deed back to the lender is subject to whatever encumbrances may have already attached to the property such as judgments, mechanics liens and subordinate mortgages. Therefore, a title search and its careful analysis by counsel are absolutely required. Moreover, there is always the danger that the deed could be deemed a preference if the mortgagor is insolvent, thus running afoul of the Bankruptcy Code.

This brief review makes the point that obtaining a deed in lieu of foreclosure must be approached with requisite caution. This is a fertile area for self help but one requiring especially careful liason with counsel.

CONCLUSION

The appraiser gives the lender a rational basis upon which to render a loan decision. If that loan goes into default, it is, of course, not the appraiser's fault. If the appraisal was accurate, that the property may be worth less than the money realized after a foreclosure is also not the appraiser's responsibility.

How much the property yields in foreclosure will be more a function of the drafting of the mortgage documents and the skill and expertise brought to the prosecution of the foreclosure action. That should be of some comfort to the professional appraiser.