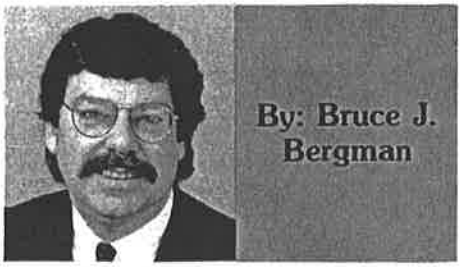
YOU CAN ENFORCE THE MORTGAGE INTEREST RATE UPON DEFAULT*



Particularly in recent years, the moment a lender must proceed with foreclosure, the possibility that a loss will ultimately be incurred becomes more real. It is not necessarily likely, but the situation is perhaps more precarious than it was five years ago.

If matters are now less pleasant for the holder of a mortgage in default — particularly the second mortgagee — lenders have even more reason to be meticulous in assuring that the full rate of return on the mortgage authorized by the documents and applicable case law is understood and pursued. To be sure, counsel may know the answers here, as may most of the vice presidents, officers and foreclosure managers. But if a point is missed by the one person supervising a particular foreclosure case, significant sums which could otherwise be captured might be neglected. To be more blunt, those amounts may simply be lost!

If this obvious analysis is correct — and clearly it is — an example important enough to require reversal at the appeals court level for a case in New York should be enlightening

For the purpose of easy review, let's cite the concept now and explain in detail later. The new case[1] (it is a New York decision, but the concept can be constructive in other jurisdictions) holds that where the mortgage documents so provide, it is the contract (i.e., note) rate of interest which attaches to principal once there is a default.

Because the unusually low interest rates of recent times tend to cloud the impact of the point to be made here, for the sake of clarity we shall refer to numbers which had more application in the past and which will, without question, prevail again at *some* time in the future.

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In New York, the statutory rate of interest is 9%. It could, of course, be different in your state. This is the percentage which applies to a judgment and should not be confused with the "legal" rate of interest which, again in New York, is 16%[2] Suppose for discussion purposes that a mortgage loan is made at 12%. In the event of default, if the mortgage makes no reference to the interest rate to be applicable, (upon default or upon maturity) then the *statutory* rate of 9% will control. Where the lender was expecting a rate of return of 12%, when the mortgage suddenly yields 9%, considerable dismay will result and the dissatisfaction will increase with the length of the foreclosure case and the size of the loan. The distaste could approach uglinesss if this situation prevails across a broad portfolio of loans. And it becomes still more unpalatable for the second mortgagee where the debt on the senior mortgage is mounting.

On the other hand, the mortgage could easily have provided that in the event of default, the note rate, or contract rate (12% in our example) will be the yield upon the principal balance. Just as common, or even more so, is a provision for some *higher* rate of interest to control upon default. It could be expressed as a percentage (perhaps 14%, or 18%) or a certain number of points above an index.[3] If that is what the mortgage says, it is to be computed by the referee and enforced by the courts.

That is the reaffirmation of the new case. There, both the note and the modification and extension agreement specifically stated that upon default, interest was to be computed at 4½% over prime. The referee correctly computed it that way. But upon the motion for judgment of foreclosure and sale (the next step in New York), the judge at the trial court level declined to confirm the referee's computation, imposing instead the lower statutory 9% interest rate.

Upon appeal, the court found the judge below to be in error and ruled that the contract rate governed rather than the statutory rate.[4] In light of all prior authority on point, the holding is eminently correct — and hardly surprising. But the principle obviously escaped the judge who had refused to agree with the referee.

If this means that the message is more elusive than we think it should be, then our review here is opportune. If your mortgage documents address the issue of interest on default, avail yourself of the remedies of your paper!

[1] *European American Bank* v. *Peddlers Pond Holding Corp.*, _____ A.D.2d _____, 586 N.Y.S.2d 637 (2d Dept. 1992)

[2] Licensing statutes in the various states could certainly permit second mortgage lenders to charge rates above what would otherwise be the maximum.

[3] Sometimes the formulation is "the highest rate allowed by law." Because in New York interest on default cannot be usurious, any rate of interest is legal, so the phraseology is lacking in clarity.

[4] The precise quote was that "It is well established that when a contract provides for interest to be paid at a specific rate until the principal is paid, the contract rate of interest, rather than the statutory rate set forth in CPLR 5004, governs until the payment of the principal or until the contract is merged into a judgment [citation omitted]".