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Four Pillars of Remedies for the Mortgage Loan in Default

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Under New York law, lenders can accelerate the debt, foreclose on the property, appoint a receiver to manage it, and seek a deficiency judgment if sale proceeds fall short. These remedies help lenders recover their investments when workouts fail.

Introduction

The commercial real estate mortgage loan is in default. The defaults are material. Discussions have occurred among lender, borrower and their representatives. There's been a forbearance agreement, or several. The loan has been "extended," pretending time will be the panacea. "Extend and pretend" has failed.

There's no deal. Borrower cannot cure its defaults or right the ship. There is no further basis to modify the loan, to right-size the debt to the value of the collateral, to salvage the lender-borrower relationship or to effect repayment of the loan in a manner acceptable to lender.

Bankruptcy triggers full recourse against a creditworthy, solvent guarantor. So bankruptcy is not likely, or even an option.

The lender has remedies.

This article describes those remedies under New York law. (This article deals only with commercial real estate loans, not residential or consumer. This article also does not deal with mezzanine or "dual collateral"—mortgage and equity pledge—loans.)

The Remedies

<u>Acceleration</u>

The defaults are monetary, such as maturity, non-payment of debt service, real estate taxes or insurance premiums. The lender has served a notice of default with reservation of the right to accelerate the debt without actually doing so. Borrower has not cured. Lender has the contractual right (every commercial mortgage loan so provides) to accelerate and demand the immediate repayment in full of entire outstanding indebtedness.

This is an incredibly powerful first remedy.

The hypothetical loan is $50 million. The term is five years. Three months' interest is past due. That amount is $500,000. Based on the default, the lender can elect to "bring forward the entire debt" to today, accelerate the maturity date to today, and demand payment in full—not just of the interest arrears but of the entire loan balance.

For commercial real estate loans governed by New York law, the lender has no obligation whatsoever to accept a post-acceleration cure of the defaults, or otherwise to de-accelerate or reinstate the loan on its original terms following such acceleration. Of course, the lender may make a business, or policy, decision to accept a cure, but the lender has no obligation to do so.

A $50 million loan; $500,00 of past due interest—in the wave of a contractual wand, the full $50,500,000 is now due (not to mention late fees, default interest, attorneys' fees and any other amounts which may constitute the "debt").

A powerful first remedy indeed.

As such, lender be wary and wise: The notice, the acceleration of the debt, must be "clear, overt and unequivocal."

Simply put, the lender should say: "Borrower is in default under the loan documents in that borrower has failed to make the monthly installments of principal and interest [since x date], which failure constitutes an Event of Default pursuant to [Section]. By virtue of such Event of Default, which has not been cured, lender hereby accelerates and demands payment in full of the outstanding principal balance of the [Note], together with accrued interest thereon [at the contract and default rates] and all other sums due and payable under the loan documents."

The lender may, or may not, choose to specify those other sums (such as late charges or protective advances).

So, here's the "Hot Tip": Clear, overt and unequivocal means precisely that. The notice should not waffle or provide optionality or room for doubt. The lender should not say in paragraph one that the entire debt is accelerated and immediately due, and in paragraph two backtrack to permit the borrower thirty days within which to cure the default.

The lender can always agree, later, to permit cure, to reinstate the loan, or to enter into a substantive loan modification or restructure.

But the lender should not do so, or invite that opportunity, in the acceleration notice. The acceleration of debt—that powerful first remedy—should not be vitiated or compromised one scintilla within the four corners of the acceleration notice. Leave compromise, or a deal, for another day, another writing.

In that vein, here's Hot Tip No. 2: The lender should reject a post acceleration tender of the arrears in the absence of a separate written agreement memorializing the cure or the loan reinstatement.

If the entire debt, say $50 million, is immediately due and borrower tenders only $500,000 representing the interest arrears, borrower did not do so for the privilege of still immediately owing a princely $49.5 million.

Borrower did so to undo the acceleration, restore its loan and rekindle the good graces of the lender. The lender can always reinstate; but if the lender wants both that first remedy (acceleration) and $500,000, the lender enters perilous turf. Defenses and lender liability lurk.

"Equity abhors forfeiture"; mortgage foreclosure is an equitable remedy. Courts of equity will not look kindly upon lenders that (i) accelerate, (ii) accept a post-acceleration tender (albeit partial), and then (iii) unabashedly foreclose, applying the tender in reduction of the accelerated debt.

Economically painful and counterintuitive though it seems, the prudent, remedy-focused lender either: (i) accepts the cure and reinstates or modifies the loan or (ii) rejects the tender, keeps the acceleration in full force and effect and pursues its other remedies. Remember: Equity Abhors Forfeiture. Noisy, sympathetic affirmative defenses attract judicial sympathy, scrutiny and delay.

<u>Mortgage Foreclosure</u>

This is a statutory remedy governed in New York by Article 13 of the Real Property Actions and Proceedings Law (RPAPL). Mortgage foreclosure in New York is judicial and requires the court's intervention and supervision every step of the way.

The process is complex and picayune. The myriad niceties, nuances, vagaries and exceptions are outside the scope of this overview of remedies.

Here's the (ordinary) process in a step-by-step nutshell:

(a) The lender serves and files a summons and verified complaint, naming as parties defendant: (i) the obligor on the mortgage note; (ii) any guarantors of (any portion of) the debt, contingent or otherwise, (iii) the mortgagor (the owner of the mortgaged property), (iv) any subordinate lienors such as subordinate mortgagees, mechanic's lienors, judgment creditors, (v) any parties (such as tenants or occupants) having an interest in the property the lender elects to foreclose and has the right to foreclose (large, prominent, anchor tenants usually obtain agreements—SNDA's—from the lender not to disturb, or extinguish, their tenancies in the event of a foreclosure of the mortgage); (vi) various municipalities; and (vii) "John Does" (interested parties that may be identified later). (The city of New York and state of New York, as well as agencies holding liens, are also named as parties defendant to the extent they have liens that are subordinate—real estate taxes are not subordinate though).

(b) The complaint is a work of art. The lender evaluates whether or not to extinguish market, or above-market, tenants. The lender determines the scope of guarantor recourse, especially as respects a guarantor's liability under the non-recourse carve-out guaranty which may not yet have ripened, but assuredly might down the road. The lender recites and establishes the debt; its perfected security interest; priority; and the defaults. This is a lengthy, meticulous process.

(c) The lender files a notice of pendency of the foreclosure action concurrently with filing the complaint. This is a terrific, valuable "sub-remedy" available under Civil Practice Law and Rules (CPLR) Article 65 in any action in which "the judgment demanded would affect the title to, or the possession, use or enjoyment of, real property [except landlord-tenant proceedings]." Mortgage foreclosure qualifies. See RPAPL 1331.

(d) The notice of pendency is constructive notice to a purchaser or to anyone who acquires an interest in or lien upon the mortgaged property subsequent to the filing by the lender of the notice of pendency. Any such subsequent interested party is bound by the judgment of foreclosure "as if" named as a party defendant. There is no need for the lender to name that interested party, supplement the summons, substitute that party as a John Doe, or amend the complaint to bring that interested party into the action.

(e) The borrower and any named guarantors have the opportunity to defend their liability for the debt and the foreclosure of the asset. The nature, extent and creativity of the "lender-liability-type" affirmative defenses and counterclaims fill the casebooks and will not be described here. The courts in New York are, by now, all-too-familiar with every borrower delaying tactic and feigned defense. The sophisticated judges have seen and heard them all, and opined (sometimes colorfully, sometimes emphatically) on most.

(f) Lender liability claims are an art form as well. They are sauteed in risk in today's modern, sophisticated commercial real estate debt structures. Such defenses and counterclaims, especially if asserted with intent to delay and without genuine factual or legal basis, or in bad faith, may trigger full or partial guarantor recourse under the non-recourse carve-out guaranty. So, borrower/guarantor proceed gingerly and with uber-caution, there's a fine line not to cross.

(g) If defenses are raised, the lender will look to bypass discovery (and its attendant costs and delays) and move for summary judgment on the law. The lender will assert there are no facts in dispute—the maturity date either passed or it did not. A portrait of that substantive motion and the borrower's myriad tactics and tales is outside the scope of this bullet-point overview.

(h) If defendants do not contest, the action is an "uncontested foreclosure" that is easier to prosecute, but not that easy to finish with alacrity or predictability. A referee (not the receiver) is appointed by the court to compute the indebtedness. There may be a hearing; usually there is not. The referee looks for evidentiary proof of ownership of the loan (referees like to see all of the original notes in the lender's possession and that the chain of title is intact) and of the calculations. There may or may not be a challenge, even if the borrower does not contest its default or the lender's right to foreclose.

(i) The referee submits a report of computations, the report is confirmed, a judgment of foreclosure is submitted to the court and, if satisfactory, the judgment of foreclosure is entered (RPAPL §1351). The judgment is called a "judgment of foreclosure and sale." This is important – "and sale" mandates a foreclosure sale, an auction, which is conducted by the same referee who calculated the indebtedness. (We have dealt with lenders that want a judgment of foreclosure but not a sale of the collateral: "We don't want to own the property." No dice. Absent a sale of the loan, or some procedural trickery, it is too late for that.)

(j) All of this is statutory. It takes time. That timeframe is unpredictable and annoying, especially to lenders more familiar with "non-judicial foreclosure" available in many other jurisdictions. "How long does an uncontested foreclosure take in New York" is the more-than-a-few decades old often repeated refrain laced with exasperation and resentment. The answer depends on the vagaries, whims and congestions of the judicial calendar; the lender's record-keeping; the referee's requirements and availability (the referee's fee is a mere pittance); and a dosage of luck. Not less than nine months, start to finish, is probably the most optimistic answer for an uncontested foreclosure. Horror stories do abound. So, too, do successful ones – a parting of the seas sublime remedy when that judgment is entered lickety-split.

(k) The auction is duly advertised in accordance with straight-forward, time-honored and largely inflexible statutory requirements. (RPAPL §231) Notice of the sale is served on all defendants that have appeared.

(l) The borrower has an "equity of redemption." Thus, at any time prior to the conduct of the auction, the borrower has the right to "redeem," or retain, the property by repaying the indebtedness in full, no questions asked. That equity of redemption sunsets with the fall of the gavel at the auction. By this stage, redemption or payment in full rarely if ever occurs. A substantive workout deal, yes; a discounted repayment, a possibility; a bankruptcy, maybe. Payment in full – that's not happening.

(m) Terms of sale are prepared and read aloud at the auction by the referee. Ten percent down; no financing or other contingencies; no due diligence; no "seller representations or warranties"; closing in thirty days. Courthouse auction tales of drama, intrigue, woe and the lender's mis-steps are legendary and up to the minute. Some are newsworthy. Customarily, the rotunda barren of bona fide attendees, the lender "credit-bids" an amount to enable the lender to become the successful bidder. The lender has a credit up to the judgment amount and needs to provide no cash up to that amount. If the lender is the successful bidder, it will take title in the name of a nominee. That is permissible. Sometimes the lender will secure a transferee of the bid or "flip the bid" either before or after the auction. Sometimes the lender will finance that acquisition.

(n) Occasionally, an arm's-length third party bidder unrelated to the borrower or the lender wins the auction and, then and there, deposits 10 percent in good funds with the referee. There are no negotiations; no give and take; no stories, pleas or compromises. The referee is an officer of the court, not a seller or buyer.

(o) The closing of the sale and the delivery of the referee's deed evidencing the conveyance (RPAPL §1353) generally occurs thirty days after the auction, sometimes earlier, if the parties agree. Title passes "as-is where-is" pursuant to the terms of the foreclosure judgment. Transfer taxes are paid. The quantum of New York City and New York state transfer taxes, and the measurement criteria of those calculations, are outside the scope of this article. Suffice it to say, for a multi-million dollar commercial mortgage foreclosure, transfer taxes play a pivotal part. The referee will file a report of the sale. That report will be confirmed by the court (RPAPL §1355).

A mortgage foreclosure, now complete, spread across a landscape replete with scores of permutations, roadblocks, adventures, fits and starts, is the lender's remedy of finality. This remedy—bargained for up front; powerful; sacrosanct; judicial—converts collateral for a defaulted debt into either cash repayment or ownership.

<u>Receivership</u>

In New York, by statute (Real Property Law §254(10) and RPAPL §1325), well-settled case law, and the typical mortgage or loan agreement, the lender-mortgagee is entitled in an action for foreclosure to the appointment of a receiver without notice (ex parte) and without regard to the adequacy (or not) of the collateral for the repayment of the mortgage debt.

This is a powerful, lender-friendly, remedy. It separates the defaulting borrower, its principals and its management company (whether affiliated or third party) from the property (the lender's collateral) and the cash generated by the property. The receiver is an officer of the court, selected by the judge from an approved ("Part 36"; 22 NYCRR §36) list of qualified court approved receivers. The receivership order (usually prepared by the lender's counsel) is fulsome; the receiver's duties, powers and control over the property are both instantaneous (once the receiver posts a routinely obtained receiver's surety bond) and almighty.

Unlike in many other jurisdictions, the lender in New York is not required to establish malfeasance, mismanagement, misappropriation, fraud, waste or diversion of revenue or "just cause" for the appointment of a receiver. Only default and acceleration.

The receiver takes possession and control of the property, the leases, the tenant security deposits and the books and records of the defaulting borrower and its management company. The receiver, with the court's consent, appoints a new property manager; the receiver preserves the asset, makes necessary repairs and capital improvements, executes new leases, and has the power, indeed the edict, to evict the tenants that do not pay rent, and to recover rent arrears. The action to recover back rent takes place not in landlord-tenant court but in front of the judge who appointed the receiver in the foreclosure action.

Most crucially the receiver collects the rent and revenue and deprives the borrower of that cash and access to that cash, as well as the tempting opportunity to divert that cash to another property, another need, or personal use.

The borrower is out of possession, out of control. Out of the money. A powerful remedy for sure.

When wielded deftly, the lender can obtain an order appointing the receiver in New York even before the borrower has been served with the complaint. A troika supports the *ex parte* nature of this remedy and this right: The statutes, the parties' contract, the caselaw.

Notably, the receiver in New York state court foreclosures merely "manages and preserves" the asset, its revenue and value. The receiver does not have the power to sell the mortgaged property. Contrast federal law (Rule 66 of the Federal Rules of Civil Procedure; 28 U.S.C. §3103, et seq.; 28 U.S.C. §754), where the receiver may sell the property with court approval. A discussion of federal receivership, and foreclosure in federal court (which requires complete diversity jurisdiction), is outside the scope of this article.

<u>Deficiency Judgment Against Guarantor</u>

The foreclosure judgment establishes liability for and the amount of the debt. If warranted, and if pled in the complaint and demonstrated to the court, the judgment itself specifies the guarantor's liability for the "guarantied" obligations," however expansive they may contractually be, as well as the quantum due to the lender from the guarantor.

New York's occasionally scary and oft-misunderstood election of remedies rules (RPAPL 1301) are thoughtfully designed to avoid multiplicity of litigation, judicial economy and inadvertent lender windfalls. The lender elects either to foreclose the mortgage or to seek recovery against the obligor on the note and/or the guarantor on the guaranty. With limited exceptions the lender cannot do both, in separate lawsuits, at the same time.

An explication of these rules, and exceptions, is outside the scope of this article. For our purposes, the lender, having underwritten the loan on the strength of income producing collateral which cannot be moved or secreted, has "elected" to foreclose its mortgage first. That foreclosure has taken place, as described above.

Also, for our purposes, the guarantor has been named in the foreclosure action in anticipation of recovery against the guarantor for the deficiency after auction. The ceiling of that deficiency depends on the scope of recourse under the guaranty. The height of that ceiling is reduced as described below.

Statutorily, as "part two" of the extant foreclosure action, the lender seeks to enter a deficiency judgment against the guarantor. As noted, liability under the guaranty has already been established and court-ordered within the confines—contested or not—of the foreclosure action. The judgment of foreclosure has a crisp decretal paragraph to that effect.

Application for and entry of the deficiency judgment against the guarantor is governed by RPAPL 1371. This statute provides the following crystal clear rule: the guarantor's liability (as already established by the court) is reduced dollar-for-dollar by the higher of: (i) the amount of the successful bid at the foreclosure auction; or (ii) the fair market value of the mortgaged property. This fair market value is set as of the date of the auction or "such nearest earlier date as there shall have been any market value thereof" (RPAPL §1371(2)).

This determination is made by the court in "deficiency judgment proceedings" at which often dueling and widely disparate appraisals of fair market value are submitted, challenged, cross-examined and ultimately ruled upon by the court.

The application for entry of a deficiency judgment must be made swiftly, within 90 days of consummation of the sale by delivery of the referee's deed. The lender seeking to enforce the guaranty must be cognizant of, essentially, a ninety-day enforcement statute of limitations. Failure to move the court timely for that deficiency judgment forever discharges and releases the guarantor's liability.

Here's a "Hot Tip" to a lender unfamiliar with the deficiency rules: If there is guarantor recourse, and if the mortgaged property is worth less than the indebtedness (overwhelmingly likely), the lender should not "bid the debt" at the auction. Some lenders, holding a $50 million judgment, want (or instruct their counsel) to bid $50 million. even if the property is worth $30 million. "Bid the debt," they say. "I'm worried the sale will be set aside." "Well, then, you've lost your deficiency claim under New York law" is the response. (And the sale will not be set aside even if you credit bid a nominal amount.)

If there is no guarantor recourse, or no wherewithal to pay, whatsoever, then it does not matter. If, however, there is any guarantor liability, or recovery to be had, it will be gone.

Deficiency judgment proceedings, and rules, apply to guaranties, and to recourse, of all varieties, direct or contingent: full payment; partial principal; debt service and carry (subject to heavily negotiated "tender" release, tail or cap, provisions); non-recourse carve-outs ("bad acts") for full debt (i.e., bankruptcy, unauthorized transfer of the property, interference with remedies) or actual losses (willful misconduct, fraud, diversion of cash flow, failure to pay real estate taxes or insurance premiums, among many others) suffered by the lender.

Real estate guaranty enforcement, guarantor liability, defenses, credits and offsets and the latest judicial pronouncements regarding guarantor liability are rich and robust topics onto themselves, not amplified here. Hot Tip to the lender: Guard scrupulously the lender's "beeline to its collateral." Seek (and obtain) recourse for acts by the guarantor that interfere with or interrupt that beeline. Bankruptcy does; so do others. Hot Tip to guarantor: Read the guaranty line by line both before taking out a pen at loan origination and before asserting defenses to the foreclosure, post-default.

The takeaway is that the guaranty is the secured lender's elixir in a struggling real estate valuation and refinancing market. Asset values have been crushed. Deficiencies have proliferated. It is valuation-based as respects a distressed asset. Real estate will right-size and slowly recover. That's historically ordained. Until that day, the deficiency judgment is yet another valuable toolbox remedy as the lender looks to recoup its loss.

Conclusion

Commercial real estate (all asset classes, actually, including those maligned yesterday and today) is a coveted, enduring, and prideful investment, even as we have passed these last few years through historically unsettling and unforeseen times and events. Both that investment, and its financing, can be safeguarded, strengthened and right-sized under the most challenging economic circumstances through a creative and collaborative loan workout.

The workout, especially one that right-sizes the asset and the debt (see, Richard S. Fries, *"Primer on Commercial Real Estate Loan Workouts and Right-Sizing, Part I,"* New York Law Journal, May 2, 2024 and *"Primer on Commercial Real Estate Loan Workouts and Right-Sizing, Part II,"* New York Law Journal, May 9, 2024), is the pathway of choice for lender, borrower, guarantor, investor and tenant alike.

The workout that works is effective and joyous.

But when there is no viable workout at hand, the lender has immensely powerful remedies. Four Pillars' worth.

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Practice Areas

Distressed Real Estate Loan Workouts and Enforcement

Real Estate, Energy, Land Use & Environmental