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Dealing With Equitable Defenses to Foreclosure

Mortgage lenders are frequently cautioned to avoid more lengthy foreclosure battles by relying upon objective standards such as payment defaults, rather than more subjective covenant defaults, as the basis on which to exercise remedies. Reliance upon the legal agreement to pay one's debt, which is at the heart of all mortgage financings, appears to limit a court considering the equitable remedy of foreclosure from giving too much credence to borrower defenses of lender bad faith, fraud or unconscionable conduct that are more easily applied to non-payment covenant defaults.

However, in light of current economic conditions and given that low interest rates may allow a troubled property to generate sufficient cash flow to pay its monthly debt service despite a material decline in the value of the property, a lender may better be able to protect its collateral by instituting foreclosure proceedings before a payment default finally occurs and therefore must rely upon a covenant default to exercise remedies. In this article, we explore equitable limitations on a mortgage lender's ability to enforce defaults, both payment and covenant defaults, and analyze ways to avoid pitfalls that may limit a mortgage lender's ability to realize upon its collateral.

The law is well-settled concerning a lender's ability to enforce the terms of its loan documents upon presentation of proof that a borrower has defaulted thereunder beyond any applicable notice and grace periods.¹ This rule of law applies equally to payment defaults as well as covenant defaults. However, there appears to be a corollary to this rule concerning lender enforcement of its remedies that applies exclusively to payment defaults and which may provide the reason that courts enforce payment defaults with some stricter level of scrutiny than covenant defaults. Unlike covenant defaults, courts have held that



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payment defaults are, absent a valid defense or applicable grace period, entitled to be enforced even if payment lagged by a single day.² Still, the equitable nature of foreclosure provides some degree of latitude for the court and while there are circumstances under which courts have been found to exercise less discretion,

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many courts examine the totality of the circumstances before adhering to the letter of the mortgage agreements. Courts may deny relief, in the enforcement of both payment defaults and covenant defaults, when evidence is presented and proven that a lender waived the existence of such default, is estopped from declaring the default, or has otherwise demonstrated bad faith, fraud, or oppressive or unconscionable conduct in some aspect of originating or administering the subject loan or pursuing the relevant default.

Reliance upon a payment default as paramount grounds for a loan foreclosure has been challenged in circumstances when acceleration was made for a payment default related to a borrower's failure to pay taxes or assessments (as opposed to debt service due the lender) or when the borrower made payment in a manner inconsistent with the loan documents but remitted payment just the same. Courts have found these payment defaults to be generally enforceable but have declined to offer them the strict enforcement suggested by a rule of law that stands for the proposition that terms of payment are generally inviolable. The foregoing instances are clearly distinguishable from a borrower's failure to pay interest and principal when due, however, they stand as reminders that courts may look to equity when some aspect of the triggering default seems to cause undue hardship. Still, one could assume that courts would be less likely to look to equity when the parties are particularly sophisticated and knowledgeable of the hardships that could result from the agreements into which they entered.

To the extent courts are faced with cases involving the actual payment of principal and interest, they tend to apply the law more strictly. In the case of *Sterling National Bank v. Goldberg*,³ the lender, Sterling National Bank, moved to foreclose on the borrower after a payment default but was faced with defenses from the borrower that Sterling National Bank had demonstrated bad faith. The lender's bad faith, adjudicated in a separate federal action, was alleged because, despite assurances to the contrary, the lender denied payment on certain payroll checks drawn on an affiliate of the borrower's bank account. Notwithstanding a federal court's finding that Sterling's actions related to denying payment of the checks amounted to bad faith, this action on the part of the lender was found by the court to be unrelated to the borrower's obligation to make its mortgage debt service payment. As such, the lender's bad faith did not cause the payment default, nor did it constitute a valid defense to the borrower's failure to pay its debt and did not, in this case, give reason to deny

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the lender's motion for summary judgment. Even in the face of certain acts of bad faith on the part of a lender, courts will examine whether such bad faith was the actual cause of a loan default before denying a lender the benefit of its negotiated transaction under the documents.

The *Sterling* case may have particular relevance in the context of commercial loans that are subject to cash management or have existing debt service reserves from which payments are debited on a periodic basis. Even though it wasn't identified as the direct cause of the borrower's payment default, bad faith was attributed to the lender in *Sterling* when it failed to notify its customer that it terminated the lines of credit from which checks had normally been drawn. Consequently, a commercial lender ought to be cautious of declaring a default that results from a mistake or automatic change in existing cash management practices of which the borrower may not have proper notice. For instance, loan documents may provide that a lender is no longer obligated to debit a debt service reserve or other account when certain debt service coverage ratios are not met or lender's collateral is otherwise compromised pursuant to specific provisions in the loan documents. In such instances, lenders should document the cash management change in a written notice to the borrower and resist relying upon a default that results from an action (or inaction) that smacks of bad faith or lack of reasonable care.

While borrowers may have more difficulty making equitable arguments in the face of a payment default, cases involving covenant defaults appear to invite such a response with varying degrees of success. In *Laber v. Minassian*,⁴ the borrower sought to dismiss the lender's enforcement of a covenant that prohibited demolition of the property improvements on the basis that the lender had not suffered any harm as a result of the borrower's actions. The court upheld the express terms of the loan documents finding that the borrower's actions had impaired the lender's security for the mortgage without assessing the merit of borrower's argument that the covenant default should be dismissed since the value of the property had actually been improved by the offending action. The argument made by the borrower in *Laber* relied in large part upon economic factors which caused the property value to soar and the borrower's assertion that the value of the bare land was sufficient to easily repay the mortgage loan. The *Laber* court's decision removes the question of economic harm from the equation, allowing the lender to rely upon the agreement into which it entered, rather than permitting the borrower to violate loan covenants even if the lender won't necessarily suffer any harm.

The *Laber* decision may be contrasted with the case of *Caspart v. Anderson Apartments Inc.*,⁵ in which the court determined that

the mortgagee could not foreclose on the mortgage notwithstanding the existence of certain municipal violations indicative of borrower's failure to comply with a covenant to maintain the property in good order. The offending municipal violations had remained on the property for 18 months without any objection of the lender. During that same period, borrower, in actions apparently known to the lender, worked expeditiously to repair the property. The court held that despite the fact that the violations constituted a default under the loan documents, permitting the lender to exercise remedies would constitute an unconscionable and oppressive outcome since it would recover collateral in the foreclosure that was substantially improved from the date of the lender's first opportunity to exercise remedies as a result of the violations. The court stated, "[c]ourts of equity have always refused their aid where a party has slept upon its rights and acquiesced to certain conduct for a great length

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of time, even though the period...is less than that which is prescribed by the appropriate Statute of Limitations."

The facts of *Laber* and *Caspart* are particularly interesting when applied to the current economic climate. Lenders in today's market could rely upon *Laber* for the principle that borrowers cannot make material changes to a property in violation of the loan documents without lender's consent, even if the changes wouldn't reduce lender's recovery on foreclosure. In an environment which sees developers trying to reposition properties quickly, *Laber* should give comfort to lenders that borrower alterations to property collateral made without a lender's knowledge or consent and in violation of the express terms of the loan documents will be deemed enforceable covenant defaults notwithstanding any borrower argument that the lender has not suffered or will not suffer any actual monetary loss. In short, the *Laber* court enforces the express terms of the loan documents negotiated between the parties.

By contrast, the findings in *Caspart* may allow a court to contradict express terms of a mortgage loan which normally serve to preserve lender remedies in the face of a lender's decision to delay its enforcement of the loan documents when the lender would be unjustly enriched by its delay. The *Caspart* facts may be applicable

to a currently stalled or delayed construction project which a developer continues to pursue with additional equity investments in reliance upon lender's failure to order borrower to cease construction or exercise other remedies. The *Caspart* decision could be troubling for a lender that seeks to enforce a long extant default on a development project that a borrower continues to improve. *Caspart* does not, however, address a circumstance where the increase in value (and resulting unjust enrichment) results from the actions of a third party, such as a zoning change, and not directly from the borrower's efforts.

The lender's decision in *Caspart* to delay enforcement of remedies can be distinguished from the lender in *Marosu Realty Corp. v. Community Preservation Corporation*.⁶ In *Marosu*, the lender delayed taking enforcement actions, to which it was entitled to pursuant to the loan documents, while advocating on the borrower's behalf to secure alternate financing and otherwise prevent a default. The borrower argued that the lender's delay amounted to a waiver of their right to foreclose. The court denied the plaintiff's contention and held that the lender could foreclose the loan since the "defendants' voluntary efforts on plaintiff's behalf do not constitute a waiver of any of plaintiff's duties under the contract...[and] the record is plain that defendants did not excuse plaintiff from its obligations under the contracts." The gulf that exists between the unjust enrichment resulting from the lender's delay in the *Caspart* case and the lender's explicit acts of good faith that delayed enforcement in *Marosu* leave much room in between to give borrowers equitable arguments. While lenders need to be cautious about delaying enforcement actions, they probably need not be as generous as the lender in *Marosu* to demonstrate good faith and fair dealing.

Lenders seeking to enforce their loan documents must examine the circumstances leading to a borrower default carefully. While the principles of law suggest that all defaults are entitled to enforcement, given that foreclosure is an equitable remedy, lenders should consider the relative strength of their argument in light of possible borrower defenses. In many instances, lenders that wait for a 'clean' default will avoid the unnecessary delay caused by a borrower's argument for equitable relief.

1. *Nassau Trust Company v. Montrose Concrete Products Corp.*, 436 N.E.2d 1265, 1269 (N.Y. 1982).

2. *New York Guardian Mortgage Corp. v. Olexa*, 574 N.Y.S.2d 107, 108 (N.Y. App. Div. 1991).

3. 2005 N.Y. Misc. Lexis 3460 (N.Y. Sup. Ct. 2005).

4. 511 N.Y.S.2d 516 (N.Y. Sup. Ct. 1987).

5. 94 N.Y.S.2d 521 (N.Y. Sup. Ct. 1949).

6. 808 N.Y.S.2d 628 (N.Y. App. Div. 2005).