Mortgage Foreclosures Involve Combination of Law, Practice, Relationships and Strategies

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For some practitioners, the intricacies and unending nuance of major commercial mortgage foreclosures are of great interest. But for most attorneys, certainly those who do not practice regularly in the field, a broader picture of what a mortgage foreclosure action is about, and what the respective goals of plaintiffs and defendants are, may be more captivating.

Why, for example, was your client named in the foreclosure? Or, what are the unique compulsions from a plaintiff's point of view? Then too, experience suggests that genuinely appreciating the underpinning of the proceedings helps unlock the mysteries of what is often viewed as an arcane pursuit. Yes, the novel details can be stimulating, but for many, something more akin to a primer might just be in order.

Ultimately, foreclosure is a startling combination of law and practice, the chemistry of the relationships and the strategies.

The Goal of a Foreclosure

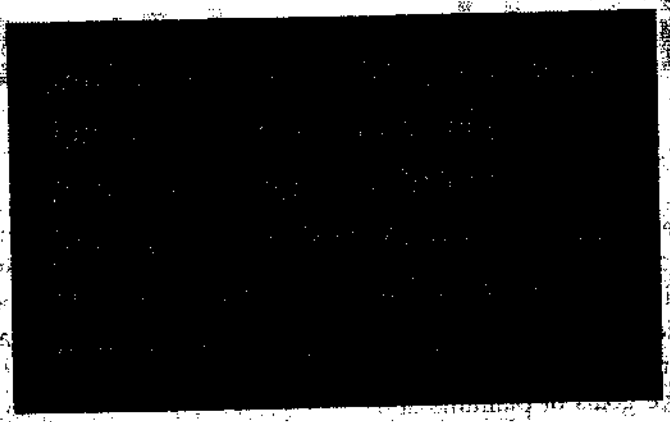
The goal is not as obvious as it might first appear. Aside from the plaintiff's desire to be made whole, the technical (although ultimately practical) goal of a foreclosure action is to cause the secured property to devolve through the foreclosure in the same legal condition it was when the mortgage was delivered. To more readily appreciate the portent of this stolid pronouncement, observe that at the inception, a mortgage lender motivated by commercial considerations makes two decisions—one, business, one legal. (This is in contradistinction perhaps to an elderly couple moving to Arizona who must take back a purchase money mortgage to facilitate the sale).

The former examines the prudence of the loan. Thus, if someone has $100,000 to spend and is buying a house assertedly worth $300,000, the need is to borrow $200,000 to complete the transaction. The question the lender asks is, would someone at a foreclosure sale pay $200,000 to buy a house worth $300,000? The answer is yes, suggesting that the business question has been satisfied.

In regard to the legal inquiry, assume that the lender expects to be in a first position. (Second or even more junior mortgage loans can be made, but for this example, contemplate a first mortgage.) A title search will be obtained and if there are any extant liens or encumbrances on the property—such as mortgages, mechanics liens, judgments, life estates, among a host of others—the lender will require that all be satisfied or disposed of as a condition of granting the loan.

Suppose that after the mortgage is executed, delivered and recorded, the owner-borrower (more precisely, the mortgagor) persuades some other lender to take a mortgage on the property for $100,000. The aggregate burden of debt on the property is now the equivalent of the property's value, $300,000. Does the original lender care? To the extent that such a quantum of debt portends the borrower's inability to remit mortgage installments, yes. But in a more compelling procedural sense, no. Should the borrower default, the original lender recognizes that the subsequent, junior, subordinate, mortgage holder will be named and served with process in the resultant foreclosure action. Presuming the efficacy of the service, one consequence of the foreclosure will be that the interest of the second mortgagee will be extinguished.[1] The purchaser at the foreclosure sale will own the property free and clear of the junior mortgage. In

short, the goal of the foreclosure will have been achieved—the property emerged from the foreclosure action in the same pristine legal condition it was when the first mortgage came into being, free of all liens and encumbrances. Conveniently, the business decision is also confirmed. Someone *would* pay $200,000 for a house worth $300,000. Conversely, the business contemplation would not have been fulfilled *unless* all subsequent lienors would be wiped out by the foreclosure action.



And the scenario of eliminating the peril imposed by later encumbrances applies to most later interests. So, if the borrower sells the property, the grantee takes subject to the mortgage and if named and served in the foreclosure action, that title is lost. Junior judgments are extinguished; likewise tenancies and so on. The only exceptions are real property taxes and certain municipal "super liens," the latter particularly of concern in New York City.

The issue of taxes is dealt with by the lender assuring payment by escrowing for taxes. Alternatively, the lender would procure tax searches, becoming thereby armed to insist that the borrower pay delinquent taxes, failing in which the lender can advance those sums, add them to the debt and foreclose for the tax default.[2]

Steps in the Foreclosure Action

The prevalent method of foreclosure in New York[3] is *judicial* foreclosure, governed by N.Y. Real Property Actions and Proceedings Law article 13 (RPAPL), although any attorney who could prosecute the case in sole reliance upon the desultory statutory provisions is worthy of deification. (*Non-judicial* foreclosure in this state is new and of much narrower application.[4])

Unlike most other litigation, which has few defined stages beyond initial pleadings and ultimate judgment, the foreclosure case has specific plateaus, each of which must be achieved in order. Inclusive of the internal procedures of mortgage servicers—which as a practical matter need to be recognized—these stages are as follows.

Collection Procedures In part because professional mortgage servicers want to preserve performing loans and avoid foreclosure, they initiate various calls and letters to the borrower, designed to elicit payment of arrears and reinstatement of the mortgage. Even though there is no firm rule, traditionally the duration of collection efforts typically does not exceed three months.

Acceleration Most mortgages require periodic payment installments, usually monthly and most often of both principal and interest. Any marginally well-drafted mortgage will also provide that upon the happening of certain events of default—such as failure to pay principal, interest or taxes, neglect to maintain insurance, among many others—the lender has the option[5] to declare due the entire outstanding balance of principal and interest.[6] If in our example the monthly mortgage payments were $1,500, after three months the lender might prefer to refrain from pursuit of the $4,500 in arrears (plus applicable late charges[7]) and instead accelerate the full balance of some $200,000. Acceleration is almost invariably the final act of the mortgage holder before the file is conveyed to counsel to foreclose.

Foreclosure Search Achieving the foreclosure goal necessitates naming all those with junior interests. Knowing who those potential parties are is revealed by analysis of a title search, the variety particularly tailored for a foreclosure action referred to, not surprisingly, as a foreclosure search.[8]

Pleadings Possessed with a listing of all junior interests, counsel prepares the summons, complaint[9] and, most often, the notice of pendency, commonly, the *lis pendens* (discussed, *infra*).

Filing of Pleadings An action in New York is instituted by the filing of the initial pleadings. Because it is possible that interests could attach to the mortgaged premises between the time the foreclosure search is completed and the pleadings filed, plaintiff's counsel is best advised to direct the title company to continue the search to the moment of filing.

Service of Process Litigators recognize the burdens of this endeavor. CPLR article 3 generally and CPLR 308(1), (2) and (4) and the service by publication dictates of CPLR 316 engender an extraordinary volume of intertwined case law. This is a particular problem in the foreclosure case both because there are often multiple defendants (all those junior lienors) and because an infirmity in service may not emerge—that is, may not be raised by a chagrined defendant—until the eve of the foreclosure sale. If service *was* defective, the ritualistic foreclosure process can be banished to the inception of the action.

Appearance and Answer[10] In addition to a CPLR 3211(a) motion to dismiss (which will only seldom have legitimate application) a defendant has four basic

advance with some modicum of equanimity. In the negligence case, for example, there are investigations and depositions susceptible to multiple adjournments, followed by lengthy trial calendars. But in the foreclosure case, interest upon the obligation accrues every day, often at a default rate in excess of the note rate. *Eventually*, with enough delay, mounting interest will create a debt greater than the value of the property. It is apparent, then, that time bears a relationship to generation of a surplus (a circumstance amenable to all) or a deficiency (an unwelcome occurrence for all).

A surplus emerges when the sum bid at a foreclosure sale exceeds the sum decreed due in the judgment to the foreclosing lender. A deficiency is a shortfall in recovery that may be viewed as the converse of a surplus, although the reverse correlation is not so exact. The deficiency is the difference between the sum due the foreclosing lender, inclusive of interest (to which is added the amount owing on all prior liens and encumbrances, also with interest, plus costs and disbursements of the action), and the greater of the market value of the foreclosed property on the date of the foreclosure sale of the proceeds of the foreclosure sale.

All parties to a foreclosure should be to some degree concerned about whether either a surplus or a deficiency will result. One way to gauge the importance of these possible events is to note the effect upon parties when there is neither a surplus nor a deficiency.

Suppose for illustration a mortgage loan of $400,000 on a property worth $500,000. (The concept would be the same for a $40,000,000 loan on a property worth $50,000,000.) Assume that the mortgage bears interest at 10% and that the borrower defaults upon the initial payment. Presume further that the foreclosure consumes one year of time to reach the juncture of a sale. The judgment of foreclosure and sale will have decreed that the sum due the foreclosing lender totals $450,000, consisting of $400,000 in principal and $40,000 in interest, with the remaining $10,000 consisting of accrued late charges, an escrow overdraft to pay taxes, together with legal fees, costs, disbursements and allowances.

On the final assumption that the value of the property had remained stable at $500,000 during the course of the foreclosure, there is some likelihood that the highest price bid at the foreclosure sale will be that sum of $450,000 due the lender. If the lender receives all the money due to it, it has neither necessity nor legal grounds to seek recompense from anyone liable for the debt—most often the borrower. Hence, there is no deficiency.

Nor is there a surplus. So long as the amount bid is no higher than the amount due the lender, no money is "left over." All proceeds go to the lender, so nothing remains against which anyone can claim.

Since most—but certainly not all—mortgage loans are designed at the inception to be prudent, there is often a "reasonable" relationship between the quantum of the loan and the value of the property it secures. The foreclosure sale *should* make the lender whole. The greater the positive disparity between the sum due the lender and the value of the property, the greater is the likelihood of a surplus. Only when the property is worth less than the amount due the lender can there be a possibility of a deficiency.

That the usual can readily become unusual should be immediately apparent. For example, if the foreclosure under discussion raced ahead in six months (unlikely though that is) and the property precipitously increased in value by 10% during that time, the numbers would clearly be different. Then the sum due the lender would be $430,000 (10% interest for six months instead of a year would total $20,000 rather than $40,000). With a 10% increase in value, the property would be worth $550,000. Under these circumstances, the difference between the total owed the lender ($430,000) and the market value of the property ($550,000) is a whopping $120,000. This suggests a considerable probability that any number of bidders would be most anxious to bid higher than the upset price. Every dollar bid above $430,000 then becomes surplus.

Although surplus is of no consequence to the foreclosing party (who cannot receive more than the debt), or to senior encumbrances (whose liens remain attached to the property), surplus is meaningful to the owner of property (usually, but not always, the borrower) who was divested of title by the foreclosure, as well as the holders of all interests of record *junior* to the foreclosed mortgage. Each of these persons or entities shares in the surplus in the order of their respective priorities.[22]

Returning to the converse—the deficiency—different assumptions in the scenario could reverse the result. Suppose that instead of taking one year, the foreclosure is contested and takes two years to complete. Now the interest component of the debt increases from $40,000 to $80,000. Assume also that the litigation adds $10,000 in additional legal fees and that the property declined in value by 10% rather than remaining stable or increasing.

Given the newly recited facts, the sum due the mortgage holder aggregates $500,000. With the property now worth $450,000, it is apparent that no one will bid a sum sufficient to make the lender whole at the foreclosure sale. The probability is that the lender will simply succeed to title by bidding a nominal sum at the sale. The lender will be deemed to have received $450,000—the value of the property. Having been owed $500,000, however, the loss, or deficiency, is $50,000. Whoever is personally liable for the mortgage debt can then be subjected to a motion to obtain a deficiency judgment.[23]

Personal Liability for the Debt

Inherent in the concept of mortgage foreclosure is sale of the property to satisfy the debt. But what if the property is worth less than the sum due to the mortgage holder? That, of course, is the noted deficiency situation, which then leads to contemplation of who the parties might be who are liable to the mortgagee.

Although this is a more ex- pansive subject than this anyone who has promised to pay the debt is a person so liable. Conspicuous in this category are signers of the mortgage note (or bond) and guarantors. They must be made defendants in the foreclosure action if that shortfall is to be assessed against them.

That such people or entities could be in jeopardy suggests that a mortgage holder might choose to forego a lengthy and possibly tortuous foreclosure, opting instead for an action at law on the note or guarantee. That could be a faster route to success and, if the obligors have the proverbial deep pockets, maybe the most efficacious way to proceed.[24]

One thing mortgagees most often cannot do is foreclose and pursue the monetary obligation simultaneously. New York, like most states, has a one-action rule or an election-of-remedies statute that prohibits such an oppressive dual assault.[25]

How Much Is Due the Lender?

The quantum of peril to those liable for the mortgage debt is a critical item in the process. Of course, the debt consists of principal and interest. Interest is generally a more momentous category than might first appear. If a mortgage is silent on the subject, upon default the principal bears interest at the contract or note rate—which is in essence the expected rate of return. If, however, the mortgage provides for some *other* rate to apply on default, that different and almost inevitably *higher* percentage will apply. That might be 15%, or 20%, or 24% or, as is so in New York, *any* rate of interest. Because interest on default is deemed neither to be a loan nor a forbearance, it cannot run afoul of usury proscriptions.[26]

But there is still more to it, some of consequence, some of less importance. Typically, a lender is entitled to recoup sums in a number of categories. Disbursements is one. Actual out-of-pocket expenditures in the foreclosure process—*e.g.*, index number, process service, foreclosure search, legal advertising, referee's fees—can be added to the foreclosure judgment. So too can late charges, but only up to the time the mortgage balance was declared due.[27] Among other sums are what various statutes may refer to as costs and allowances.

Of usually greater significance are legal fees.[28] Although no statute authorizes recoupment of legal fees in a foreclosure action, the contract (the mortgage) can so provide and typically does. Then, reasonable legal fees as determined by the court (not the referee) can be added to the judgment. Especially in a heavily litigated case, these sums can be quite substantial.

Also in the category of meaningful items are advances made by the plaintiff to protect the lien of the mortgage, such as taxes, insurance and payments to senior mortgagees. Depending on the nature of the property, these can be weighty amounts. And then there is the matter of interest on those advances. Here the same concept controls as with interest on the principal. If the mortgage is silent, the note rate applies. But if a separate provision is made, a higher rate can prevail. It is therefore easy to observe how a mortgage debt can precipitously rise well past expectations of the uninitiated.

Receiverships in Foreclosure

Notwithstanding that mortgagee's counsel is armed with all the techniques to solve the early problems in a foreclosure, a mortgagor could choose nevertheless to litigate. This situation can then be exacerbated by physical deterioration of the property, resulting in diminution of the mortgage security to the point where the mortgagee will sustain a loss.

A permutation of this idea relates to a commercial property, for example, a shopping center or an apartment building. The mortgagor subjected to a foreclosure, knowing the case will ultimately be lost, embarks on a course of action to "bleed" the property. He collects all the rents and profits but neglects repairs, payment of taxes, insurance and every other possible cost. This turns a handsome profit for the mortgagor and funds a protracted defense to the foreclosure. Under these circumstances, one need not expound at length upon the expected deteriorated value of the mortgaged property at the conclusion of the foreclosure.

In response to this very real dilemma, the mortgagee has a great asset in the ability to appoint a receiver.[29] In a foreclosure action, when the lender believes that the property may decline in value during the progress of the case or that the mortgagor or some occupant may allow the property to depreciate or be vandalized, the

appointment of a receiver is available to preserve the premises for the ultimate benefit of the mortgagee.

The receiver stands in the shoes of the owner. Once appointed and qualified, the receiver has the right to collect all rent due or to become due arising out of the premises. The receiver collects the income, maintains insurance, pays taxes and makes repairs. The property is, therefore, preserved. In addition, any excess income is applied to reduce the mortgage debt, and consequently a twofold purpose is served. Still further, the mortgagor's interest in delaying the foreclosure is greatly diminished, if not entirely eliminated.

Conclusion

How does one adequately sum up a subject as expansive as mortgage foreclosure? The ready answer is that it is not achievable. Even a delineation of but a few of the topics excluded exposes the futility of the endeavor: settlement strategies and devices, defenses to foreclosure, parties to the foreclosure action, venue of the case, deed in lieu of foreclosure, partial foreclosure, strict foreclosure, the upset price, foreclosure sale procedures and infirmities, condominium issues, co-op foreclosures and eviction after foreclosure.

Living with foreclosure every day, however, reveals that it is much like every other area of the law—when it is understood viscerally, it is not so mysterious. Maybe this will serve as a beginning.

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1. How, in turn, a junior mortgagee assesses and protects its position is in itself a worthy subject. For a further review, see 1 Bergman on New York Mortgage Foreclosures § 2.16, (Matthew Bender & Co., Inc. 2001) (hereinafter "Bergman"); *See also, Foreclosure of the Second Mortgage—The Nuances of Default on a Second Mortgage are Worthy of Note*, 11 Servicing Mgmt., 32 (Dec. 1999); *Are You Really Junior?—It Sure Matters!*, Equity, Oct., 1998, at 24; *Assault On The Second Mortgage*, 7 Servicing Mgmt., 15 (Mar. 1996); So *What's Your Position, Junior?*, 6 Servicing Mgmt., 68 (Feb. 1995); *A New Look at RPAPL Section 1351 Relief—A Treat for Lenders*, N.Y. St. B. Ass'n Real Prop. L. Sec. Newsl. Vol. 19, No. 4 at 7 (Oct. 1991).
2. What represents an actionable mortgage default is an expansive subject. For a lengthier analysis, see *Default and Acceleration*, in 1 Bergman ch. 4.
3. *See generally Overview and Guide to the Basics of Mortgage Foreclosure Concepts and Strategies*, in 1 Bergman ch. 2.
4. Non-judicial foreclosure—actually "power of sale" foreclosure in New York—became effective on July 7, 1998 with creation of a new RPAPL article 14. It sunset on July 1, 2001 with the reasonable prediction, however, that it would be extended. While designed to reach a sale within about three months of initiating the procedure, it is confined essentially to non-residential properties, does sometimes require court intervention, and has a number of infirmities which diminish its efficacy. For a further discussion, see *Non-Judicial Actions—Statutory Ambiguities Could Cause Delays in Default Cases*, N.Y.L.J., Feb. 10, 1999, p. 5, col. 2; *Non-Judicial Foreclosure*, in 1 Bergman ch. 8.
5. *See* 1 Bergman § 4.03.
6. *See Default and Acceleration*, in 1 Bergman ch. 4.
7. *See* 1 Bergman § 1.10.
8. *See Ordering and Analyzing the Foreclosure Search*, in 1 Bergman ch. 11. Who precisely those parties are to be is another major topic, for which reference is invited to *Parties to the Foreclosure Action*, in 1 Bergman ch. 12.
9. There is, of course, much to preparation of the complaint in a mortgage foreclosure action. For details, see *The Foreclosure Complaint*, in 2 Bergman ch. 16.
10. For a complete discussion of this subject, see *Responses to the Complaint: Law and Strategies for Plaintiffs and Defendants* in 2 Bergman ch. 19.
11. *See Role of the Referee*, in 2 Bergman ch. 20. *The Prickly Referee's Hearing—If You Stumble*, N.Y. Real Prop. L.J. Vol. 24, No. 1 at 36 (Winter 1996).
12. As a practical matter, a motion for summary judgment in the foreclosure case would also seek the appointment of a referee.
13. *See* 2 Bergman § 20.03.
14. *See* 2 Bergman § 20.06.
15. *See Judgment of Foreclosure and Sale*, in 2 Bergman ch. 27; *Foreclosure Sales—Unlocking The Bidding 'Mystery' There Shouldn't Even Be One*, N.Y.L.J., Nov. 29, 1995, p. 5, col. 2.
16. *See The Foreclosure Sale—Process and Elements*, in 3 Bergman ch. 30.
17. *See The Foreclosure Closing and Distribution of Sale Proceeds*, in 3 Bergman ch. 31.
18. *See* CPLR article 65; *Notice of Pendency in the Foreclosure Case*, in 1 Bergman ch. 15.
19. RPAPL § 1331.
20. For a discussion of practice tips relating to the filing of a *lis pendens*, see 1 Bergman, § 15.08[1].
21. CPLR 6501; 1 Bergman § 15.02.
22. For a full discussion of surplus monies in the foreclosure case, see *Surplus Money Proceeding*, in 3 Bergman ch. 35.
23. *See generally Deficiency Judgments*, in 3 Bergman ch. 34.
24. *See* 1 Bergman § 7.13.
25. *See Election of Remedies*, in 1 Bergman ch. 7.
26. *See* 1 Bergman § 6.02[3][g].
27. *See* 1 Bergman § 1.10. *Confirmed at Last—Yes, Virginia, There are Late Charges, and in New York Too*, N.Y.L.J., Jan. 26, 1994, p. 5, col. 2.
28. *See Legal Fees*, in 2 Bergman ch. 26.
29. For more on this subject, see *No Scamming This Time—Protecting Receiver and Foreclosing Plaintiff from Deception*, N.Y.L.J., Sept. 25, 1996, p. 5 col. 2; *The 5 Percent Question—Receiver's Commission: Confusion Reigns Over "How Much,"* N.Y.L.J., May 24, 1995, p. 5 col. 2; *Appointing and Paying Receivers in the Mortgage Foreclosure Action*, N.Y. St. B.J. Vol. 62, No. 1, at 34 (Jan. 1990); *Receiverships in the Foreclosure Action*, in 1 Bergman ch. 10.