CRITICAL MORTGAGE CLAUSES FOR DRAFTING AND LITIGATION*

By Bruce J. Bergman

Introduction

Stating what upon presentation is obvious may not be the ideal way to seize attention, but it is nevertheless worthy of observing that the verbiage used in a mortgage is of overriding importance in the enforcement of the document. Whether there is an actionable default is a function of what the mortgage says. The remedies for breach depend upon the provisions of the mortgage. And what sums are secured by the mortgage — and thus collectible from those obligated for the debt — are typically broader than the principal and interest recited in the mortgage note. These amounts too come from the language of the mortgage.

If one contemplates the verbosity of a typical bank mortgage, it will suggest — and correctly so — that drafting an appropriately expansive mortgage to address almost anything which might occur in a complex transaction is a daunting task. Even assuming anything close to perfection is achievable, it is rarely necessary. Some provisions really are more basic, more relevant and, thus, more meaningful.

With the caveat that we do not here intend to even approach the full breadth of mortgage drafting, let us highlight some practical necessities.

Legal Fees

If a lender is constrained to foreclose, from its perspective, being awarded legal fees in the action seems quite appropriate. A borrower would hardly join in the delight, but the subject is obviously important. To make the point immediately, legal fees *can* be awarded in a mortgage foreclosure case, if the *mortgage* so specifies, although always in an amount a court deems reasonable.[1]

For some detail, the prevailing American rule is that each party to a lawsuit must bear its own counsel fees.[2] This general rule can be altered, however, either by statute or contractual agreement between the parties.

In New York, no statute requires a mortgagor in a foreclosure action to pay the legal expenses incurred by the foreclosing plaintiff in prosecuting the action. However, such an obligation can be, and frequently is, included in the mortgage documents. New York courts have consistently held that legal fees are awardable to a foreclosing plaintiff in the judgment of foreclosure and sale where the mortgage documents so provide.[3]

The essence of decisional law in New York is clear. Where a mortgage provides for legal costs to the foreclosing party, it is to be enforced. Moreover, the right of a mortgagee to recovery of reasonable attorneys' fees is recognized if it is provided for in the mortgage instrument,[4] and contracts which provide for the payment of reasonable attorneys' fees by an opposing party will be enforced.[5] Provisions which require the payment of an attorney's fees when the lender is required to retain counsel are not uncommon[6] and may be considered an enforceable provision for liquidated damages.[7]

While an appropriately worded clause in a mortgage will compel an award of attorneys' fees upon foreclosure, such a clause, if inserted only in the note or bond, will not be sufficient to support such an award. This is so even when the terms of the note are incorporated by reference into the mortgage.[8]

The reason for this rule is that if a clause for the payment of attorneys' fees contained in a document other than the mortgage is enforced, then the lender will have priority over the borrower's judgment creditors, who will not have had notice of the borrower's obligation.[9]

Precisely when language in a mortgage will support an award of counsel fees is sometimes a source of consternation to parties employing the widely used statutory or standard title company form of mortgage. While that form does mention attorneys' fees, it provides for recovery of legal expense only in actions other than those brought to foreclose the mortgage. Attorneys' fees, therefore, cannot be awarded in a mortgage foreclosure action based upon a mortgage containing that standard clause.[10] Similarly, legal fees will not be awarded if a derivative of the form developed by the former New York Board of Title Underwriters (NYBTU) is used and does not clearly provide for the recovery of such fees in a foreclosure action.[11]

Late Charges

Although perhaps apparent, 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. Additionally, expenses are generated in attempting to collect overdue payments. Further, there is usually a cost factor attendant to handling the actual receipt of tardy remittances. There should be compensation for all this.

The percentage of the overdue payment that may be added on as the late charge is usually determined by state law (or federal regulation, for certain types of lenders). In New York, Real Property Law § 254-b provides that a 2% late charge may be assessed for payments more than 15 days overdue. This maximum prevails for a one- to six-family dwelling.

Since standard mortgage forms do not encompass this item, its consideration is noteworthy.

Perhaps because the quantum of late charges encountered in a typical mortgage foreclosure, especially the residential situation, tends to be relatively small, it is not frequently an issue of major consequence. When it is an item of contention, the time associated with litigating the

(Continued on Page 6)

(Continued from Page 5)

point may be disproportionate to the amount due. Hence, it may often be left to bargaining and partial concession.

This is not to say, however, that the idea should be neglected, either in mortgage formulation or foreclosure. This is especially the case either when evaluated through a large portfolio or in the case of a substantial commercial mortgage.

While there has been little litigation on the subject, there is no doubt that late charges are valid in a mortgage and are awardable in a foreclosure[12] — but only through the moment of acceleration.[13]

Interest On Default

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

Where foreclosures tend to be protracted, and New York is prone to that, 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 applicable rate at various stages becomes an important factor to both lender and borrower.

New York, like all states, has a "legal rate of interest"; the interest rate an obligation bears upon default. In common parlance, it may also be referred to as the "judgment rate." That rate in New York is nine percent. It should not be confused with the maximum legal interest of 16%. If a mortgage makes no mention of the rate to apply upon default — and as noted, many usual forms do not address the point — the applicable rate in New York will be that nine percent.[14] While the legal or judgment rate is subject to change, it occurs only rarely.

Where foreclosure litigation is extended, and especially where the mortgage is large, the lost interest can be considerable. When a loan is made bearing interest at 12% for example, and a default occurs, it makes sense for the amount due to yield interest at the mortgage or contract rate. That makes the return on the investment at least consistent, fraught with no surprise and removes what would otherwise be an advantage to a defaulter.

The rate could be higher still. Some mortgages might provide that on default the balance shall bear interest at 15%, or perhaps the "highest rate allowable by law." Such a formulation will be upheld.[15] 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 corollary proposition relates to interest upon maturity. It is conceivable that near the end of the mortgage term there could be a default which remains uncured, followed by the natural maturity of the mortgage. Perhaps more common is the situation of a relatively short term interest only mortgage with a balloon payment due at the end.[16] Interest payments are missed near the conclusion and then the full balance of principal becomes due.

In either instance, if the mortgage is silent upon the subject, the matured amount will only bear interest at the legal rate of nine percent.[17] Even if interest on maturity is recited as the contract rate, which should certainly be considered, that rate could be well below market percentages by the time the mortgage matures. If so, the mortgagor has some incentive to allow the balance to remain unpaid. Hence, consideration should be given to providing that interest upon maturity be some percentage points above the contract rate, or be tied to some measure of prevailing rate of interest.

Case law authority clearly supports the foregoing propositions and underscores the strategies a mortgage drafter may wish to adopt. There is no difficulty with the applicable rate of interest from the time of default until maturity, the latter occurring either upon acceleration or in the natural course when the period of the mortgage expires. Interest following default and prior to maturity is payable at the rate fixed in the note.[18]

Upon acceleration, or maturity by virtue of some other circumstance, the situation is different. Where the mortgage contract is silent as to the rate of interest to be paid upon maturity or acceleration, the legal (*i.e.*, judgment) rate of interest shall apply.[19] If, however, the mortgagee wisely contemplates in the documents the question of interest upon acceleration and makes provision therefor, the rule changes again. Where the contract provides that a specified rate of interest is to apply until the full principal balance is remitted, that specified rate will be enforced until the time judgment issues.[20] Once the judgment of foreclosure and sale issues, interest is payable at the prevailing legal (*i.e.*, judgment) rate.[21]

Interest On Advances

A critical corollary to interest on default is interest on those payments, or, as it is sometimes referred to, "advances" made by the mortgagee on the mortgagor's behalf, among them, insurance, taxes and payments to prior mortgagees. Similar problems and solutions apply to interest on advances as to interest on the mortgage loan and, therefore, much of the previous discussion should be considered in this context as well.

Insurance

In the event a borrower allows insurance to lapse, the lender must consider advancing the insurance premium. This would protect the security, which would otherwise be greatly diminished if, for instance, the mortgaged premises were destroyed by fire.

Although that advance might only be $500 for one dwelling, the number swells across a large mortgage portfolio and is obviously of greater moment on a shopping center, office or apartment building. The FNMA form mandates that the same rate of interest on such advances as on

(Continued on Page 7)

(Continued from Page 6)

the mortgage itself will apply. However, other typical forms do not address the point, which means in New York, the judgment rate will attach — a yield which cyclically could be below the rate in the mortgage.

When the judgment rate approximates the rate on the face of the mortgage instrument, the consequences of a discrepancy are less severe. Since, however, cyclical interest rates suggest that eventually rates will rise, and possibly be much higher, the gap can become more meaningful. The problem is solved simply by inserting a clause in the mortgage to cover the point, for example, by providing that insurance advances shall bear interest at the rate provided in the note, or alternatively, some higher rate selected by the lender.

Consideration must also be given to the cost of funds to the lender or investor. If the lender or the investor borrows money at perhaps 12%, in order to pay insurance premiums, when the return on that advance is only 9%, a loss has been incurred — one that could have easily been avoided by use of a clause such as suggested in the previous paragraph.

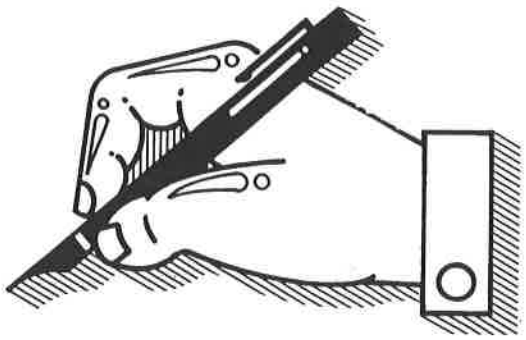
Taxes

The same analysis applicable to advances for insurance payments 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.

The obligation on the part of a first mortgagee to pay real estate taxes when the borrower has neglected to do so is obvious. Where the first lender does not escrow for taxes, as sometimes happens, tax failures become a more crucial consideration for a lender in a second or more junior position. Even when there is an escrow, it can become overdrawn — essentially unfunded — if mortgage payments are not made.

Although it is not often that the holder of a second mortgage need worry about it, the obligation to protect the mortgage by advancing tax payments can arise. For example, during the term of the second mortgage, the first mortgage could be satisfied, thereby thrusting the second loan into a first mortgage position. Alternatively, 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, a minimum.

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



Other Advances

The advances that a mortgagee may make on a mortgagor's behalf by no means end with insurance and tax payments. If a borrower defaults on a second mortgage, there will almost invariably be a default on the first mortgage. Conversely, a prior mortgage could be breached — monetarily or otherwise — with the second still current. In either case, the junior mortgage would be placed 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. It should be observed that once the balance on the first mortgage is accelerated, the first mortgage can validly insist upon payment in full (unless the FNMA form of mortgage is being used, which provides that reinstatement is allowed until judgment of foreclosure issues, and a judgment of foreclosure and sale has not yet issued). This means that protection of the second position could require some large outlay of cash. Extrapolating that concept to a portfolio, or to the case of a very large first mortgage, demonstrates that interest on advances of this magnitude requires strict attention. Since the mortgage must specifically make provision for this, astute draftsmanship is once again essential. In sum, a mortgage would prudently provide that such advances as must be made to the holder of a senior mortgage shall bear interest at some appropriate interest rate consonant with solid business practice.

Of lesser 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 municipal violations on the property which the borrower may ignore and securing the property against vandalism should it become abandoned. The applicable rate of interest for each of these items should be considered in drafting, analyzing or modifying a proposed mortgage instrument.

Compensation For Other Charges

A lender can incur any number of expenses during the life of a mortgage. However, the demand for reimbursement from the mortgagor is likely to be challenged unless the mortgage instrument expressly requires it.

(Continued on Page 8)

(Continued from Page 7)

Suppose, for example, a 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 if this is regularly repeated or for hundreds or thousands of such 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 almost 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. Since the search costs money, repayment for that too should be required in the documentation.

When a mortgage is satisfied, whether 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 has a cost factor, whether prepared in-house or by lender's outside attorney, mortgage holders typically request a modest fee. However, that request can validly be made only if the mortgage so provides — and standard forms generally do not.

Other examples or peripheral charges that can accumulate are those incurred in processing:

- insurance loss payments;
- ownership transfers;
- easements;
- extensions or modifications of the loan;
- reduction certificates;
- assignments of the mortgage; and
- releases of lien.

A well drafted mortgage should make the reference to these and any other expenses unique to lender's business.

Still More

The length of the foregoing delineation should immediately suggest that, of course, there will be more to drafting the mortgage. For example, a mortgage cannot be prepaid in New York — a matter of considerable consequence — unless provision is made for that. Hence, this is something to consider.

The converse is that a lender may wish to impose a prepayment penalty if a mortgage is paid prior to maturity. Although there is much nuance to this, a key consideration is to prepare the clause to allow a prepayment penalty to be incurred in the event of an involuntary prepayment, which is how the courts construe redemption in the mortgage foreclosure situation.

The mortgage drafter may wish to consider including a due on sale or due on transfer provision so that someone who buys the property does not get the benefit of the mortgage which may have been tailored for one particular borrower. Moreover, a lender might wish to take an escrow for taxes to be assured that property will not be lost for a default in remitting real property taxes.

Conclusion

Lest what is designed to be a helpful discussion become an unwieldy opus, suffice it to conclude by noting that, yes, of course, mortgage drafting is an expansive subject. But much that is critical has been discussed here and it is to be hoped that the review is enlightening and will aid in the preparation of your next mortgage.

Endnotes

1. Attention is invited for an in depth analysis of legal fees to 2 *Bergman on New York Mortgage Foreclosures,* Chap. 26.
2. Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 44 L.Ed.2d 141, 95 S. Ct. 1612 (1975).
3. Matter of Nicfur-Cruz Realty Corp., 50 B.R. 162 (Bankr. S.D. N.Y. 1985); In re Berry Estates, Inc., 47 B.R. 1004 (Bankr. S.D.N.Y. 1985); In re Guccione, 41 B.R. 289 (Bankr. S.D.N.Y. 1984); United States v. Bedford Assocs., 548 F. Supp. 748 (S.D.N.Y. 1982); In re Am. Motors Prod. Corp., 98 F.2d 774 (2d Cir. 1938); Chelsea/22 Assocs. v. Fleissner, 540 N.Y.S.2d 815 (App. Div., 1st Dept. 1989); Kenneth Pregno Agency, Ltd. v. Letterese, 112 A.D.2d 1032, 492 N.Y.S.2d 824 (2d Dept. 1985).
4. City of Utica v. Gold Medal Packing Corp., 54 Misc. 2d 721, 283 N.Y.S.2d 603 (1967).
5. In re Nicfur-Cruz Realty Corp., 50 B.R. 162 (Bankr. S.D.N.Y. 1985).
6. In re Am. Motors Products Corp., 98 F.2d 774 (2d Cir. 1938).
7. Bank of Smithtown v. Pelletier, N.Y.L.J. Oct. 26, 1977, at 14, col. 6 (Sup. Ct., Suffolk Co., De Luca, J.). *See also, inter alia,* Fed. Land Bank of Springfield, Massachusetts v. Ambrosano, 89 A.D.2d 730, 453 N.Y.S.2d 857 (3rd Dept. 1982); Inter-City Investor Corp. v. Kessler, 56 A.D.2d 645, 391 N.Y.S.2d 894 (2d Dept. 1977); General Lumber Corp. v. Landa, 13 A.D.2d 804, 216 N.Y.S.2d 33 (2d Dept. 1961).
8. Federal Land Bank of Springfield v. Handschuh, 125 Misc. 2d 686, 480 N.Y.S.2d 294 (1984).
9. *Id.*
10. Vardy Holding Co. v. Metric Resales, Inc., 131 A.D.2d 564, 516 N.Y.S.2d 490 (2d Dept. 1987).
11. Li v. Astoria Fed. Sav. & Loan Ass'n, 81 A.D.2d 587, 438 N.Y.S.2d 865 (2d Dept. 1981).
12. Centerbank v. D'Assaro, __ Misc. 2d __, 600 N.Y.S.2d 1015 (1993); DiMitri v. Tutunjian, 103 Misc. 2d 977, 427 N.Y.S.2d 362 (1980); City Streets Realty Corp. v. Jan Jay Construction Enterprises Corp., 88 A.D. 2d 558, 450 N.Y.S.2d 492 (1st Dept. 1982).
13. Centerbank v. D'Assaro, *supra* note 12.
14. Metropolitan Sav. Bank v. Tuttle, 290 N.Y. 497, 49 N.E.2d 983, *reh'g denied,* 291 N.Y. 634, 50 N.E.2d 1018 (1943); Levy v. Par 3 Golf Dev. Corp., 74 A.D.2d 865, 426 N.Y.S.2d 49 (2d Dept. 1980).
15. *See* Levine v. State, 106 A.D.2d 709, 484 N.Y.S.2d 678 (3d Dept. 1984).
16. A balloon payment arises in a mortgage for which the stipulated periodic payments do not result in the total amortization of the original principal amount at the maturity of the loan. This necessitates a final payment larger than the earlier ones — the balloon payment.
17. Metropolitan Sav. Bank v. Tuttle, 290 N.Y. 497, 49 N.E.2d 983, *reh'g denied,* 291 N.Y. 634, 50 N.E.2d 1018 (1943); Levy v. Par 3 Golf Dev. Corp., 74 A.D.2d 865, 426 N.Y.S.2d 49 (2d Dept. 1980).
18. Title Guarantee & Trust Co. v. 2846 Briggs Ave., Inc., 283 N.Y. 512, 29 N.E.2d 66, *reh'g denied,* 284 N.Y. 685, 30 N.E.2d 725 (1940); Ferris v. Hard, 135 N.Y. 354, 32 N.E. 129 (1892); O'Brien v. Young, 95 N.Y. 428 (1884); Ward v. Walkley, 532 N.Y.S.2d 426 (App. Div., 2d Dept. 1988); Levy v. Par 3 Golf Dev. Corp., 74 A.D.2d 865, 426

(Continued on Page 1)

(Continued from Page 8)

N.Y.S.2d 49 (2d Dept. 1980); Jamaica Sav. Bank v. Cohan, 38 A.D.2d 841, 330 N.Y.S.2d 119 (2d Dept. 1972). Stull v. Joseph Feld, Inc., 34 A.D.2d 655, 309 N.Y.S.2d 985 (2d Dept. 1970).

19. Metropolitan Sav. Bank v. Tuttle, 290 N.Y. 497, 49 N.E.2d 983, reh'g denied, 291 N.Y. 634, 50 N.E.2d 1018 (1943); Title Guarantee & Trust Co. v. 2846 Briggs Ave., Inc., 283 N.Y. 512, 299 N.E.2d 66, *reh'g denied*, 284 N.Y. 685, 30 N.E.2d 725 (1940); Ferris v. Hard, 135 N.Y. 354, 32 N.E. 129 (1892); Ward v. Walkley, 532 N.Y.S.2d 426 (App. Div. 2d Dept. 1988); Levy v. Par 3 Golf Dev. Corp., 74 A.D.2d 865, 426 N.Y.S.2d 49 (2d Dept. 1980); Jamaica Sav. Bank v. Cohan, 38 A.D.2d 841, 330 N.Y.S.2d 119 (2d Dept. 1972).

20. Ward v. Walkley, 532 N.Y.S.2d 426 (App. Div. 2d Dept. 1988); Citibank, N.A. v. Liebowitz, 110 A.D.2d 615, 487 N.Y.S.2d 368 (2d Dept. 1985); Levine v. State of New York, 106 A.D.2d 709, 484 N.Y.S.2d 678 (3rd Dept. 1984); Schwall v. Bergstol, 97 A.D.2d 540, 468 N.Y.S.2d 47 (2d Dept. 1983); Astoria Fed. Sav. & Loan Ass'n v. Rambalakos, 49 A.D.2d 715, 372 N.Y.S.2d 689 (2d Dept. 1975).

21. Taylor v. Wing, 84 N.Y. 471 (1881); Ward v. Walkley, 532 N.Y.S.2d 426 (App. Div. 2d Dept. 1988); Citibank, N.A. v. Liebowitz, 110 A.D.2d 615, 487 N.Y.S.2d 368 (2d Dept. 1985); Schwall v. Bergstol, 97 A.D.2d 540, 468 N.Y.S.2d 47 (2d Dept. 1983); Astoria Fed. Sav. & Loan Ass'n v. Rambalakos, 49 A.D.2d 715, 372 N.Y.S.2d 689 (2d Dept. 1975).

The author of *Bergman On New York Mortgage Foreclosures*, Matthew Bender & Co., Inc. (1990), Mr. Bergman is a partner in the law firm of Certilman Balin Adler & Hyman in East Meadow and an Adjunct Associate Professor of Real Estate with New York University's Real Estate Institute where he teaches the mortgage foreclosure course. A graduate of Cornell University and Fordham Law School, 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.

EARTH DAY
APRIL 22, 1994