

Real Estate Law & Practice

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MONDAY, NOVEMBER 19, 2012



Is Your Default **Foreclosable?**

Facts and equity determine the answer.

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There exist two major theories of mortgage law in the United States: the title theory, in which title to the collateral is transferred to the mortgagee until the debt secured by the mortgage has been satisfied; and the lien theory, where legal title to the property remains with the mortgagor and the mortgagee is granted a lien on

the collateral until satisfaction of the debt secured by the mortgage.

In a mortgage foreclosure, one inalienable right of a mortgagor or borrower is their right of redemption or right to repay the debt secured by the mortgage and obtain a release of the lien of the mortgage against their property.

In New York, this right of redemption is generally available at any time after a default of the underlying

obligation until the foreclosure auction has occurred. The inalienable nature of a mortgagor's right of redemption is further codified in the many court rulings that strike down waivers and other creative mechanisms that "clog" the mortgagor's right of redemption. The inviolate nature of the equity of redemption reflects the severity that New York courts regard the divestiture of title and evidences the high level of scrutiny that courts will apply to the foreclosure process. In the recent downturn, we have seen many cases where foreclosures were dismissed for a myriad of technical reasons.

In this context, the question of when can a mortgage be foreclosed in New York becomes relevant. This article will discuss whether all defaults under a mortgage loan, whether they be monetary, material, non-material or otherwise, will enable a lender to maintain a foreclosure proceeding that will be enforced by a New York court.

Under New York law, there is well-established precedent granting mortgagees the right to accelerate a loan and commence a foreclosure proceeding following a monetary default. Generally courts have held that "when a mortgagor defaults on loan payments, even if only for a day, a mortgagee may accelerate the loan, require that the balance be tendered or commence foreclosure proceedings."¹ When faced with non-monetary defaults, the courts have turned to principles of equity to aid in determining whether a mortgagee is entitled to foreclosure as a remedy. In exercising its equitable authority, New York courts have introduced a level of uncertainty into the analysis of whether a mortgagee will be authorized to commence foreclosure proceedings. While courts seem inclined to permit the commencement of foreclosure proceedings, there exist examples in which the court exercises its equitable authority to deny this remedy to mortgagees. While these decisions cannot pinpoint how a court will rule in a particular circumstance, they do provide insight into the court's decision-making process.

As indicated, New York courts have generally upheld a mortgagee's right to commence a foreclosure proceeding following a mortgagor's failure to make a payment due under the loan documents. Barring a statutory impediment or an act of forbearance by the mortgagee, a foreclosure may be commenced immediately following the expiration of any contractually agreed-upon grace period.² Following the commencement of foreclosure proceedings, courts will typically not deny a motion for summary judgment by the mortgagee unless the mortgagor asserts a valid defense, such as tender of the entire amount then due, bad faith on the part of the mortgagee or an unconscionable act.³

Foreclosure Allowed

In addition, relevant case law reflects that courts are apt to allow a foreclosure following the material non-monetary default of a mortgagor. In *Jordan v. Sharpe*, the mortgagee sought to foreclose on the collateral because of the mortgagor's failure to insure the property upon due notice.⁴ The mortgagor did not refute the claim that it had failed to insure the property, but instead sought to defend itself by claiming that the mortgagee made misrepresentations with regard to the property prior to its purchase.⁵ The court did not accept the mortgagor's claims and refused to vacate the order of foreclosure that was predicated on mortgagor's failure to properly insure the property. In *European American Bank v. Village Square Associates*,⁶ the mortgagee provided a loan to finance the construction of a shopping center. In support of its motion for summary judgment, the mortgagee presented evidence showing that the mortgagor had defaulted on its loan because (1) two of the guarantors suffered an adverse material change in their financial condition, and (2) the mortgagor breached a warranty provision that no additional funds would be required by admitting that such funds were required to complete the shopping center. The court noted that these facts were sufficient to entitle the plaintiff to accelerate the loan and prevail on its cause of action to foreclose the mortgage.⁷

In *Laber v. Minassian*, the defendant defaulted on its mortgage by demolishing a gas station building and other improvements located on the property without the consent of the mortgagee.⁸ The mortgage contained a covenant stating that the building and improvements could not be demolished without the consent of the mortgagee. After the razing of the building, the mortgagee exercised its right to accelerate the loan. In defense of its actions, the mortgagor presented evidence that the value of the property without the demolished building was more than sufficient to secure the principal amount of the mortgage.

In its ruling allowing the foreclosure proceeding to move forward, the court noted that "while it is true that an action to foreclose a mortgage is an action in equity, it is equally true that a court of equity may not relieve a defaulting debtor from the consequences of his action merely because the results are harsh."⁹ The court also noted that accepting the mortgagor's argument would create a "dangerous precedent whereby any landowner would be entitled to destroy the building on the property without the consent of the mortgagee merely because the raw land had a value in an amount greater than the principal due on the mortgage."¹⁰ Although the court did not exercise its equitable authority to prohibit the foreclosure proceeding because of its apprehension of creating a dangerous precedent, this case seems to illustrate that when presented with a more sympathetic set of circumstances, the court may choose to deny the maintenance of a foreclosure proceeding.

In *Homes & Savings Bank v. Jamel Realty*,¹¹ the mortgagee commenced a foreclosure proceeding

after the mortgagor defaulted on its construction loan by failing to provide proof that it had the ability to continue the construction project as contemplated by the building loan agreement.¹² At the time of the default, the mortgagor required \$900,000 to complete the applicable stage of the project while possessing less than \$400,000 in undisbursed loan proceeds. The mortgage contained a provision that permitted the mortgagee to call a default:

if any statements, details, budgets or revisions submitted by Borrower to Lender indicate, in the opinion of Lender, that the estimated cost of construction of the Improvements is in excess of the amount of funds available to Borrower to complete and pay for such construction.¹³

The mortgagee claimed that the mortgagee acted unreasonably when it declared a default. In denying the mortgagor's claim, the court noted that under the circumstances, there is no support for the claim that the mortgagee acted unreasonably or in bad faith when it declared that the mortgagor was in default.¹⁴ Here, the court was willing to allow the maintenance of a foreclosure proceeding following a material non-monetary default, notwithstanding, in the court's view, the harsh results of such proceeding to the mortgagor.

Under New York law, there is well-established precedent granting mortgagees the right to accelerate a loan and commence a foreclosure proceeding following a monetary default.

Foreclosure Denied

Alternatively, when faced with potentially unduly harsh outcomes, the court has utilized its equitable authority and refused to allow the maintenance of a foreclosure proceeding. In *Loughery v. Catalano*, the mortgagor defaulted on its mortgage by making alterations to the property without the consent of the mortgagee.¹⁵ The alterations amounted to the replacement of a window with a door, the replacement of two foundation piers and the removal of a rear stairway that was replaced with a deck. The mortgagee did not claim it had been injured by the alterations, or that the security had been impaired in the slightest degree, but nevertheless maintained that it was entitled to foreclosure because the parties agreed to a provision requiring mortgagee consent to any alterations of the property. In dismissing mortgagee's complaint, the court noted that "an action to foreclose a mortgage is equitable in its nature, and an election to demand payment of principal sum will not be enforced if unconscionable in character."¹⁶ As evidenced by this case, even if the express language of a mortgage entitles a mortgagee upon a breach to accelerate the loan and pursue foreclosure, the court may refuse to allow the maintenance of a foreclosure proceeding if the court believes the outcome to be unconscionable.

In *Rockaway Park Series v. Hollis Automotive* the mortgagor purchased property that was subject to existing building violations.¹⁷ The mortgagee was aware of the building violations when the

two parties entered into the loan agreement. The mortgage contained a clause providing that the whole principal sum would become due and payable at the option of the mortgagee in the event of the mortgagor's failure to comply with an order of the New York Department of Housing.¹⁸ The mortgagee later sought to commence a foreclosure proceeding claiming that the mortgagor was in default due to the existence of the building violations. In dismissing the mortgagee's foreclosure proceeding, the court noted that it may be unconscionable to "insist upon adherence to the letter of an agreement" and allow the mortgagee to benefit on its inaction.¹⁹ Again, we see how a New York court will utilize equitable powers to deny the maintenance of a foreclosure proceeding if the court believes that the strict enforcement of the express terms of the loan documentation would be unconscionable due to the mortgagee's own action or inaction.

New York courts have uniformly held that in the absence of a valid defense they will not prohibit the exercise of foreclosure as a remedy for a monetary default. When presented with material non-monetary defaults, the case law indicates that the court will not prohibit the maintenance of foreclosure proceedings so long as in the court's opinion the outcome of such proceeding will not be unconscionable or unduly burdensome and harsh on a mortgagor. The case law seems to indicate what one would expect is reasonable; that is, that a non-material default, while technically a violation of a loan agreement or mortgage will most likely not be enforceable by the courts to divest a borrower of its real property. Obviously, determinations in this area are very fact intensive and while loan documentation will continue to amount to hundreds of pages of representations, warranties and covenants, when the remedy under these documents amounts to the loss of real property, the courts will continue to look at the facts of a non-monetary default very closely.

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1. *First Fed. Sav Bank v. Midura*, 264 A.D.2d 407 (2d Dept 1999).

2. *Fannie Mae v. Shiraz Associates*, 2011 N.Y. Misc. LEXIS 6415 (2011).

3. *New York Guardian Mortgagee v. Michael Olexa*, 176 A.D.2d 401 (3d Dept 1991).

4. *Jordan v. Sharpe*, 92 A.D.2d 946 (3d Dept. 1983).

5. *Id.*

6. *European Am. Bank v. Village Sq. Assoc.*, 212 A.D.2d 754 (2d Dept. 1995).

7. *Id.* at 755.

8. *Laber v. Minassian*, 511 N.Y.S.2d 516 (1987).

9. *Id.* at 545 (internal citation omitted).

10. *Id.* at 547.

11. *Home & City Sav. Bank v. Jamel Realty*, 186 A.D.2d 936, (3d Dept. 1992).

12. *Id.* at 938.

13. *Id.* at 939 n.1.

14. *Id.* at 938.

15. *Loughery v. Catalano*, 191 N.Y.S. 436 (1921).

16. *Id.* at 438.

17. *Rockaway Park Series v. Hollis Automotive*, 135 N.Y.S.2d 588 (1954).

18. *Id.* at 956.

19. *Id.* at 957.