Critical Strategy When a Lender Holds Two Mortgages on the Same Property*

Bruce J. Bergman**
Garden City, New York

EDITORIAL COMMENT: We are again privileged to have a piece by Bruce Bergman in the area of his expertise of mortgage foreclosure. He deals with the interesting and important matter of two mortgages in the hands of a single party, and the considerations that apply in proceeding to foreclosure. The piece may make one recall the story of the Lady and the Tiger, but Bruce does not leave you hanging in the air. He suggests ways to proceed.

Introduction

When a lender holds two mortgages on the same property, the strategy employed in foreclosing those mortgages can either provide protection or engender a loss. How to assess the situation does not readily emerge simply from a reading of case law, which suggests that a practical analysis of the options available can be quite helpful.

Suppose, for example, a lender gives a two hundred thousand dollar mortgage on a property worth three hundred fifty thousand dollars. For some reason — and it does occur — the borrower later requests and is given an additional fifty-thousand dollar loan secured by a mortgage on the same property. If there are no intervening judgments, liens, mortgages or other encumbrances which have attached to the property since the recording of the original mortgage, the lender would typically consolidate the new mortgage with the original so that they form one lien. Sometimes though a lender may not follow that path and may be content simply to hold two separate mortgages, the first senior and superior to the second.

If there **had** been intervening interests, a consolidation could not in any event have elevated the junior mortgage to a position of superiority over those intervening interests. In this latter situation, consolidation would have perhaps been inappropriate.

When there is an uncured default on two separate mortgages held by the same lender on the same parcel, eventually both mortgages should be accelerated and then a foreclosure of one or both mortgages must ensue. Because they are separate debts, they cannot be combined in one action.

The lender then faces the choice of how to proceed and there are a number of alternatives, each of which require some explanation of the foreclosure process. To immediately assess the courses of action recommended, perhaps the best choice is to foreclose the junior (or second) mortgage initially. The next choice, although it may be equal in efficacy to the first option, is to initiate foreclosures on both mortgages simultaneously. The least effective course is to foreclose only the senior mortgage — although there is a possible solution to the infirmity of this final path. The explanations follow.

The First Option — Foreclosing the Junior Mortgage

If the junior mortgage alone is foreclosed, the lender will either derive all sums due upon that obligation (thus being made whole) or will itself be the successful bidder at the foreclosure sale and succeed to title. If an outside bidder buys, that bidder takes the property burdened by the lender's senior mortgage, which of course survives foreclosure of any junior interest. The bidder, who then becomes the owner when there is a closing after the foreclosure sale, must then either satisfy the surviving senior mortgage — thus making the lender whole for the remaining portion of the mortgage loan — or suffer divestment of title through foreclosure of the senior mortgage.

If the new owner pays off the mortgage which remains, the lender has derived complete recompense for the loans. If the new owner is unable or unwilling to satisfy the surviving mortgage, a foreclosure sale will yield either the sum due the lender or title to the property. With fifty thousand dollars in hand from the initial foreclosure, the lender should suffer no loss in owning the property for a two hundred thousand dollar investment (the amount of the first mortgage) when the property is worth three hundred thousand dollars. (In stating that the lender received

(Continued on Page 22)

(Continued from Page 21)

fifty thousand dollars upon the initial foreclosure sale, the amount is presented solely for illustrative purposes. A loan in that amount, even with an immediate default, would generate a larger sum owed to the lender by the time a foreclosure sale occurs because the actual sum due would be increased by interest, costs, disbursements, allowances and if applicable, legal fees.) [See *Bergman on New York Mortgage Foreclosures*, Chapter 27 for a discussion of the various additions to the amount owed. See Chapter 28 for a discussion of computing the upset price and Chapter 26 to assess whether legal fees will be compensable.]

The Second Option — Foreclosing Both Mortgages

Instead of foreclosing only the second mortgage, the lender could opt to simultaneously initiate foreclosure of both the first and second mortgages. The goal would be to bring the junior mortgage to a sale first. (Reversing the order of sale would damage the lender because foreclosure of the senior mortgage would **extinguish** the junior, the consequences of which will be discussed under option three.) Strategically, both foreclosures would be brought to the point where a judgment of foreclosure and sale has issued. A sale would be advertised for the junior mortgage [See *Bergman on New York Mortgage Foreclosures*, Chapter 30 for discussion of the requirements for advertising], but the senior foreclosure would halt in place at the moment of judgment.

The scenario then returns to option number one. If no one bids at the junior sale, the lender becomes the owner, free to sell the property for any amount — presumably in excess of the aggregate of both its mortgages. (The lender can of course issue a satisfaction of its senior mortgage when the property is sold and at the same time discontinue the senior foreclosure and cancel the lis pendens.)

If there **is** a bidder at the junior foreclosure sale, title is taken subject to the senior mortgage which, under this second approach, is imminently to result in a sale. Therefore, the new owner is compelled to satisfy the surviving senior mortgage that much faster or suffer loss of title at the foreclosure sale. Hence, there is some advantage to what is here denominated the second choice.

The Third Option — Foreclosing the Senior Mortgage

A lender **could** elect to refrain from foreclosing the junior mortgage and choose instead to initiate foreclosure upon the senior mortgage alone. Since holders of interests junior and subordinate to the mortgage in foreclosure are "necessary" parties [See *Bergman on New York Mortgage Foreclosures*, Chapter 12 for exploration of the parties to a foreclosure action], this suggests the anomalous necessity for the lender to name itself in the foreclosure in its capacity as second mortgagee. That means that at the foreclosure sale, anyone who takes title does so **free** of the lender's junior mortgage which was extinguished by the sale. While presumably the lender will derive two hundred thousand dollars at the foreclosure sale (plus interest, costs, disbursements, allowances and, if applicable, legal fees), what has happened to the fifty thousand dollars secured by the now-extinguished junior mortgage? The simple response is that this sum is lost, which is hardly a favorable result for the lender. Hence, foreclosing solely the senior mortgage when the lender holds both a senior and junior mortgage position is a dangerous approach which portends a loss.

Solutions to Foreclosing Senior Interest Alone

Notwithstanding the patent infirmity in foreclosing a senior interest when the lender holds both a senior and junior mortgage, there are two alternatives which can solve the problem. One solution is for the lender to refrain from naming itself as a party defendant as a junior mortgagee. While in its subordinate capacity the lender is indeed a necessary party, it is not an indispensible party. It retains the option to purposefully neglect to name itself as a party defendant. [See *Bergman on New York Mortgage Foreclosures*, Chapter 12 for explanation of the distinction between necessary and indispensible parties.] If no one objects to that non-joinder, the result is that the lender's unnamed junior interest survives the foreclosure sale and continues to encumber the property. Then the bidder at the senior foreclosure sale will be bound to satisfy what had been a subordinate mortgage or suffer foreclosure in failing to do so.

There is, however, a caveat to consider here. Other defendants in the foreclosure action **can** object to the non-joinder. If the court believes the non-joinder will result in prejudice to any party, it has the authority to order joinder. In that instance, the noted solution will fail. [See *Bergman on New York Mortgage Foreclosures*, Chapter 12, for an explanation of the circumstances under which joinder can be mandated.]

There is yet another alternative for the lender who elects to foreclose the senior mortgage alone and at the same time name itself as a party defendant. Recalling that in the example the sum due the lender upon the senior mortgage is two hundred thousand dollars, and upon the junior mortgage, fifty thousand dollars (enhanced in reality in each instance by interest, costs, disbursements, allowances and, if applicable, legal fees), the lender could proceed upon the assumption that the property is genuinely worth well in excess of the mortgaged sums, *i.e.*, three hundred fifty thousand dollars.

At the foreclosure sale (of the senior mortgage), the lender could bid up to the two hundred thousand dollar "upset price." [See *Bergman on New York Mortgage Foreclosures*, Chapter 28 for discussion of upset price computation.] If that is the successful bid, the lender has an apparent bargain because it then owns the property and can presumably sell it for at least what is owed to it, and probably considerably more than that. With such a property value, however, there is certainly a possibility, and perhaps a probability, that some outside bidder would wish to avail himself of an apparent bargain by bidding two hundred one thousand dollars. Although the

(Continued on Page 23)

(Continued from Page 22)

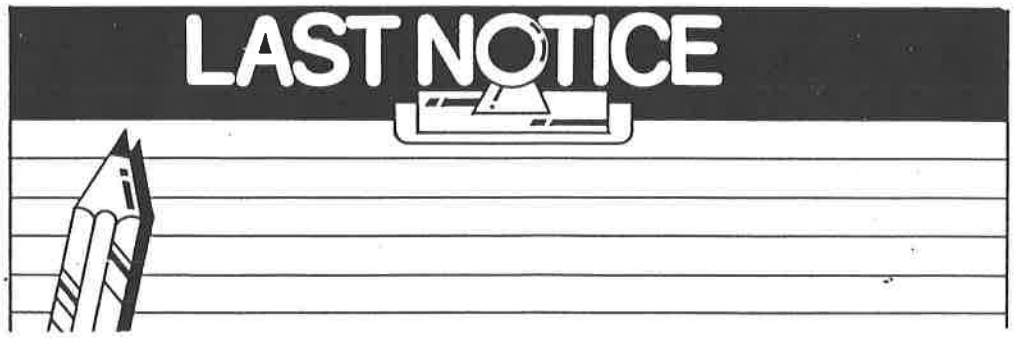
lender then recoups the sum due on the senior mortgage, it loses the amount owed on the junior mortgage.

The lender's riposte is to outbid everyone — **up to the aggregate due on both its mortgages**, *i.e.*, two hundred fifty thousand dollars. To explain, if someone bids two hundred one thousand dollars, the lender can bid two hundred two thousand dollars. (The bidding could, it should be observed, proceed in smaller increments.) If there are no further bids, the lender becomes the owner. At the noted bid amount, the lender has created a **surplus** of two thousand dollars. Assuming that the most senior encumbrance on the property extinguished by the sale was the lender's junior mortgage — which is a critical assumption — the first claimant to surplus is the lender. Thus, it owns the property, at a bargain price, **and** recoups the two thousand dollar surplus.

This scenario prevails all the way up to a bid price of two hundred fifty thousand dollars. If the bidding goes that far — which is not unrealistic under the circumstances — the lender becomes the owner **and** recoups the fifty thousand dollar surplus. Past two hundred fifty thousand dollars, the lender need not bid (and should not bid unless its primary goal is to own the property) because it is assured of garnering both the two hundred thousand dollars due on the senior mortgage and, through surplus, the fifty thousand dollars due on the junior mortgage. [For a detailed review of surplus money proceedings, see *Bergman on New York Mortgage Foreclosures*, Chapter 35.] Indeed, pursuant to RPAPL Section 1351(2) the lender can be paid the amount due on its second mortgage without necessity of a surplus money proceeding so long as there are no other mortgages on the premises. [See RPAPL Section 1351(2) for the requirements to bring about this result.]

Although this scenario provides comfort to the lender, it presupposes that the lender has first priority to claim against surplus. That would not be the case if interests intervene between the lender's first and second mortgages. Consequently, caution in analyzing the status of title to the property is essential here.

****Mr. Bergman is a partner in the law firm of Roach & Bergman in Garden City and an adjunct, associate professor of real estate with New York University's Real Estate Institute where he teaches the mortgage foreclosure course. He is a member of the American College of Real Estate Lawyers and past chair of the Real Property Law Committee of the Nassau County Bar Association. He is the author of *Bergman on New York Mortgage Foreclosures*, Matthew Bender & Co., Inc. (1990).**



Real Property Law Section
Summer Meeting

July 11-15, 1990

Sonesta Beach Hotel & Spa
Bermuda