Real Estate Finance (Fall 2000 – Gaudio)

COURSE OUTLINE

3 Ways to Finance Real Estate Transactions:

(1) Borrow from 3rd party lender – MOR gives mortgage to lender (MEE);
(2) Mortgage takeover – assume takes subject to the mortgage and gives personal obligation for the loan, or subject to, no personal obligation but can still be foreclosed.
(3) Seller Financing – (a) purchase money mortgage (like 3rd party lender) or (b) installment land contract.

There might also be a mortgage takeover with seller financing (to cover seller's equity) or wrap-around financing.

EQUITABLE MORTGAGE:

Whatever format (deed absolute) used to finance – if real estate secures the payment of money (whether or not purchase price): courts will look beyond form (substance over form) and will treat as a mortgage. *Flack v. McClure*. Cannot be determined from any particular fact – sum total of proof. Courts will examine 6 elements, if the weight of the elements show financing, then courts will treat as a mortgage:

(1) necessitous need for loan; (2) debt in existence (recognized); (3) adequacy of alleged purchase price compared to value of real estate; (4) who is in possession following the deed (grantor or lender); (5) who is paying taxes and insurance premiums (grantor or lender), (6) sophistication of the parties. Parol evidence will generally be allowed to illustrate the full agreement. The statute of frauds will not be used as a device to create fraud. Burden of proof is generally by clear and convincing evidence. *Downs v. Ziegler*.

INSTALLMENT LAND CONTRACTS:

Courts will treat ultimately in equity as a mortgage. Installment contract is a contract to buy, by paying purchase price over time. Seller holds title until paid in full, buyer has the right to possession during the term.

If buyer fails to make payments (defaults) there are traditional remedies to the vendor. The **vendor** may declare a forfeiture wherein he keeps title and payments to date. There is no equity of redemption or foreclosure proceedings. Problems for vendor:

(1) if contract for sale is recorded, vendor must bring quiet title action. Also, if vendee in possession, may have to bring ejectment action. Whether or not quiet title action, should seek estoppel certificate from vendee (defaulting buyer). May also have to seek ejectment/forceable detainer.

(2) Strict foreclosure. May be the rule in state law that limits forfeiture or the vendor may desire the court's assistance. He may have court issue order to pay (to vendee) by date certain or lose forever.

(3) Action for specific performance. Vendor may not want the property back. Usually applies where the value of the property has dropped and forfeiture would result in a deficiency. The vendor would bring an action to force purchase at prior agreed price, and in the alternative to have the property sold, apply the proceeds and the vendee would owe the deficiency. *Summit*

House v. Gershman. However, if vendor declares forfeiture, he can not later seek specific performance because by declaring forfeiture, he terminated the contract, therefore no specific performance.

(4) The vendor could bring an action for damages – just seek damages for the deficiency. Damages may include: loss of rental value, costs of repossession, refinancing, and sale, misc. like attorney's fees, appraisal and title costs.

(5) Actual foreclosure – treat just like a mortgage (least desirable to the vendor).

The **vendee** may raise the following issues when at risk of a forfeiture:

(1) set aside forfeiture only if special circumstances that shock the conscience of the court. *Russell v. Richards*.

(2) vendee (buyer) must have paid substantial portion of the purchase price. *Peterson v. Hartell*.

(3) court will grant relief simply because forfeiture is drastic, may require judicial sale of property and apportionment of proceeds. *Sebastian v. Floyd*.

What relief will the **vendee** be granted by a court? (In cases of waiver or unconscionability)

(1) allow redemption – give second chance, pay purchase price or its lost.

(2) allow reinstatement or curing of the debt – pay up delinquent amounts (and damages) and return to original payment schedule.

(3) allow seller to quiet title and terminate contract. But refund all payments to buyer in excess of damages (restitution).

(4) treat exactly as a mortgage – go to foreclosure and any excess from sale goes to vendee. *Sebastian v. Floyd*.

MORTGAGEABILITY OF TITLE THAT VENDEE HAS:

Courts have recognized that the equitable title a vendee has is mortgageable. Installment contracts may proscribe assignment (is mortgage an assignment at time made? The strongest argument for proscription is in title theory states). The contract should specifically permit the vendor to mortgage its interest.

May the vendor terminate the contract following default:

The most serious problem is whether the vendor may terminate the contract by undertaking forfeiture procedures and terminate the rights of the MEE under the doctrine of superior title. Some jurisdictions require notice to the MEE to terminate its rights.

If the mortgage is viewed as an assignment of the vendor's equitable rather than merely a security interest in the equitable title, notice is more likely to be required. The contract should provide that if the equitable title is mortgaged, the vendor will give notice of any default or forfeiture to the MEE, and the right to cure or redeem. If the notice provisions are proper the contract will likely be given full force and effect. The contract should also require the MEE to give the vendor notice of the existence of any mortgage it makes, or the vendor may argue it has no obligation to search for record claims that arose after the sale to the MEE.

What about the First Mortgage?

If there is already a first mortgage on the property, that first mortgage could be foreclosed and wipe out the new MEE's interest. To avoid this, the parties should get the first MEE to

agree to give the new MEE notice of any default on the first and an opportunity to redeem (most desirable). Alternately, the new MEE could require the vendor to get an estoppel letter from the first MEE, and require the vendor to agree to some procedure to make sure its payments to the first MEE are made on time (like make the payments to new MEE who would pass them on the original MEE).

MORTGAGE THEORIES:

Title Theory: Fee simple on condition subsequent. In theory, MEE has title to possession, but gives it to MOR until he may default, then retakes (minority view).

Lien Theory: MOR only gives a lien on the property. Title remains in MOR until the equity of redemption is foreclosed.

Intermediate Theory: MOR has title until default, then it transfers to MEE.

LEASES:

A lease that predates a mortgage has priority. In the event of foreclosure, the purchaser may not terminate the lease or up the rent. However, the purchaser may enforce obligations of the lease against a tenant. To cancel the tenant's priority, the MEE should require that all existing tenants execute subordination agreements before the mortgage is executed. In consideration, the MEE will give non-disturbance agreements to the signing tenants (if they are good leases). The MEE should also require assignment of the rents.

New leases (after a mortgage) do not have priority and the MEE may terminate upon foreclosure. In some jurisdictions, a MEE may keep a good lease simply by not joining the tenant upon foreclosure. This leaves the lease mutually enforceable by the purchaser at foreclosure and the tenant. If the jurisdiction doesn't allow non-joinder of tenants, the mortgage agreement may require subsequent tenants to attorn to the MEE. The consideration will likely be a non-disturbance agreement. The mortgage agreement should also require assignment of the rents.

ASSIGNMENTS OF RENT:

MOR may assign rents to MEE. If it does, money goes first to tax, insurance then to the mortgage debt. An assignment can be absolute or a security assignment. Absolute = right now, not for security purposes, like an outright sale. Gives MEE an immediate interest and protection from later creditors. The MEE can make a demand for rents at anytime if truly absolute, or upon default without foreclosure. The tenants are required to pay directly to the MEE upon default. An absolute assignment may violate lien theory policies – that the MEE is not entitled to possession until foreclosure because its only interest in the real estate is a lien.

Most, assignments of rent are security assignments. Given as further security for payment of debt (and most courts interpret assignments for security rather than absolute). In lien theory states, the MEE has no interest except upon default because rents are a part of possession (by appointment of receiver or taking possession of rents before the landlord gets them). So the MEE must record the assignment to perfect its security interest in the rents. . Courts say that the MEE has no real interest until activation occurs (MEE takes rents), so anybody who takes priority can take over the assignment. So unless recorded, another secured party (especially BR trustee) or lien holder can take.

The Rest. calls it an additional mortgage on the rents, it creates a lien on the rents in the MEE. Under the Rest., the MEE can collect rents immediately upon default, by making demand on tenant.

RECEIVERS:

MEE in possession is not an ideal situation (under very tight scrutiny, exposed to much liability). A receiver is somebody to take the property over, to prevent waste and generate profits. Generally, there must be impairment of the security prior to appointment of a receiver (and usually assignment of rents). Whether there is impairment or not depends on:

The value of the real estate vs. the amount of the debt;

Has there been or is waste (unreasonable conduct that results in physical damage and substantial diminution in the value of the estate, can also be tax delinquency, failure to maintain and repair, or failure to collect rents, or retention of rents – waste creates tort action) being committed;

MOR's solvency – if solvent, generally no need, if insolvent, need receiver;

Whether or not an agreement – not controlling, but in some states, if there is an agreement, the MEE can get a receiver. *Dart v. Western Savings*.

A receiver pays expenses first and liens second. A receiver may disaffirm a lease if it contravenes a provision in a prior recorded or was made while the MOR was in default and was not commercially reasonable when made.

WASTE:

Recovery for waste may not exceed the least of: (1) the actual harm caused by the waste; (2) the amount of the mortgage debt; (3) the amount by which the MEE's security interest has been impaired, up to the loan amount (L/V ratio * reduced value of property = X. Amount of debt – X).

INSURANCE:

Rule: Mortgage should contain a loss payable clause – pay proceeds to MEE up to amount of debt, any residual to MOR. Whether or not proceeds can be used to rebuild? If specific agreement says to pay debt, will be controlling. If silent, the majority of courts will allow to be used to rebuild (also Rest. view).

MEE'S LIABILITY FOR ENVIRONMENTAL CLEANUP:

G/R, liability is joint and several. *1996 amendments to CERCLA*, During term of mortgage: rejected *Fleet Factors*, said no liability unless the MEE has actual management of the property. After term of Mortgage (or after default), MEE not liable unless participates in management (like runs the operation). Also, he must attempt to dispose in a commercially reasonable fashion (can't hold forever).

ESCROWS: (for insurance and real estate taxes)

Process by which MEE requires borrowers (high loan to value) to deposit 1/12 of the expected taxes and insurance for the next year. In most states, interest does not have to be paid on the account.

MOTGAGE TRANSFERS:

Methods: (1) refinancing (sell property, use proceeds of buyers new loan to payoff old loan); or (2) mortgage takeover. In a mortgage takeover, the buyer can receive in two ways:

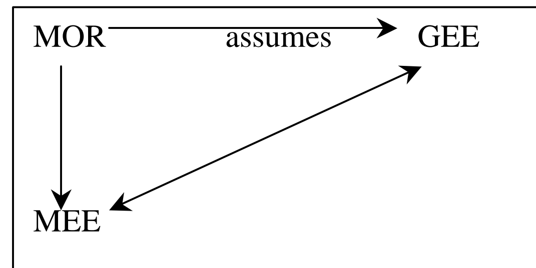
(a) Subject to the Mortgage: sell subject to the mortgage lien. Buyer takes no personal liability to repay. MEE cannot get a deficiency judgment from the buyer., but the buyer will still lose the property.

(b) Assumption of the Mortgage: buyer takes subject to and promises to pay debt, gives personal liability for deficiency judgment by MEE. The buyer will also lose the property. An assumption should comply with the statute of frauds. If the GEE accepts a deed and occupies the real estate knowing of the contents of the deed, it is usually considered part performance and the GEE will be found to have made and enforceable promise (absent a fraud).

How does the MEE come after the buyer? There are 3 theories or recovery from an assuming grantee (also look below to break in the chain of assumptions):

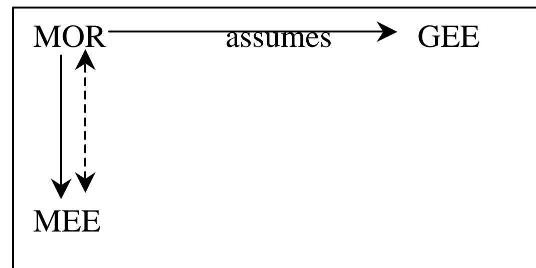
(1) Third Party Beneficiary Contract:

The GEE agreed to pay MOR, therefore, the intended beneficiary must be MEE. Courts readily find the intent to benefit the MEE. The MEE can overcome a break in the assumptions if it can show that it was the intended beneficiary.



(2) Equittable Assets Theory (minority):

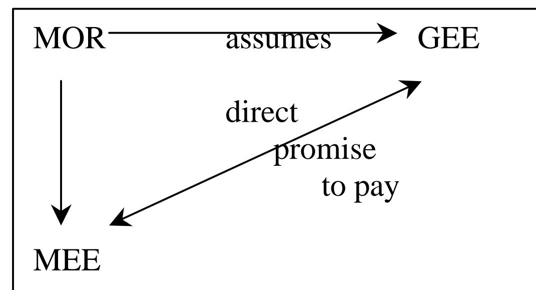
NO promise by GEE to MEE, but MOR has an asset – a cause of action for payment from the GEE (an equitable asset). Therefore, MEE can enforce against MOR and get its assets. One of those assets is the right to go against the GEE. So, MEE can sue MOR and MOR must implead GEE.



Under the suretyship subrogation theory, the MEE is considered subrogated to the MOR's suretyship rights against the GEE. But, if he has none, the MEE cannot go beyond that point to recover.

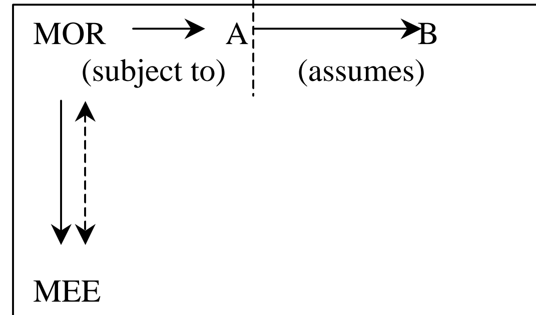
(3) Direct Promise Approach (**general case** with institutional lenders:

by due on sale clause in the mortgage, the MEE can declare due and payable. Therefore, MOR and GEE ask MEE to agree to mortgage takeover (to avoid acceleration). MEE can then sign contract with GEE to get its direct promise to



pay in consideration for avoiding the due on sale clause.

<u>Break in the Chain of Assumptions</u>:

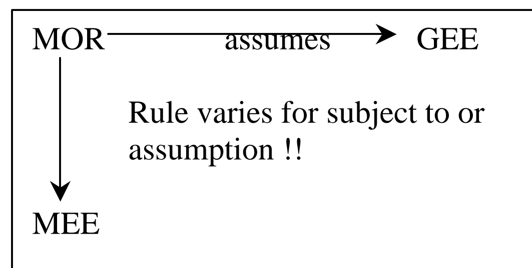


Here, MEE can't get to B by methods 1 and 3, above, but the question whether a 3rd party beneficiary was intended may arise – but hard to show intent to give gratuitous benefit to MEE. Under 2, MEE can go against MOR, but A breaks the chain. (Because A took subject to, he gave no personal liability to MOR or MEE. B's promise of personal liability was only to A – it doesn't extend to MOR or MEE where A made no such promise).
Like in *McVeigh v. Mirabito*.

<u>VESTING OF MEE'S RIGHTS</u>:

Can MEE relieve GEE of obligations? Can he change the obligation up until the time that the MEE brings suit or changes its position (by releasing the MOR)?

Is the MOR released after making a transfer to the GEE? NO, MOR is still personally liable unless the MEE executes a release, or there is a release by operation of law (MOR is foreclosed). It is like a suretyship:



If MEE agrees with GEE to make a substantial change in the debt or the terms of the loan, this will release the MOR <u>in Assumption</u> (not part of the original bargained for exchange – would not be fair). In a <u>Subject To</u> situation, MOR is released only to the amount exceeding the value of the land, it is still liable for any deficiency.

This is also called a <u>suretyship theory</u> – MOR is the surety for the agreement between MEE and GEE (principal on the obligation). In *First Federal v. Arenas*, the MEE agreed to the GEE (Richardson) to increase the term to 20 years at an increased interest rate (+1¼ %), this changed the agreement materially so the Arenas (MOR) were released.

<u>DUE ON SALE CLAUSES</u>:

Term in mortgage that MEE may declare entire amount due if property is sold are generally enforceable. This is because it impairs the MEE's security by: (a) new purchaser may be poor credit risk; or (b) fear of waste of the property.

Related are Due on Encumbrance Clauses, that if the property is subject to any further encumbrances, the loan will be accelerated because it jeopardizes the MOR's ability to repay the MEE. These however are subject to restrictions in the Garn-St. Germain Act. Reasons to accelerate do not include: creation of junior mortgages, transfers incident to divorce, at death and inter vivos to certain relatives, and leases for three years or less with no option to purchase. Only applies to mortgaged real estate containing less than five units.

HOLDER IN DUE COURSE:

Ability of holder in due course (like a bona fide purchaser – subsequent purchaser, for value, without notice) to recover from promisor is to protect commerce. If was not the case, purchasers of note would be unprotected. The UCC requires 3 things to be a holder in due course (of a note):

(1) the note must be negotiable ((a)signed by maker, (b)contain an unconditional promise to pay a fixed sum of money; (c) payable on demand or at a definite date, and (d) payable to order or to bearer);

(2) the note must be properly negotiated ((a) possession of note must be transferred to holder, and (b) if the instrument may be payable to order, it must be indorsed to the holder); and

(3) the holder must be a bona fide purchaser ((a) holder must take note for value, (b) holder must take in good faith, and (c) holder must take without notice) also called qualificaition.

When these conditions are satisfied, it cuts off personal defenses available against payee of note. (Ex. Lack of consideration). But, real defenses such as fraud, forgery, etc are not cut off, and can be raised by a holder in due course. *Banker's Trust v. 236 Beltway Invest.* In *Banker's Trust*, the note did not contain enough information to determine a sum certain, it was a variable rate.

Some claiming to be holders in due course are not innocent of defects and are thereby not holders in due course. For example, deeds of trust taken by construction companies and given to finance companies because of the close connectedness doctrine. If the claiming holder in due course has knowledge of the deception, the claimed status will not protect the note.

ESTOPPEL CERTIFICATES:

Are used by MOR to represent to potential purchaser that it has no claims against the MEE. Can take the place of a holder in due course.

The maker of the obligation will make payments to holder of the note at its own risk. The obligation is on the maker to discern the proper payee. *Rogers v. Seattle First* (attempted to pay lender, and were directed to construction company. Payments made to construction company (original holder) were not forwarded on. There are two general exceptions: (1) where original payee is and agent for the Holder in due course; or (2) if payment to the original payee was authorized by course of dealing where the holder in due course did not object. Generally, if you are directed to make payments to the original holder, they are the servicing agent for the HDC.

MORTGAGE PARTICIPATION:

Lead lender sells portions of the loan to other lenders. Usually in the case of very large mortgages. Category also includes mortgages securitization where a bunch of small mortgages

get bundled and the lender sells certificates for mortgage participation. These may also need to be registered as a security.

Generally, there is a very detailed agreement that the lead lender has duties and authority to make collections, enforce, etc. Arguments may be raised that the arrangement was not a participation but was instead a loan by the subordinate lenders to the lead. Factors to consider are: guaranty of repayment by the lead to a participant, participation of a different kind thatn the underlying debt, different payment arrangements between borrower and lead than between participants and lead, discrepancy between interest rate on underlying note and the rate specified in the participation agreement. *In Re Coronet*.

PREPAYMENT OF MORTGAGE:

Generally, there is no right for the MOR to prepay (at common was "perfect tender in time"). MEE can require a penalty if the note is silent.

Arguments for penalty: (1) mutuality: lender made loan at specified interest and term, it may not call the loan early or raise the rate except at maturity – must protect sanctity of contracts; to allow prepayment would give the MOR the power to rewrite the contract while limiting the MEE. The MOR would respond that ARMs and due-on-sale clauses are exactly the opposite, giving the MEE the ability to rewrite the contract.

(2) As a corollary, the MEE will also argue that it needs the penalty to recoup its administrative costs incurred in making the loan that would normally be recovered over the term. The MOR would respond that the practice of charging points by lenders is intended to pay administrative costs.

Arguments against penalty: (1) usury, what is the interest rate in relation to the maximum allowed by law? The MOR would response no, not a charge to borrow, it is a charge on the privilege of pre-paying.

(2) The MOR should argue that the penalty is unreasonable liquidated damages. But the MEE will respond that it simply a charge for early payment, not a charge for breach of contract giving damages. Alternatively, the MEE will also argue that the penalty is for alternate performances under the contract.

(3) The MOR will also argue unconscionability. The lender has an advantageous bargaining position and is attempting to take advantage of it. This argument usually loses. The MEE will argue that the MOR has the choice, to pay as scheduled, or pay early with a penalty.

Some statutes limit penalties for prepayment – FNMA gives right to prepay without penalty.

A greedy lender could possibly enforce a prepayment penalty upon invokement of a due on sale clause. Lenders may also enforce upon default and acceleration. Otherwise, borrowers could avoid prepayment penalty by defaulting.

LATE PAYMENT PENALTIES:

Applies to payments that are late, but before the loan has been accelerated. Generally late payment penalties are allowed if the amount charged is reasonable. A reasonable amount is generally limited to 5%-6% of the late installment amount not yet paid. *Fleet v. One-0-Six*.

MERGER DOCTRINE:

Title Theory Analysis: MEE holds fee simple subject to a lien (in one hand) and a lien in the other hand. When they come together, they merge and the MEE has title in fee simple absolute. Lien Theory Analysis: MEE holds lien in one hand and an obligation to pay in the other. When they merge, the lien disappears. Debt Theory Analysis: Note (right to receive payment) disappears into title. Can't owe yourself money.

When 1st and 2nd MEE is same person and he forecloses the 2nd mortgage: If MEE buys at foreclosure sale, he then owes himself the 1st mortgage. Therefore, it disappears – he can't owe himself an obligation to pay. Otherwise, MEE would have the real estate (and its value) and be owed by the MOR for the value of the first mortgage. Would create double or at least enhanced recovery. *MidKansas v. Dynamic*. Most courts do not apply where MEE forecloses on first mortgage.

DEED IN LIEU OF FORECLOSURE:

A deed in lieu of foreclosure is not a clog in the equity of redemption because it is voluntary by MEE, MOR can execute the deed in lieu of. It occurs after, not prior to the mortgage, it doesn't pre-commit the MOR, therefore not a clog.

Can be advantageous to the MEE: satisfies debt a lot faster than foreclosure; avoids costs of foreclosure and the potential for loss in BR. However, junior mortgages are not foreclosed because it is not a foreclosure.

Can be advantageous to MOR, may look better on a credit history than a foreclosure.

Peugh v. Davis, court said to be deed in lieu of foreclosure, must meet three criteria: (1) cannot be equivocable – MOR's interest must be transferred in writing; (2) value of property must be adequate consideration for the release; and (3) MOR cannot retain possession.

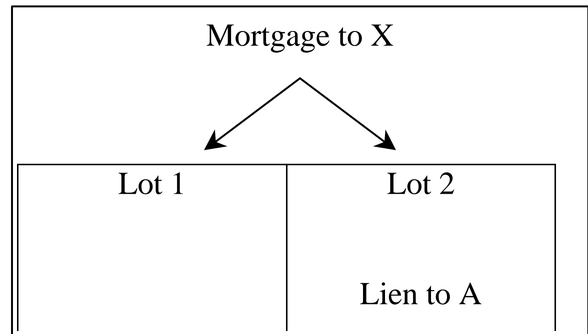
ACCELERATION CLAUSES:

Acceleration clauses are necessary to avoid having to foreclose for each late installment (would have to divide up the real estate to sell and satisfy debt). It gives the right to the MEE to declare the entire balance due. Usually acceleration clauses are literally enforced. Acceleration is always optional (to avoid prepayment penalty by default). Can be triggered by: non-payment of the debt, non-payment of taxes or insurance; non-monetary defaults like failure to maintain. Statutes may allow reinstatement following acceleration (FNMA Art. 22 and 19), usually must be done 5 days prior to foreclosure sale.

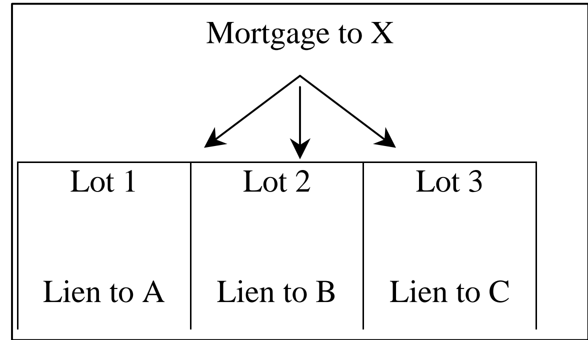
Sometimes courts will consider innocent failures to pay *Fed. HomeLoan Mtg. v. Taylor*, bank continually accepted late payments (waived) until like a year later, then bank decided to reject and accelerated 6 months later. Court said in this circumstance it would be unjust to accelerate, the circumstances would render it unconscionable.

MARSHALLING OF ASSETS:

When there are at least two pieces of property secured by senior lien to X, if X foreclosed first against the lot with lien to A, it would wipe out A's interest. Here, the court should apply the 2 Funds Doctrine. The MEE (X) must satisfy first out of the unencumbered "fund". If both have junior liens, apply inverse order of alienation as below.



Under the **Inverse Order of Alienation Rule**, a creditor must satisfy his debt (judgment) against properties in the inverse order that liens were applied. Here liens were given chronologically to A, then to B, and last to C. So, the MEE (X) would take property in that inverse order, first C (lot 3 –most recent lien), then B (lot 2) , then A (lot 1).



<u>A hybrid</u> might be where there are three properties and only 2 are encumbered by junior interests. In that case, two-funds doctrine would dictate exhaustion of the unencumbered parcel first, then apply inverse order of alienation to remaining parcels until satisfaction is reached.

<u>JUDICIAL FORECLOSURE</u>:

Court supervises pay up or sold. Join all proper parties, if not paid by date, sold at sheriff's sale.

<u>POWER OF SALE FORECLOSURE</u>:

Power in deed or mortgage to allow MEE or trustee (proper person) to sell property without judicial intervention.

<u>STRICT FORECLOSURE</u>:

Only in the Northeast: if not paid by date certain, the MOR's equity of redemption is foreclosed and there is not refund to MOR of any excess.

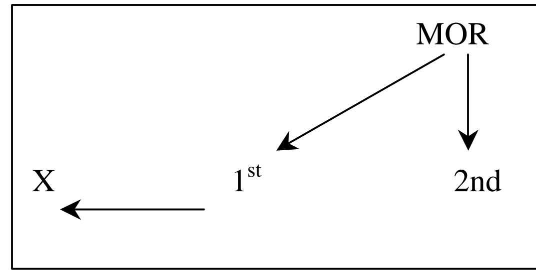
<u>NECESSARY PARTIES AND PROPER PARTIES</u>:

<u>Necessary</u>: Those who if not joined will cause the proceeding to fail – by not returning the property to the state it was in (by removing subsequent liens & easements. Although still won't remove interests prior to that being foreclosed). Only those parties that are properly joined are foreclosed. May include tenants who are subordinate to the lease (either by entering after the mortgage or by subordinating and signing non-disturbance agreements).

<u>Proper</u>: It is highly convenient and desirable to join these parties, but whose absence would not defeat the purpose of the foreclosure. Those persons with <u>personal liability</u>, those whose interests may be in dispute, and intervening assuming grantees. May also be a lease party you object to, may wish to determine interests.

<u>Failure to Join</u>: To avoid problems, you should always file a <u>lis pendens</u> in foreclosure proceedings. This gives notice to all subsequently acquired interest holders that you have begun foreclosure and they can lose whatever interest they purchase.

Subject matter of the foreclosure is the property itself (in rem action). The object is to get the property back free and clear of all subsequent liens – to return title to the real estate to the condition it was in at the time of the first mortgage.

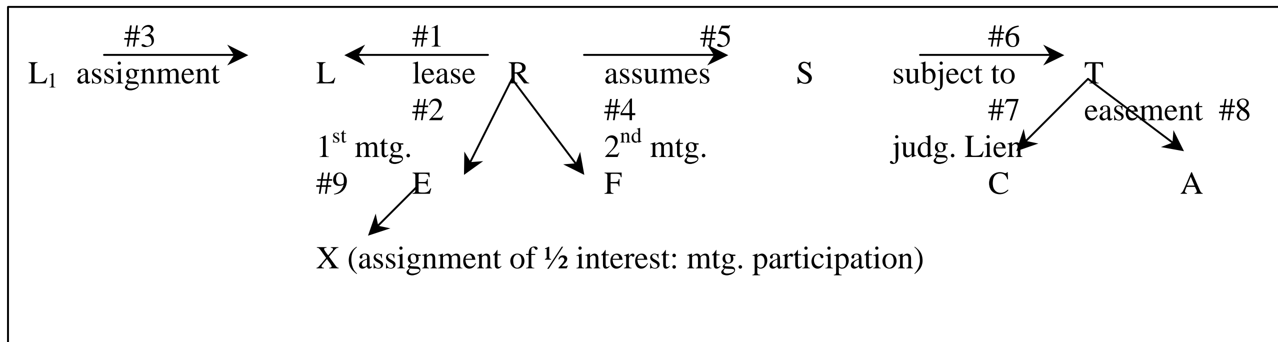


<u>Failure to Join</u>: Examples

<u>Ex</u>. X purchases at foreclosure sale from 1st MEE who failed to join 2nd MEE. So, 2nd MEE could foreclose or redeem first mortgage. How can X fix it?

(1) X can reforeclose 1st mortgage: (2) X can redeem by paying off 2nd mortgage; or (3) X can use strict foreclosure. Available only if: inadvertent, and proceeds from 1st MEE's foreclosure sale were insufficient to give residuals to payoff 2nd MEE. X would ask the court to set a date for 2nd MEE to payoff or lose it.

<u>Former Exam Question</u>: Who are necessary parties and who are proper in a foreclosure by E?



<u>Transactions</u>:

#1. <u>R to L (lease):</u> L is neither necessary nor proper because the lease was prior to the mortgage. E is only entitled to get rid of claims after the date #2 (assuming there is no subordination agreement). E cannot get rid of L by foreclosure, E could join L if there was an issue as to the actual date of the lease, etc. If L was joined, he could move to sever.

#2. <u>R to E (1st mtg.)</u>: R is a proper party. This is an in rem action, no reason to need R to get real estate. R doesn't own the real estate (T, A, & C now own). R still has potential liability (R has not been released from his promise to pay – he assumed), so E should join R to get a deficiency judgment for R's personal liability.

#3. <u>L_1 to L (assignment of lease)</u>: has same interest as L. L_1 is neither necessary nor proper party.

#4. <u>R to F (2nd mtg.)</u>: F is a necessary party. Junior lienors must be joined to get full resolution and termination of later acquired (junior) interests. However, if E fails to join F, it is not fatal, F's interest just remains as an outstanding mortgage on the real estate.

#5. <u>R to S (assumption):</u> S is a proper party. S is not a necessary party because it doesn't own the property, but it did assume the note and thereby give personal liability. As with R above, S should be joined to get a deficiency judgment for personal liability. (If S had taken subjet to, he would be a non-party to the suit).

#6. <u>S to T (subject to):</u> T is a necessary party (most). T currently holds all the sticks, he is the owner. If E failed to join T, it would terminate all interests except T's ownership. Purchaser at the foreclosure sale would buy T's mortgage. T retains the equity of redemption unless joined.

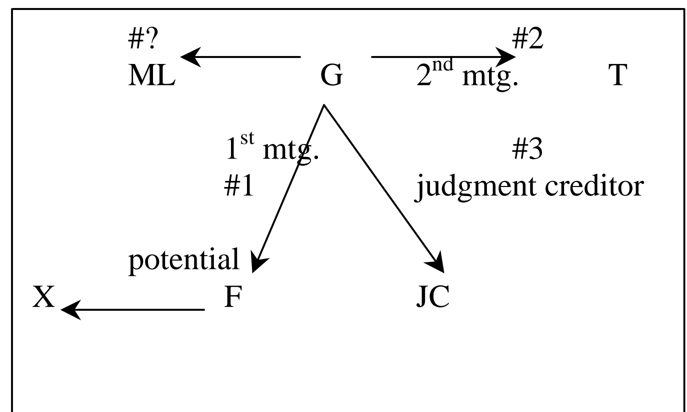
#7. T to C (judgment lien): C is a necessary party. It owns whatever in rem interest the judgment lien comprises. To settle C's interest, E must join. Failure to join will leave C's interest outstanding.

#8. T to A (easement): A is a necessary party. Like C, A owns some of the bundle of sticks. Must be joined to settle its interest or the interest will remain outstanding.

#9. E to X (assignment of ½ interest– mtg. participation): X is not a necessary defendant, but should be joined as a party-plaintiff necessary to the action. Otherwise, would submit all other parties to a 2nd suit. If true participation, where E is the lead lender, it could probably take action to protect X's interests).

If F was foreclosing, E would not be a necessary party. F is not entitled to get rid of E. F would take subject to the 1st mortgage to E. 1st MEE should have right to choose when or if to foreclose. E would be proper if F needed to determine status/priority of mortgages.

Other former Exam Question:
First Financial wants to foreclose on Gardener. In addition, there is a second deed of trust (T), and a judgment creditor who are clearly junior to the 1st mortgage. Also, there is a mechanic's lien (M) that claims it is superior. The president and vice-president of Gardner are also personally liable on the note.



Here, G is a necessary and in fact indispensable party. It is the owner in fee of the real estate. The 2nd MEE and the JC are also necessary since a failure to join them would fail to terminate their junior interests in the real estate that were created after the first mortgage was executed. Also, all tenants who are subordinate to the mortgage are necessary parties if the MEE wishes to terminate those leases. These include both those that leased after the first mortgage and those that have subordinated and signed non-disturbance agreements. Tenants whose leases are superior may not have their leases terminated by foreclosure and are therefore neither necessary nor proper.

The mechanic's lienor is proper for the limited purpose of determining whether his lien is superior to the 1st mortgage. If its interest is superior, he can have the action dismissed as to him. If it is subordinate, then he is a necessary party because his interest must be terminated to give the purchaser at foreclosure the rights of the MOR at the time of the first mortgage.

Because the president and vice-president are personally liable, they are also proper parties. Their liability may come into play if the proceeds of the sale are insufficient and their company doesn't pay. They are not necessary because they do not have any interest (personally) in the real estate, but it would be highly desirable and convenient to join them and obtain a personal judgment against them in the same proceeding.

POWER OF SALE FORECLOSURE:

Very efficient (cheaper and faster than judicial foreclosure). Steps: (1) give notice to MOR and junior interests (all necessary parties). Statutes generally do not require direct notice to junior interests. (2) No hearing ! (3) Sale conducted (by MEE, trustee, or state designated agent). Questions may arise as to quality of title because there is a potential for a lack of procedure/finality as opposed to judicial foreclosure where it is court supervised. Those issues might be defective notice, or not actual default.

Who can purchase at power of sale foreclosure? Some statutes say that the MEE may not (just looks bad). In Wyoming, the MEE can purchase at its own sale. If the lien is a deed of trust, the trustee may never purchase (statutes generally require trustee to be impartial, see, *Wansley v. First Nat'l*), but a MEE can purchase at a deed of trust sale unless too closely connected to trustee. *Cox v. Helenius* (attorney acting as trustee breached fiduciary duty). Issues may be whether sale is conducted in reasonable commercial fashion (notice and fair price). Some states avoid the potential for problems by requiring the sale to be conducted by a designated agent. Foreclosure sale terminates the equity of redemption – gives fee title to purchaser. *Land Assoc. v. Becker*.

VOID TITLE AND VOIDABLE TITLE:

Void: Not title passes. Like when a defect in foreclosure, say like no actual default prior to foreclosure, fraud, forgery, total failure to notify, purchase by MEE in jurisdiction that proscribes – then the defect would render the title void.

Voidable: Lesser problem. Say the notice was late, etc, but the MOR probably had notice, this would render the title voidable (not void) – a challenger must bring lawsuit before a bona fide purchaser intervenes. A bona fide purchaser (of the voidable title) would prevail.

CONSTITUTIONAL ISSUES TO TAKE PROPERTY:

Must receive notice and opportunity for hearing – only applies to state action (when state does the foreclosing – 5th Amend.). *Ricker v. U.S.*, notice of acceleration of indebtedness was not notice of foreclosure – gave no opportunity for hearing prior to foreclosure and did not even state when foreclosure would begin. A private or semi-independent party is not required to give a hearing. *Warren v. Gov't. Nat'l Mort. Assoc.*

What kind of notice is adequate: (1) parties with known interest and address should be served in person (mailed or delivered); (2) parties with known interests/unknown addresses, notice by publication; (3) parties with unknown interests and unknown addresses = publication. Must give "best notice possible." *Mullane*.

STATUTORY RIGHT OF REDEMPTION:

Redemption from sale – begins at date of sale as opposed to equity of redemption (that terminates at sale). A MOR can waive the statutory redemption, either the length of the period, or entirely. Purpose is to force bidders to approach the fair market value. However, in reality it limits bids because of statutory redemption period (during which the purchaser may not posses or resell). There is a movement to do away with this right.

Who can redeem? Anyone by paying the amount of the sale price (not the debt, but includes costs + interest). Who gets paid depends on whether the jurisdiction applies strict priority or a scramble method. Wyoming is a hybrid.

LIMITS ON RECOVERY:

MEE can sue on debt (obtain judgment on personal obligation and foreclose to enforce) or foreclose (sell then obtain deficiency judgment), but generally not both at the same time. If it chooses to foreclose first, it can seek a deficiency later. In some states, the MEE must foreclose before seeking a deficiency (one action rule).

Security First doctrine says the MEE must go against the real estate first.

Fair Value Statutes say the amount of the deficiency is limited to the difference between the debt and the FMV (deficiency = FMV-debt).

Anti-Deficiency Statutes prohibit deficiency against MOR in: (1) Purchase Money Mortgage, (whether vendor or 3rd party financed); and (2) power of sale foreclosures. Limits MEE's recovery to the property – forces MEE's to ensure good security prior to making a loan. Policy: purchase money is borrowed to purchase the property. Seller should know what it is worth, and a 3rd party lender should take steps to protect its security.

The statutes may or may not limit recovery as to the MOR only. Some statutes also limit recovery as to guarantors

BANKRUPTCY:

Ch. 7 is "straight" bankruptcy (liquidate all assets to pay all debts possible), Ch. 11 is business reorganization (debtor keeps assets, foreclosure is stayed), Ch, 13 is individual reorganization (wage earner), and Ch. 12 is farmer and rancher reorganization (like Ch. 11, but debt can be written down).

Automatic Stay: prohibits foreclosure proceedings as soon as petition is filed and applies to all bankruptcies. Most central to reorganization because generally the debtor (business or individual) needs the real estate to survive. The petition must be filed by the date of the foreclosure sale to stay the foreclosure.

In straight BR, the BR trustee can abandon the real estate if its value does not exceed the debt owed. If the value does exceed (when there is equity in the property), the BR trustee may sell with or without the liens attached. If sold with liens attached, the lien (mortgage) will attach to the proceeds. BR trustee may sell at a private or public sale.

BR trustee may set aside fraudulent transfers made within 1 year prior to the BR (§ 548), and preferential transfers made within 3 months prior to a BR petition (§ 547). What if at the foreclosure sale (within 1 year prior to BR) property sells for only 40% of debt? *Durrett*, in dicta said that reasonable equivalent value was 70% of FMV. *Madrid*, said transfer cannot be set aside if it was a fair sale -- examine reasonable equivalent value if sold at foreclosure sale that was non-collusive and regularly conducted. *Bundles*, said that the sale price was not a conclusive presumption – will look at FMV, fair appraisal, broad advertising, and competitive bidding in fact. Rest. position is must be 20% of value. **The current rule from the *BFP v. Resolution Trust* case** is as long as it was a non-collusive, properly conducted foreclosure sale in accord with state law, and the price was not so low as to shock the conscience of the court, it will not be set aside. (presumption that price received at a properly conducted foreclosure sale proceeded according to state law was a reasonable equivalent to the property's actual value). Minority went with *Bundles* approach.