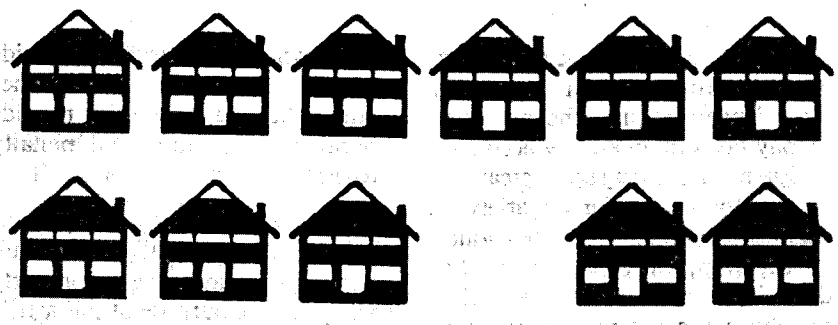

The Dangers of a Mortgagor's Tax Default to an Existing Mortgage

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In view of the leniency that many courts have shown mortgagors in actions to foreclose for tax defaults, mortgage lenders should escrow for taxes whenever possible, provide written notice of any default by the mortgagor, and, if necessary, pay any overdue tax and add the amount to the mortgage.

ONE OF THE WAYS that municipal taxing authorities enforce the collection of real property taxes is by divesting the owner of title if the taxes are not ultimately paid. A tax default not only presents a problem for a property owner but for the mortgage lender as well, because the

lien of his mortgage is extinguished when the property is lost. This is why most lenders require the owner to prepay taxes in an escrow account.

But not all mortgagees create an escrow for taxes—for a variety of reasons. For example, an individual, partnership, or corporation that deals in property may take back a purchase money mortgage upon sale. If the mortgagee lacks the staff or the wherewithal to pay taxes on the various due dates to the various taxing jurisdictions, it may abdicate this responsibility to the owner. Sometimes a lender who takes a second or a third mortgage may leave the task to prior mortgagees.

Even sophisticated lenders may waive on occasion the customary right to escrow for taxes if the borrower is a preferred customer who has asked that he be allowed to pay the taxes. After all, a property owner has a real incentive to pay the taxes himself, because he can earn a much higher rate of return than the lender will pay for the escrow.

While an owner has a vested interest in paying real property taxes, he may neglect this duty for a variety of reasons:

- Due dates may be missed because of clerical errors;
- A cash flow problem may force the owner to choose between a mortgage payment, needed building maintenance and repairs, or real estate taxes; or
- An owner may consciously decide to forego the payment of taxes, since many collecting authorities provide liberal grace periods and penalty provisions.

Whatever the reason, real property taxes can often fall into default and, in turn, may cause the property to be lost. The purpose of this article is to examine the effects of default upon existing mortgages.

TAX COLLECTION PROCEDURES

Although the procedures by which taxing authorities collect overdue taxes vary considerably among jurisdictions, two basic approaches are currently in use: the "in rem" method and the sale of tax liens.

In Rem Method

New York City is a prime example of a jurisdiction that uses the in rem method. In the case of commercial property, one year after the lien date for a particular tax, the property is listed "in rem." The applicable period for residential property is three years. The city gathers all properties in this category and files a lis pendens notice that advises the world of the existence of a claim to the property.

A proceeding is then begun that enables the city treasurer to deed the property to the city some six months later. Although the owner has lost his property at this point, he has one year within which to redeem it. The

mortgage lien, however, has been terminated.

Tax Lien Sales

The sale of tax liens is perhaps a more common enforcement device. After real property taxes remain unpaid for a period provided by local statute, the taxing jurisdiction advertises liens for sale on delinquent parcels.

By way of example, suppose that $200,000 in delinquent taxes were outstanding on an apartment complex. Anyone could submit a bid to the taxing authority, and the purchaser of the lien would obtain the right to collect interest, usually a substantial amount, together with the principal sum.

The property owner, the mortgagee, a tenant, or other party with an interest in the property, as defined by local statute, may pay the principal, plus interest, to the purchaser of the lien before the expiration of a period—typically one or two years—specified by statute. At the end of this period, the lienholder must provide the parties entitled to redeem with one last chance to pay. This is accomplished by sending what is called in many areas a "notice to redeem." If none of the parties accepts this opportunity, the appropriate local fiscal officer issues a deed to the lienholder, the owner then will have lost the property—subject once again to redemption, in some areas, if the municipality was the lienholder—and the mortgage lien will have been extinguished.

Notice of Sale

One peripheral issue should be noted. The advertisement of the original lien sale must actually have been served upon the mortgage holder. A mortgagee is entitled to notice reasonably calculated to apprise him of a pending tax sale of property upon which he holds a mortgage. *See Mennonite Board of Missions v. Adams,* 462 U.S. 180 (1983).

Thus, when a mortgage has been recorded—as is almost invariably the case—constructive notice by publication must be supplemented either by notice mailed to the mortgagee's last known address or by personal service. Absent such service, constructive notice alone does not satisfy the due process clause of the fourteenth amendment, unless the mortgagee is not reasonably identifiable.

MORTGAGES IN DEFAULT • Lenders have always relied on the concept of acceleration to enforce the mortgage obligation and protect against the extinguishment of the mortgage lien resulting from some default of the borrower. The acceleration clause in a typical promissory note provides that the holder of the mortgage may declare the entire principal balance immediately due and payable upon the occurrence of any of certain events enumerated in the mortgage. Typical events include:

• Failing to pay an installment of principal or interest;

• Neglecting to keep the premises insured;

• Failing to keep the premises in proper repair;

• Making unauthorized alterations on the property; or

• Refusing to cure municipal violations.

After a default, an astute mortgagee indicates his election to accelerate by some overt, unequivocal act, usually by sending a letter or by actually beginning an action to foreclose. If principal and interest have not been paid and the entire balance due has been accelerated, the mortgagee need not accept mere arrears and is free to proceed with a foreclosure action to its conclusion. *See Graf v. Hope Building Corp.,* 254 N.Y. 1, 171 N.E. 884 (1930).

Despite the strictness of the acceleration rule, however, it must be remembered that foreclosure is an equitable action and courts try to be fair. While accelerating the mortgage debt even one day after the grace period has expired is not considered unfair, certain defenses are available despite default. *See Bolmer Brothers v. Bolmer Construction Co.,* 114 N.Y.S.2d 530 (Sup. Ct. 1952). For example:

• Under some circumstances, oral assurances to the mortgagor that payment could be withheld for a time may be deemed a waiver of acceleration. *See Nassau Trust Co. v. Montrose Concrete Products Corp.,* 56 N.Y.2d 175, 436 N.E.2d 1265, 451 N.Y.S.2d 663 (1982);

• Retention of payments for a length of time incompatible with a desire to reject them may be deemed a waiver of acceleration. *See Battim Associates v. L. & L. Estates,* 186 Misc. 141, 58 N.Y.S.2d 96 (Sup. Ct. 1945); and

• Although seldom invoked, estoppel can furnish a defense. *See Manufacturers and Traders Trust Co. v. Cottrell,* 71 A.D.2d 538, 422 N.Y.S.2d 990 (1979).

Precisely what a given court will consider equitable under the particular circumstances varies so widely that no specific guidelines can be stated.

TAX VS. PAYMENT DEFAULTS • Standard mortgage acceleration clauses treat all defaults alike, with one prevalent exception: When taxes are not paid, the mortgagor usually is entitled to some notice period to cure—unlike defaults for mortgage payments, which normally require no notice.

It would seem reasonable to assume, therefore, that a mortgagee who duly notified a mortgagor of the latter's failure to pay a tax and gave him the requisite period to cure the

default should be able to begin foreclosure action, free from any defenses, when the period expires. Surprisingly, this is not the case. While a defaulting owner can derive comfort from this fact, a mortgagee faces a major problem.

The courts' different attitudes towards tax defaults and payment defaults are difficult to reconcile. If a mortgagee can lose his security when taxes are not paid, he should be able to foreclose for such failure. The courts, however, have not always agreed with this concept.

Courts have viewed the payment of principal and interest on the mortgage as the primary obligation, the acceleration of which is the fixing of a maturity date. *Graf v. Hope Building Corp.*, 254 N.Y. 1, 171 N.E. 884 (1930) (Cardozo, J., dissenting). A requirement to pay taxes, however, stands on a different footing and involves no payment to the mortgagee. Rather, it is a collateral undertaking imposed to protect the mortgagee against impairment of his security. *Id.*

Since foreclosure is an action in equity and thus involves the concept of fairness, a court of equity has the power to examine the circumstances and grant relief from a default if its actions will achieve a result that is perceived to be fair.

ACCELERATION FOR TAX DEFAULTS • Nevertheless, it is possible to have a foreclosure upheld when a tax default is the basis. In a typical situation, taxes are not paid, the mortgagee gives the owner notice that taxes must be paid, and when they are not, begins the foreclosure. The mortgagor protests after the action is started, but the court rejects the defense.

Courts that have allowed foreclosure in this situation have generally cited the following elements in support of the foreclosing party:

- The defaults were substantial. *See East New York Savings Bank v. Carlinde Realty Corp.*, 54 A.D.2d 574, 387 N.Y.S.2d 138 (1976);
- Notice was timely and clearly given. *See Jamaica Savings Bank v. Cohan*, 36 A.D.2d 743, 320 N.Y.S.2d 471 (1971);
- Attempts to cure either were not made or were patently insincere. *See Strochak v. Glass Paper Making Supplies Co.*, 239 A.D. 312, 267 N.Y.S. 282 (1933); and
- The excuse for failure to pay taxes was lacking in credibility. *See Neubauer v. Smith*, 40 A.D.2d 790, 337 N.Y.S.2d 592 (1972).

Although not every case that allowed acceleration for taxes contained each of these elements, most elements must be present if a mortgagee is to have any hope of foreclosing when taxes are not paid. Conversely, the owner-mortgagor may assume that a foreclosure

against him will be unsuccessful if some combination of these elements does not emerge from the facts of the case.

Cases Disallowing Acceleration

In view of these principles, foreclosure for tax defaults would seem to be the rule rather than the exception. The opposite, however, is true. Generally, courts are extraordinarily sympathetic in the area of tax defaults, an attitude that goes back at least to the 1890s. A sampling of such cases illustrates the lengths to which courts have gone in the past to disallow acceleration for tax defaults.

In *Noyes v. Anderson,* 124 N.Y. 175, 26 N.E. 316 (1891), a foreclosure was begun when a sewer assessment remained unpaid for more than one year. In response, the owner claimed that she had learned of the tax default only one day before the service of the summons and complaint, when she made the payment. She attributed her failure to pay until then to the negligence of her son—a fact that hardly should have bound the mortgagee. The court ruled out any inference that the defendant did not desire to pay the taxes and concluded that her failure to pay was not willful neglect. Finding that no prejudice resulted to the plaintiff, the court dismissed the foreclosure, without, however, explaining why the owner's intent was relevant.

In a case decided during the Depression, the court in *York v. Hucko,* 146 Misc. 201, 262 N.Y.S. 62 (Sup. Ct. 1933), disallowed foreclosure, although the mortgagee had given oral notice, as permitted by the mortgage document, of the tax default and the mortgagors tendered the overdue taxes only after the foreclosure had begun. The court was persuaded by evidence that the mortgagors were foreigners and did not understand English or governmental procedures, the sheriff had told them that they still had six months to pay the taxes, and payments of principal and interest were current. Finally, economic conditions facing the agricultural community were especially difficult.

In *Lincoln Savings Bank v. Six Moffat Realty Co.,* N.Y.L.J., Mar. 25, 1980, at 15, col. 8M (N.Y. 1980), the court ruled against the foreclosing party, even though the mortgage provided that the mortgagee could accelerate without giving the mortgagor notice of the latter's failure to pay taxes. The mortgagee had begun the foreclosure when the mortgagor neglected to pay three quarterly installments of taxes and water charges. The taxes were paid only after the action was begun. The court found that notice, although not required by the mortgage contract, is a warning "customarily" given and therefore is a prerequisite to foreclosure. The default was held to be excusable, since it was due only to inattention and had not damaged the lender.

Although the summarized cases represent only a few of the decisions on point, a reading of such cases reveals that courts are inclined to rule against foreclosure for tax defaults approximately twice as often as they find in favor of foreclosure.

Mortgagors generally may assume that courts will apply certain principles when asked to permit a foreclosure for failure to pay taxes. Courts generally will regard a failure to pay taxes as merely "technical," a default only upon a collateral obligation. Equity will provide relief if the circumstances warrant, and any of the following factors may elicit the courts' sympathy:

- A waiver or forbearance by the mortgagee. *See Seamen's Bank for Savings v. Wallenstein Realty Corp.*, 6 N.Y.S.2d 706 (Sup. Ct.1938);
- Principal and interest are otherwise current. *See Clark-Robinson Corp. v. Jet Enterprises, Inc.*, 159 N.Y.S.2d 214 (Sup. Ct. 1957);
- Failure to pay taxes was not willful and was due to inattention or error. *See Noyes v. Anderson*, 124 N.Y. 175, 26 N.E. 316 (1891);
- Notice was not given or, if given, was equivocal. *See Bowery Savings Bank v. Corner Bay Shore Associates*, 46 Misc. 2d 788, 260 N.Y.S.2d 457 (Sup. Ct. 1965);
- Notice was given, but no opportunity to cure was provided. *Id.*
- The mortgagee suffered no damage or prejudice. *Clark-Robinson v. Jet Enterprises, Inc.*, 159 N.Y.S.2d 214 (Sup. Ct. 1957); or
- The mortgagor tendered the arrears or legitimately attempted to tender the arrears even after foreclosure had begun. *Karras v. Wasserman*, 91 A.D.2d 812 (1982).

MORTGAGEE STRATEGY • In view of the leniency that many courts show mortgagors in actions to foreclose for failure to pay taxes, what approach should a mortgagee adopt?

Assuming that the mortgagee does not elect to escrow for taxes and avoid the problem altogether, it must keep a close watch upon the mortgagor's tax payments to avoid this dangerous situation.

If the mortgage provides, as is the norm, for notice of default and an opportunity to cure, the mortgagee must give timely, clear, and unequivocal notice, in writing, lest a question of fact arise concerning oral notice. When a mortgage contains a cure period, usually 30 days, any attempt to foreclose before the conclusion of that period is premature.

If a mortgagee has given notice and no cure is forthcoming, the best self-help is to pay the tax itself and add this amount to the mortgage debt. Thus, when the debt itself has not been paid, the courts have much less room to void the foreclosure action.

CONCLUSION • Courts are generally reluctant to permit a foreclosure that is based upon the owner's failure to pay taxes. They may permit foreclosure when the quantum of the default is significant, the failure to pay is willful, and the borrower has not attempted, or has made only a half-hearted attempt, to tender tax arrears. Even if a case contains all these elements, however, the mortgagee cannot be sure of his position and is well advised to act carefully.

For Further Study

Articles in *The Practical Lawyer*

An Introduction to Debt Collection Law, by Lois M. Woocher, THE PRACTICAL LAWYER, October 1983, p. 31.

A Guide to Mortgage Foreclosure Strategy and Mechanics, by Bruce J. Bergman, THE PRACTICAL LAWYER, June 1982, p. 11.

How a General Creditor Can Protect Himself from a Federal Tax Lien, by William T. Plumb, Jr., Harry D. Shapiro, and Joseph Kovner, THE PRACTICAL LAWYER, September 1981, p. 75.

A Comprehensible Due-on-Sale Clause, by Lynn B. Squires, THE PRACTICAL LAWYER, April 1981, p. 67.

A "Due-on-Sale" Clause for an Equity Owner, by Bernard H. Goldstein, THE PRACTICAL LAWYER, January 1981, p. 57.

Alternative Residential Mortgages for Tomorrow, by William Griffith Thomas, THE PRACTICAL LAWYER, September 1980, p. 55.

Outlines and Forms in the *ALI-ABA Course Materials Journal*

Commercial Loan Documentation, by Richard J. Nassberg, COURSE MATERIALS JOURNAL, Vol. 8, No. 5, p. 99.

Adequate Protection for Property in Bankruptcy, by Harvey R. Miller and Martin J. Bienenstock, COURSE MATERIALS JOURNAL, (Part I) Vol. 8, No. 1, p. 31; (Part II) Vol. 8, No. 2, p. 75; (Part III) Vol. 8, No. 3, p. 43.