WHEN THE SENIOR FORECLOSES—SOME OBSERVATIONS UPON PROTECTING THE SECOND POSITION

By Bruce J. Bergman

One of the primary perilous aspects of holding or enforcing mortgages is the jeopardy imposed upon a junior lender when a senior mortgage goes into default. While, to be sure, such are the vicissitudes for which junior lenders must be steeled in advance, the danger to the subordinate position is not therefore rendered any less traumatic.

If default upon a first mortgage elicits a foreclosure action, the subordinate mortgagee obviously recognizes that its mortgage is subject to total extinguishment, and there is nothing more serious than that consequence. How to protect the junior position? The answer is found in some basic legal and business decisions.

Most often, when a senior mortgage goes into default, there is also a default on the subordinate mortgage. (It doesn't have to happen that way but as a practical matter it most often does.) Although vigilant attention to defaults is always recommended, first mortgagees have the luxury of knowing that they are in a senior position and, save loss of title for tax defaults or precipitous physical deterioration of the property, not much can sunder their security. That is not so for the subordinate lender who to a significant extent is at the mercy of a vigorous first mortgagee. Thus, when faced with a default upon a senior mortgage, the junior should give special consideration to instituting its own foreclosure faster than it might otherwise contemplate. The goal is for the junior to arrive at a foreclosure sale first, that is, before the senior. If achieved (and if there is equity in the property) someone should buy the property at the junior sale and the problem then evaporates.

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Even if the subordinate lender is unfortunately desultory in its attention to foreclosing, it should at least embark upon some reasonable steps to diminish the senior's ability to rush through to a foreclosure sale. In deed of trust states, where foreclosures move quickly, the ability to accomplish this may be quite limited. Where judicial foreclosure is the prevailing method, however, interposition of a general notice of appearance (or like document however it may be denominated in your state) adds not inconsiderable detainment to the first's foreclosure. At the same time, it allows the junior to track the progress of and assess the senior's efforts.

Whether or not the junior lender can beat the senior to the courthouse steps, when to advance money to the senior is a critical decision which must be addressed. This then leads to the realm of business, rather than legal, decisions.

The last thing a lender desires to do is write a check to someone else, even to protect its position. (You may have to do it, but you cannot be expected to like it.) Do you have to write a check? If the senior arrives at a foreclosure sale before you do, the answer is yes, unless you have no equity to protect.

Saving the vital strategy of protective bidding at a senior sale to some other occasion, let us address advancing sums to a senior **prior** to its foreclosure sale. The exigent point to consider is the default rate of interest on the senior mortgage *vis a vis* the junior. As you know, most well drafted mortgages will provide for the applicable rate of interest when default ensues. It could be the note rate, or it could be higher, for example, 12%, 14%, 18%, 24% or "the highest rate allowed by law."[1]

If an advance is made to the senior, the junior can add that sum to its own debt, together with whatever interest its own mortgage attaches to such advances. So, a key component in the ultimate analysis is whether it makes more sense to stop the accrual of interest on the senior **now**, adding the advance to your own debt, or allow interest due the senior to accrue.

An example should make the point. The first mortgage accrues interest at the default rate of 24%. Your junior mortgage assesses interest on advances at 14%. If you do nothing, interest on the senior, which you may eventually pay, mounts at a precipitous rate. If the advance **is** made, that accrual is reduced to 10% — the difference between the senior's default rate and your rate on advances. The higher the rate on your advances, the greater is the reduction in the interest buildup you suffer. (This all presupposes, of course, that you will ultimately collect on your debt.) If your advance rate is **greater** than the senior's default rate, then paying the senior could actually yield a **profit.**

In the end, its a combination of both a numbers game and a measurement of how perilous it is for your department to write a large check. It is rarely any easy choice, but it is one which must be knowledgeably faced.

[1]Note, in New York, as it is in some other states, usury does *not* have application to interest on default. In states where that concept applies, there is thus no limit upon what the default rate of interest could be, although as a practical matter, few lenders would consider assessing a rate in excess of that applicable to criminal usury. (In New York, for example, criminal usury can exist for rates in excess of 25%.)

State Bar Publishes Two Bergman Articles.

The January 1992 Convention issue of the *New York State Bar Journal* published an article by Bruce J. Bergman, a partner with the firm of Certilman Balin Adler & Hyman. Entitled "First Mortgage vs. Condominium Common Charge Lien — in Legal and Political Battle," this should be the seminal discussion of an extremely contentious dilemma facing both lawyers and legislators trying to untangle the priorities between certain mortgages and sums due to condominiums. The *Real Property Law Section Newsletter* of the State Bar followed in the January 1992 issue with Mr. Bergman's piece "Those Insidious Claims of Oral Representation — Some Emerging Comfort for Lenders." Mr. Bergman chairs the foreclosure department of the law firm and authored the two volume work, *Bergman on New York Mortgage Foreclosures.*