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ATTORNEYS

EARL DRAYTON FARR, JR.
(Senior Counsel)

GUY S. EMERICH

JACK O. HACKETT II

MICHAEL P. HAYMANS

CHARLES T. BOYLE

DAROL H.M. CARR

DAVID A. HOLMES

GARY A. KAHLE

JENNIFER R. HOWELL

ROGER H. MILLER III

DOROTHY L. KORSZEN

WILL W. SUNTER

ERIC M. DECKER

AS INTEREST RATES RISE, SO DO MORTGAGE FORCLOSURES

By: Roger H. Miller
October, 2006



For most of us, a mortgage assisted us in buying the house in which we live. Mortgages have also enabled many real estate investors to purchase investment property. Oftentimes, these mortgages obtained by investors have adjustable interest rates, sometimes with interest-only payments. Also, many sellers have agreed to take back a promissory note and mortgage in conjunction with the sale of their property.

With the recent downturn in the real estate market coupled with the increase in interest rates, many investors are finding it harder to sell those investment properties. Some investors are facing the possibility of foreclosure, and sellers and lenders who financed these sales are looking to collect. Sometimes, sellers, and even employees of institutional lenders, have misconceptions about how the foreclosure process works. Some believe that if the note and mortgage are not paid, that they can simply "take the property back." The truth of the matter is that the lender may or may not get the property, depending on the outcome of the foreclosure process.

A mortgage is a security interest in property that secures the payment of a debt. The mortgage is a lien on the property, which is the collateral securing the payment of the debt. The borrower gives the lender a promissory note ("note") and mortgage on the property. If the note is not paid according to its terms, the lender can foreclose the mortgage to seek payment of the note through the sale of the collateral.

The note and mortgage specify how long the loan must be in default before the foreclosure process can be initiated. This time frame can be anywhere from zero to thirty days, or longer. The note and mortgage will also dictate whether any written notice of the default must be given to the borrower. After the time frame required under the note and mortgage has elapsed and written notice has been given, if required, the lender can initiate the foreclosure process.

The foreclosure process involves researching title to the property being foreclosed to determine the proper parties to the suit. A mortgage-holder should include in the foreclosure action all parties whose interest in the property is subordinate to that of the mortgage-holder. Parties with subordinate interests would include second mortgage-holders, lienors, tenants, and anyone else that may claim an interest in the property.

After the suit is filed, the named parties must be served with notice of the lawsuit. This requires the mortgage-holder, or more likely its counsel, to make a diligent effort to find the defendants and to have them served with a copy of the lawsuit. While this sounds simple, finding and



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servicing people who do not want to be found can be quite challenging. If after diligent effort, some or all of the defendants cannot be personally served with the lawsuit, then the mortgage-holder may constructively serve the defendants by publishing notice of the action in the newspaper.

After service, the defendants have 20 days to answer the complaint. The mortgage-holder then submits affidavits as to the amount owed, its right to foreclose and its costs and attorney's fees associated with the foreclosure (provided the note and mortgage provide for the recovery of attorney's fees, which they usually do). If these affidavits are not contradicted with opposing affidavits from the borrower or other defendants, the judge enters a final judgment awarding the mortgage-holder the amount due under the note and mortgage. At that time, the mortgage-holder turns in the original note and mortgage to the court in exchange for the judgment. If the mortgage-holder does not have the originals, a separate count must be added to the original complaint to reestablish the lost note and mortgage.

Once the final judgment is entered, the court sets a date on which the mortgaged property will be sold if the judgment is not paid. This foreclosure sale date must be at least 20 days from the date of the judgment. The foreclosure sale date is then published in the paper for two consecutive weeks.

The judgment can be paid and the mortgage redeemed at any time prior to the conclusion of the foreclosure sale. Not only can the original borrower redeem the mortgage, but a second-mortgage holder or other party who is being foreclosed can also redeem and pay the mortgage.

Assuming the judgment is not paid prior to the sale, the judgment-creditor (previously the mortgage-holder) has a credit in the amount of the judgment, plus accrued interest and costs, to bid at the foreclosure sale. Therefore, the judgment-creditor can bid on the property, without coming out of pocket, up to the amount of the judgment. If no one at the sale outbids the judgment-creditor, then the judgment-creditor gets the property and its judgment is reduced by the amount it bid to acquire the property. The judgment-creditor can seek a deficiency judgment against the borrower if it did not use all of its judgment to bid on the property, but depending on the borrower, that judgment may be worthless.

Punta Gorda Office:
99 Nesbit Street
Punta Gorda, FL 33950
Phone: 941.639.1158
Fax: 941.639.0028

Englewood Office:
33 S. Indiana Avenue
Englewood, FL 34223
Phone: 941.460.9334
Fax: 941.460.9443

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As with any lawsuit, the borrower has thirty days from the judgment to appeal. Furthermore, if the borrower files bankruptcy prior to the sale, the mortgage-holder must proceed in the bankruptcy court. Provided the property is worth as much as the mortgage, the mortgage-holder should receive through the bankruptcy court all of the money owed on account of the mortgage.

If someone else in attendance at the sale outbids the judgment-creditor who bids the full amount of its judgment, the judgment-creditor can continue to bid on the property, but must have the cash to bid any amount in excess of its judgment. The high bidder at the sale ends up with the property. Any amounts paid in excess of the judgment would be held by the court for any junior lien-holders that were foreclosed, or the borrower.

As you can see, holding a mortgage on property does not ensure that you will automatically get the property in the event of non-payment. Alternatively, you may end up with the property when it is cash that you wanted. Furthermore, depending on the defendants and whether a bankruptcy is involved, the process, which normally takes four to six months, could take substantially longer.

If you hold a mortgage that is not being paid according to its terms, you should contact a real estate attorney. You are typically entitled to recover the attorney's fees and costs expended in collecting on the note and mortgage.

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Punta Gorda, FL 33950
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Fax: 941.639.0028

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33 S. Indiana Avenue
Englewood, FL 34223
Phone: 941.460.9334
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