REAL ESTATE UPDATE

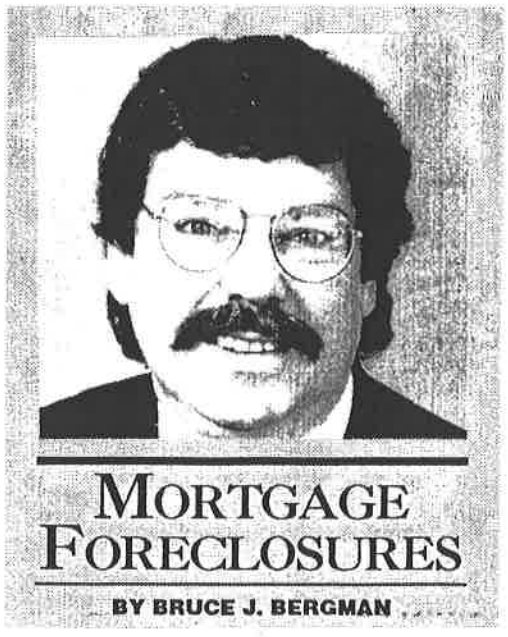
Introducing Instability

What? Failure to Pay Is Not Mortgage Default? Since When?

NOT SINCE time immemorial, or merry old England, or in this century (at least since 1930), except that a new case obliquely — and might it be immediately observed, bewilderingly — may say just that.[1] If there is any order at all to be made upon the subject of mortgage defaults, at least it can be said that the primary obligation of a mortgagor is to pay the debt, so that the most critical, seminal breach is the failure to pay.[2]

Is it possible, then that failing to remit a mortgage payment to the lender may not be per se actionable, creating something akin to a Yellowstone proceeding in a mortgage foreclosure case?[3] Should there be genuine validity to such a pronouncement, it has the potential to be patently destructive to the rights of mortgage holders which have otherwise been well understood and relied upon by mortgagees for so many years.

Comparing what the new case seems possibly to say with traditional notions of mortgage enforcement creates the dilemma. From a lender's perspective, the most potent weapon in the enforcement arsenal is the option to accelerate, that is, to declare immediately due and payable the entire balance of principal and interest. The leverage obtained, and concurrently the power to pursue foreclosure and protect the investment is obvious. Hence, a mortgagee's ability to exercise the acceleration option is of overriding importance.



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Terms of the Contract

To be sure, before acceleration can occur, there must be some default.[4] But a mortgage is a contract, to be construed pursuant to the parties' intentions and as expressed by their language.[5] Critically, courts are not empowered to supply an omitted contractual term under the guise of construction, so that where the language is clear and unambiguous, it must be given effect.[6]

Stated more specifically, the well established rule in New York is that a mortgagor is bound by the terms of his contract, including the acceleration clause.[7] This all suggests strongly and obviously that if a mortgage payment is not made, acceleration and foreclosure could readily follow, virtually immune to assault.

As it almost always is with the law, there are exceptions to the rules. But here, the category of exception is key. Acceleration, for example, is considerably less certain where the nature of the default is neglect to pay real

property taxes.[8] Although a compelling and coherent argument can be made as to the seriousness of such a defalcation, case law twice as often will deaccelerate the mortgage if real property taxes are ultimately paid.[9]

Another area where enforcement is perhaps difficult to predict with certitude is the breach of failure to repair.[10] Similarly irresolute are alterations without mortgagee's consent[11] and the existence of building violations.[12] Stronger and more comforting for the lender are the provinces of demolition without consent[13] and failure to issue an estoppel certificate.[14]

Failure to Pay

Effectively irresistible is breach of the due on sale provision[15] and breach of the obligation to insure the mortgaged premises.[16] And at the pinnacle of the mortgage enforcement hierarchy is the avoidance of that most sacred obligation, the imperative to pay.

Although it may be an old story to veterans of foreclosure campaigns, before 1930, New York Courts certainly considered failure to pay principal and interest to be a material breach of the mortgage contract and generally permitted acceleration for that default. The case law, however, was somewhat unfocused. Whatever amorphous doubts may have existed were banished in 1930 when *Graf v. Hope Building Corporation*[17] was decided by the Court of Appeals.

The seminal and perhaps most frequently cited cases in the realm of foreclosure law, *Graf* became the template against which defaults and their relationship to acceleration are measured. *Graf* was followed in 1932 by *Albertina Realty Co. v. Rosbro Realty Corp.*,[18] which was, in turn, followed by *Ferlazzo v. Riley.*[19] *Graf, Albertina* and *Ferlazzo* form a fundamental trilogy that is repeatedly relied on by the New York courts when addressing mortgage defaults.

These cases and their progeny clearly establish that failure to pay principal and interest is a firm basis upon which a mortgagee may resort to acceleration and that acceleration premised upon such default is neither penalty nor forfeiture. Interwoven with these rules enunciated in *Graf, Albertina* and *Ferlazzo* are the concepts that a borrower is bound by the terms of the mortgage contract, and accordingly, default cannot be relieved unless fraud, unconscionable or oppressive conduct, waiver or estoppel on the lender's part is established.[20]

'Graf'

The facts in *Graf* so stunningly make the point of a pervasive, strict acceleration doctrine in New York (for failure to pay) that a review should buttress this analysis.

The lender in *Graf* held two consolidated mortgages with a 20-day grace period attendant to payments. The principal of the mortgagor corporation was the only person authorized to sign checks. That principal was embarking upon a foreign trip which was to commence eight years before the mortgage would have come due in the normal course.

Before he left, his clerk incorrectly computed the interest believed to be due. The principal signed the check for the unknowingly deficient sum and left for Europe. Fortuitously, the error was recognized before the date the remittance was due. The mistake was revealed to the lender who was told that when the principal returned from Europe, the shortfall would be made good.

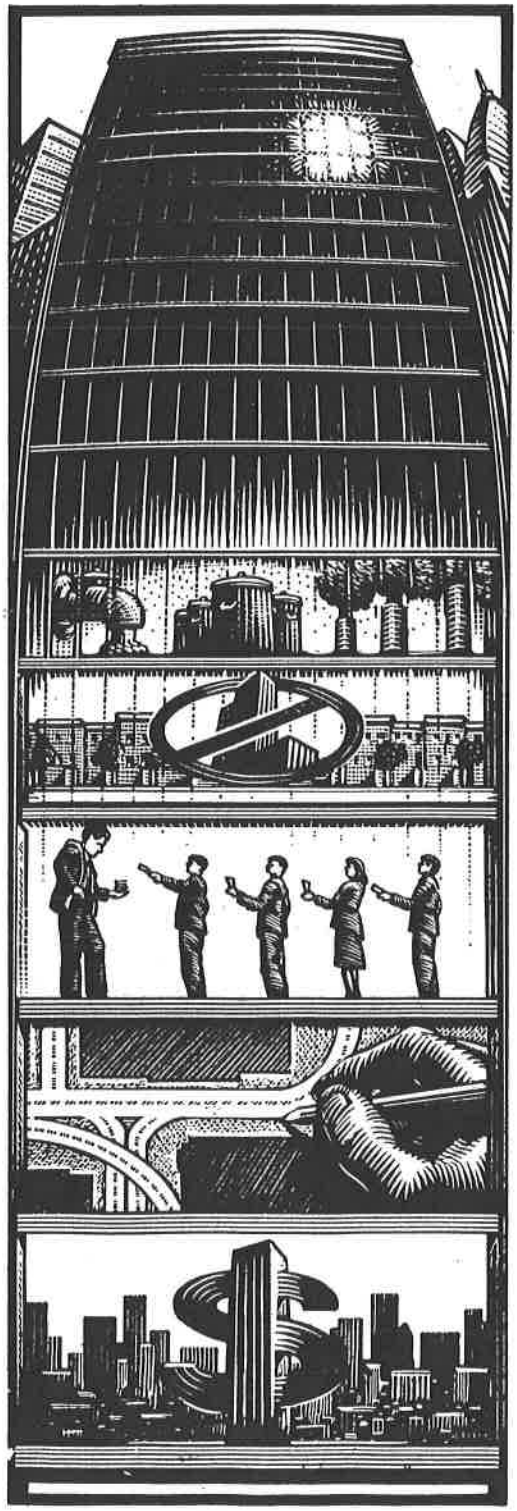

ILLUSTRATION BY JOHN MacDONALD

Pending such submission, however, the already signed check for the smaller amount was to be forwarded. The lender received and negotiated the check for the lower amount. Unexpectedly, another error in payment occurred unbeknown to the corporate principal despite his presence upon returning from Europe. In the face of what had ripened into a default, the lender commenced a foreclosure action one day after the grace period. At that point, the borrower submitted the arrears. The lender, though, insisted upon the strict terms of its mortgage contract, rejected the tender and declined to halt the foreclosure action.

The Court of Appeals, in reversing the First Department's decision to the contrary, held for the lender, enforced the validity of the acceleration and found the tender by the borrower to have been properly rejected. In so holding, the Court of Appeals made these observations which set the trend for what continues to be the status of the law on these points:

> "On the undisputed facts as found, we are unable to perceive any defense to the action . . . [the lender] may be ungenerous, but generosity is a voluntary attribute and cannot be enforced . . . Here there is no penalty, no forfeiture . . . nothing except a covenant fair on its face to which both parties willingly consented. It is neither oppressive nor unconscionable . . . In the absence of some act by the [lender] which a court . . . would be justified in considering unconscionable he is entitled to the benefit of the covenant. The contract is definite and no reason appears for its reformation by the courts . . . We are not at liberty to revise while professing to construe. Defendant's mishap, caused by a succession of its errors and negligent omissions, is not of the nature requiring relief from its default. Rejection of plaintiff's legal right could rest only on compassion for defendant's negligence. Such a tender emotion must be exerted, if at all, by the parties rather than by the Court. Our guide must be the precedents prevailing since courts of equity were established in this state. Stability of contract obligations must not be undermined by judicial sympathy. To allow this judgment to stand would constitute an interference by this court between parties whose contract is clear." [21]

Acceleration

The principles enunciated in *Graf* together with the considerable progeny the decision has engendered provide a firm judicial stance permitting acceleration when there is a default in payment upon a mortgage, and there is no doubt about it.

Consequently, that the lender has acted aggressively, or that the results are harsh, will not provide the basis for equitable relief in favor of the borrower.[22] Acceleration premised upon a default in paying principal and interest is not avoided upon a plea of sympa-

thy.[23] The borrower will also be unsuccessful in attacking the acceleration on the basis that the default is for a de minimis amount.[24]

Where the mortgage breach is neglect to pay a sum due the lender, acceleration is permissible immediately upon expiration of the applicable grace period. Accordingly, acceleration may ensue, six days,[25] three days,[26] or even one day after the grace period has concluded.[27]

Confronted then with a 64-year onslaught of cases from the Court of Appeals on down palpably asserting that neglect to pay is the cardinal sin of mortgage commerce, what tribunal would deign to say it ain't so? The Third Department may have attempted (inadvertently) to do just that.[28] Of course, the facts require analysis.

Plaintiffs contracted to purchase a substantial unimproved parcel from defendants. The conveyance was made contingent upon town approval of a subdivision and use of an existing right of way.

However, plaintiffs soon waived these contingencies, proceeded to close and executed a purchase money mortgage to defendants.

After the closing, plaintiffs sought, but were denied, town approval for a subdivision and use of the existing right of way for access to the parcel. Claiming that defendants and their real estate agents fraudulently induced the transaction by misrepresenting that preliminary subdivision approval had been granted by the town, plaintiffs launched the suit and pleaded for monetary damages.

Further, and upon the advice of their attorney, plaintiffs refrained from remitting monthly mortgage installments to defendants/mortgagees, instead depositing those sums with the county clerk.

A lawsuit was one thing; a mortgage default another. Defendants accelerated the mortgage balance and counterclaimed for mortgage foreclosure. The result was essentially a standoff.

The complaint against defendants/mortgagees was dismissed. (Plaintiffs could easily have determined the truth or falsity of the alleged representations about preliminary subdivision approval. Anyway, there could not have been reliance upon the assertions, if made, because an express provision in the contract meaningfully contradicted the oral representation, thus negating possible reliance upon the latter).

But the counterclaim for foreclosure was also denied, conditioned upon turnover of the funds in the county clerk's account to defendants. (Nothing was said in the decision about lost interest.)

In its affirmance, the Third Department's penultimate declaration casually addressed the mortgage default (failure to pay) with this language:

"As a final matter, in the absence of evidence of bad faith, we have no disagreement with the Supreme Court's equitable determination that plaintiffs' deposit of several mortgage payments into escrow did not constitute a breach justifying acceleration of the note and mortgage."

Of course, none of this is in accord with *Graf*. Bad faith is not the issue. The borrower in Graf certainly evidenced no bad faith, merely an understandable, sympathetic, inadvertent error. Yet he suffered foreclosure. In the offending case, the borrower did not even have a viable action to support withholding of mortgage payments. It may appear forthright and symmetrical to deposit payments with a neutral court officer or elected official, but the net result, the funds not being paid to the mortgagee, is precisely the same.

So the problem with the case is that it opens the door to defaulting borrowers to deny an income stream to a lender under the guise of litigating a legitimate but perhaps faintly related "issue."

If the property is income producing, the litigation protracted, and the mortgagee in reduced circumstances, it's a recipe for disaster. An innocent lender could be bludgeoned into anything if the circumstances are right (or maybe more aptly, wrong) if this case will serve as precedent. And *that* is the problem.

Here, the mortgagors may have been pardonable naifs. Once a default existed, the result of their misadventure would have been to suffer foreclosure (or be forced to refinance) because a mortgagee can lawfully reject reinstatement after acceleration.[29]

The court did not want that to happen. To avoid a perceived draconian result, the court purported to invoke equity, understandable and assuredly commendable, but violative of Court of Appeals doctrine.

It is doubtful that the court affirmatively intended to subvert precedent on this point. Rather, it somewhat offhandedly reached a practical and amiable solution to an odd happenstance. The hope, for lenders at least is that this holding stays *sui generis* and does not proliferate. *In*stability will do nothing to aid a troubled arena.

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(1) *Pinney v. Beckwith*, ___ AD2d ___ , 608 NYS2d 738 (3d Dept. 1994).

(2) *Graf v. Hope Building Corp.*, 254 NYl, 171 NE 884 (1930).

(3) As apparently set forth in *Pinney v. Beckwith*, supra, at note 1.

(4) *King v. Giordano, NYLJ*, June 21, 1978, at 15, col. 3 (Sup.Ct., Kings Co.); *Dale Holding Corp. v. Dale Gardens Inc.*, 186 Misc. 940, 59 NYS2d 210 (1945).

(5) *Brayton v. Pappas*, 52 AD2d 1871, 383 NYS2d 723 (4th Dept. 1976).

(6) Id.

(7) *Laber v. Minassian*, 134 Misc2d 543, 511 NYS2d 516 (1987).

(8) See 1 *Bergman on New York Mortgage Foreclosures*, §4.14[1][a],[b],[c] and [d] (Matthew Bender & Co. Inc., rev. 1994).

(9) Compare the cases cited at 1 *Bergman on New York Mortgage Foreclosures* §4.14[c] with those noted at §4.14[d].

(10) See cases cited at 1 *Bergman on New York Mortgage Foreclosures*, §4.14[2].

(11) See cases cited at 1 *Bergman on New York Mortgage Foreclosures*, §4.14[3].

(12) See cases cited at 1 *Bergman on New York Mortgage Foreclosures*, §4.14[5].

(13) See cases cited at 1 *Bergman on New York Mortgage Foreclosures*, §4.14[4].

(14) See cases cited at 1 *Bergman on New York Mortgage Foreclosures*, §4.14[6].

(15) See cases cited at 1 *Bergman on New York Mortgage Foreclosures*, §4.11.

(16) See cases cited at 1 *Bergman on New York Mortgage Foreclosures* §4.12.

(17) Supra, at note 2.

(18) 258 NY 472, 180 NE 176 (1932).

(19) 278 NY 289, 16 NE2d 286 (1938).

(20) *Ferlazzo v. Riley*, 278 NY 289, 16 NE2d 286 (1938); *Albertina Realty Co. v. Rosbro Realty Corp.*, 258 NY 472, 180 NE 176 (1932); *Graf v. Hope Building Corp.*, 254 NY1, 171 NE 884 (1930); *Mariash v. Bastianich*, 88 AD2d 829, 452 NYS2d 190 (1st Dept. 1982); *National Bank of North America v. Cohen*, 89 AD2d 725, 453 NYS2d 849 (3d Dept. 1982); *Hudson City Sav. Inst. v. Burton*, 88 AD2d 728, 451 NYS2d 855 (3d Dept. 1982); *Ford v. Waxman*, 50 AD2d 585, 375 NYS2d 145 (2d Dept. 1975); *Shell Oil Co. v. McGraw*, 48 AD2d 220, 368 NYS2d 610 (4th Dept. 1975); *Albany Sav. Bank v. Clifton Park Equity Dev. Ltd.*, 46 AD2d 823, 360 NYS2d 512 (3d Dept. 1974); *Jamaica Sav. Bank v. Cohan*, 36 AD2d 743, 320 NYS2d 471 (2d Dept. 1971); *Kelmenson v. Boulevard Constr. Corp.*, 232 AD 847, 249 NYS 46 (2d Dept. 1931); *Pizer v. Herzig*, 120 AD 102, 105 NYS 38 (1st Dept. 1907); *In Rem Tax Foreclosure Action No. 31, Borough of Manhattan*, 136 Misc2d 522, 518 NYS2d 916 (1987); *George H. Nutman Inc. v. Aetna Business Credit Inc.*, 115 Misc2d 168, 453 NYS2d 586 (1982); *Gratton v. Dido Realty Co., Inc.*, 89 Misc2d 401, 391 NYS2d 954 (1977); *Stith v. Hudson City Sav. Inst.*, 63 Misc2d 863, 313 NYS2d 804 (1970); *Bolmer Bros. v. Bolmer Construc. Co.*, 114 NYS2d 530 (Sup.Ct. 1952); *A.C. & H.M. Hall Realty Co. v. Bel-De-Bue Inc.*, 72 NYS2d 659 (Sup.Ct. 1947); *Armstrong v. Rogdon Holding Corp.*, 139 Misc. 549, 247 NYS 682 (1930).

(21) *Graf v. Hope Building Corporation*, 254 NYl, 171 NE 884 (1930), at 4-5.

(22) *Key International Manufacturing v. Stillman*, 103 AD2d 475, 480 NYS2d 528 (2d Dept. 1984); *Shell Oil Co. v. McGraw*, 48 AD2d 220, 368 NYS2d 610 (4th Dept. 1975); *Jamaica Sav. Bank v. Cohan*, 36 AD2d 743, 320 NYS2d 471 (2d Dept. 1971).

(23) *Graf v. Hope Building Corporation*, 254 NYl, 171 NE 884 (1930); *Jamaica Sav. Bank v. Cohan*, 36 AD2d 743, 320 NYS2d 471 (2d Dept. 1971); *Laber v. Minassian*, 134 Misc2d 543, 511 NYS2d 516 (1982); *Verna v. O'Brien*, 78 Misc2d 288, 356 NYS2d 929 (1974).

(24) *In Rem Tax Foreclosure Action No. 31, Borough of Manhattan*, 136 Misc2d 522, 518 NYS2d 916 (1987).

(25) *Bolmer Bros. v. Bolmer Constr. Co.*, 114 NYS2d 530 (1952).

(26) *Albertina Realty Co. v. Rosbro Realty Corp.*, 258 NY 472, 180 NE 176 (1932).

(27) *Graf v. Hope Building Corporation*, 254 NYl, 171 NE 884 (1930).

(28) *Pinney v. Beckwith*, ___ AD2d ___ , 608 NYS2d 738 (3d Dept. 1994).

(29) See 1 *Bergman on New York Mortgage Foreclosures*, §4.06.