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PROTECTION OF MORTGAGEE'S INVESTMENT WHEN THE SECURITY IS CONDEMNED IN NEW YORK

I. INTRODUCTION

One holding a bond (or note) secured by a mortgage on real property plays a dual role in law; he is a creditor as to the mortgagor-debtor, and he is the holder of an interest¹ in the mortgaged land. Although obviously connected through the security relationship of the bond and mortgage, these two interests are ordinarily held to be based on distinct agreements.²

When faced with a default in payment the mortgagee-creditor may either foreclose the mortgage or sue for a judgment on the debt as evidenced by the bond,³ but he ordinarily may not do both at the same time.⁴ Should the foreclosure prove inadequate to satisfy the debt, the mortgagee can obtain a deficiency judgment against the mortgagor,⁵ but if no motion for a deficiency judgment is made, the mortgagee has "no right to recover any deficiency in any action or proceeding."⁶ To avoid this restriction to some degree, the mortgagee may sue first on the bond, foreclosing later to recover a deficiency. This course is subject to statutory limitations;⁷ having obtained a judgment on the bond, the mortgagee may not foreclose until the judgment is returned wholly or partially unsatisfied.⁸

II. WHEN THE SECURITY IS CONDEMNED

When the land embraced by the mortgage is taken by eminent domain, the award paid by the condemnor⁹ substitutes for the land as security for the debt,¹⁰ and the mortgage lien, formerly on the land itself, is transferred to the

1. N.Y. Real Prop. Law § 240(4).

2. See *Taylor v. American Nat'l Bank*, 63 Fla. 631, 57 So. 678 (1912), dealing with the negotiability of a note secured by a mortgage, in which the court pointed out that the pledge of real property securing a note is a distinct agreement not affecting the promise to pay but simply providing a remedy for failure of performance; *Thorpe v. Mindeman*, 123 Wis. 149, 101 N.W. 417 (1904); 37 Am. Jur. Mortgages § 517 (1941).

3. *Swanson v. United States*, 156 F.2d 442 (9th Cir. 1946); *Dudley v. Congregation of St. Francis*, 138 N.Y. 451, 34 N.E. 281 (1893); see *Bank of New York v. Kennedy*, 183 Misc. 819, 54 N.Y.S.2d 122 (Sup. Ct. 1944), aff'd mem., 269 App. Div. 747, 55 N.Y.S.2d 115 (1st Dep't 1945); *Wright v. Wimberly*, 94 Ore. 1, 184 P. 740 (1919).

4. See N.Y. Real Prop. Actions Law § 1301; N.Y. C.P.L.R. § 5236(b).

5. N.Y. Real Prop. Actions Law § 1371.

6. *Id.* Cases holding that a similar prior statute did not negate the mortgagee's right to sue on the bond all involve situations where no foreclosure action had been taken. See, e.g., *First Nat'l Bank & Trust Co. v. Eisenrod*, 263 App. Div. 227, 32 N.Y.S.2d 641 (3d Dep't 1942); *Dry Dock Sav. Institution v. 106-108 Ridge St. Corp.*, 188 Misc. 617, 66 N.Y.S.2d 761 (Sup. Ct. 1946).

7. See N.Y. Real Prop. Actions Law § 1301; N.Y. C.P.L.R. § 5236(b).

8. N.Y. Real Prop. Actions Law § 1301.

9. N.Y. Condem. Law § 13.

10. *Chicago v. Salinger*, 384 Ill. 515, 52 N.E.2d 184 (1943); *Fliegel v. Manhattan Sav. Bank*, 296 N.Y. 214, 72 N.E.2d 161 (1947); *Muldoon v. Mid-Bronx Holding Corp.*, 287

condemnation award¹¹ (hereinafter referred to as the award). The mortgagee is entitled to participate in the award to the extent of his interest.¹² The rationale behind this rule is that although the mortgagee has a right to guard his security against impairment, he is powerless to prevent the public from taking the property by condemnation.¹³ Because his lien upon the land so taken is destroyed,¹⁴ the award stands in place of the land and the mortgagee is an equitable lien thereon.¹⁵

If the mortgagee asserts his claim against the award during the condemnation proceedings,¹⁶ the court may direct the condemnor to pay the money into court,¹⁷ pending determination of the mortgagee's right to the award.¹⁸ By thus asserting his claim, the mortgagee can protect his rights as a secured creditor.

If the mortgagee fails to assert his claim, the condemnor may pay the award to the mortgagor without liability to the mortgagee,¹⁹ even though the latter is, as an "owner,"²⁰ a necessary party to the condemnation proceedings.²¹ Should such a payment be made, it is not clear whether the mortgagee can follow the award *qua* award.²² Professor Osborne states that payment of the award

N.Y. 227, 39 N.E.2d 217 (1942); *Bank of New York v. Kennedy*, 183 Misc. 819, 54 N.Y.S.2d 122, (Sup. Ct. 1944), *aff'd mem.*, 269 App. Div. 747, N.Y.S.2d 115 (1st Dep't 1945); 27 Am. Jur.2d Eminent Domain § 257 (1966); 29A C.J.S. Eminent Domain §§ 196, 201 (1965); 19 N.Y. Jur. Eminent Domain § 136 (1961).

11. See, e.g., *Swanson v. United States*, 156 F.2d 442, 450 (9th Cir. 1946); *United States v. Certain Lands in Borough of Brooklyn*, 129 F.2d 577, 579 (2d Cir. 1942); *Chicago v. Salinger*, 384 Ill. 515, 52 N.E.2d 184 (1943); *In re Dillman*, 276 Mich. 252, 267 N.W. 623 (1936); *Muldoon v. Mid-Bronx Holding Corp.*, 287 N.Y. 227, 39 N.E.2d 217 (1942); *State v. Fitzgerald*, 154 Ore. 182, 58 P.2d 508 (1936).

12. N.Y. Condem. Law § 22. See, e.g., *Swanson v. United States*, 156 F.2d 442 (9th Cir. 1946); *United States v. Certain Lands in Town of Highlands*, 49 F. Supp. 962 (S.D.N.Y. 1943); *In re Dillman*, 276 Mich. 252, 267 N.W. 623 (1936); *Muldoon v. Mid-Bronx Holding Corp.*, 287 N.Y. 227, 39 N.E.2d 217 (1942); *State v. Fitzgerald*, 154 Ore. 182, 58 P.2d 508 (1936).

13. See, e.g., *In re Dillman*, 276 Mich. 252, 267 N.W. 623 (1936).

14. See, e.g., N.Y.C. Admin. Code § B15-37.0 (1963).

15. See *Muldoon v. Mid-Bronx Holding Corp.*, 287 N.Y. 227, 231, 39 N.E.2d 217, 218 (1942), in which Chief Judge Lehman writes "[t]he right of the holders of a mortgage to payment of the award . . . is a right which such holders may assert upon equitable principles Since the lien of the mortgage upon the land taken was destroyed when title vested [in the condemnor] they have been awarded a right to resort to the compensation which must be paid to the owner of the land."

16. N.Y. Condem. Law § 22.

17. *Id.*

18. *Id.*

19. See *Merriman v. City of New York*, 227 N.Y. 279, 125 N.E. 500 (1919); *In re Long Island R.R.*, 174 Misc. 1037, 22 N.Y.S.2d 706 (Sup. Ct. 1940); *In re Sea Beach Ry.*, 148 N.Y.S. 1080 (Sup. Ct. 1907), *aff'd mem.*, 196 N.Y. 533, 89 N.E. 1112 (1909).

20. N.Y. Condem Law § 2.

21. N.Y. Condem Law § 4(1).

22. The following of an award as an award is not covered by statute, and case law does not decide the point.

to the mortgagor places the mortgagee "in the same position he would have been in had he never bargained for and obtained security."²³ Of course, the mortgagee still has the bond and can enforce a judgment thereon against the mortgagor's assets, which might now include the money from the award; he may, however, find himself involved in a costly, time-consuming and possibly fruitless effort in so attempting to enforce the judgment because the mortgagor may have spent or hidden the money.²⁴

III. THE INTEREST RATE PROBLEM

Time, perhaps a considerable period of time, passes from commencement of the condemnation proceedings²⁵ to the determination of the amount of the award²⁶ and to payment of the award.²⁷ Award recipients are therefore entitled to interest on the award from the date that title vests in the condemnor to the date the final award is ready for payment.²⁸ The mortgagee, like any other recipient, is entitled to receive interest from the condemnor. In New York the rate of such interest is limited by statute to four per cent where the condemnor is a municipal corporation,²⁹ and it is this limitation which often gives pause to the mortgagee-creditor deciding how best to seek redress.

It is quite likely that the bond representing the debt called for interest payments at a rate higher than four per cent. In *Security National Bank v. Sabatelli*,³⁰ it was held that a mortgagee seeking payment out of the award at the interest rate called for in the bond had, by resorting to the award, "elected to substitute the obligation of the sovereign for the contractual obligation in the bond,"³¹ and that "[i]n such case, the law is clear that the [mortgagee] will be limited to such rate of interest as the sovereign may be required to pay to the owner from the date of the vesting of title."³² This means that a mortgagee who asserts his claim at the condemnation proceedings *before taking any action* on the bond will be limited to the lower statutory interest rate on the award. It does *not* mean that he cannot proceed in an action on the bond to recover a deficiency should the award prove inadequate to satisfy the debt. In *Sabatelli*, the award was more than large enough to

23. G. Osborne, *Mortgages* 334 (1951).

24. See Kaplan, *Rights of Mortgagees in Condemnation Proceedings*, 12 *Brooklyn L. Rev.* 103 (1943).

25. N.Y. Condem. Law § 4.

26. Such determination may involve a trial of issues. N.Y. Condem Law § 11.

27. The issue of who is entitled to be a recipient is one that may be tried by the condemnation court. *In re Samuel Gompers Houses*, 214 N.Y.S.2d 217 (Sup. Ct. 1961).

28. See, e.g., *In re Stephen Wise Housing Project*, 38 Misc. 2d 455, 236 N.Y.S.2d 785 (Sup. Ct. 1962).

29. N.Y. Gen. Munic. Law § 3-a.

30. 38 Misc. 2d 503, 236 N.Y.S.2d 775 (Sup. Ct. 1962).

31. *Id.* at 504, 236 N.Y.S.2d at 777 citing *Muldoon v. Mid-Bronx Holding Corp.*, 287 N.Y. 227, 39 N.E.2d 217 (1942).

32. 38 Misc. 2d at 504, 236 N.Y.S.2d at 777 (citation omitted).

cover the mortgagee's claim, but in *Bank of New York v. Kennedy*,³³ where a balance of \$39,700 remained due on the bond after payment of the award to the mortgagee, the court rejected the argument that "acceptance of the award in condemnation proceedings constituted an election, [so that the mortgagee] may not proceed on the bond."³⁴

A somewhat more involved question arises when the mortgagee, instead of going directly to the condemnation proceedings to protect his interests, first obtains a judgment on the bond, computed on the basis of the bond interest rate. Often, the mortgagor's lack of assets, other than the condemned property, results in the return of an unsatisfied judgment. Can the mortgagee enforce the judgment to its full extent at the condemnation proceeding, i.e., to the extent of the debt principal plus the rate of interest specified in the bond? In *Muldoon v. Mid-Bronx Holding Corp.*,³⁵ the court, in holding the mortgagee entitled to payment out of the award at the statutory interest rate, specifically left this question unanswered.³⁶

The query seems to have lain dormant until quite recently when it was raised again in *Copp v. Sands Point Marina, Inc.*³⁷ In this case, the defendant corporation executed a note secured by a mortgage on land located in Nassau County. The note called for an interest rate of five per cent, payable semi-annually. At condemnation proceedings title to the land vested in the Town of North Hempstead, and thereafter two interest payments³⁸ fell due and were not paid.³⁹ Plaintiffs, holders of the bond and mortgage, asserted no claim against the award at the condemnation proceedings⁴⁰ but instead sought summary judgment on the note to recover the interest arrears.⁴¹ Summary judgment was denied by special term,⁴² which was reversed by the appellate

33. 183 Misc. 819, 54 N.Y.S.2d 122 (Sup. Ct. 1944), aff'd mem., 269 App. Div. 747, 55 N.Y.S.2d 115 (1st Dep't 1945).

34. 183 Misc. at 821, 54 N.Y.S.2d at 124.

35. 287 N.Y. 227, 39 N.E.2d 217 (1942).

36. Id. at 231, 39 N.E.2d at 218.

37. 21 App. Div. 2d 824, 251 N.Y.S.2d 516 (2d Dep't 1964), aff'd, 17 N.Y.2d 291, 217 N.E.2d 654, 270 N.Y.S.2d 599 (1966).

38. The two payments totalled \$5,175. 17 N.Y.2d at 293, 217 N.E.2d at 655, 270 N.Y.S.2d at 600.

39. The non-payment of interest was admitted by defendant, who argued that from the time title vested in the condemnor plaintiffs were entitled only to the four per cent rate required of the condemnor. Id.

40. This fact was stressed by the appellate division when the case reached that court. 21 App. Div. 2d 824 251 N.Y.S.2d 516 (2d Dep't 1964). It did not appear crucial to the court of appeals, which reasoned that the condemnation proceedings affected only the mortgage lien and not the debt evidenced by the note. 17 N.Y.2d 291, 294, 217 N.E.2d 654, 655, 270 N.Y.S.2d 599, 600 (1966).

41. It is unlikely that it would have made any difference had plaintiffs sought judgment on the note in the full amount of the debt. The fact that only interest was sought may explain plaintiffs' failure to proceed against the award, since a judgment on a relatively small sum such as this might well appear enforceable without resort to the award.

42. Unreported. Special term relied on *Westchester v. P & M Materials Corp.*, 35 Misc.2d

division,⁴³ two justices dissenting.⁴⁴ In granting the motion for summary judgment the appellate division held that if plaintiffs should later seek payment out of the award, defendant would have a "right to a refund of the amount equal to the difference between the statutory 4% interest rate payable in the condemnation proceeding and the contract 5% payable under the mortgage note"⁴⁵

In affirming,⁴⁶ the court of appeals held that the substitution of the award for the security formerly provided by the mortgaged land did not deprive the mortgagee of his right to sue on the debt as evidenced by the bond.⁴⁷ The court alluded to the unanswered question in *Muldoon*,⁴⁸ asking "whether . . . the holder of the note may assert his rights against the mortgagee [sic] in an action on the note and not be circumscribed by the change of the status of the security,"⁴⁹ and answering that he "may sue at law thereon and, in so doing, . . . recover interest at the rate specified [in the bond]."⁵⁰ This answer, however, tells us only that the mortgagee has a right to sue on the bond. It does not tell us which interest rate will apply if he later seeks to satisfy the judgment out of the condemnation award. Interestingly, the court of appeals made no mention of the appellate division's proviso regarding a "refund" of the difference in interest rates if plaintiffs were to seek satisfaction out of the award. The reason for this silence is conjectural. The high court may have felt no need to discuss this aspect of the interest rate problem, or it may have overlooked the difficulties raised by affirming the lower court while remaining silent on part of that court's ruling. For whatever reason the court of appeals failed to confront the issue, we must take a closer look at the appellate division's "refund" proviso, which because of its somewhat peculiar wording, bears more than one practical interpretation.

For example, suppose that a mortgagee obtained a judgment on the note for

197, 225 N.Y.S.2d 143 (Sup. Ct. 1962), aff'd mem., 17 App. Div. 2d 822, 232 N.Y.S.2d 743 (2d Dep't 1962), for the rule that plaintiffs' only remedy was to look to the condemnation award. That case, unlike *Copp*, did not involve an action on the note but a mortgagee's effort to assert his mortgage lien against the award before payment to the owner of the land.

43. 21 App. Div. 2d 824, 251 N.Y.S.2d 516 (2d Dep't 1964).

44. The dissent was based on the proposition that the contract between the parties was subordinate to the exercise of the power of eminent domain and that the parties never contemplated the contractual interest rate surviving the statutory rate. No citations are given in support of the dissent. *Id.*, 251 N.Y.S.2d at 516.

45. *Id.*, 251 N.Y.S.2d at 516.

46. 17 N.Y.2d 291, 217 N.E.2d 654, 270 N.Y.S.2d 599 (1966).

47. *Id.* The court dismissed special term's reliance on *Westchester v. P & M Materials Corp.* as erroneous.

48. 287 N.Y. at 231, 39 N.E.2d at 218. Chief Judge Lehman had said that the court would not decide what would happen if the mortgagee had "chosen to enforce the obligation of the bond in accordance with its terms and . . . resorted to the award only to the extent necessary to pay a deficiency." *Id.*, 39 N.E.2d at 218.

49. 17 N.Y.2d at 294, 217 N.E.2d at 655, 270 N.Y.S.2d at 600.

50. *Id.*, 217 N.E.2d at 655, 270 N.Y.S.2d at 600.

\$106,000, representing principal of \$100,000 and interest at six per cent. Assume further that the condemnation award was for \$200,000. If the mortgagor had no assets against which to levy execution, and the judgment were returned *wholly* unsatisfied, how much of the award would be paid to the mortgagee? The answer is \$104,000, representing principal of \$100,000 (the extent of the mortgagee's interest in the condemned land) and interest at the rate of four per cent. The condemnor is not obligated to the mortgagee for more than \$104,000 out of the award, and the mortgagee is thus limited to a \$104,000 recovery.

But what arithmetic will be used to determine how much of the award will be paid to a mortgagee *who has partly satisfied his judgment on the bond* before looking to the award? Assume that in the example above the mortgagee is able to satisfy the judgment to the extent of \$10,000 out of the mortgagor's assets other than the award. If he then goes to the condemnation proceedings, will the \$10,000 already collected simply be deducted from the \$104,000 to which the mortgagee would have been entitled had he proceeded against the award in the first place? Or will the mortgagee be able to collect the entire unsatisfied portion of his judgment out of the award? In other words, will the mortgagee get \$94,000 or \$96,000 from the award?

A literal reading of the appellate division's language, that the mortgagor would have a "right to a refund,"⁵¹ would indicate that the mortgagee would receive \$96,000 from the award, but would then have to refund \$2,000, representing the difference in interest rates, to the mortgagor. The mortgagor would thus be able to escape part of the obligation he assumed in executing the note, and this at the expense of the mortgagee, who has done nothing to justify being saddled with the loss. In view of this, a literal reading of the appellate division holding appears inappropriate. What seems to be more likely, and certainly more equitable, is to allow the mortgagee to collect as much of the award as he would have received had the judgment on the bond been *entirely* unsatisfied, less that amount which he was able to collect from other assets of the mortgagor. Thus, in our hypothetical, the mortgagee would collect \$96,000 out of the \$104,000 "set aside" for him in the condemnation award. The result of this interpretation is that the mortgagee receives his bargained-for-return on his investment, and the mortgagor does not escape his obligation.

CONCLUSION

A mortgagee faced with condemnation of the land securing the mortgage may pursue redress either by making a claim against the condemnation award in the condemnation proceedings, later satisfying a deficiency in an action on the bond,⁵² or he may first obtain a judgment on the bond and if necessary complete his recovery by claiming against the condemnation award.

In making his choice of remedies, the mortgagee must consider several factors, including the cost of obtaining and enforcing a judgment on the note, the possibility of the mortgagor secreting assets should the award be paid to him

51. 21 App. Div. 2d at 824, 251 N.Y.S.2d at 516.

52. See text accompanying note 34 *supra*.

and the possibility of other liens on the mortgagor's assets. If the mortgage debt is relatively small, the mortgagee may best protect himself by asserting his claim in the condemnation proceedings. This course of action would also be wisest where the mortgagor has no assets against which to satisfy a judgment on the note.

Where the mortgage debt is large, and consequently the interest rate is a serious consideration,⁵³ the mortgagee must also consider the economic position of the mortgagor. If the mortgagor is financially healthy, with more than enough assets other than the mortgaged property to satisfy a judgment on the note, then a suit on the note may be the logical choice for the mortgagee.

It is where the mortgagor's assets will only partially satisfy a judgment on the note that the mortgagee's decision becomes difficult. If those assets are greater than the difference between the contractual and statutory interest rates, the mortgagee has the opportunity to recover the monetary equivalent of a fully satisfied judgment on the bond by obtaining such a judgment, executing on the mortgagor's assets and satisfying the remaining deficiency out of the award. (This would not hold true if a literal reading were given to the appellate division's holding in *Copp*. However, as pointed out earlier, a literal interpretation makes little sense, and the court of appeals failed to discuss the issue of a possible refund to the mortgagor.)

There is an important element of risk to the mortgagee in such a procedure, for the judgment on the bond must be returned partially unsatisfied in time for the mortgagee to make his claim at the condemnation proceedings.⁵⁴ The condemnation statute⁵⁵ sets no time limit for the filing of a claim,⁵⁶ but the mortgagee would have to assert his claim before the award is distributed⁵⁷ or he may find that "his only recourse will be an expensive court action . . . to recover funds, which, by that time, may have been secreted or dissipated."⁵⁸ The prudent mortgagee will balance this risk against the diminution in his recovery which would be caused by making his claim in the condemnation proceeding before taking action on the bond.⁵⁹

From the foregoing discussion it is plain that the investment of a mortgagee-creditor is well-protected when the land securing his investment is threatened with condemnation. How best to take advantage of that protection is up to the mortgagee, who may choose the plan of action best suited to the facts of his own particular case.

53. The seriousness of collecting only four per cent interest as against the contract rate of interest is apparent when we realize that a mortgage may well be for millions of dollars, as when a mortgage is given for a new office building, and the mortgagor is a corporation having no other assets.

54. N.Y. Real Prop. Actions Law § 1301; N.Y. C.P.L.R. § 5236(b).

55. N.Y. Condem. Law.

56. N.Y. Condem. Law § 9; see *United States v. 243.22 Acres of Land*, 45 F. Supp. 361, 362 (E.D.N.Y. 1942).

57. *United States v. 243.22 Acres of Land*, 45 F. Supp. 361, 362 (E.D.N.Y. 1942).

58. Kaplan, *Rights of Mortgagees in Condemnation Proceedings*, 12 *Brooklyn L. Rev.* 103 (1943). See also discussion in text accompanying notes 22-29 *supra*.

59. See text accompanying notes 30-32 *supra*.