

TRANSACTIONAL REAL ESTATE

Loan Structuring And the Equity of Redemption



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As the sheer quantity of lending activity continues its inevitable augmenting climb away from the recession, lenders are making significant efforts to avoid a repeat of past mistakes. In this environment, it is not uncommon for lenders to seek all possible combinations of material credit enhancement, more stable and predictable security, and optionality to convert existing loans to mezzanine or equity status. The lending community should be aware that there are risks that arise from the exercise of such caution, however. Among other things, lenders must be careful not to violate legal principles which could operate ultimately to render their protective efforts void.

Specifically, lenders must be wary of violating (also known as “clogging”) the “equity of redemption,” which protects a defaulting borrower’s rights of repayment during the period of time between a default and a foreclosure sale. The equity of redemption, if deemed “clogged” by a court, may serve to nullify offending mortgage provisions and may, ultimately, prevent a lender from obtaining access to the property or equity interest secured by their loan agreements and collateral documents.

In this article we discuss the equity of redemption and how it operates. We will then examine two specific scenarios in which lenders, in their attempted belt-and-suspenders approach to loan structuring, must navigate carefully to avoid violating the equity of redemption and, ultimately,

losing out on their expected bargain.

The Equity of Redemption

The equity of redemption is an ancient doctrine, developed in England in the 17th century,¹ but one that is still consistently invoked by courts evaluating the propriety of lender conduct in the mortgage context. Fundamentally, the principle establishes the borrower’s equitable right to pay and discharge a mortgage debt, after forfeiture by the terms of the mortgage contract.² “Therefore, the equity of redemption is the mortgagor’s right to reinstate or discharge the mortgage after a default, and before a foreclosure sale, by paying the mortgagee the amount of the principal and interest then due, plus the mortgagee’s enforcement costs.”³

In New York, the right of a mortgagor to redeem the mortgaged property is considered to be an essential and inseparable part of the mortgage.⁴ Indeed, since as long as a century ago, New York courts have found that “[t]he equity of redemption is inseparably associated with a mortgage and the essential characteristic thereof, so that, whenever it appears that a deed was given as security, the right to redeem always exists in equity. Such a deed is a mortgage by operation of law, and the right to redeem, when not expressly provided for, is read into the instrument by the law.”⁵ Due to such vigilant and consistent protection by the courts of this borrower’s right, therefore, lenders must remain keenly aware of this principle when structuring financing transactions. A lender’s infringement on this right, even in a circumstance where the borrower consents, runs the risk of being declared void and unenforceable.

The right of redemption lasts from the time of default up to the time of a foreclosure sale.⁶ In *Carnavalla v. Ferraro*, for example, plaintiffs, contract vendees of the mortgagor, had entered into a contract to purchase the property at issue after a judgment of foreclosure and sale had been entered against the mortgagor but before the sale had actually been conducted.⁷ The trial court granted the defendant mortgagee’s motion for summary judgment, which was based on the position that the plaintiffs had no right to redeem the mortgage at that time.⁸ The Second Department reversed, finding that the entry of a judgment of foreclosure and sale did not divest the mortgagor of his title and interest in the property until the sale was actually conducted, and thus the mortgagor had the capacity to enter into a contract to sell the property to the plaintiffs, who, in turn, had the right to demand that the mortgagee allow them to redeem the mortgage before the foreclosure sale.⁹

Once the sale has in fact taken place, however, the right is extinguished as a matter of law, and cannot be revived even by court order.¹⁰ This rule held true in *United Capital v. 183 Lorraine Street Assocs.*, where the defendant mortgagor moved to redeem the property after the foreclosure sale had taken place.¹¹ The trial court held, and the Second Department affirmed, that such motion must be denied, finding that the owner’s right to redeem had been extinguished at the time of the foreclosure sale.¹²

Lenders must therefore be wary of clogging the equity of redemption, i.e., preventing the borrower’s right to discharge the debt prior to a foreclosure sale. Clogging can occur in a number of ways. One example is where a lender includes as a provision in an initial

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mortgage that, at the time of the granting of the mortgage, the deed to the property at issue must be placed in escrow and, upon default, the deed will be delivered out of escrow to the mortgagee. Another example is where the lender, at the time the loan is made, obtains via a provision in the documents an option to purchase or convert the loan to equity. In both of these instances, the lender will likely be found to have clogged the borrower's equity of redemption because such provisions function to cut off the borrower's right to redeem the property after default. Indeed, ultimately, if a dispute over a mortgage goes to litigation, and the lender attempts to rely on such a provision, the courts are likely to find it void.¹³ Lenders should thus be careful to follow the basic pointers outlined below to avoid clogging the right of redemption in these situations.

Deeds in Escrow

Zealous lenders may attempt to secure their investment by structuring the transaction to require that the deed of the property at issue be placed in escrow, with the explicit written understanding that, upon the mortgagor's default, the escrow agent will deliver the deed out of escrow to the mortgagee.¹⁴ Such a provision in an initial mortgage, however, will be considered void as a violation of the equity of redemption. A similar practice involves requiring that the mortgagor agree to assign its interest in the property to the mortgagee upon a default.¹⁵ As in the case of a deed in escrow, when such a requirement is included as part of the parties' original agreement, it will be found invalid and unenforceable.¹⁶ Again, the rationale is that by employing such tactics, the mortgagee is prematurely cutting off the mortgagor's right to redeem the property (i.e., before the foreclosure sale). The courts will almost always hold such provisions void given the venerable tenet that law and public policy alike abhor forfeiture.¹⁷

A provision contained in an initial mortgage purporting to permit a mortgagee to acquire the mortgagor's right of redemption at the time the mortgage is given will generally be deemed unenforceable. Lenders should be careful, therefore, in providing for this acquisition at the time the mortgage is given. By contrast, some jurisdictions permit a deed to be placed in escrow as part of a mortgage modification agreement post-default.¹⁸ A deed in lieu of foreclosure, therefore, is usually considered valid because such an instrument is given subsequent to the original mortgage, in a voluntary transaction supported by independent consid-

eration.¹⁹ The subsequent agreement, however, must be fair given the circumstances of the case—the mortgagee will not be permitted to take advantage of the mortgagor.²⁰

It is essential that when structuring loan transactions, lenders remain cognizant of the equity of redemption principle, and avoid including any provision at the outset which would interfere with the borrower's right to discharge a debt prior to a foreclosure sale.

Obtaining an Option

Another approach lenders should be cautious with is attempting to obtain an option to purchase or convert the loan to equity at the time the initial mortgage is given (as opposed to, as discussed above, post-default). In New York, the equity of redemption is a statutory right and may not be interfered with by the lender's taking an equity interest in the property.²¹ A mortgage in which the lender obtains an option to purchase or convert the loan to equity at the time the loan is made is generally considered to clog the borrower's equity of redemption, since the borrower cannot free the property from the mortgage merely by paying the lender the amount due on the loan.²² Under such conditions, the option may be considered unenforceable.²³

However, certain states—including New York—have statutes that do not apply the clogging rule in this context under particular circumstances. In New York, a mortgage in which the lender has the option to acquire an interest in the mortgaged property or the entity owning the property, will be valid, pursuant to NY CLS Gen Oblig. §5-334 if: (a) the lender's right to exercise the option is not contingent upon the borrower's default on the mortgage; and (b) the loan is for a principal sum of \$2,500,000 or more.²⁴ Lenders in New York may therefore avoid clogging problems by complying with each of these two conditions, and effectively acquire an option to acquire an interest in the mortgaged property or the entity owning the property. In certain scenarios, the possession of this option may also serve the ancillary

benefit of increasing the ability of a lender to manage a work-out so as to minimize the risk of loss.

Conclusion

It is essential that when structuring loan transactions, lenders remain cognizant of the equity of redemption principle, and avoid including any provision at the outset which would interfere with the borrower's right to discharge a debt prior to a foreclosure sale. Provisions requiring that the deed to the property at issue be placed in escrow at the time of the mortgage, and providing in the conversion of the mortgage to an equity interest in the property, will both generally be considered clogs on this well-settled right and will generally be deemed void and unenforceable. By making adjustments in timing and structure, coupled with appropriate contractual provisions, however, lenders can achieve their lending criteria while still protecting themselves in a way that will ultimately be upheld by the courts.

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1. R.W. Turner, "The Equity of Redemption: its Nature, History and Connection with Equitable Estates Generally," (Wm. W. Gaunt & Sons, 1986).

2. Joseph Rasch, *New York Law and Practice of Real Property*, Vol. 2, §33.177 (2d. Ed. 1991).

3. *Id.*

4. *Id.*; *Dickinson v. Oliver*, 195 N.Y. 238, 246 (1909).

5. *Massari v. Girardi*, 119 Misc. 607 (Sup. Ct. 1922).

6. *Forbes v. Aaron*, 918 N.Y.S.2d 118, 120 (N.Y. App. Div. 2d Dept. 2011); *People v. Klem*, 915 N.Y.S.2d 607, 608 (N.Y. App. Div. 2d Dept. 2011); *United Capital v. 183 Lorraine St. Assocs.*, 675 N.Y.S.2d 543, 543-44 (N.Y. App. Div. 2d Dept. 1988).

7. 722 N.Y.S.2d 47, 48 (N.Y. App. Div. 2d Dept. 2011).

8. *Id.*

9. *Id.*

10. *Northwest Mortg. v. Brown*, 830 N.Y.S.2d 158, 159 (N.Y. App. Div. 2d Dept. 2006).

11. 675 N.Y.S.2d 543, 543-44 (N.Y. App. Div. 2d Dept. 1988).

12. *Id.*

13. Real Estate Financing—Commercial, Chapter 3H Mortgage Modification Agreements, §3H.21 Deeds in Escrow.

14. *Id.*

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. Real Estate Financing—Commercial, Chapter 3H Mortgage Modification Agreements, §3H.21 Deeds in Escrow.

20. *Id.*

21. Real Property Service: New York, Vol. 3, §33:8 (2008 Cumulative Supplement); N.Y. CLS RPAPL§1352.

22. *Id.*

23. *Id.*; *Boyarisky v. Froccaro*, 125 Misc. 2d 352, 359-361 (Sup. Ct. 1984).

24. NY CLS Gen Oblig. §5-334 (2013).