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CHAPTER 15

Foreclosure and Other Remedies

SYNOPSIS

§ 15.01 Overview of Foreclosure and Other Remedies

When a loan goes into default, at some point the lender may begin the foreclosure process. This chapter examines a mortgage lender's remedies under the law of New York State (the "State"), starting with the appointment of a receiver. The discussion then turns to a few State statutes that significantly limit the lender's flexibility, and discusses some measures lenders might want to take (but rarely do take) in structuring their loans to respond to those statutes.

After a brief discussion of the possible interaction between a foreclosure sale and a fire at the property just before the sale, the chapter concludes with a discussion of the transfer taxes that apply to a foreclosure sale.

New York's nonjudicial foreclosure statute is covered separately in Chapter 16.

This chapter does not aim to cover the entire topic of a mortgagee's remedies under New York law, or even a significant part of that topic. To the contrary, this book focuses on commercial mortgage loan closings rather than loan enforcement. Anyone who closes a commercial mortgage loan needs to have some idea of how the lender would enforce the documents if the loan went bad, and also needs to know what the documents should say to facilitate the most effective possible enforcement of the lender's remedies. Closing counsel does not, however, need to know too many nuances about the foreclosure process, because most of those nuances do not affect the loan documents or the closing process. New York's judicial foreclosure process is quite nuanced indeed, involving a complex

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combination of the State's Real Property Actions and Proceedings Law ("RPAPL"), Civil Practice Law and Rules ("CPLR"), and other statutes.

In some ways it is unfortunate that common law legal systems and legal professionals draw such a bright line between attorneys who close deals and attorneys who go to court. "Deal lawyers" often write their documents in a vacuum, not really knowing how courts think or how courts might respond to the finely honed words of a document.[1] But clients hire attorneys—not poets or journalists—to write legal documents because attorneys are supposed to know how courts think. Today's deal lawyers often lack that knowledge. They may have practiced for years and never seen a courtroom since they were sworn into the bar.

In civil law countries, in contrast, the lawyers who write documents are often the same lawyers who go to court to enforce or interpret those documents. This is partly because the litigation process is so much simpler and less procedural. It therefore tolerates a lower level of specialized litigation expertise. But it also means that when a lawyer who tries a case goes back to doing "deal work," he or she has the benefit of knowing exactly how judges deal with documents. This probably helps them do a better job for their clients.

The goal is of this chapter is to take some small steps toward bridging the gap in New York commercial mortgage practice. If a loan actually does go into default, however, New York commercial foreclosure practice is the domain of lawyers who have done it before. One of them should be engaged or consulted.

§ 15.02 Appointment of a Receiver

[1] Waiver of Notice

A lender that has commenced a foreclosure action may obtain appointment of a receiver without notice if the borrower waived notice of such an appointment as part of the mortgage documents.[1] Therefore, in any mortgage in the State, the lender should insist that the borrower expressly waive notice of the appointment of a receiver. Borrowers typically agree to such a waiver, or at least recognize that the point is not negotiable.

Appointment of a receiver without notice is so routine that under New York's mortgage interpretation statute, described in § 3.03, *above,* if a mortgage says the

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[1] In the author's related limited experience with litigation, courts aren't too interested in finely honed words. Instead, they typically paint with a broader brush, figure out who's the "good guy" and who's the "bad guy," and reach what they consider the right result accordingly.

[1] *See* N.Y. Real Prop. Actions and Proceedings Law ("RPAPL") § 1325(1) ("Where the action is for the foreclosure of a mortgage providing that a receiver may be appointed without notice, notice of a motion for such appointment shall not be required.").

mortgagee is entitled to appointment of a receiver, then this language automatically means the mortgagor waives notice.[2]

Does this mean a lender does not really need to include a waiver of notice in its mortgage, because the lender can rely on RPL Section 254? Probably not. Section 254, though, certainly provides a second bite at the apple, a decent argument, for any New York lender or its counsel that neglected to include a waiver of notice in its mortgage.[3]

[2] Sample Language: Appointment of Receiver

The following language or its equivalent should be on lender's counsel's "short list" of provisions to include in any New York mortgage:

Appointment of Receiver. On the occurrence of any Event of Default, Mortgagee may apply for and immediately obtain appointment of a receiver of the Mortgaged Property, to be vested with the fullest powers permitted under applicable law. Mortgagee may do so as a matter of right and without regard to, or the necessity to disprove: (a) the adequacy of the security for the Secured Obligations; or (b) the solvency of Mortgagor or any other person liable for payment of the Secured Obligations. Mortgagee may have a receiver appointed without notice to Mortgagor or any other person. Mortgagor and every other person liable for payment of the Secured Obligations hereby: (a) waives, and authorizes Mortgagee to waive, any requirement that a receiver post a bond;[4] (b) waives any requirement for notice of appointment of a receiver; and (c) consents to such appointment.

[3] Further Language on Receivers

Lender's counsel might want to add some further language on receivers to try to obtain additional waivers from the borrower and also to address certain other issues and concerns about the rules that govern a receiver under New York law. That additional language, which is not at all standard, might consist of some or all of the following included below.[5] Bracketed provisions are particularly unusual. Though some of the language suggested here might seek to "invade" the court's control of the process, no court has (to the writer's knowledge) actually considered and rejected provisions of the types suggested here. They may be worth a shot.

Additional Procedures Regarding Receivers. [Subject to such approval by the court,

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[2] N.Y. Real Prop. Law ("RPL") § 254(10).

[3] The Legislature could get to the same place, much more directly, by amending RPAPL to say that appointment of a receiver does not require notice to the borrower.

[4] No assurance is provided as to the enforceability of this waiver.

[5] This language could also be used as part of the proposed order of appointment of a receiver.

if any, as nonwaivable law may require, Mortgagee shall have the power to recommend the person who shall serve as receiver and to negotiate all terms and conditions under which such receiver shall serve.] [Except to the extent that Mortgagee elects otherwise,] any receiver shall have the power and authority to do the following, subject to such approval by the court, if any, as nonwaivable law may require: (a) engage counsel, including a law firm, as the receiver selects; (b) engage a managing agent, to whom such receiver may delegate any or all responsibilities relating to management and operation of the Mortgaged Property; (c) enter into, amend, modify, cancel, terminate, or enforce Space Leases on such terms as the receiver shall determine; (d) file any applications or other documents with any Governmental Authority, insurance carrier, utility company, or other third party that Mortgagor could file in its capacity as owner of the Mortgaged Property; [(e) comply with all reasonable requests, instructions, and directions of Mortgagee, all without any requirement for Mortgagee to obtain consent or joinder by Mortgagor or approval by the court;] (f) otherwise have and exercise any and all powers otherwise available to a receiver; and (g) pay for all the foregoing from the Rents, any other source arising from the Mortgaged Property, or any other source legally available to the receiver. [Mortgagee shall have the right to terminate the appointment of any receiver at any time and thereafter have the same receiver or some other receiver appointed in accordance with this paragraph.]

One should not assume that a court will enforce all of these additional provisions. The court may conclude, for example, that they are overly lender-oriented, whereas the receiver acts for the court. On the other hand, the appointment of a receiver can give a mortgagee tremendous leverage against the borrower, by choking off the borrower's cash and hence forcing the borrower to go into pocket to hire counsel if the borrower wants to mount a war against the lender. This leverage can make all the difference in the world. If and when a loan goes into default, a lender might very much appreciate the options that become available if the loan documents contain more aggressive language rather than language that has been trimmed back to avoid offending anyone's sensibilities. A practitioner should consider these issues in ultimately deciding what to ask for when enforcing the loan documents, but a lender will probably benefit by having more rather than fewer options available after a default.[6]

If real property collateral consists of a hotel, the lender should give some thought to the hotel's liquor license and how a receivership might affect it. That license will often help drive the profitability of the hotel. For New York lenders, however, there appears to be no magic language to add to the loan documents that

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[6] As in other states, a lender will typically appoint a receiver rather than take possession of the collateral itself as a "mortgagee in possession," a status that many lenders regard as worse than death. Under some circumstances, however, New York law may give a mortgagee good reasons to want to be a "mortgagee in possession." *See* John K. Bouman, *Powers, Limitations and Liabilities of Mortgagees in Possession and Receivers of Rents and Profits,* 23 N.Y. Real Prop. L.J. 105 (1995).

will guarantee a receiver can continue to use the borrower's liquor license. New York liquor law treats a liquor license as a "privilege," not an asset, and thus it cannot be transferred without the State Liquor Authority's prior approval. Appointment of a receiver would be considered a transfer.

New York's Alcoholic Beverage Control Law does provide that a receiver "may continue to carry on such business . . . for the balance of the term for which such license was effective, with the same rights and subject to the same restrictions and liabilities as if he had been the . . . original holder . . . of such license or permit, providing the approval of the liquor authority shall be first obtained."[7] Before the authority will allow a receiver to carry on such business, the receiver must first "file a statement setting forth in such form and substance as the liquor authority may prescribe the facts and circumstances by which [the receiver] has succeeded to the rights of the original licensee."[8] The liquor authority then has the discretion to deny or permit the continuance of the business.[9]

A prudent lender taking over a hotel should seek approval from the liquor authority as early as possible to try to minimize any interruption to liquor sales and the resulting revenue streams.

In structuring and documenting a New York hotel loan, a lender might respond to these issues in two ways.

First, the lender might insist on having a separate entity, such as a third-party hotel manager, hold the liquor license instead of the borrower. This may or may not make sense based on the business structure of the hotel. And borrowers will rarely change their business structures to accommodate concerns like these.

Second, the lender might add language to the mortgage or loan agreement to try to make it a bit harder for the borrower to get in the way if a receiver ever needs to obtain a liquor license for the hotel. For example, this language can't hurt and might help:[10]

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[7] N.Y. Alco. Bev. Cont. Law § 122.

[8] N.Y. Alco. Bev. Cont. Law § 122; *see also* Canale v. New York State Dep't of Taxation & Finance, 84 Misc. 2d 786, 378 N.Y.S.2d 566 (2d Dep't 1975) (receiver appointed in foreclosure action occupies same position as mortgagor, provided receiver complies with Alcoholic Beverage Control Law provisions on receiver's continuation of business).

[9] N.Y. Alco. Bev. Cont. Law § 122. Informal conversations with the liquor authority suggest a hesitancy to have receivers operate hotel alcoholic beverage facilities, based on the transient, limited, and probably short-term nature of their interest in the property.

[10] The author acknowledges K.C. McDaniel as the source for this suggestion and an earlier version of this language. McDaniel's extensively annotated model hotel loan agreement constitutes required reading for any hotel lender. *See* ALI-ABA, Modern Real Estate Transactions program materials, July 27-30, 2005, Vol. 2, at 995, available online at <http://www.ali-aba.org/aliaba/CL004.htm>.

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Borrower grants (and consents to creation of) a security interest in favor of Lender in all licenses, permits, property, and rights of Borrower relating to the sale and use of liquor, beer, and wine in the Mortgaged Property (the "Liquor Rights"). Borrower consents to any application by Lender (or its assignee or a Receiver appointed on Lender's behalf) for any permit(s) or license(s), including[11] under Alcoholic Beverage Control Law § 99-b(1)(a), to allow, after an Event of Default, any: (a) exercise of the Liquor Rights; and (b) sale of any Collateral that requires any such permit or license. For purposes of the previous sentence, Borrower irrevocably authorizes and directs any licensing authority to rely on Lender's certificate as to the existence of an Event of Default, and to disregard any contrary assertion or direction by Borrower.

A receiver's other, more general, powers should also prove helpful in the lender's and its receiver's efforts to preserve and exploit any hotel's liquor license. Still, a hotel lender should not assume that a receiver will actually be able to obtain any necessary liquor authority approvals. Any analysis of the consequences of a default should consider the possible interruption of liquor revenues, along with any other revenues that indirectly depend on the continued existence of a liquor license.

[4] Strategic Opportunities

The lender's ability to appoint a receiver without notice means that New York lenders can, and often do, use the appointment of a receiver to take control of the property in a way that seeks to deny the borrower any opportunity to remove collateral or books and records, or otherwise frustrate the lender's enforcement of remedies. To do it, the lender proceeds as follows:

1. *Foreclosure Papers.* The lender prepares complete foreclosure papers, including a notice of pendency, and a motion for appointment of a receiver.
2. *Commencement and Service.* The lender commences the foreclosure action, perhaps late on a Friday afternoon, by filing the complaint in court. (At one time, the lender would also need to serve any one defendant as an element of commencing the action—often the State or New York City (the "City"), both of which are defendants in any foreclosure action, because of actual or potential claims for unpaid income or other (non-real-estate) taxes. The requirement to serve at least one defendant no longer exists as an element of commencing the foreclosure action. Other procedural considerations may, however, dictate serving all defendants as soon as possible. This issue lies beyond the scope of the present work.)

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[11] The loan documents should say, once, that "including" means "without limitation."

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3. *Ex Parte Appointment.* On an *ex parte* basis, the lender applies for appointment of a receiver, based on language of the type suggested in § 15.02[2], *above*. Judges are often happy to accommodate these requests.

4. *Borrower Surprise.* The borrower first learns about the foreclosure action, and the appointment of a receiver, only when the receiver tells the tenants to start paying to the receiver rather than the borrower, or arrives to take over possession of the collateral, perhaps with a security guard and a locksmith in tow.

This technique can prevent the borrower from hiding books and records (if maintained on-site) or removing collateral when the borrower realizes the end is near. For a hotel, the strategy may work particularly well because so much of the value and cash flow of a hotel depends on day-to-day operations, management, and personal property.[12] By denying the borrower prior notice of the appointment, the lender also denies the borrower an opportunity to file bankruptcy before the lender has unambiguously exercised its rights to take control of the property. This can help the lender's position when the borrower does file a bankruptcy petition—which often happens the day after the receiver has been appointed.

The preceding discussion is intended to give "closing counsel" a general idea of the opportunities that a well drafted receivership clause can create. It is not intended as a reliable or complete roadmap to the details of foreclosure practice, and should not be relied upon as such.

§ 15.03 Coordination of Remedies

[1] Two Routes for Enforcement

When a lender accepts a mortgage on real property in the State as security for a loan, New York law imposes some restrictions on when and how the lender can simultaneously (1) foreclose under the mortgage (a "foreclosure"), and (2) sue the borrower or a guarantor on the same note (a "personal lawsuit").[1] Because these rules do not always force the lender to "elect" one remedy or another, they are described here as "coordination of remedies" rules rather than "election of remedies" rules. (These rules are, however, often referred to elsewhere as "election of remedies" rules.)

Although New York's coordination of remedies rules are less treacherous for a

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[12] If a third party manages the hotel, this may complicate matters or simplify them—depending in part on whether the third-party manager is a true third party or merely the borrower in disguise.

[1] *See* RPAPL § 1301. The text assumes "the action" in RPAPL § 1301(3) means the foreclosure action, as discussed below.

lender than, for example, California's "one form of action" rules,[2] a lender must consider them early in planning its strategy to enforce any recourse loan documents and occasionally in structuring the loan.[3]

New York's rules on coordination of remedies are briefly summarized as follows.[4]

[2] Foreclosure First

Once a lender has started a foreclosure action, or has obtained a judgment in a foreclosure action, New York Real Property Actions and Proceedings Law § 1301(3) provides that the lender cannot initiate a separate personal lawsuit unless the court grants permission to do so.[5]

New York courts do not readily allow lenders to start a separate personal lawsuit once the lender has started foreclosure, even if the lender's foreclosure has been frustrated by an intervening bankruptcy.

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[2] *See generally* Cal. Civ. Proc. Code § 726. *See also* Dennis B. Arnold, *Anti-Deficiency Protection in Multi-State Transactions,* 469 Practising L. Inst.: Com. Real Est. Fin. 171 (May 2001).

[3] In 1998, New York adopted a nonjudicial procedure for foreclosure proceedings, to supplement the existing judicial procedure. The nonjudicial option varies only slightly, if at all, in how it treats these issues. *See* Chapter 16.

[4] *See* RPAPL § 1301(1) (barring foreclosure action when final judgment for plaintiff has been rendered in a personal lawsuit, unless and until execution against defendant's property on the judgment has been issued by the appropriate sheriff and been returned wholly or partly unsatisfied); RPAPL § 1301(3) (barring a personal lawsuit after commencement of foreclosure action, unless plaintiff obtains leave of court).

[5] *See* RPAPL § 1301(3). This statute provides: "While the action is pending or after final judgment for the plaintiff therein, no other action shall be commenced or maintained to recover any part of the mortgage debt, without leave of the court in which the former action was brought." Boiled down a bit, the statute means the lender cannot start a personal lawsuit once the lender has started a foreclosure action, unless and until the lender loses in the foreclosure action. Where the statute refers to "the action" or "the former action," such reference means a foreclosure action. Marine Midland Bank, N.A. v. Lake Huntington Dev. Group, 185 A.D.2d 395, 585 N.Y.S.2d 836, 837 (App. Div. 1992); Dollar Dry Dock Bank v. Piping Rock Builders, Inc., 181 A.D.2d 709, 581 N.Y.S.2d 361, 362 (App. Div. 1992). *See also* Security Nat'l Servicing Corp. v. Liebowitz, 281 A.D.2d 615, 722 N.Y.S.2d 69, 70 (App. Div. 2001). In the *Liebowitz* case, the assignor commenced a foreclosure action in 1992, which was still pending (quietly) when the assignor assigned the mortgage to the assignee in 1997. In 2000, the assignee obtained a summary judgment of foreclosure. In 2001, the Appellate Division held that the summary judgment was improper, because with the 1992 foreclosure action still pending, the assignee should not have been permitted to foreclose without court approval. The case teaches any mortgage assignee that it may want to: (1) obtain assurances about the pendency of a foreclosure action when it acquires a mortgage; and (2) check for other pending actions when it starts a foreclosure.

In *Manufacturers Hanover Trust Co. v. 400 Garden City Associates,*[6] for example the lender, held a guaranty and a note. When the loan went into default, the lender started a foreclosure action. The borrower filed bankruptcy, and the lender sought leave to proceed against the guarantor. The court denied the motion, concluding that bankruptcy is merely a "temporary stay of plaintiff's foreclosure action," and lender was not "permanently frustrated in foreclosure."[7] The court stated in passing that this result would not always be true, but under the circumstances of the particular case, felt itself "constrained to hold plaintiff to its election of remedies" in part because "there is nothing before this court to indicate that the value of the mortgaged property does not provide adequate security for the mortgages."[8]

Once the lender has started foreclosure, the courts require a showing of "special circumstances" before allowing the personal lawsuit. While bankruptcy alone is not a "special circumstance," something more, such as rapidly declining collateral value, unexpected environmental issues, or mismanagement, may satisfy the "special circumstances" requirement and convince a court to permit the lender to start a personal lawsuit even during the foreclosure. In addition, if a tax sale (or a foreclosure sale under a senior mortgage) extinguishes the lender's mortgage during the foreclosure, the court may allow the lender to start a personal lawsuit.[9]

In *Stein v. Nellen Development Corp.,*[10] the lender held a second mortgage and commenced foreclosure, as did the holder of the first mortgage. The first mortgagee held its foreclosure sale first, "buying in" the property for the amount of the first debt and wiping out the second lien. Even though the plaintiff (the holder of the second mortgage) had failed to name certain personal guarantors in the original complaint, the court allowed the plaintiff to proceed against them. Once the plaintiff lost its lien in the first mortgage foreclosure sale, the plaintiff could freely proceed against the personal obligors. The court stated:

> The question as to whether special circumstances have been shown is regulated by consideration of equitable principles on a case by case basis, and generally the focus of inquiry is upon whether the plaintiff could have obtained all the relief it was entitled to in the foreclosure action without the undue burden of commenc-

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[6] 150 Misc. 2d 247, 568 N.Y.S.2d 505 (Sup. Ct. 1991).

[7] 150 Misc. 2d 247, 568 N.Y.S.2d 505, 507 (Sup. Ct. 1991).

[8] 150 Misc. 2d 247, 568 N.Y.S.2d 505, 507 (Sup. Ct. 1991).

[9] First Nat'l Bank of Downsville v. Atkin, 183 Misc. 2d 425, 704 N.Y.S.2d, 440, 443 (Del. County 2000), *aff'd,* 279 A.D.2d 779, 718 N.Y.S.2d 499 (App. Div. 2001) ("An intervening tax foreclosure has been held to constitute a 'special circumstance' sufficient to permit the interposition of a claim for recovery on the note, after the commencement of a mortgage foreclosure action.").

[10] 123 Misc. 2d 268, 473 N.Y.S.2d 331 (Sup. Ct. 1984).

ing an action on the debt.[11]

In this case, loss of the plaintiff's lien meant they "lost all the relief to which they were entitled under the foreclosure action. Therefore the only remedy left to plaintiffs is to sue upon the mortgage debt."[12]

Permanent loss of the ability to obtain a personal judgment as the result of a bankruptcy would constitute "special circumstances."[13] Mere "law office failure" by lender's counsel would not constitute special circumstances.[14]

In effect, during the pendency of the foreclosure, absent special circumstances, if the lender wants to try to obtain a "personal" judgment against the borrower or a guarantor, the lender needs to rely on, and comply with, the procedures for obtaining a deficiency judgment within the foreclosure action, as described below. In other words, the mortgagee needs to prosecute the personal lawsuit as part of the foreclosure action and comply with the deficiency judgment procedures.

[3] Personal Lawsuit First

Once a lender has started a personal lawsuit, the lender can still commence a foreclosure action at any time until the lender obtains a "final judgment" against the defendant in the personal action.[15] Once the lender obtains that final judgment in the personal action, though, New York Real Property Actions and Proceedings Law § 1301(1) says the lender cannot commence foreclosure, unless and until the mortgagee has tried to execute on the judgment and such execution has been returned by the sheriff, wholly or partly unsatisfied.[16] If the mortgagee tries to

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[11] 123 Misc. 2d 268, 473 N.Y.S.2d 331, 333 (Sup. Ct. 1984).

[12] 123 Misc. 2d 268, 473 N.Y.S.2d 331, 334 (Sup. Ct. 1984).

[13] Valley Sav. Bank v. Rose, 228 A.D.2d 666, 646 N.Y.S.2d 349 (App. Div. 1996).

[14] Wand v. Saleh, 218 A.D.2d 647, 630 N.Y.S.2d 367, 368 (App. Div. 1995). For more on "special circumstances," *see* Kenneth M. Block and Jeffrey B. Steiner, *Election of Remedies: Lender Must Choose Foreclosure or Action on Debt,* N.Y.L.J., May 16, 2001, at 3.

[15] The statute does not define a "final" judgment, and the cases have not interpreted that word in this context. Under typical understandings of the term, a "final" judgment would probably not include a judgment: (1) for which the period for filing a notice of appeal has not yet expired; or (2) that is the subject of an active appeal. If the lender started a personal lawsuit in another state or a foreign country and obtained a judgment, would that constitute a "final judgment"? The statute doesn't say. The lender would argue that the foreign judgment couldn't possibly be a "final judgment" if it could not be enforced in New York without taking significant additional steps (e.g., domesticating the judgment). The borrower would argue that a "final judgment" of another judicial system is still a judgment and still final under the law that governs it. In a Manhattan foreclosure the author worked on starting in 2003, the court ruled for the borrower on this question, in an unreported decision.

[16] *See* RPAPL § 1301(1) (requiring leave of court and a wholly or partially unsatisfied judgment at law to commence foreclosure, after the lender has commenced a personal lawsuit and obtained a

enforce the loan under the "personal lawsuit first" option as described above, the statute does not expressly allow a court to grant the mortgagee an exception to the general rule. In contrast, a court does have such authority under the "foreclosure first" option, as described above.

Under the State's coordination of remedies rules, a lender should be able to start a personal lawsuit on day one, and a foreclosure on day two.[17] If the lender waits too long and obtains a judgment in the personal lawsuit, then the lender can no longer start the foreclosure (unless and until the judgment is returned as uncollectible, as described above). Once the lender starts the foreclosure, the lender may need to suspend the personal lawsuit because the statute provides that a personal lawsuit may not be "maintained" during the pendency of the foreclosure. The author has not been able to locate a case that actually requires the lender to suspend, *i.e.,* not "maintain," its personal lawsuit once it commences a foreclosure, although the statutory language would seem fairly clear.

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judgment). Note that the execution needs to be "returned wholly or partly unsatisfied." The public officer responsible for executing a judgment would be the County Sheriff, who can sometimes act quite quickly. The judgment does not need to be totally uncollectible. *See* Kenneth M. Block and Jeffrey B. Steiner, *Election of Remedies: Lender Must Choose Foreclosure or Action on the Debt,* N.Y.L.J., May 16, 2001, at 3 (discussing case in which mortgagee obtained personal judgment and tried to execute on a five-year stream of lottery winnings; court held the judgment could not be deemed to have been returned wholly or partly unsatisfied until the end of the five years). *See also* Smith v. Household Fin. Realty Corp. of N.Y. (*In re* Smith), 262 B.R. 594, 601-03 (Bankr. E.D.N.Y. 2001) (suggesting lender may be able to foreclose mortgage after bankruptcy court has set aside a personal judgment against borrower).

[17] Several courts have expressly validated this sequence of enforcement. *See* First Fid. Bank, N.A., N.J. v. Best Petroleum, Inc., 757 F. Supp. 293, 296 (S.D.N.Y. 1991) (Judge Griesa applying New York law) ("When the present [guaranty enforcement] action was commenced, there was no foreclosure action pending, and therefore the bringing of this action was not a violation of § 1301."); Citibank, N.A. v. Covenant Ins. Co., 150 Misc. 2d 129, 567 N.Y.S.2d 983, 985 (Sup. Ct. 1991) (lender could have commenced a personal action "and later brought an action to foreclose the mortgage without the necessity of seeking court permission"); Marine Midland Bank N.A. v. Lake Huntington Dev. Group, Inc., 185 A.D.2d 395, 585 N.Y.S.2d 836, 838 (App. Div. 1992) ("No final judgment has been rendered in favor of the Bank on any claim based on the mortgage debt [including the then-pending guaranty litigation] and, therefore, there was no statutory bar to the commencement of the foreclosure action.").

In D'Agostino v. Wheel Inn, Inc., 65 Misc. 2d 227, 317 N.Y.S.2d 472 (County Court 1970), the lender started a personal lawsuit, then started a foreclosure proceeding before obtaining a judgment in the personal lawsuit. The court concluded: "plaintiff's foreclosure action is not barred by its prior pending action [and] leave of the court is not a necessary prerequisite to plaintiff's commencement and maintenance of its foreclosure action." *Id.* at 474. The court concluded that if the legislature had wanted to bar all simultaneous enforcement activities (personal lawsuit and foreclosure at the same time) it could have done so, but did not. *Id.* at 475-476. After discussing some of these cases, Bergman concluded that "it should now be the rule that R.P.A.P.L. section 1301 is inapplicable to the situation of initial suit on the debt followed by an action in foreclosure." Bruce J. Bergman, Bergman on New York Mortgage Foreclosures § 7.08 (LexisNexis Matthew Bender).

In contrast, once a lender starts a personal lawsuit, it can change its mind, and proceed via foreclosure instead, provided it either: (1) has not obtained a judgment in the personal lawsuit; or (2) has obtained a judgment, but that judgment has been returned unsatisfied in whole or in part.[18]

[4] Enforcement of Judgment in Personal Lawsuit

In addition to the coordination of remedies statutes described above, before commencing a personal lawsuit, a lender must consider the effect of New York Civil Practice Law and Rules 5236(b), which states: "Real property mortgaged shall not be sold pursuant to an execution issued upon a judgment recovered for all or part of the mortgage debt."[19]

As a result of this rule, if a lender does obtain a judgment in a purely personal lawsuit—entirely independent of a mortgage foreclosure—the lender may obtain a judgment against the borrower, and is free to enforce it against all assets of the borrower except one: the "[r]eal property mortgaged."[20]

This rule would appear to be motivated by a desire to give a mortgage borrower the protections available under New York Real Property Actions and Proceedings Law, as opposed to whatever protections would be available in a mere personal lawsuit independent of the mortgage. It means that for most real estate loans, the lender has no reason to bother commencing a personal lawsuit against a single-asset borrower to collect the debt. Because most of those loans are nonrecourse anyway, this outcome hardly seems troublesome. If, hypothetically, the lender wanted to sue the single-asset borrower for some form of liability within a nonrecourse carveout, the lender would argue that the claim does not constitute "all or part of the mortgage debt" but instead constitutes something else, such as a "tort"-type claim. No reported case considers this issue.[21]

As another possible issue arising under CPLR 5236(b), what happens if the

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[18] For a summary of New York's coordination of remedies rules and a discussion of some recent cases, *see* Andrew H. Levy & Farzana Kanji, *Lenders Face Hurdles to Recover on Debt,* N.Y.L.J., Jun. 17, 2002, at S1; Kenneth M. Block & Jeffrey B. Steiner, *Election of Remedies: Lender Must Choose Foreclosure or Action on the Debt,* N.Y.L.J., May 16, 2001, at 5.

[19] CPLR 5236(b); *see also* CPLR 5230(a) (to the same effect).

[20] This probably applies only where the "mortgaged property" is located in New York, as a New York court probably lacks jurisdiction to do anything affecting out of state real property. *See* Greate Bay Hotel & Casino v. Chan, 239 A.D.2d 295, 657 N.Y.S.2d 424; (App. Div. 1997).

[21] Nonrecourse carveouts consume a tremendous amount of time, attention, and legal effort in negotiating and thinking about commercial real estate finance. *See, e.g.,* Joshua Stein, *Nonrecourse Carveouts: How Far Is Far Enough?*, Real Estate Review, Summer 1997, at 3. The absence of reported cases on the issue discussed in text may say something about the real-world practicalities of nonrecourse carveouts, at least as they relate to single-asset real estate borrowers. Guarantors are, of course, a different story.

lender's collateral consists of both real property and personal property (such as furniture, fixtures, and equipment ["FF&E"] in a hotel, or a pledge of partnership interests)? Could the lender obtain a judgment in a personal lawsuit and enforce it against the FF&E or the partnership interests, without running afoul of CPLR 5236(b)? The cases don't say. The lender would argue that CPLR 5236(b) refers to "[r]eal property mortgaged" and not "any property mortgaged" to the lender. The lender would also note that New York's UCC contains specific rules about how a lender with real property and personal property collateral may or must proceed, and those rules allow the secured party to obtain and enforce a judgment against the UCC collateral.[22] On the other hand, particularly if the lender uses a single mortgage to cover all its collateral, both real and personal, the borrower would argue that CPLR 5236(b) prevents the lender from enforcing a judgment even against the personal property security. Even if the borrower loses the argument, it could cause a year's delay in litigation.

Therefore, if a lender obtains substantial personal property security for a loan (such as a hotel loan or a loan secured in part by a block of cooperative apartments), the lender might want to structure the security documents in a way that negates any argument that CPLR 5236(b) limits the lender's ability to enforce any personal judgment against personal property. For example, the lender should avoid using the verb "mortgage" in the granting clause for any personal property security interest. And the lender might want to separate UCC security agreement(s) for UCC collateral, rather than throw the UCC collateral into the mortgage.[23] On the other hand, CPLR 5236(b) seems highly unlikely to become irrelevant except under very unusual circumstances. Even then, the lender would seem to have the better of the argument. Therefore, even if a lender holds significant personal property collateral, the lender might conclude that any risks under CPLR 5236(b) do not justify significant additional paperwork or complexity.

§ 15.04 Antideficiency Rules

[1] Overview

The State's antideficiency rules, at least as expressed in the statute book, are just as straightforward and compact as the coordination of remedies rules.[1] As in

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[22] *See* UCC §§ 9-601(a)(1), 9-604.

[23] *See also* Andrew H. Levy and Lawrence J. Diamond, *Remedies Under a Mortgage Covering Real and Personal Property*, N.Y.L.J., Mar. 3, 1993, at 1 (favoring separate personal property security agreement to enhance mortgagee's flexibility to proceed against personalty separately from realty).

[1] *See* RPAPL § 1371(2) (allowing defendant to reduce amount of uncollected debt by fair

the case of the coordination of remedies rules, these antideficiency rules are far less burdensome than those of other states, such as California.[2]

[2] Procedure

To obtain a deficiency judgment against the borrower or a guarantor as part of the foreclosure action,[3] the lender needs to name that party as a defendant in the first instance and properly serve that defendant.[4] The judgment of foreclosure and sale needs to contain an adjudication of personal liability.[5] After the referee has held the foreclosure sale[6] and delivered the deed, the lender will then move to confirm the foreclosure sale. The lender must also at the same time seek leave to obtain a deficiency judgment, and must file the motion within 90 days after delivery[7] of the foreclosure deed.[8] If the lender satisfies these requirements, the

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market value of foreclosed property); RPAPL § 1371(3) (deeming proceeds of sale regardless of amount to be in full satisfaction of mortgage debt and barring recovery of any deficiency under certain circumstances).

[2] *See generally* Cal. Civ. Proc. Code § 726. *See also* Dennis B. Arnold, *Anti-Deficiency Protection in Multi-State Transactions,* 469 Practising L. Inst.: Com. Real Est. Fin. 171 (May 2001).

[3] This discussion assumes the loan contemplates full or partial recourse against the borrower or a guarantor, which would be the exception in long-term financing for stabilized commercial real estate. Unless the borrower has expressly covenanted to pay the note, *i.e.,* has placed its general assets at risk, any New York mortgage is deemed to be nonrecourse. RPL § 249. *See also* N.Y. Gen. Oblig. Law ("GOL") § 5-705 (grantee deemed not to assume existing mortgages). Hence, the nonassuming grantee has no personal liability. The discussion in the text also assumes the lender is proceeding through a foreclosure (in which the lender wants to obtain a deficiency judgment) rather than a purely personal lawsuit on the note.

[4] RPAPL § 1371(2).

[5] *See* Gellens v. Saso, 44 N.Y.S.2d 84, 85 (Sup. Ct. 1943) (failure to provide for personal liability in the judgment of foreclosure and sale is "fatal"). This requirement does not appear in the statute, or at least is not readily apparent.

[6] If the lender plans to seek a deficiency judgment, the lender should start the bidding well below the full amount of the debt. This proposition sounds rather obvious, but lenders have been known to bid the entire amount of their debt and then express surprise to learn they cannot obtain a deficiency judgment. Given the provisions of RPAPL § 1371 as described in text, a lender should consider bidding up to the fair market value of the collateral on the date of the auction. That strategy would alone justify obtaining a current appraisal of the mortgaged property.

[7] In numerous cases, courts have struggled with the question of when the deed has actually been delivered. For example, delivery to the lender's attorney will probably constitute delivery.

[8] RPAPL § 1371(2). The 90-day time limit is fundamental—"jurisdictional"—and strictly applied. *See* Lennar v. Northeast Partners Ltd. P'ship v. Gifaldi, 258 A.D.2d 240, 695 N.Y.S.2d 448, 450-51 (App. Div. 1999) (90 days "is a Statute of Limitations" and runs from date of the deed, even if mortgagee argues deed was "in escrow" until much later); Union Realty Partners, Ltd. v. Menicucci, 270 A.D.2d 339, 704 N.Y.S.2d 611, 612 (App. Div. 2000) (failure to move for deficiency judgment within 90 days after consummation of foreclosure sale "bars" mortgagee from obtaining one). The statute also imposes certain additional procedural requirements.

lender can potentially obtain a deficiency judgment. If the lender fails to satisfy any one or more of the requirements, including, for example, the requirement to file the deficiency judgment motion within 90 days after delivery of the foreclosure deed, the lender cannot obtain a deficiency judgment.[9] Because of the absolutely immovable character of the 90-day deadline, a lender's counsel should plan ahead to prevent any possible issue. For example, because a motion for a deficiency judgment will require proof of the value of the collateral, the lender should order an appraisal but need not wait until after the deed has been delivered.

[3] Amount of Judgment

The lender's deficiency judgment will equal the foreclosure judgment (plus interest and certain other items) reduced by whichever of the following is higher: (1) the successful foreclosure bid; or (2) the fair market value of the mortgaged property as of the date of the foreclosure sale (or the last earlier date when the mortgaged property had any value), as determined by a court-appointed referee in hearings held for that purpose.[10] The fair market value, as determined by the referee after the fact, may bear no relation at all to the amount of the successful bid.[11]

If the lender does not comply with the statutory requirements described above, it cannot obtain a deficiency judgment.[12]

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[9] *But see* Security Pac. Mortgage & Real Estate Servs., Inc. v. Herald Center Ltd., 731 F. Supp. 605 (S.D.N.Y. 1990) (allowing plaintiff mortgagor, more than 90 days after judgment, to amend judgment to seek deficiency judgment). This case was described, perhaps euphemistically, as an "anomaly and fact sensitive" in Andrew H. Levy & Farzana Kanji, *The Complexity of Enforcing Real Estate Loans in New York,* N.Y.L.J., Oct. 10, 2002, at 4 (discussing New York antideficiency rules with an emphasis on multiple collateral).

[10] RPAPL § 1371(2). *See also, e.g.*, Melino v. National Grange Mutual Ins. Co., 213 A.D.2d 86, 630 N.Y.S.2d 123, 125 (App. Div. 1995), *citing* Norstar Bank v. Morabito, 201 A.D.2d 545, 607 N.Y.S.2d 426, 427 (App. Div. 1994) ("the Bank is entitled only to the difference between the balance formerly owed under the mortgage, plus interest, and the fair market value of the property"). The guarantor or other personal obligor will argue in these proceedings that although the collateral sold for $X at foreclosure auction, it was really worth $2X, and hence the lender should be deemed to have received $2X as foreclosure sales proceeds. In other words, the successful bidder paid too little. If the foreclosure auction was duly conducted and properly announced, and the mortgagee gave the guarantor plenty of notice of the sale, and the guarantor had an opportunity to outbid the successful bidder (assuming the guarantor had the resources to do so), but the guarantor chose not to do so, could the lender claim some form of estoppel against the guarantor? Not according to the terms of the statute. *But see* Section 15.05[3], *below* (suggesting untested language for a guaranty to seek to support such an estoppel argument).

[11] *See* BTC Mortgage Investors Trust 1997-SI v. Altamont Farms, Inc., 284 A.D.2d 849, 727 N.Y.S.2d 513, 514 (App. Div. 2001) (valuation process).

[12] RPAPL § 1371(3). Moreover, once the lender has started the foreclosure action, as long as the

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[4] Multiproperty Loans

A Court of Appeals case decided in 1986 holds that when a lender makes a multiproperty loan and then forecloses, a deficiency hearing will be required (unless the court orders otherwise) after the foreclosure sale for each property, to limit the borrower's remaining exposure on its other assets to an amount that takes into account the deficiency analysis after each foreclosure sale.[13] In addition, the foreclosure action should identify and allow the lender to proceed against all the collateral as part of the complaint.[14] These requirements can severely complicate a multiproperty loan, particularly if some of the collateral is located out of state.[15] In some cases, these considerations may be enough to motivate breaking one loan into separate promissory notes, although this is not customary in New York.

For language to seek to mitigate this problem, *see* Section 16.03[5], *below*.

§ 15.05 Lender Response to Coordination of Remedies and Antideficiency Rules

[1] Pitfalls After Default

Although the preceding two sections cover the main elements of New York's coordination of remedies and antideficiency rules, and although the discussion sounds fairly simple and straightforward, this area always raises endless permutations and combinations (and pitfalls for the lender) once a loan goes into default. It has spawned a reasonably large body of jurisprudence, in which each case relates to its own facts, in some cases producing results that do not necessarily make intuitive sense under the circumstances. The reported cases seem to point in enough directions that a judge can reach any conclusion he or she wants to reach.

Moreover, the reported cases either omit most or all of the facts or describe a

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lender has not been thrown out of court, the lender cannot start a separate personal action on the note or on the guaranty, as described above. Therefore, when the lender chooses foreclosure and starts the action, the lender must name and serve all possible obligors as defendants. *See* Federal Deposit Ins. Corp. v. Robin Constr. Corp., 2 A.D.3d 395, 767 N.Y.S.2d 866, 867 (N.Y. Sup. Ct. 2002) (denying motion to amend deficiency judgment to include guarantors after foreclosure sale had been completed).

[13] Sanders v. Palmer, 68 N.Y.2d 180, 507 N.Y.S.2d 844, 499 N.E.2d 1242 (N.Y. 1986). *See also* Andrew H. Levy & Farzana Kanji, *The Complexity of Enforcing Real Estate Loans in New York,* N.Y.L.J., Oct. 10, 2002, at 4 (discussing application of *Sanders* in later cases).

[14] If the complaint specifies the order of sale of collateral (probably starting from most valuable to least valuable), the court may be willing to dispense with the requirement for a separate hearing after each sale.

[15] *See* Marvin R. Baum, *Problems in Foreclosing Multiple Mortgages Securing a Single Debt,* N.Y. St. B. Ass'n Real Prop. L. Sec. Newsletter, Oct. 1987, at 4. *See also* Andrew H. Levy, *Multi-State, Cross-Collateralized Real Estate Deals,* N.Y.L.J., Aug. 16, 2000, at 1.

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factual background so complex and bizarre that the case ultimately stands as precedent for very little. The area is extremely hard to summarize, and the discussion here does not fully do so.

These complexities may, in and of themselves, argue for the simplicity of nonrecourse lending. They also may give a lender another reason to prefer the bankruptcy process, through which a lender might, for example, be able to persuade the court to auction off the collateral[1] and yet preserve the borrower's personal liability, possibly without regard to New York's coordination of remedies and antideficiency rules—a so-called snatch dirt resolution of the bankruptcy case.

Beyond having some rudimentary awareness of New York's coordination of remedies and antideficiency rules, any mortgage loan practitioner simply needs to remember one rule: Do not commence any action or do anything else to enforce a mortgage loan (if the loan provides for any form of recourse liability or other collateral) without carefully considering New York Real Property Actions and Proceedings Law (RPAPL) §§ 1301 and 1371 and related law.[2]

[2] Waiver?

Can lenders "solve" the coordination of remedies and antideficiency problems by having the borrower and the guarantor "waive" the protections of these statutes? Probably not. So far, no lender appears to have tried such a strategy. Any such waiver would probably face an uphill battle to be enforceable. At a minimum, the parties would probably need to recite specific reasons and circumstances justifying the waiver, explaining why the lender should not be bound by New York RPAPL §§ 1301 and 1371. If such a waiver were effective, then every lender would add one to its documents immediately, and New York RPAPL §§ 1301 and 1371 would become meaningless—probably not what the Legislature had in mind.

On the other hand, if a lender tried to include waiver language in its documents but the waiver failed, would the lender be any worse off than if the documents had said nothing at all on the topic? No cases appear to have considered these questions, but as lenders continue to try to learn from experience, they may wish to look further into the waiver option.

A waiver might be more likely to work if it is entered into after the loan goes into default, to induce the lender to refrain from exercising remedies immediately.

[1] 11 U.S.C. § 363(b)(1) and (k).

[2] For a thorough discussion of these statutes, *see* Robert H. Bowmar, *A Mortgagee's Election of Remedies in New York: Still a Trap for the Unwary,* 2 N.Y. Bus. L.J. 34 (1998) (part one); 3 N.Y. Bus. L.J. 28 (1999) (part two). This journal is published by the New York State Bar Association's Business Law Section.

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In other contexts, courts have sometimes been more tolerant of such measures when created as part of a workout than as part of the original loan.

[3] Possible Language for Guaranty

If a lender holds a guaranty of principal of a loan, a lender might also try to achieve the functional equivalent of a "waiver," or at least a decent argument, by adding language such as the following to the guaranty:

> Guarantor agrees and acknowledges that, provided Lender has notified Guarantor of the date, time, and place of any judicial or nonjudicial foreclosure sale of the Mortgaged Property (and any adjournment of any such sale): (a) Guarantor covenants to and shall attend the sale and shall bid the full market value of the Mortgaged Property; (b) if Guarantor does not enter a bid higher than the otherwise highest bid for the Mortgaged Property, then such highest bid shall be conclusively deemed to be the full market value of the Mortgaged Property; and (c) Guarantor shall be estopped from asserting that such highest bid was less than the full market value of the Mortgaged Property.

This language should do no harm. It is, however, creative and untested. There is no assurance that a court will pay any attention to it. This might be particularly true against the backdrop of a failed real estate project in which both the project and the guarantor have suffered financial problems and, almost by definition, the guarantor probably no longer has the capacity to make a substantial bid at the foreclosure sale (otherwise, the guarantor would have already figured out a way to save the project).

No lender or its counsel should rely upon any language of the type suggested here, but may wish to try using it in the appropriate case.

[4] Choice of Law

A lender might also want to explore having the law of a state other than New York govern the loan (as opposed to the lender's enforcement remedies), an approach that raises issues similar to those discussed in Chapter 17. In general, however, lenders doing business in New York (and their New York counsel) usually prefer to choose New York's law rather than some other state's law to govern the loan itself (as opposed to the real property remedies).

Along similar lines, a lender might be able to proceed in federal court, and treat the whole matter of coordination of remedies as a "procedural" (federal law) issue rather than a "substantive" (state law) issue. One lucky lender did exactly this in *Midwest Fin. Acceptance Corp. v. Se-Fish Assocs.*[3] In that case, a federal court

[3] No. 1417, 2000 U.S. Dist. LEXIS 7920 (W.D.N.Y. May 31, 2000).

concluded that joinder of remedies is a federal question.[4] Applying Federal Rule of Civil Procedure 18, the court allowed the mortgagee to seek two remedies at once: mortgage foreclosure and a judgment on the promissory note.[5] Concluding that the entire discussion relates to "not what the parties litigate, but how," the court rejected the borrower's argument that RPAPL 1301 is a "'rule of substance' which should . . . predominate over a similar federal rule."[6]

[5] Separate Obligations

Some discussion in the cases cited above suggests that if a lender holds a guaranty of "nonrecourse carveouts" (or of any other obligations beyond principal and interest), the lender may gain leverage if it can clearly demonstrate that the obligations covered by the guaranty are not the same as the obligations to pay principal, interest, and other amounts under the mortgage loan documents. These cases support the concept that a lender can enforce different obligations simultaneously.

The lesson for a lender: If possible, any ancillary guaranty, such as a guaranty of nonrecourse carveouts, should make very clear that the guarantor's obligations relate to different and distinct indebtedness and obligations, and do not merely overlap the same mortgage debt that constitutes the main obligation.

To avoid these issues, a "carveout guaranty" should ideally be structured so the guarantor must pay something other than principal, interest, and other charges. Exactly what that "something" should be may not be easy to define, although "reimbursement of protective advances," *e.g.,* real estate taxes, insurance, or other payments by the lender to cure the borrower's defaults, does not seem far-fetched.

A guaranty might, for example, include language such as the following:

Guarantor unconditionally guaranties that Borrower shall pay and perform all the Nonrecourse Carveouts, as defined in the Loan Agreement. This obligation of Guarantor shall exclude any obligation to pay principal of or interest on the Loan. Guarantor acknowledges that Guarantor's obligations under this Guaranty represent obligations independent of, separate from, and in addition to Borrower's obligations to repay principal and interest of the Loan. Accordingly, Lender may enforce this Guaranty independently of, separately from, and in addition to any enforcement of Borrower's obligations to pay principal and interest of the Loan.

To the extent that the nonrecourse carveouts make the guarantor personally

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[4] No. 1417, 2000 U.S. Dist. LEXIS 7920, at *2 (W.D.N.Y. May 31, 2000).

[5] No. 1417, 2000 U.S. Dist. LEXIS 7920, at *5–6 (W.D.N.Y. May 31, 2000).

[6] No. 1417, 2000 U.S. Dist. LEXIS 7920, , at *8 (W.D.N.Y. May 31, 2000) ("'[W]hen a situation is covered by one of the Federal Rules . . . the court has been instructed to apply the Federal Rule"' (*quoting* Hanna v. Plumer, 380 U.S. 460, 471 n.2 (1965)).

liable for the entire loan, for example, on a bankruptcy or prohibited transfer, this approach would not work. In that case, a lender might be well advised to obtain two guaranties. One would cover principal and interest of the loan, effective on any event that triggered personal liability for the entire loan. The second would cover the other Nonrecourse Carveouts, using language like that suggested immediately above.

[6] Federal Court?

As another possible response to New York's coordination of remedies rules, a commercial mortgage lender might explore the possibility of bringing a foreclosure action in federal court. At least one recent federal decision supports the view that RPAPL § 1301 set forth "procedural" rules not binding on a federal court in diversity jurisdiction.

In *Midwest Financial Acceptance Corporation v. SE-Fish Associates*,[7] the foreclosing mortgagee started a foreclosure action and an action for a money judgment against the guarantors on the debt at the same time and in the same complaint—but in federal court rather than state court. The plaintiff sought to prosecute both actions simultaneously, and the defendants argued that simultaneous prosecution violated New York's RPAPL § 1301. The federal district court concluded that the plaintiff was simply seeking to join multiple claims under federal procedural rules on joinder, which governed to the exclusion of RPAPL § 1301.[8] The court rejected the defendants' argument that RPAPL § 1301 represented a "rule of substance" under New York law.[9] And the court had little patience with the defendants' arguments about the "policy" behind RPAPL § 1301.[10]

Of course, any commercial mortgage lender that wants to rely on the *Midwest Financial Acceptance* case will need to figure out a way to bring its action in federal court, which may not always be easy. And the plaintiff will need to anticipate that the defendant will raise all the arguments that the *Midwest Financial Acceptance* court rejected—a process that could cause significant delay in the federal court action.

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[7] 2000 U.S. Dist. Lexis 7920 (W.D.N.Y. 2000) (unpublished opinion). *See also* Citizens Bank & Trust Co. v. SE-Fish Assoc., 2003 U.S. Dist. LEXIS 18486 (W.D.N.Y. 2003) (irrelevant subsequent history and citing other irrelevant subsequent history).

[8] 2000 U.S. Dist. Lexis 7920, at *5-6 (W.D.N.Y. 2000).

[9] 2000 U.S. Dist. Lexis 7920, at *7 (W.D.N.Y. 2000).

[10] 2000 U.S. Dist. Lexis 7920, at *13-14 (W.D.N.Y. 2000).

§ 15.06 Planning Ahead: Use of Multiple Mortgages

[1] Structuring

In closing and structuring mortgage loans, a New York attorney cannot do much to "plan ahead" to prevent problems arising from New York's coordination of remedies and antideficiency rules, except perhaps the following.

A lender should be able to avoid some of the New York "coordination of remedies" and "antideficiency" rules by breaking one loan into two entirely separate loans, each secured by a separate mortgage, one or both covered by separate guaranty(ies), possibly allowing the lender to proceed separately, and obtain separate judgments, in enforcing each of the two loans.[1] This approach will be particularly attractive in cases in which part or all of the debt (or both of them) is guaranteed. It may have less value for single-asset loans that are completely nonrecourse.[2]

A court might, if pushed by a creative and well-represented borrower, conceivably regard such a structure, based on simultaneous loans, as abusive or overly creative. On the other hand, there is no law against one lender making multiple loans secured by multiple mortgages, and the right to make a loan should imply a right to enforce a loan. If the loan documents describe totally separate loans and permit totally separate enforcement (fairly easy to achieve), by what principle of law or equity should a lender be forced to treat multiple loans as one? Of course, if the court decided to find such a principle, perhaps the court would find a way to punish the lender for trying to "get around" New York's borrower protections. This punishment would take the form of a finding that the lender needed to enforce the same remedy at the same time for both mortgages—treating

[1] A two-mortgage structure also might produce certain other benefits, as described in § 6.13, *above.* A lender will need to be strategic in deciding which of its two mortgages to foreclose first. Typically, the lender would choose the more senior, if the second is personally guarantied. The lender, however, might proceed on the second instead under the circumstances discussed in the next footnote. In enforcing a construction loan, a lender might choose to commence a personal lawsuit—instead of a foreclosure—on the debt secured by a project loan mortgage, as the priority of this mortgage against mechanics' liens is quite uncertain. *See* Chapter 5.

[2] Even in a single-asset nonrecourse loan, the use of multiple mortgages may allow the lender to foreclose under only the subordinate mortgage and keep the senior mortgage "alive" for purposes of future mortgage recording tax savings. This might in theory produce higher bids at the foreclosure sale. The analysis must, however, consider the extent to which the "surviving" mortgage would cause the foreclosure sale to incur transfer taxes that would otherwise be avoided. These transfer taxes are discussed in § 15.08, *below.* Like most other issues in this area, it is one that need not be considered until after default. In the meantime, the use of multiple mortgages might create flexibility that would not otherwise exist. The discussion demonstrates again the degree to which tax considerations create gratuitous complexity and issues in any New York mortgage-related transaction.

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the two mortgages as one. One side or the other of the lender's enforcement activities would then be invalidated or suspended to the extent required under New York's coordination of remedies and antideficiency rules.[3]

[2] Favorable Cases

A few cases, including some relatively recent ones, have looked somewhat favorably on a lender's separate and simultaneous enforcement of two "independent" mortgages on the same collateral.[4] During the real estate depression of the 1990s, a leading commentator on New York foreclosures published an article on the mechanics and issues of foreclosing multiple mortgages held by the same lender on the same property, treating the issues raised by the structure as being purely mechanical and not going to fundamental validity.[5]

In one notable foreclosure proceeding during the real estate depression of the early 1990s, the lender had fortuitously (because of the various complexities of New York law and practice discussed elsewhere in this work) obtained a whole series of separate notes and mortgages rather than just one. The lender also obtained a single guaranty covering all the notes and the entire loan, which the guaranty defined as just one loan, even though that loan was made in a series of tranches. A single loan agreement apparently governed the entire financing. The references to a single loan might have made it easy for a court to decide the entire financing was a single loan requiring a single enforcement proceeding.

When the loan went into default, the lender started foreclosure proceedings on most but not all of the various mortgages it held—the mortgages that secured 26 out of the 30 notes the lender held, the lender's building loan. The lender

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[3] Although the law abhors forfeitures, a court that reached the result described in the text would apparently not abhor the forfeiture that would result from denying a lender the right to enforce its loan documents in accordance with their terms.

[4] In a 1976 case, the Appellate Division issued a favorable ruling in a report that sets out no facts whatsoever beyond the existence of two mortgages, one of them guaranteed. Seawood Investors, Inc. v. Goldstein, 51 A.D.2d 592, 378 N.Y.S.2d 987 (App. Div. 1976). The court said that the lender was not barred from foreclosing one mortgage and at the same time suing on the guaranty for the other. "The fact that the separate loans were secured by separate mortgages on the same premises is irrelevant, since there was no consolidation or merger of the two mortgages. Plaintiff had the right to bring whatever combination of lawsuits it deemed advisable to better assure full payment of both loans." *Id.* at 988. *See also* Bank Leumi Trust Co. of N.Y. v. Mari-Age Bridals, Inc., 215 A.D.2d 422, 626 N.Y.S.2d 535 (App. Div. 1995) (no meaningful statement of facts, but court allowed lender to foreclose the mortgage and enforce a related guaranty simultaneously, finding that they represented different debts); P.T. Bank Central Asia v. Wide Motion Corp., 233 A.D.2d 151, 649 N.Y.S.2d 151 (App. Div. 1996) (to similar effect; again, no facts).

[5] Bruce J. Bergman, *Critical Strategy When a Lender Holds Two Mortgages on the Same Property,* N.Y. St. B. Ass'n Real Prop. L. Sec. Newsl., July 1990, at 21. *See also* Bruce J. Bergman, Bergman on New York Mortgage Foreclosures § 2.07 (LexisNexis Matthew Bender).

simultaneously tried to enforce the guaranty, but only as it related to the handful of "indirect cost" notes for which the lender did not actually commence foreclosure proceedings.

The borrower objected, of course, saying all the notes were really a single loan and the lender could not treat it as two. The court allowed the lender to proceed, saying:

> Defendants argue this action-motion [is] barred by RPAPL § 1301. However, this statute does not prevent a plaintiff from bringing an action on two distinct obligations[:] the mortgage debt in the foreclosure action and the instant action on the guaranty of the Indirect Cost Loans. (Seawood Investors v Goldstein, 51 AD2d 592, 378 N.Y.S.2d 987). Defendants concede that the amended complaint in the building loan mortgage foreclosure action omits the Indirect Cost Loans, thus, the danger RPAPL § 1301 seeks to prevent, double recovery of the same mortgage debt is not present here.[6]

In other words, the court was willing to let the lender enforce the guaranty of some of the indebtedness at the same time the lender foreclosed the mortgage securing the remainder of the indebtedness, even in the face of documents that could have supported treating the entire financing as a single loan that could be enforced only as a whole. Presumably, the court would have been even more receptive to the lender's two simultaneous enforcement actions if the two pieces of the same loan had been documented as entirely separate loans.

Assuming such a bifurcation works, and the case described above suggests that it does, it allows the lender to put pressure on the borrower on two fronts at once: first, under one loan, the foreclosure against the property; and, second, under the other loan, the prospect of immediate personal liability.[7] The extra leverage may save years of litigation.[8] Of course, the borrower will argue that the two loans are really one, and because the lender tried to proceed in different ways under both at once, the lender must be punished under New York's one form of action rules.[9]

Whether a lender should try to enforce two mortgage loans separately, as two

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[6] Citibank, N.A. v. Ian Bruce Eichner, memorandum decision in unreported case on file with author, Supreme Court, State of New York, New York County, Index No. 12525/91 (Justice Carol E. Huff), at 3.

[7] *See* Michael J. Feinman & William Zeena Jr., *Election of Remedies Statute's Effects on Holders of Mortgage Loan Guarantees,* N.Y.L.J., Mar. 11, 1992, at 1 (favoring use of two-mortgage structure when part or all of the loan is personally guaranteed and discussing litigation cited in preceding footnote). *See also* Andrew H. Levy & Lawrence J. Diamond, *Remedies Under Multiple Mortgages: Opportunities and Pitfalls,* N.Y.L.J., Dec. 31, 1992, at 1 (again favoring use of multiple mortgages precisely to facilitate simultaneous enforcement of mortgage and guaranty).

[8] The use of multiple mortgages instead of one could create certain other advantages, described in § 6.13, *above.*

[9] *But cf.* Simon v. Superior Court, 4 Cal. App. 4th 63, 5 Cal. Rptr. 2d 428 (Ct. App. 1992)

entirely separate loans, is an important question. It is, however, a question whose answer can wait until the loan goes into default. At the time of closing, it is submitted that a New York lender should seriously consider requiring that the parties structure a financing transaction as multiple separate mortgage loans, at least when the lender holds a meaningful personal guaranty of part or all of the debt.[10] Use of two mortgages is certainly not customary, but it may create flexibility later.[11] Moreover, the incremental burden to a lender is less than it might be in some other state, because a New York lender already needs to deal with multiple mortgages because of the mortgage recording tax and, for construction financing, the Lien Law.[12]

[3] Sample Language: Multiple Mortgages

If a lender decides to try to create future flexibility by holding two mortgage loans instead of one, the lender may wish to include language in the mortgage(s) to support the argument that the lender holds two separate loans, and can deal with them and enforce them separately. The lender might want to consider using language like the following, which at the time of writing had never been tested in court:

Multiple Mortgages. If Mortgagee at any time holds or acquires any mortgage(s) encumbering the Mortgaged Property other than this Mortgage (any such other mortgage, an "Independent Mortgage"), then each such Independent Mortgage shall, regardless of when and how Mortgagee obtained or acquired such Independent Mortgage, constitute at all times a separate, distinct, and independent mortgage, securing obligations that are separate, distinct, and independent from the Secured Obligations under this Mortgage. Therefore, if Mortgagee exercises any Mortgagee's Remedies, then such exercise of Mortgagee's Remedies shall not in any way limit, affect, impair, suspend, delay, or defer Mortgagee's right(s) to exercise any rights or remedies under any Independent Mortgage or any indebtedness secured by such Independent Mortgage. Similarly, if Mortgagee resorts to any remedies under any Independent Mortgage or any indebtedness secured thereby, then such exercise of remedies shall not limit, affect, impair, suspend, delay, or defer Mortgagee's right(s) to exercise any rights or remedies under this Mortgage or regarding the indebtedness this Mortgage secures. Mortgagor recognizes and acknowledges that Mortgagee

(rejecting similar use of multiple mortgages in context of California's much more difficult one-form-of-action rules).

[10] The lender may require a personal guaranty of one loan but not the other. In that case, the personal guaranty should attach to the more junior and riskier piece of the loan, to avoid the grief that befell the lender in Chemical Bank v. Meltzer, 93 N.Y.2d 296, 690 N.Y.S.2d 489, 712 N.E.2d 656 (1999). *See* § 13.02, *above.*

[11] *See* § 6.13, *above,* which discusses some reasons a lender may want to break one mortgage loan into two separate mortgage loans.

[12] One could also describe this approach as turning a problem into an opportunity.

would not have been willing to make (or acquire, as the case may be) either of the two separate loans secured by this Mortgage and any Independent Mortgage if such two separate loans were to be deemed to constitute a single integrated loan. Accordingly, Mortgagor acknowledges that such two separate loans do not constitute a single integrated loan. All Mortgagee's Remedies under this Mortgage and any Independent Mortgage shall be determined as if such Independent Mortgage were held by an independent third party and not by Mortgagee.

Language similar to the foregoing might also be used in the loan agreement and other loan documents for the transaction. More generally, the lender should also document each loan as an entirely separate transaction,[13] to preserve the position that they are entirely separate and can be enforced separately.[14] A lender might prefer this second path and avoid "protesting too much" about the separateness of the various loans.

If the lender obtains a guaranty of one note and mortgage but not the other note and mortgage, the lender should assure that the guaranty document refers strictly to only one note and mortgage. The guaranty should not contain, for example, broad and general language in which the guarantor guaranties all obligations related to the loan or the loan documents. (Guaranties often contain such language.) Instead, the guarantied obligations should be very narrowly defined as consisting of a particular note or loan, not even a piece of some larger loan, but rather an entirely separate obligation. Otherwise, the lender invites arguments that the whole transaction is a single combined transaction and the guaranty relates to all of it.

As noted, a lender should think long and hard before actually trying to rely on a two-mortgage structure after a loan goes into default. If the lender chooses not to try to enforce multiple mortgages separately, then one would think the lender's position should be no worse than if the lender had merely held a single mortgage loan.[15]

Whatever the advantages of such a structure, it does not seem to have attracted

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[13] The loan documents themselves help, but if the borrower claims the multiple loans are really one loan, the borrower will seek discovery of the lender's entire file—commitment letter, correspondence, internal approvals, and so on. If this paperwork shows the parties treated the transaction as a single loan, the lender may want to make sure that the paperwork also shows a reasoned business decision to convert one loan into two, with a reasonable explanation of why. These considerations help explain the popularity of some "document retention" programs that result in retaining less paper rather than more (subject of course to regulatory and legal requirements, particularly the proscription on destroying files once a matter goes into litigation).

[14] At some point in the process, the lender might consider assigning one of the loans to a separate entity—related or unrelated—to provide further support for the lender's position.

[15] The arrangement may suffer from at least the following problems: (1) extra complexity, paperwork, and hence cost and risk of mistakes at the original closing; and (2) one of the mortgages

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much, if any, use by New York mortgage lenders and their counsel. They may fear the extra complexity it entails. They may have forgotten that loans can and do go into default (perhaps an unfortunate byproduct of the demarcation between "deal lawyers" and "litigators" in modern law practice), and lenders should think about how to maximize their leverage when that occurs. Lenders' counsel may also recognize that it is always safer to do things the way they have always been done, for fear that whoever does new and creative things will cause new and creative problems arising from unexpected and unpredictable circumstances, for which they will then be blamed.

§ 15.07 Of Fire and Foreclosure

[1] Mysterious Fires

A number of cases, in New York and elsewhere, have dealt with the fact pattern in which a building mysteriously burns down a few days before the foreclosure sale, the lender does or does not know about the casualty, and the lender holds a foreclosure sale. In the worst case, the lender bids the entire amount of its loan at the foreclosure sale. Who then receives the insurance proceeds?

As a general rule, the courts often say that under these circumstances, the lender was made whole at the foreclosure sale. The lender bid the amount of its loan and agreed to accept the burnt-out building in full satisfaction of the loan. At that moment, the lender's loan was extinguished. The lender therefore no longer has any "insurable interest" once its loan has been repaid. Therefore the lender is entitled to nothing more than the burnt-out building.[1] Under this reasoning, if the court awarded the insurance proceeds to the lender, that would amount to a "windfall."[2]

Similar issues arise when the borrower holds other claims against third parties relating to the real property, such as claims for negligence or bad construction against architects and contractors. After a "full credit bid" at foreclosure, do those claims belong to the borrower or the lender? Who owns them?

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would be a "second" mortgage, which is usually considered a bad thing (though in this context probably should not be considered a bad thing).

[1] For an extensive discussion of New York cases in this area, *see* Peter V. Coffey, *Fires and Foreclosures,* N.Y. State Bar Ass'n Real Prop. L. Sec. Newsl., Oct. 1990, at 23.

[2] *See* Joshua Stein, *Property Insurance: Lenders' Hot Buttons In Loan Closings and Administration,* 442 Practising L. Inst.: Com Real Est. Fin. 727, 737-738 (May-June 1999) (describing this theory as "hypertechnical," proving only that courts hate mortgage lenders even more than they hate insurance companies). *See also* Patrick A. Randolph, Jr., *A Mortgagee's Interest in Casualty Loss Proceeds: Evolving Rules and Risks,* 32 Real Prop. Prob. & Tr. J. 1 (1997).

[2] Inconsistent New York Cases on Insurance Proceeds

In several New York cases,[3] the borrowers have tried to assert that New York's antideficiency rules preclude a lender from obtaining the benefit of the insurance coverage or third-party claims under these circumstances. These borrowers have argued that the insurance payments or payments by negligent architects and contractors should go to the former borrower instead of the lender. If this argument succeeded, of course, mysterious fires on the eve of foreclosure might become even more frequent than bankruptcy filings as a last-minute, pre-foreclosure planning technique for borrowers in distress.[4]

Notwithstanding the general rule that the lender loses under these circumstances, several New York cases have given the lender the benefit of the insurance coverage and the third-party claims even after the lender held a foreclosure sale. The cases do not indicate whether the lender bid the entire amount of the loan, and under the logic of these cases it does not matter. In each case, the court based its conclusion on the fact that the borrower had, in the loan documents, expressly assigned these rights to the lender.[5] The courts reasoned that the borrower's assignment of these rights, as set forth in the mortgage, is perfectly enforceable between borrower and lender.[6]

The courts in these cases rejected the following arguments made by the borrower: (1) the lender had not sought a deficiency judgment, and a claim for the insurance proceeds is just like a deficiency judgment;[7] and (2) the foreclosure sale

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[3] *See* cases discussed *below,* this subsection.

[4] Of course, this planning technique might raise its own problems, starting with the former borrower's likely lack of an "insurable interest" and continuing with the New York Penal Code.

[5] *See* L.G.H. Enters., Inc. v. Kadilac Mortgage Bankers, Ltd., 225 A.D.2d 735, 640 N.Y.S.2d 155, 156 (App. Div. 1996) (although mortgagee could not recover insurance proceeds after foreclosure by relying on a mortgagee's loss payable clause, the mortgagee can recover under a direct assignment of those proceeds in the mortgage); Melino v. National Grange Mut. Ins. Co., 213 A.D.2d 86, 630 N.Y.S.2d 123, 125 (App. Div. 1995) (borrower "did nothing more than assign, during the course of what is presumed to have been an arm's length transaction, her rights under [the] insurance policy to the Bank," and such assignment is perfectly effective notwithstanding the foreclosure sale and alleged termination of the lender's mortgage); TIG Ins. Co. v. Wilshire Credit Corp., 269 A.D.2d 524, 703 N.Y.S.2d 501, 501-02 (App. Div. 2d Dept. 2000) (mortgagee was "contractually entitled to the proceeds of the policy notwithstanding its failure to obtain a deficiency judgment"). *See also* Howard W. Kingsley, *Lenders Awarded Post-Foreclosure Rights,* 27 N.Y. Real Prop. L.J. 107 (1999).

[6] *See also* GMS Capital Corp. v. Siegmund Spiegel/Baldur Peter, P.C., 251 A.D.2d 542, 674 N.Y.S.2d 733 (App. Div. 1998) (similar treatment of borrower's claims against allegedly negligent architects).

[7] L.G.H. Enters., Inc. v. Kadilac Mortgage Bankers, Ltd., 225 A.D.2d 735, 640 N.Y.S.2d 155, 156 (App. Div. 1996) (referring to Supreme Court ruling); T.I.G. Ins. Co. v. Wilshire Credit Corp., 269 A.D.2d 524, 703 N.Y.S.2d 501 (App. Div. 2d Dept. 2000).

"terminated" the lender's mortgage and whatever assignments the mortgage contained.[8]

The result in these cases seems reasonable enough, although a more satisfying basis for it would be the following. When the borrower assigned the insurance policy and other third-party claims to the lender, they became part of the lender's collateral. They traveled with the real estate. At the foreclosure sale, the lender as successful bidder bought not only the burnt-out hulk but also the insurance policy and any claims of the borrower under the insurance policy, as part of the same "lot" being sold at auction. Now the lender, as successful bidder, owns not only the charred doorknobs and the sooty kitchen sink (or the smoldering foundation of the former building). It also owns the insurance policies, any claims that the borrower could have asserted under the insurance policies, the borrower's claims against negligent architects and contractors, and everything else that was previously part of the lender's collateral.

In the author's opinion, this "bundling" approach tracks business expectations, typical mortgage loan documents, and the underlying theory of secured lending. Under this logic, if a third party were the successful bidder, the insurance policies would belong to the third party rather than the lender. This would make more sense.

The preceding discussion does not consider the impact or implications of insurance law requirements to the effect that any recipient of insurance proceeds must have an "insurable interest" in the affected asset. If the lender has been fully paid, it may lack an "insurable interest." The lender would argue that the "insurable interest" that defined the limits of the insurance claim was actually the borrower's interest at the moment of the fire—and lender acquired the borrower's claim through the foreclosure sale.

[3] Loan Documents

From a documentation perspective, these cases teach lender's counsel the following lessons:

- *Insurance Policies and Claims as Element of Collateral.* The collateral should include, and the borrower should expressly assign to the lender, all rights and claims under insurance policies. Such a provision typically appears in most institutional mortgages.
- *Insurance Proceeds Payee.* The documents should say that any check for insurance proceeds should be payable solely to the lender, and the

[8] Melino v. National Grange Mut. Ins. Co., 213 A.D.2d 86, 630 N.Y.S.2d 123, 125 (App. Div. 1995).

borrower should expressly direct the insurance carrier to pay the insurance proceeds to the lender. Such a provision is quite common, though perhaps not quite as common as the first one. Without such a provision, a joint check could languish for months if the borrower decides not to endorse it.

- *Appointment of Lender as Agent.* In the loan documents, the borrower should appoint the lender as the agent's attorney-in-fact to endorse checks for insurance proceeds. Although such a provision may not be enforceable, it should not hurt. Not all New York mortgages contain it.[9]

- *Scope of Collateral.* The mortgage should also treat as part of the collateral any other third-party claims that should "travel with" the asset—anything from claims against negligent architects and contractors to claims the borrower might be able to assert against the seller of the property or a governmental agency. Mortgages typically do not go as far in this area as they might.[10]

To implement the last suggestion above, the lender might include language like the following in the mortgage:

If, as of the date when any Loss Proceeds are payable, a Foreclosure has divested Borrower of title to the Mortgaged Property, then the Loss Proceeds, as part of the Mortgaged Property, shall be paid to (and shall belong to) the then owner of the Mortgaged Property, even if the successful bid at any foreclosure sale equaled or exceeded the amount of the Obligations. Mortgagor acknowledges that the successful bidder at any Foreclosure shall acquire, as part of the Mortgaged Property sold at Foreclosure, all then existing or potential rights to receive Loss Proceeds, together with all Loss Proceeds previously paid. Mortgagee's collection, application, or release of any Loss Proceeds shall not cure or waive any Default or notice of Default or invalidate any act done under any notice of Default.

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[9] In the event of a fire, the lender will probably want to give the insurance carrier a copy of the mortgage provision(s) suggested in this paragraph and the preceding one.

[10] More generally, the challenge to lender's counsel is to think of every possible asset, right, or property interest that should be part of the lender's collateral. If lender's counsel leaves anything out, the omission will give the borrower leverage when the loan goes into default. The problem is particularly acute in hotel loans, where the collateral has hundreds of components and moving parts and is a living and breathing business, not merely a real estate investment. *See* Joshua Stein, *Hotel Loans: Underwriting, Structuring, and Lenders' Due Diligence*, Real Estate Review, Winter 1997, at 32. The lender's lien needs to capture every piece of that business. The laundry list of collateral can continue for many pages. In today's world of single-purpose borrowers, secured real estate lenders of all types might be well advised to include catch-all language in their security documents, so that the lender's lien extends to all property of any type whatsoever that the borrower owns, even if the laundry list does not already expressly include it. Revised Article 9 of the Uniform Commercial Code, adopted in New York effective July 1, 2001, facilitates this process.

If a mortgage does not contain helpful provisions of the types suggested above, and perhaps even if it does, a lender is well advised to check its collateral immediately before any foreclosure sale, to determine whether any fire has occurred. If it has, then the unpredictability of the law in this area means a lender should play it safe by deferring the foreclosure sale, and pushing forward the insurance adjustment process, until the lender is absolutely sure that any foreclosure sale will not impair the lender's rights to insurance proceeds. Or the lender can tailor its bidding strategy to reflect the diminished value of the real property.

§ 15.08 Transfer Taxes on Foreclosure and Substitute Transactions

[1] Foreclosure and Alternatives

When a mortgage loan goes into default, the borrower may eventually lose the real property that stood as collateral for the loan. If that real property collateral is located in New York, the borrower's transfer of title, even though involuntary, may incur substantial transfer taxes. Exactly how substantial depends on how the parties structure the transfer. The following discussion summarizes how those taxes would apply to various possible transfers that might result when a borrower defaults under a loan and the lender exercises remedies under its mortgage. Some of the issues covered here may to a rather limited degree affect the original closing and documentation of the mortgage loan, as described in § 3.06, *above* and § 15.08[6], *below*.

This discussion uses the following defined terms. The owner of the real property (the "borrower") owes money (the "loan") to a lender (the "lender"). To secure the loan, borrower has granted lender a mortgage (the "mortgage"), encumbering real property (the "property") in New York State (the "State"), possibly in New York City (the "City"). At the time of default, the outstanding balance of the loan, including principal, interest, and all other charges (the "loan balance") probably exceeds the value of the property (the "property value").

The transfer taxes that might apply to an exercise of remedies under the mortgage (or some other transfer of the property as a result of the loan default) (together, the "Transfer Taxes")[1] consist of the following:

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[1] Whether these Transfer Taxes should apply to a transfer of distressed real estate to a bona fide lender is an issue beyond the present discussion. In any such transfer, borrowers and lenders would note that no one is "making money." Transfer Tax advocates would point out, however, that all parties are engaged in the real estate investment business and presumably make money, or intend to make money, over a series of transactions, some of which succeed and some of which do not. When they undertook those transactions they knew, or should have known, that these Transfer Taxes existed. They should have factored the possible cost of these Transfer Taxes into their investment

- *State Tax.* The New York State Real Estate Transfer Tax (the "State Tax"); and
- *City Tax.* If the Property is located in the City, then the New York City Real Property Transfer Tax (the "City Tax").[2]

If the loan goes into default, then unless something else happens,[3] lender will probably at some point try to foreclose under its mortgage. When a lender forecloses, it holds an auction sale in which the highest bidder acquires the property from borrower and the proceeds of the sale go to repay the loan, followed by any junior claims to the property (a "foreclosure"). If any money remains, borrower receives it.

Lender will usually be the most likely purchaser at any foreclosure, for the following reasons. Unlike a third party purchaser, when a lender bids at foreclosure, a lender need not pay cash for the entire purchase price for the property. Instead, lender "pays" most of the purchase price by giving borrower a credit against the loan, the money borrower already owes lender (and money that is already out the door and probably unrecoverable from lender's perspective). This is called a "credit bid." Lender must still pay certain costs in cash.

If lender lets any other bidder acquire the property for less than the loan balance (a "short bid"), then lender usually has no hope of recovering any part of the loan that exceeds the short bid.

In contrast, lender can with impunity bid up to the loan balance and assure itself of ownership of the property for no incremental cash outlay beyond the loan that lender already funded many months or years before. As long as the bidding stays at or below the loan balance, lender can bid more easily, and may have a greater incentive to bid, than anyone else.

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analysis as one of the possible costs and risks of doing business in an industry that can often be very profitable. Borrower would argue that it has already paid a substantial mortgage recording tax—a payment that ended up only buying the borrower the privilege of eventually losing the property to lender—and it is unreasonable to impose another tax burden on such a transaction. Transfer Tax advocates would also point out that the various taxing authorities always need more money.

[2] A few other counties or municipalities in the State impose their own transfer taxes. This discussion considers only the City Tax and the State Tax. One cannot assume that other county or municipal transfer taxes would track the City Tax or the State Tax.

[3] Something else almost always happens. Usually a distressed loan never reaches the point of foreclosure. Instead, borrower and lender often agree on some form of workout—an extension of time, a change in the loan terms, a delivery of more collateral, an accrual of some interest, or other changes. The parties hope that if they adopt the right strategy for the property and wait long enough, the problem will solve itself and everyone will come out whole. This hope is often justified and sometimes not. It usually represents a "win-win" solution, because lenders do not want to own property and borrowers are often better than lenders at making a property work, even if they have already failed once.

For these reasons, extensive third-party bidding is unlikely unless lender: (1) promotes bidding by advertising the sale aggressively and giving bidders enough information about the property to justify substantial bids; (2) lets bidders know that lender will not necessarily credit-bid higher than all short bids (a decision that would reflect lender's determination that the property value is less than the loan balance), and hence their bidding might not be futile; and (3) otherwise adopts a systematic and effective strategy to attract bidders.

Lenders may, however, prefer to take title to the property through a relatively quick and simple foreclosure auction, and then find a third-party purchaser through a more deliberate and orderly process. To minimize Transfer Taxes, a lender may try to locate a third-party purchaser during the period between the foreclosure auction and the closing of title pursuant to that auction. Title would then be conveyed directly to the third party, and Transfer Taxes paid once. An assignment (at a profit) of the winning bid may, however, itself attract some Transfer Tax.

Once a property reaches the point of foreclosure, borrower may decide that it would be futile to try to preserve its equity in the property, because such equity will often have vanished long before.[4] In that case, borrower may be willing to cooperate with lender to help lender take title to the property without a fight, and in a way that might mitigate Transfer Taxes.[5] Such cooperation might be structured in one of three possible ways:

1. *Friendly Foreclosure:* Lender holds a foreclosure under its mortgage without objection by borrower. At lender's foreclosure sale, either lender or (occasionally) a third party purchases the property; or

2. *Deed in Lieu:* Borrower conveys the property to lender, or possibly lender's designee, by delivering a deed in lieu of foreclosure; or

3. *Bankruptcy Reorganization Transfer:* Borrower transfers the property to lender, or, again, possibly lender's designee, through a prepackaged plan

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[4] Usually, a property stays out of substantial distress as long as the property value exceeds the loan balance. The problems begin when the property value starts to fall below the loan balance, *i.e.,* when borrower's equity drops to zero and then becomes negative.

[5] Borrowers that want to be able to borrow again later, whether from today's lender or any future lender, will often realize that cooperation makes more sense than a fight. Although lender will not be happy to take back the property, lender recognizes that this was one of the possible outcomes that lender bargained for. If borrower gives up the property peacefully, borrower's principals will usually be welcomed for future real estate finance transactions. On the other hand, if borrower develops a reputation for fighting with lenders merely to drag out the inevitable loss of the property, that reputation will travel quickly and widely in the lending community. Some Manhattan real estate investors who made a hobby out of tormenting lenders in the early Nineties find that some lenders refuse to do business with them—but other lenders are happy to do so.

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of reorganization under Chapter 11 of the federal Bankruptcy Code.[6]

Each of these three alternatives requires cooperation between borrower and lender, and will usually be the outcome of a negotiation between the parties. For each of these three alternatives, the Transfer Taxes will apply and be calculated differently. Those variations may drive the choice of how the parties decide to resolve the loan. (For Transfer Tax purposes, a foreclosure and a friendly foreclosure are equivalent.)

The following calculation of Transfer Taxes assumes the loan balance exceeds the property value.[7] That assumption is almost always correct when a property reaches this point. (If the property value exceeded the loan amount the borrower would, as a practical matter, have figured out a way to repay the loan and prevent the foreclosure.) The following discussion also assumes borrower and lender are not affiliated.[8]

The possibility of avoiding payment of mortgage recording taxes (as opposed to Transfer Taxes) through a Bankruptcy Reorganization Transfer is discussed in § 13.06, *above.*

[2] State Tax

The State Tax is four-tenths of one percent (0.4 percent) of the consideration the grantor receives for any conveyance of real property.[9] By its terms, the State Tax applies to a foreclosure, including a friendly foreclosure, or a Deed in Lieu, just as it would to any other transfer of the property.[10]

The State Tax defines consideration as the sum of all of the following:

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[6] It is sometimes suggested that a "Bankruptcy Reorganization Transfer" may also include a transfer that borrower makes (as debtor in possession or through a bankruptcy trustee) while operating under Chapter 11 even before the court has confirmed a plan of reorganization. For example, in approving a sale of the property under 11 U.S.C. § 363, the court could state, in the order approving the sale, that the transfer is being made for the purpose of facilitating a future plan of reorganization, and is therefore exempt from Transfer Taxes based on 11 U.S.C. § 1146(c), as more fully discussed below. The courts will not necessarily accept such a broad reading of 11 U.S.C. § 1146(c). For more on the use of Chapter 11 as a technique to mitigate New York's taxes, see Section 13.06 *above*.

[7] If the property is hopelessly "underwater," *i.e.,* the loan balance far exceeds the property value, lender may find it makes economic sense to reduce the loan balance unilaterally, just to save Transfer Taxes when taking title to the property. This happened regularly during the real estate depression of the early 1990s.

[8] Affiliation will usually reduce the Transfer Taxes otherwise payable.

[9] N.Y. Tax Law § 1401(e). More technically, the State Tax is $2.00 per $500, rounded up to the next $500.

[10] N.Y. Tax Law § 1401(e).

- *Purchase Price.* "[T]he price actually paid or required to be paid for the real property . . . whether or not expressed in the deed and whether paid or required to be paid by money, property, or any other thing of value"[11]; plus
- *Debt Relief.* Cancellation or discharge of an indebtedness or obligation (whether in whole or in part)—which is exactly what happens to a mortgage in a foreclosure[12]; plus
- *Remaining Liens.* The "amount of any mortgage . . . lien or other encumbrance, whether or not the underlying indebtedness is assumed"[13] (the "Remaining Liens"). This last element of consideration would include, for example, any mortgage that is senior to the mortgage being foreclosed. That senior mortgage remains on the property before and after foreclosure.

The State Tax would apply to a foreclosure and its alternatives as described in the following subsections.

[a] Foreclosure Purchase by Lender

In the case of a foreclosure, or friendly foreclosure, in which lender buys the property, consideration for State Tax includes, but is not limited to, the sum of:

1. *Formula Amount.* The higher of the bid price or the amount of the judgment, typically the loan balance, plus
2. *Remaining Liens.* The remaining liens.[14]

That calculation of consideration assumes all debt is nonrecourse. For recourse debt, consideration is capped at an amount equal to the property value.[15]

[b] Foreclosure Purchase by Third Party

If the party that purchases the property out of the friendly foreclosure is not

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[11] N.Y. Tax Law § 1401(d). In a foreclosure or Deed in Lieu, this variable would typically equal zero, unless someone were paying the borrower extra consideration for its cooperation.

[12] N.Y. Tax Law § 1401(d).

[13] N.Y. Tax Law § 1401(d).

[14] N.Y. Comp. Codes R. & Regs. tit. 20, § 575.11(a)(3)(i).

[15] N.Y. Comp. Codes R. & Regs. tit. 20, § 575.11(a)(3)(i). The varying treatment of recourse and nonrecourse debt makes theoretical sense, but should rarely make much practical difference. If for some reason, *e.g.,* accounting, reporting, or cosmetics, lender intends to bid significantly more than the property value in a friendly foreclosure, the parties may want to consider amending a nonrecourse loan to make it "full recourse" to a single-asset borrower in preparation for the foreclosure. Any such amendment would, of course, create its own issues. When the lender files its State Tax return, it will need to explain how it calculated the property value. This would typically require a contemporaneous appraisal, which the lender should be ready to show the taxing authorities when audited.

related to lender, the definition of consideration for State Tax changes a bit. Under these facts, "consideration" includes, but is not limited to, the bid price plus remaining liens.[16] That definition of consideration applies whether the debt is recourse or nonrecourse.[17]

[c] Deed in Lieu

When a borrower conveys real property to a lender in exchange for cancellation of a nonrecourse debt, the consideration includes, but is not limited to, the sum of:

1. *Loan Balance.* The unpaid balance of the debt secured by the mortgage, plus
2. *Remaining Liens.* The remaining liens,[18] plus
3. *Other.* The sum of any other amount paid by the grantee for the real property.[19]

The third component of consideration listed above for a Deed in Lieu does not include any Transfer Taxes that lender pays for borrower, unless lender has either contractually assumed liability for the taxes or has waived its right to recover those Transfer Tax payments from borrower.[20]

If the mortgage secures recourse debt, then consideration will not be deemed to exceed the property value.

[d] Bankruptcy Reorganization Transfer

Under both federal law and State law, any Bankruptcy Reorganization Transfer is exempt from the State Tax.[21]

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[16] N.Y. Comp. Codes R. & Regs. tit. 20, § 575.11(a)(3)(ii).

[17] N.Y. Comp. Codes R. & Regs. tit. 20, § 575.11(a)(3)(ii).

[18] Remaining liens could presumably be either senior or junior to whatever mortgage is held by the grantee under the Deed in Lieu. The test is whether they stay in place after the conveyance. Because a Deed in Lieu does not terminate any subordinate estates (as would a Foreclosure), junior mortgages would simply remain unless they are affirmatively released before or simultaneously with the transfer.

[19] N.Y. Comp. Codes R. & Regs. tit. 20, § 575.11(a)(2)(i).

[20] N.Y. Comp. Codes R. & Regs. tit. 20, § 575.11(a)(2)(i). If borrower has any assets other than the property, then borrower will not cooperate with the transfer unless lender agrees to pay the Transfer Taxes and waive any obligation of borrower to do so. Because most borrowers have no assets other than the property, though, borrowers may not care about having residual liability for Transfer Taxes. That result would change, of course, if borrower's principals have personally guarantied the payment of Transfer Taxes.

[21] 11 U.S.C. § 1146; N.Y. Comp. Codes R. & Regs. tit. 20, § 575.9(b)(8). This exemption creates a tax-saving opportunity for borrowers and lenders, especially in high-tax states. As a result of this exemption, in the early 1990s, a prepackaged plan of reorganization became a favored

[e] Liability for State Tax

For both foreclosures and Deeds in Lieu, borrower is primarily liable for the State Tax.[22] In both cases, if borrower does not pay the tax or is exempt from paying it, lender becomes liable.[23]

[3] City Tax

The City Tax for transfers of commercial real estate consists of a percentage of the consideration for the transfer. The tax rate starts at 1.425 percent of the consideration. If the consideration exceeds $500,000, the tax rate rises to 2.625 percent.[24]

Like the State Tax, the City Tax applies to foreclosure and Deed in Lieu transactions.[25]

[a] Consideration, Generally

When the property is transferred to anyone other than lender, the City Tax defines consideration in a manner consistent with the State Tax. Both define consideration as the sum of:

1. *Purchase Price.* The price actually or required to be paid, without deduction for any mortgages or liens,[26] plus
2. *Debt Cancellation.* The cancellation or discharge of indebtedness,[27] plus
3. *Remaining Liens.* The amount of any mortgage, lien, or other encumbrance that remains in place, whether or not the underlying indebtedness is assumed.[28]

[b] Friendly Foreclosure

When a lender buys in the property by friendly foreclosure, the City Tax deviates from the State Tax by defining consideration without examining fair

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technique to transfer distressed New York real estate. *But see* § 13.06, *below,* regarding the limitations of the "Chapter 11 tax exemption."

[22] N.Y. Tax Law § 1404.

[23] N.Y. Tax Law § 1404.

[24] N.Y.C. Admin. Code tit. 11, § 2102(9).

[25] 19 R.C.N.Y. § 23-03(a).

[26] In a foreclosure or Deed in Lieu, this variable would typically equal zero, unless someone were paying the borrower extra consideration in exchange for its cooperation.

[27] N.Y.C. Admin. Code tit. 11, § 2101(9). This variable would capture the borrower's "relief from indebtedness" arising from the foreclosure sale.

[28] N.Y.C. Admin. Code tit. 11, § 2101(9).

market value or whether the loan balance exceeds the bid price. In this context, the City Tax defines consideration as the sum of:

1. *Bid.* The bid price, plus
2. *Senior Liens.* Senior liens not canceled by the sale, plus
3. *Advertising.* Advertising expenses, plus
4. *Taxes.* Taxes, plus
5. *Other.* Other costs paid by the purchaser.[29]

[c] Deed in Lieu

When a borrower transfers property to a lender by Deed in Lieu, the general statutory definition of "consideration" would apply, defining "consideration" to include the loan balance plus remaining liens.[30]

[d] Bankruptcy Reorganization Transfers

The City Tax, like the State Tax, is preempted by federal bankruptcy law.[31] Bankruptcy Reorganization Transfers are therefore exempt from City Tax.[32] Unlike the State Tax, the City Tax statute contains no express exemption for transfers arising under federal bankruptcy law,[33] although the City Tax regulations do provide for such an exemption.[34]

[e] Liability

As with the State Tax, borrower is primarily liable for payment of the City Tax.

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[29] 19 R.C.N.Y. § 23-03(d)(2).

[30] N.Y.C. Admin. Code tit. 11, § 2101(9). The City's regulations state, however, that the consideration for a Deed in Lieu will equal only the loan balance. 19 R.C.N.Y. § 23-03(d)(1). The CCH New York Tax Analysis service repeats this statement without question. CCH N.Y. Tax Analysis § 145.244(4) (2001). The author would submit that this regulation is inconsistent with the City's administrative code, and the regulation should not be relied on because the administrative code governs. If the regulation could be relied on, it might create some additional planning and structuring opportunities for borrowers and lenders that want to consummate Deeds in Lieu. The City's real property transfer tax return form takes the same side as the statute (not the regulation), by treating remaining liens as part of the consideration for a Deed in Lieu. This is another example of how the forms and instructions for the City Tax sometimes shed more light than any other available resource on the City Tax. Even if one follows the statute rather than the regulation, might a lender forgive part of the loan balance in preparation for the Deed in Lieu, and thereby reduce the City Tax?

[31] 11 U.S.C. § 1146.

[32] 11 U.S.C. § 1146. *See* § 15.08[2][4], *above.*

[33] N.Y.C. Admin. Code tit. 11, § 2106 (listing exemptions, without providing one for bankruptcy transfers).

[34] *See* 19 R.C.N.Y. § 23-03(j)(8).

If borrower does not pay, then lender must.[35]

[4] A Final Complication

If lender pays the Transfer Taxes because borrower has failed to do so, then the State treats lender's payment of the Transfer Taxes as additional consideration—the "Recursive Consideration." The Recursive Consideration is itself subject to an additional layer of State Tax.[36] The State Tax provides for only one exception from this rule. For a Deed in Lieu only, lender's payment of Transfer Taxes will not be treated as further consideration if lender has neither (1) contractually agreed to assume the tax liability, nor (2) waived its right to recover the tax payments from borrower.[37]

The City also addresses Recursive Consideration. If lender agrees to pay Transfer Taxes, the City requires lender to use the following formula to calculate the total City Tax. First, lender must determine the "tentative" City and State Transfer Taxes based on the consideration excluding transfer tax liabilities.[38] Then, lender adds the sum of those "tentative" transfer taxes to the consideration and calculates the City Tax based on that total.[39]

What if lender pays the Recursive Consideration? Will that payment itself constitute further consideration, triggering a second layer of Recursive Consideration? How about a third layer? And a fourth layer? The process could conceivably continue forever and require help from a mathematician to calculate the total Transfer Tax ultimately due.

The Transfer Tax authorities at both levels seem to have passed up this opportunity to impose additional Transfer Tax. They stop at one layer of Recursive Consideration.[40]

[5] Summary

The following table summarizes the Transfer Taxes imposed on the transactions discussed in this section.

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[35] N.Y.C. Admin. Code tit. 11, § 2104.

[36] N.Y. Comp. Codes R. & Regs. tit. 20, §§ 575.4(b), 575.11(a)(ii).

[37] N.Y. Comp. Codes R. & Regs. tit. 20, § 575.11(a)(ii).

[38] 19 R.C.N.Y. § 23-02(2).

[39] 19 R.C.N.Y. § 23-02(2).

[40] N.Y. Comp. Codes R. & Regs. tit. 20, § 575.4(b); 19 R.C.N.Y. § 23-02(2). This result is similar to the holding in Old Colony Trust Co. v. Commissioner of Internal Revenue, 279 U.S. 716, 49 S. Ct. 499, 73 L. Ed. 918 (1929). In that classic federal income tax case, the Supreme Court held that to impose multiple layers of tax-upon-tax in such a fashion would produce "an absurdity which Congress could not have contemplated." *Id.* at 731.

	State Tax	*City Tax*
Foreclosure by Lender (Friendly or Otherwise)	0.4% × ((The Higher of Foreclosure Judgment or Bid Price) + Remaining Liens)[41]	2.625% × (Bid Price + Remaining Liens + Other Amounts Paid)
Borrower Conveys to Lender Via Deed in Lieu	0.4% × (Loan Balance + Remaining Liens + Other Amounts Paid)	2.625% × (Loan Balance + Remaining Liens)
Bankruptcy Reorganization Under Chapter 11 to Transfer Property	Exempt under State and Federal law	Exempt under Federal law

[6] Implications for Mortgage Loan Closings

The preceding discussion of Transfer Taxes applies primarily when a loan has gone into default and lender is considering foreclosure and its alternatives. Real estate finance lawyers and their clients should, however, keep the substance of this discussion in mind when they structure their transactions.

Lender should remember that if a loan ever goes into default, someone will need to pay the Transfer Taxes, which add up to a significant dollar amount in substantial commercial transactions. Lender's underwriting may factor in some allowance for Transfer Taxes if the loan defaults.[42] The loan documents should require borrower (and ideally borrower's guarantors) to pay any Transfer Taxes that may be due.[43]

If lender assumes that lender will resolve any default through a Bankruptcy Reorganization Transfer, lender may want to try to quantify the legal and other costs of that process, as well as the time it may take. Lender should not, however, assume a Bankruptcy Reorganization Transfer will be available as a mechanism to save Transfer Taxes, for three reasons.

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[41] This formula assumes lender buys the property. On that assumption, if the debt is recourse, then consideration is capped at property value. If a third party buys the property, consideration will be the bid price plus remaining liens, regardless of recourse.

[42] An allowance for Transfer Taxes may already be implied in lender's requirement for an "equity cushion" for any loan. If the loan is 75 percent of the property value at closing, the remaining 25 percent of borrower equity covers a multitude of risks, including perhaps this one. After deducting an allowance for Transfer Taxes in foreclosure (or its alternatives), though, a 25 percent equity cushion may become a 21.975 percent equity cushion. Similarly, a transaction that looks like a 90 percent loan may become a 93.025 percent loan, with an equity cushion of only 6.975 percent.

[43] *See* § 3.06, *above,* for sample language.

First, a Bankruptcy Reorganization Transfer requires borrower cooperation. For that reason, lender may want to obtain covenants from borrower's principals that they will cooperate in a "prepackaged plan of reorganization"—or be personally liable for the entire loan—if the loan goes into default and borrower's cure periods have expired.

Second, a Bankruptcy Reorganization Transfer may take longer than a friendly foreclosure, although the impact of any such delay will vary with the context.

Third, a conservative lender should not assume a Bankruptcy Reorganization Transfer will always be available as a technique to eliminate Transfer Taxes. The availability of this technique may just be a temporary anomaly until Congress reconsiders the larger question of how bankruptcy law should treat single-asset real estate borrowers and bankruptcies.

While the author favors any legitimate technique to reduce Transfer Taxes otherwise payable, the use of a Bankruptcy Reorganization Transfer in place of a Deed in Lieu does seem to be "too good to be true" in the long run. If borrower were an operating business so that the bankruptcy process in theory created value for everyone by preserving a "going concern," then perhaps federal bankruptcy law should preempt Transfer Taxes as a way to force all parties to "share the pain" and contribute to the "larger good."

Most real estate bankruptcies like those described in this section are, however, just a dispute that involves one asset and two parties—borrower and lender—when the property no longer supports the loan and hence borrower may eventually lose the property one way or another. No "larger good" is served by preserving borrower's ownership of the property, as opposed to letting lender have it. That possible change of ownership is just a conveyance that may or may not happen, rather than the cataclysmic destruction of a business with attendant loss of jobs and loss of value to society as a whole that Chapter 11 is supposed to prevent.

Based on similar concerns about the dubious link between single asset real estate and the "larger good" that bankruptcy supposedly serves, Congress in 1994 cut back some of the bankruptcy protections that apply to "single asset real estate."[44] The 1994 amendments applied only to mortgage loans of $4,000,000 or less. The 2005 bankruptcy amendments removed that cap, so now all debtors that own "single asset real estate" will face somewhat tighter bankruptcy procedures.[45] If these changes represent the beginning of a trend and the trend continues, then at some point Congress may also decide that borrower-lender conveyances

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[44] 11 U.S.C. § 362(d)(3).

[45] *See* Robert M. Zinman, *New Bankruptcy Law Affects Real Estate Investments*, 33 N.Y. Real Prop. L.J. 173 (2005) (describing changes to 11 U.S.C. § 362(d)(3)).

through Bankruptcy Reorganization Transfers (functionally just Deeds in Lieu closed through the bankruptcy courts) do not justify being exempted from routine Transfer Taxes.[46] The author would agree with such a decision. As excessive as New York's transaction taxes may be, no federal purpose is served by using the bankruptcy process as a mechanism to eliminate these taxes.

§ 15.09 Judicial Foreclosure

Although nonjudicial foreclosure, when available, will probably be the preferred enforcement technique for most New York commercial mortgages, a lender may also want to consider what language it can add to a mortgage to facilitate judicial foreclosures when the need arises. Beyond the generic language on foreclosure in any typical multistate mortgage, and the special provisions suggested elsewhere in this book, no particular state-specific foreclosure language usually appears in New York mortgages.

To be on the safe (though somewhat nonstandard) side, counsel to a New York commercial mortgage lender may want to include language such as the following as part of the article of the mortgage that covers the lender's remedies after an Event of Default:

Without limiting Lender's ability to resort to any or all of the rights and remedies listed above or otherwise available to Lender, Lender may also commence and prosecute a judicial foreclosure action under Article 13 of the New York Real Property Actions and Proceedings Law.

§ 15.10 Clogging the Equity of Redemption

New York recognizes the common-law concern about "clogging the equity of redemption," a somewhat vague concept that courts can use when they think a mortgagee's rights unreasonably impair the mortgagor's ability to achieve "free and clear" ownership of the collateral.

The term "equity of redemption" means that the mortgagor, after making all required payments and performing all obligations under the mortgage, is entitled

[46] Although the author certainly believes that New York's Transfer Taxes are excessive and inappropriate, particularly as they apply to the transactions described in this section, the appropriate solution is not for the federal government to override the State and City, but instead for the State and City to cut back their Transfer Taxes. On the other hand, while striking a blow for federalism may be a great thing, the State Tax itself exempts Bankruptcy Reorganization Transfers (along with other transfers pursuant to federal bankruptcy law), without the need for Congress to do so. The City Tax statute contains no such exemption, although the regulations do. *See* § 15.08[3][d], *above.* Both taxing authorities might, of course, eliminate such exemptions if they were dropped from the federal bankruptcy code.

to a discharge of the security obligation.[1]

This right cannot be "clogged." Therefore, the mortgagor cannot, as part of the original mortgage transaction or in a collateral agreement, cut off or surrender the mortgagee's right to redeem.[2] Any agreement that purports to do so is void and unenforceable as being against public policy.[3]

Thus, courts in New York and elsewhere have repeatedly held that foreclosure is the mortgagee's only remedy to cut off the mortgagor's right of redemption.[4]

The contours, meaning, and implications of "clogging the equity of redemption" are not particularly clear in New York or elsewhere, but the concept remains a potential arrow in the quiver of a desperate or creative borrower faced with an unusual loan structure that won't go away.

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[1] Mooney v. Bryne, 163 N.Y. 86 (1900), Reich v. Cochran, 213 N.Y. 416, 107 N.E. 1029 (1915).

[2] Mooney v. Bryne, 163 N.Y. 86, 88 (1900), Goldblatt v. Iris Constr. Corp., 28 Misc. 2d. 621, 211 N.Y.S.2d 234 (1960).

[3] Gitlin v. Schneider, 42 Misc. 2d. 230, 238, 247 N.Y.S.2d 779 (2d Dep't 1889).

[4] *See, e.g.*, Moulton v. Cornish, 138 N.Y. 133, 33 N.E. 842 (1893); Green v. Fry, 93 N.Y. 353 (1883). For more on clogging the equity of redemption, see John C. Murray, Clogging Revisited, <http://firstam.com/faf/pdf/jmurray/clogging.pdf> (available only online); Jeffrey L. Licht, *The Clog on the Equity of Redemption and its Effect on Modern Real Estate Finance*, 60 St. John's L. Rev. 452 (1986); Laurence G. Preble & Davis W. Cartwright, *Convertible and Shared Appreciation Loans: Unclogging the Equity of Redemption*, 20 Real Prop. Prob. & Tr. J. 821 (1985). A web search on the topic of "clogging" will produce thousands of articles about shoes, but almost none about the equity of redemption.