TIGHTENING YOUR MORTGAGE DOCUMENTS

By Bruce J. Bergman

INTRODUCTION

A successful mortgage portfolio is liable to be jeopardized by problems in one, or a combination of four significant areas:

- Inaccurate appraisals (which create an illusory or non-existent equity cushion)
- Sloppy collection practices (which can allow the running of interest to erode the equity)
- Unskilled attorneys (who either cannot bring the foreclosure to a conclusion or lack the expertise to enforce all the lender's rights)
- Inartfully drawn mortgage documents (which do not provide requisite safeguards and appropriate recompense for expenditures)

The first three areas should be readily ascertainable and susceptible to rapid remedy. For example, while an occasional "bad" appraisal is an occupational hazard, consistent errors will be apparent and new appraisers can be engaged. Similarly, collectors or mortgage officers who pursue payment with less than due diligence or skill will be noticed sooner or later. Likewise, attorneys who are out of their element can be replaced when their subpar abilities surface.

Faulty mortgage papers, however, are perhaps less obvious. If one doesn't know the advantages of well crafted documents, it is very difficult to appreciate the benefits which **could** be available. This is what this article is about.

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Mortgage deficiencies may arise either from the deleterious clauses they include, or the helpful provisions they exclude. To explain, many lenders employ, or buy paper composed of the Federal National Mortgage Association (FNMA) form of mortgage. Howsoever one views the philosophy behind it, the FNMA version is clearly skewed for the borrower's benefit, both by virtue of provisions it imposes and those it neglects. Even for those lenders who may eschew FNMA formulations, other so called standard forms rarely contain the protective clauses knowledgeable mortgage companies would prefer.

INFIRMITIES IN FNMA

Eliminating for the moment language to be suggested for inclusion in a mortgage, there is some unfortunate verbiage found in the typical FNMA form. Paragraph 18, to select a special instance, is particularly irksome and not readily recognized. It provides that the borrower has an absolute right to reinstate the mortgage at any time up to judgment, so long as all arrears and fees past due are paid in full.

That certainly **sounds** reasonable. Indeed, it is probably fair to say that most lenders are pleased to accept reinstatement at **any** time if arrears are paid in full. But what about the borrower who has been a constant source of delinquencies, problems, staff time and expense? State law is generally uniform in providing that once the full balance due on a mortgage has been accelerated, the lender need **not** accept reinstatement, although the **option** to do so is retained.[1] Under proper circumstances, a lender **should** be able to say "enough," which is precisely what traditional state law has always permitted. The FNMA form extinguishes that lender's right to a great extent.

Of concern too is paragraph 19. Regardless of how egregious the borrower's breach of the mortgage may be, and notwithstanding the number of times he has been in violation in the past, this clause says the lender **must** provide a detailed thirty day notice letter as a prerequisite to acceleration! Since state law generally imposes no such requirement, this clause represents a significant intrusion upon a lender's traditional rights. It automatically adds at least thirty days interest to the debt — of some consequence if the equity is thin — and engenders additional staff time and expense, even if this is one of those loans lender no longer wishes to carry.

The mortgage company aggrieved by the consequences of these paragraphs does have a ready solution. Astute draftsman prepare a rider to the mortgage which either eliminates these offensive provisions or ameliorates their thrust. This is not to suggest that a lender should be ungenerous or ungracious, rather that consideration should be given to retaining those rights lenders normally have, to be exercised when the lender deems it appropriate.

PROTECTIVE PROVISIONS

The language and court interpretation of every conceivable item which could appear in a mortgage in every state would fill volumes and is not especially relevant to this discussion. We may assume that most mortgages contain the basics. The overlooked clauses which can help a lender are the proper focus.

—LEGAL FEES

In most jurisdictions, mortgage foreclosures tend to be recondite, highly technical, time consuming and potentially expensive. Especially when a foreclosure becomes protracted — as when vigorous defenses or a bankruptcy are encountered — legal fees incurred by the lender can be substantial. Even if the cited factors which increase legal costs are not present, the salient inquiry is why should the lender bear the burden of the expense? If the borrower caused the default, he should be responsible for the resultant legal fees engendered by the lender's necessity to protect itself.

While the FNMA form obligates borrower to pay lender's legal fees upon **reinstatement,** it does not authorize

[1]. For a more thorough discussion of acceleration and its strategic role in the collection-foreclosure process, see "Protecting the Loan — Aggression or Compassion," **Equity** (Sept. 1986) and "Acceleration — The Key to Foreclosure," **Equity** (March 1987).

inclusion of legal expense if a foreclosure proceeds to a conclusion! Moreover, and perhaps surprisingly, most "standard" forms also do not provide recompense to the lender for payment to its attorney. If these fees are not included in the foreclosure judgment — and they cannot be if the mortgage documents did not so specify — when the value of the property is close to the loan amount, the legal cost component could easily be the difference between a loss and being made whole.

These thoughts, then, suggest that lenders are well advised to assure that their documents do contain an appropriate legal fee clause. While some jurisdictions may cover this by statute, most do not. Instead, the general rule is that the papers themselves must clearly specify this obligation. In some states, a legal fee clause in the note alone is insufficient. It must actually be inserted in the **mortgage**.[2]

There are two ways to approach this. One method is to provide for "reasonable" legal fees. Counsel to the foreclosing lender is well advised to keep thorough time records in the case so that when a court considers the award, these records will support the claim. This is also important to the lender which may have obligated itself to pay the full attorneys bill even if the court granted less than the entire request.

What the lender pays its attorney is not normally the measure of the recovery. Rather, the assessment is the amount of time reasonably developed by the circumstances of the case at the lawyer's usual hourly rate. Whether the court, in turn, accepts counsel's regular charges depends upon his experience, standing in the legal community and years of practice.

Significantly, in many areas, house counsel is not entitled to a separate legal fee, as they are considered employees of the lender. Thus, consideration should be given to engagement of outside counsel to recoup this substantial outlay if the noted rule applies in your state.

An alternative approach to protect the lender is to express recoverable legal fees as some percentage of the outstanding loan balance. This can often yield a more favorable result, although at the very least it gives the court more latitude to grant reasonable fees based upon actual hours expended — which can often be less than the percentage of the loan balance. The only possible shortcoming of this method is that courts in some states may interpret the percentage as a "cap" or maximum. Yet, foreclosures so heavily litigated as to create legal fees in excess of the percentage should be rare enough. Therefore, this system should prove advantageous in the majority of situations a lender will face.

As an exigent footnote on this point, an increasingly common defensive tactic is the defaulting borrower's filing of a petition in bankruptcy. This creates still further legal costs which may not be recoverable in the usual fashion. Accordingly, it is a good idea to entertain a clause providing legal fee reimbursement specifically for bankruptcy litigation.

Lest all this be misconstrued as merely a device to enrich attorneys, lenders should be mindful that the greater the quantum of legal fees in the judgment (borne by the borrower) — or paid directly by the borrower — the less the lender will have to absorb. In addition, an attorney's fee clause puts considerable salutary pressure on the defaulter to make good his obligation because the more he delays and litigates, the more it will cost him. Thus, careful drafting here serves the dual purpose of compensating the lender **and** bringing unwanted litigation to a more rapid conclusion.

—DUE ON SALE

Should interest rates rise precipitously in the future, today's mortgage at ten percent could be a very poor investment some years hence, although such is the risk any lender takes with a fixed rate, as opposed to a variable rate mortgage. But your loan was made to a particular person or persons, based in some considerable measure on his or their credit.[3] If strangers purchase the property, should they necessarily receive the benefit of what may become a below market rate mortgage? Perhaps not.

This was a lesson learned in the late 1960's and early 1970's 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 lenders the right — at its option — to accelerate the mortgage, if the property is transferred, further creating an opportunity to keep the portfolio competitive.

Most standard mortgages do **not** contain such a provision. While the FNMA version does, it may not be quite as comprehensive as a lender would want. For example, if the borrower is a corporation, a stock sale would not run afoul of "due on sale" as formulated in FNMA.

Enforcement of this clause in the various states has been uneven and confusing. With the passage, however, of Section 341 of the Garn St Germain Depository Institutions Act 1982, any state law prohibitions upon exercise of clauses of this type have been preempted. So long as the clause is skillfully drafted, lenders may derive comfort from its enforcibility under the terms of the cited federal statute.

—LATE CHARGES

Although perhaps obvious, there is considerable benefit to inclusion of a late charge provision in a mortgage. If a payment is submitted beyond the grace period, interest is effectively lost, since use of the money was delayed. Further, there is usually a cost factor attendant to handling receipt of tardy remittances. There should be compensation for this.

What percent will comprise the late charge is usually covered by state law or federal statute, depending upon the nature of the lender. Typically, the charges range between two and five percent. Again, since standard mortgage forms do not encompass this item, consideration of it is noteworthy.

—PRESERVING THE INTEREST

Of conspicuously vital concern is the issue of interest upon default. Although some forms address this, most are silent — and that severely impacts upon a lender's rate of return.

In those states where foreclosures

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[2]. This is sometimes a rude awakening for a lender who assumes that a legal fee clause in the note should be enough. Although disconcerting, it is understandable because mortgage notes — as opposed to the mortgage itself — are usually not recorded. Thus, junior lienors don't have notice that legal costs superior to their own debt exist.

[3]. Although the original mortgagor still remains personally liable for the debt (unless an **assumption** was recognized) they may not be locatable, which makes their obligation sometimes rather illusory.

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tend to be lengthy, exacerbated of course by an assiduous defense, the passage of time from the date of default until a foreclosure is concluded can be quite lengthy. With interest accruing during that period, the rate applicable becomes an important factor.

All states have a "judgment" rate of interest.[4] That is the interest rate an obligation bears upon default. Just to give an example, that rate in New York is nine percent, somewhat below even today's modest market percentage. If a mortgage makes no mention of the rate to apply upon default — and as noted, most usual forms do not address the point — the applicable rate will be that nine percent (in New York), or whatever the comparable category is in your state.

If foreclosure litigation is extended, and especially if the mortgage is large, the lost interest can be considerable. When a loan is made bearing interest at twelve percent, when a default occurs, it makes sense for the amount due to yield interest at the mortgage or contract rate of that twelve percent. That makes the return on the investment consistent, fraught with no surprise and removes what would otherwise be an **advantage** to a defaulter!

The rate could even be higher. Some mortgages might provide that on default the balance shall bear interest at fourteen or fifteen percent, or perhaps the "highest rate allowable by law." In sum, the result of sage draftsmanship is that even in the face of default, the principal of the loan generates a respectable return, thereby diminishing any damage caused by a foreclosure mired in convoluted litigation.

A critical corollary to interest on default is interest on advances. Suppose a borrower allows insurance to lapse. To protect the security, which would otherwise be wiped out if the mortgaged premises burned down, the lender must consider paying the insurance premium.

Although that advance might only be five hundred dollars for one dwelling, the number swells across a large mortgage portfolio. What rate of interest is returned on those advances? Fortunately, the FNMA form mandates that the same rate of interest as the mortgage itself will apply. But other typical forms do not address the point, which means in most jurisdictions the **judgment** rate will attach — a yield most likely below the rate in the mortgage.

When there is a close relationship between the judgment rate and the face rate in the mortgage, the consequences of a discrepancy are less severe. Since, however, cyclical interest rates suggest that **eventually** rates will rise, and possibly much higher, the gap becomes more meaningful. The problem is solved simply by inserting a clause in the mortgage to cover the point.[5]

Precisely the same analogy can be made with regard to tax advances. When real estate taxes are not paid, ultimately the lender must pay those taxes or the lien of the mortgage will be extinguished by a tax deed to either the local taxing authority or the purchaser of a tax lien. (Procedures for divestment of title for failure to pay real property taxes are so

4. In some states, it may be called the "legal" rate. Since both terminology and rates are so divergent in the various jurisdictions, it suffices to discuss only the principle of what type of rate applies on default.

5. Consideration must also be given to the cost of funds to the lender or investor. If either of them borrows money at, say, twelve percent at some future time, in order to pay insurance premiums, when the return on that advance is only nine percent, a loss has been incurred — one that could easily be avoided.

disparate for the thousands of taxing jurisdictions around the country that the procedures cannot be discussed here. But the dangerous **result** is essentially the same.)

Although it is not often that the holder of a second mortgage need worry about it, the obligation to protect the mortgage by advancing taxes **can** occur. For example, during the term of the junior mortgage, a prior loan could be satisfied. Or, the first mortgage could be held by an individual not possessed of the sophistication usually associated with institutional lenders. Either way — and there are other scenarios — the holder of the second mortgage may indeed be constrained to pay those taxes. If that is the case, this advance too should bear interest at the mortgage rate — at a minimum.

As it is with insurance, FNMA imposes the mortgage rate for tax advances. Unfortunately, other standard forms do not. Lenders may therefore wish to consider a rider to a FNMA form to increase the applicable interest rate for this default, or if some different form is being used, address preparation of a clause to cover this event.

Interest on advances by no means stops with insurance and taxes. If a borrower defaults on a second mortgage, there will almost invariably be a default on the first mortgage. It is even possible that a prior mortgage could be breached — monetarily or otherwise — with the second still current. In either case, the junior mortgage is in jeopardy.

Because foreclosure of the first mortgage will extinguish junior liens, the holder of the second mortgage must either pay sums necessary to reinstate or satisfy the first mortgage in full. Recall that once the balance on a mortgage is accelerated, the lender can validly insist upon payment in full (unless it's prior to judgment and a FNMA form is being used). This means that protection of the second position will require some large outlay of cash. Extrapolating that concept to a portfolio makes the point that interest on advances of this magnitude requires strict attention. Since the mortgage must specifically make provisions for this, astute draftsmanship is once again essential.

Of lessor import, but still worthy of note, are advances for such peripheral charges as legal costs to defend a collateral attack on the mortgage, costs to cure violations on the property which the borrower may ignore and securing the property against vandalism should it become abandoned.

—DURATION OF INTEREST

In most jurisdictions, the last step before advertising the sale is entering a judgment. While the mechanics of this are within the realm of lender's attorneys, a conceptual issue arises at this juncture. Once the judgment is obtained, the total amount owed the lender (including all the possible advances discussed) will bear interest only at the judgment rate — even if the mortgage provided for interest on advances in the way it has been suggested.

Regrettably for lenders, the mere obtaining of a judgment does not assure that the litigation is at an end. There is always room for further dilatory tactics by the defaulting borrower — legitimate or otherwise. He may choose the eve of sale to file for bankruptcy, with all the detainment that causes. Or, he may suddenly claim that legal papers in the foreclosure were never served upon him, requesting an opportunity at the eleventh hour to submit an answer. And there are a host of other bases which can be put forward to intercept foreclosure, at least for a while.

If successful with any of these efforts, the lender's judgment amount could yield the comparatively low judgment rate of interest for an extended period, which could in turn endanger a loan where the sum due approaches the value of the property. A possible solution to this dilemma is a provision in the mortgage stating that the mortgage rate will apply until the property is sold in foreclosure or until the full amount due is paid. In some states, such a clause will not be effective. In others, it **may** be. Consultation with lender's counsel on the issue could be helpful.

—RECOUPING COSTS

There are any number of expenses a lender can incur during the life of a mortgage. If payment for these is to be made, the demand is unlikely to resist challenge unless the mortgage specifically supports the payment.

Suppose, for example, 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 may be inconsequential for one mortgage, but not for hundreds or thousands of loans. Repayment for bounced check charges **can** be made an obligation of the mortgage and **must** be if recovery here is to be obtained.

What if payment of taxes is an issue? Mortgages will always empower the lender to demand receipted tax bills to demonstrate payment. If the borrower neglects or refuses to honor this obligation, instead of foreclosing, the lender might elect to order a tax search to reveal the status of payments. The search costs money and repayment for that too should be mentioned in the documents.

When a mortgage is satisfied, resulting from litigation or the natural course of payments, the borrower is entitled to request a satisfaction piece to record, demonstrating to the world the lifting of the encumbrance. Because preparation of that document costs money, whether prepared in house or by lender's outside attorney, mortgage holders typically request a modest fee. But they can validly make that request **only** if the mortgage says so — and standard forms generally do not.

Other examples of peripheral charges that can accumulate are those incurred in processing insurance loss payments, ownership transfers, easements, extensions or modifications, reduction certificates, assignments, and releases of lien, among many others. Your mortgage should make reference to these and any other expenses unique to your business or locale.

CONCLUSION

No mortgage is now or ever could be entirely perfect. As in any area of evolving law, custom or regulation, there is always a new wrinkle which could never be anticipated. That doesn't mean, though, that a lender cannot strive to make its documentation as cost effective and responsive as possible to its needs.

Whenever a collection problem or difficulty in the foreclosure process is noticed, it is recommended that lender analyze the situation to see if a change in the documents themselves could have

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fice of Regulatory Policy, Oversight & Supervision'' which was the former "Office of Examination and Supervision" issued Memorandum AB 80 to clarify R41C. It raised almost as many questions as it answered, but for this group, the most relevant seems to be "compliance with Freddie Mac and FNMA appraisal and appraisal reporting guidelines (and standard form reports) is sufficient for appraisals on existing 1 to 4 family dwellings and multi-family properties."

The appraisal report of the future will probably require more research and analysis, such as a detailed sales history of the subject property for at least 3 years prior to date of appraisal, as well as sales history of many of the comparables.

FNMA and Freddie Mac are expected to issue amended guidelines to require six attachments to the FNMA standard form:

Pictures of the subject
Sketch of floor plan
Pictures of comparables
Map of subject and comp locations
Certificate (may be on file with lender)

For "proposed to be built" projects more in depth information and documentation will be required.

Heavy documentation of highest and best use considering current land use regulation, economic/market demand, trends, suitability, etc. will be required.

Some of the most significant areas of R41C is that it has:

1. Raised the consciousness of the financial industry.
2. It has established a definition of market value in a major segment of the market with an all cash reference.
3. Created the need for the appraiser to address market analysis — the appraiser to comment on the feasibility of the project.
4. When valuing a property which is a "mix" of real estate, tangible and intangible personal property (like a hotel which has L & B, management, leases, personal property, business value) value must be stated for real estate only and if desired, the other items may be valued.
5. Placed appraisers as well as management people under Title 18 of the U.S. Code. This is the criminal code which says in part: anyone who knowingly and willfully includes a false report over the value of land, etc., shall be liable to a fine (up to $5,000) and jail (up to 2 years) per count.
6. It recognizes the standards of practice adopted by the nine organizations and makes all appraisals subject to those standards.
7. The most controversial is the asset classification rules which create required reserves for different types of property loss projections. This was modified in part in February, but is still a significant item.

For the appraiser, the effect of all of this is a shift from the narrow, defined approach to appraisal, to a much broader approach, which includes the blending of market research with traditional appraisal.

"REMIC'S"

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creating multi-class instruments has been going on ever since the development of the CMO in 1983, REMIC's offer a much simpler, pass-through alternative to the somewhat cumbersome and complicated bond structure required with CMO's.

Having been involved with structuring what is thought to be the first second mortgage residential REMIC brought to market in the United States, I would recommend the following for any lender/originator who is considering a REMIC:

- Be patient!
- Have the ability to portfolio or warehouse at least $25-$100 million of mortgages.
- Obtain a good investment banker who understands the product and is willing to work hand-in-hand with you.
- Be sure you originate quality assets that will be placed in the REMIC.
- Be willing to commit resources to the project.
- Hire a good accountant that understands the product and can work hand-in-hand with you and your investment banker.
- Finally, be sure you have a thorough understanding of the loan loss and pricing models.

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prevented it. Over time, that can avoid many untoward consequences.

In the meantime, the suggestion here is that "standard" forms alone do not provide all the protection to which lenders are justly entitled. Attention to the propositions in this article just might help.